Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions—Part I

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Since the height of the financial crisis in 2008, the merger and acquisition deal flow has been patchy and fragmented. M&A activity has recently increased notably with 2015 marking the United States' most profitable merger market since the financial crisis.[1] According to global professional services firms such as PricewaterhouseCoopers and Deloitte, the momentum in the M&A market is expected to continue in 2016.

Franchise businesses have increasingly been a focus for M&A deals, particularly for deal-flow starved private equity firms attracted by stable royalty streams. Over the past two years, the North American franchise community has seen a few megadeals,[2] including Burger King's C$14.6 billion corporate inversion of Tim Hortons, as well as several large deals. The advantages of merging or acquiring a franchise system are considerable. As well as providing stable, recurring revenue streams, a franchise system can present an opportunity to expand quickly and efficiently with low capital expenditure (compounded when the franchise system operates in a growth industry); focus on new geographic markets or customer bases without incurring start-up costs; inherit new product lines or services as part of a diversification growth strategy; and benefit from the goodwill and strength of an established brand.

Franchise M&A transactions have become more sophisticated over the past decade. Moreover, franchise M&A transactions involve unique considerations that are relevant from the initial strategy discussions, to the letter of intent and due diligence stages, and through the drafting and negotiating of the transaction documents. The terms of an M&A deal are laid out in the cornerstone document commonly referred to as the purchase agreement

1. Anthony Read, *Global M&A Volume Surpasses $4tr in 2015 YTD*, DEALOGIC—M&A STATSHOT, Nov. 4, 2015, http://www.dealogic.com/media/market-insights/ma-statshot/.
2. Defined as those that are over U.S.$1 billion.

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(irrespective of the underlying stock or asset purchase transaction). This article focuses on some of these unique considerations that a prospective purchaser should address and that will ultimately shape the terms of the purchase agreement. The article begins with a general discussion of representations and warranties and the current seller-oriented market in which parties transact. The rest of the article is split into two parts: (1) a discussion of certain best practice principles that apply in drafting representations and warranties, and (2) an exposition of various representations and warranties and how they are crafted from the unique considerations that apply in franchise M&A transactions. Part II of this article, to be published separately, will deal with additional best practice principles and further franchise M&A specific representations and warranties.

Representations and Warranties: Representations and warranties are the factual statements of present or past fact that parties make and are included in most purchase agreements.[3] They are used to expressly record the parties' understanding as to the conditions and facts under which they are entering into the bargain. In the M&A context, they occupy a material part of the purchase agreement. Typically, the seller provides a comprehensive set of representations and warranties to the purchaser regarding the condition of the business to be acquired and how it has been operated. The purchaser's representations and warranties are often limited to a few general ones.

This article focuses on the seller's representations and warranties and how they are negotiated from the perspective of the purchaser within the franchise M&A context. The seller's representations are important because a prospective purchaser is unlikely to be able to verify every detail about the seller's business.[4] The seller typically has one motivation: to limit the scope of its representations and warranties and the corresponding potential liability flowing from them as much as possible.

Representations and warranties serve a number of important functions in M&A transactions and are often subject to intense negotiations. First, they provide the purchaser with disclosure and warranty as to the true state and condition of the business and its operations, assets, and liabilities. Second, they allow the purchaser to address special considerations and concerns that have arisen from its due diligence. Third, they allow the parties to allocate the risk of liability (through termination or indemnity) for various matters associated with the business.

When dealing with particular industries and market segments, specific considerations and representations and warranties come in to play. The franchise business model is unique and has been described in different ways. In the author's view, a franchise operation can be depicted as a complex web of

3. Tina L. Stark, *Another View on Reps and Warranties*, 15:3 Bus. L. Today 49 (2006).

4. John C. Ramirez, Aaron M. Rotkowski & Irina V. Borushko, *The Importance of Sellers' Representations in M&A Transaction Purchase Agreements*, Willamette–Bankr. Transaction & Structure Insights 1 (Winter 2014), http://www.willamette.com/insights_journal/14/winter_2014_2.pdf.

relationships among suppliers (which provide the necessary inputs for the business); the franchisor (which establishes and monitors the business model); and the franchisees (which deliver the products and services to the consumer). The most intricate part of the web is the unique franchisor-franchisee relationship that is based on a comprehensive interdependence. In some cases, the relationship includes master franchisees that have their own franchisees in the relevant jurisdiction. Special attention must be paid to this complex web of relationships from the outset, and particularly during the due diligence process of an M&A deal, as a number of issues and deficiencies often surface during proper due diligence of a franchise system.[5] This will lead to the inclusion of specific representations and warranties in the purchase agreement to address these issues and deficiencies arising from the complex web.

Given the nature of a franchise relationship, certain legal obligations can fall to the responsibility of either the franchisor or the franchisee (and both in some cases), depending on the terms of the agreements and the parties' conduct under the agreements. For example, franchisors increasingly have been held liable for cybersecurity and data breaches, joint employer rulings, menu labeling law obligations, human rights violations, and breaches of disability laws. Moreover, this can be more complex and precarious where additional layers in the complex web exist, such as master franchise arrangements and their franchisees. These sorts of matters must be rigorously addressed in the due diligence process, which will often result in a number of tailor-made representations and warranties addressing the risks across various relationships and jurisdictions where the franchisor operates. This can be a contentious area of negotiation because franchisors are uncomfortable giving representations and warranties on matters that they perceive to be the responsibility of the franchisees, notwithstanding that vicarious liability may attach to a franchisor in certain circumstances. There are a number of different mechanisms to address an impasse on these points, for example, potentially restructuring the contractual relationships by amending the obligations of each of the parties under the terms of the relevant agreement, further due diligence on specific matters to determine whether there are any risks that the prospective purchaser should be concerned about, or representations and warranties insurance.

Seller's Market: The best knowledge and negotiation skills cannot stand up to unequal bargaining power and the dynamics of a transaction. It has been the case for some that we are in a seller's market. The harsh reality of recent trends is that sellers provide fewer representations and warranties, shorter survival periods, and more materiality qualifiers than was previously the case. Not surprisingly, there has been a significant increase in the use of

5. Barry Kurtz, *Digging into Franchises*, 16:4 Bus. L. Today (2007), http://apps.americanbar.org/buslaw/blt/2007-03-04/kurtz.shtml.

representation and warranty insurance in both the United States and Canada over the past decade (also as such products have become more available and less expensive).

In recent times, due diligence and representations and warranties, among other things, are curtailed by bidding processes and negotiation ultimatums imposed on the transaction by sellers. It is not uncommon for sellers to require potential purchasers to detail their plans for the due diligence as part of the bidding process. This can spark a bidding war for the lightest and fastest possible due diligence, thereby disadvantaging purchasers from having the opportunity to identify issues that may be addressed in properly drafted representations and warranties. Worse is the scenario where sellers impose strict constraints around due diligence, the amount of information made available, and the timing for the process. Once again, this leads to a situation where the purchaser is likely to have more risk and exposure under the final representations and warranties included in the purchase agreement.

Accordingly, the best practice principles and expositions around representations and warranties in this article must be considered in the light of the current market conditions. In contrast, much of what is discussed in this article paints a portrait of the optimal approach and coverage that a purchaser can achieve in negotiating representations and warranties. This is not to render the best practice principles and expositions solely academic or of marginal value. Rather, the author's intention is that they provide a comprehensive analysis of the strongest possible position, which purchasers can use in a meaningful way to understand what protection they can expect and require in the context of the particular deal, what fits their risk appetite, and what are the deal breakers in the negotiation process.

I. General Best Practices

When it comes to drafting representations and warranties in the franchise M&A context (and in some cases generally), a number of best practice principles apply, some of the most critical of which are set out below.

A. *Tailor to the Transaction*

Representations and warranties ought to be deliberately and thoughtfully crafted and wrought from the issues identified in the due diligence stage; the specific risks that the purchaser is concerned about, based on the industry or operations of other franchise businesses; and appropriate and fair negotiation. Although the standard representations and warranties of a well-drafted general M&A agreement go a long way toward providing an appropriate bargaining position between the seller and purchaser, certain representations and warranties need to be customized to address deal specific concerns of the parties. This facilitates more meaningful negotiations between the parties, as opposed to posturing and power plays based solely on risk allocation. Standard representations and warranties can, in fact, create problems for the seller when they are not specifically customized for use in the franchise context.[6]

B. *No Panacea*

There can be a temptation to rely too heavily on representations and warranties in order to get the deal done expeditiously. Representations and warranties should not be a replacement for a proper due diligence process, which is necessary to fully understand the risks associated with the business. It is a balancing exercise to maintain the momentum of the deal while conducting meaningful due diligence at various stages of the transaction, together with addressing the identified risks and concerns in the purchase agreement. Having said that, where there are missing elements and unknowns arising from the due diligence process (e.g., undocumented arrangements with certain suppliers), representations and warranties can serve to bridge the gap.[7] Once the risks and unknowns are actually identified, meaningful representations and warranties can be crafted to specifically address them.

C. *Qualified and Limited*

Sellers generally look to qualify and limit the many representations and warranties in a purchase agreement. The most common qualifiers used to curb the scope and extent of representations and warranties include: (1) knowledge qualifiers, (2) materiality qualifiers, (3) quantitative thresholds, and (4) look-back periods. Knowledge qualifiers restrict the particular representation and warranty to the constructive or actual knowledge of the seller, a subset of its representatives, or both. An example of a knowledge qualifier includes: "To the seller's knowledge, there are no lawsuits currently commenced . . ." Many purchase agreements include a very specific definition of the seller's knowledge, which can operate to further qualify the effectiveness of a representation and warranty. The variations to this definition include: (1) whether "knowledge" refers to actual or constructive knowledge (or both); (2) whether the seller's knowledge is imputed from representatives holding certain offices, positions/titles, or specifically named individuals; and (3) whether due inquiry is required or presumed.[8] Materiality qualifiers are used to avoid technical and insignificant matters, e.g., "The seller has complied with all applicable tax laws excluding minor breaches that are unlikely to cause any material adverse effect." Thresholds are quantitative limitations that can be used to separate permitted or insignificant matters from the factual statement, e.g., "Since the date of the financial statements, the seller has

6. Dawn Newton, Rebekah Prince & Les Wharton, *Negotiating Key Provisions in the Agreement*, *in* MERGERS AND ACQUISITIONS OF FRANCHISE COMPANIES 62 (Leonard D. Vines & Christina M. Noyes eds., 2014).

7. P. Thao Le, Reeves McGee & Breton Permesly, *Basics: Franchise-Related Mergers and Acquisitions*, IFA LEGAL SYMPOSIUM 21 (2014).

8. Daniel Avery & Kyle S. Crossley, *Use of Knowledge Qualifiers for Representations and Warranties*, BLOOMBERG LAW, June 15, 2013, http://www.bna.com/use-of-knowledge-qualifiers-for-representations-and-warranties/.

not made any capital expenditure exceeding $10,000." Look-back periods are retrospective time limitations placed on representations and warranties, used in the following way: "All advertising and marketing materials used by the seller over the past five years have been provided to the purchaser . . ." Excessive qualification of representations and warranties should be reflected in the purchase price. The fire sale valuation methodology often adopted in distressed M&A transactions demonstrates one extreme point on the spectrum. It is customary for these sorts of transactions to be executed on a "where is, as is" basis with very few representations and warranties.

D. *Watch Survival Periods and Liability Limiters*

The best crafted representations and warranties can be undermined if not combined with robust supporting provisions. First, survival periods for representations and warranties are key. Typically they are made at the time of signing the agreement and restated at the closing of the transaction. Their longevity, generally between twelve and twenty-four months, can be heavily negotiated with different time periods ascribed to distinct groups of representations and warranties with the more fundamental ones receiving a longer life. Next, the consequences for breach of the representations and warranties should include, at a minimum, termination rights in favor of the purchaser (prior to closing) and indemnification in favor of the purchaser (post-closing). The seller will use mechanisms, such as the imposition of a deductible on all claims under the indemnity, to ameliorate its exposure to these consequences. For example, such a mechanism could state that a seller will not be liable for the first $100,000 for each indemnity claim. In addition, a seller may include a "basket" mechanism that, for example, states that until claims reach an amount of $100,000, the seller will not be liable to indemnify the purchaser. Finally, sellers often seek to include an absolute and total liability cap, such as the amount of the purchase price, on indemnity claims. Negotiation of representations and warranties and other provisions in the purchase agreement should be undertaken with a full understanding of survival periods and liability limiters.

E. *Parties and Guarantors*

Even more critical and controversial in the context of representations and warranties is the negotiation of the identity of the parties and individuals standing behind the representations and warranties (and/or the indemnification for breach of the representations and warranties). As a minimum position, the purchaser should ensure that the entities and individuals that own the business assets are party to the purchase agreement and jointly and severally stand behind the representations and warranties and grant the corresponding indemnities. Corporate structure diagrams are crucial for determining and providing quick ongoing reference to entities/individuals and asset holding and are generally prudent practice in all M&A transactions. Charting out the entities and ownership of such entities, together with their assets, will make for a smoother and more certain M&A transaction. Beyond the minimum position, the final determination of which parties should sign the agreement and stand behind the representations and warranties will be based on the imperatives of protection, practicality, and, ultimately, negotiation. Protection is necessary for the purchaser because, if the entities or individuals standing behind the representations and warranties have little or no means, recourse becomes fiction. Practical from the sense that a seller providing the representations and warranties must have knowledge of the subject matter, although this can be overcome by having the party stand behind the indemnity even though they might not have provided the representations and warranties.

Negotiating the representations and warranties is a risk allocation exercise. While an explanation or description of these mechanisms is beyond the scope of this article, it is also worth noting that a number of additional mechanisms, including holdbacks, adjustments to the purchaser price, escrows, and progressive payment of purchase price, are available to the parties to assist in arriving at a mutually acceptable position on representations and warranties. In addition, representation and warranty insurance is available to both sellers and purchasers.

II. Drafting Representations and Warranties

We now turn to a review and analysis of the unique critical considerations that should be addressed in acquiring a franchise system and how representations and warranties can be crafted to address those considerations. It should be noted that:

1) The unique considerations selected for discussion, while unequivocally critical from the author's perspective, certainly do not purport to be exhaustive of all matters that should be addressed.
2) Part II of this article will address a further set of unique considerations.
3) The discussion, analysis, and model representations and warranties are intended to stimulate thought and provide insight and guidance on the unique considerations that apply to franchise M&A.
4) In the current seller's market, purchasers often make numerous compromises on representations and warranties.
5) While only a handful of critical considerations are discussed, it is intended that the methodology, rationale, and tools of analysis used and suggestions on how to deal with them can be extrapolated to others.
6) The discussion and analysis of representations and warranties apply, for the most part, whether the transaction is an asset or stock transaction.

7) The discussion and analysis of representations and warranties relate specifically to transactions involving U.S. and Canadian franchise systems (although they may be applicable beyond that), but certain parts do address global operations.
8) The focus of this review and analysis is on the representations and warranties provided by the seller to the purchaser of an entire franchise system, and the purchaser's perspective on such representations and warranties.

There is nothing more important and valuable in a franchise system than its intangible assets.[9] These assets are broadly categorized as intellectual property and associated goodwill, key relationships, material contracts and human capital, each of which is discussed further below. In any franchise M&A transaction, the process must reflect an appreciation of, and place a degree of focus on, these assets in the context of the franchise business model, as should the representations and warranties of the purchase agreement.

A. *Intellectual Property*

Intellectual property is without a doubt one of the most critical aspects of the acquisition of a franchise system. The inherent value of intellectual property is not hard to see when one considers the logos, signage, and other aesthetics associated with a franchise brand. However, the intellectual property of a franchise system goes well beyond trademarks or branding. Most franchise operations rely on multiple layers of intellectual property assets, which include not only trade dress, industrial designs, copyrights, domain names, and trade secrets, but often patents as well.

The foremost concern for a purchaser with respect to intellectual property—from trademarks to software source code—is whether all of the relevant property rights have been properly identified and secured by the seller. If the rights are proprietary, do proper ownership records exist and have they been properly processed? If the rights are licensed from a third party (e.g., software or domain names), are such rights contractually secure, for what term, and on what conditions?[10] The ultimate objective is that the purchaser acquire a properly secured perpetual right to use all of the intellectual property that is either necessary for the operation of the target or otherwise adds value to it as a going business. A key component of this objective is to confirm that all relevant intellectual property has been appropriately protected, whether by registration, use, assignment, or other means, in all of the relevant jurisdictions. Not only should these matters be examined during the due diligence stage, but they should also be addressed by the representations and warranties in the purchase agreement. Hav-

9. Richard G. Greenstein & Joel Buckberg, *The Basics of Buying and Selling a Franchise Company*, ABA Forum on Franchising, W 11 at 1 (2005) [hereinafter Greenstein & Buckberg].
10. Carey C. Jordan, *The Top Five Intellectual Property Traps In M&A Transactions*, Lexology, Aug. 31, 2010, http://www.lexology.com/library/detail.aspx?g=ea39b939-6d90-4536-984c-e9e1b4fccfd5.

ing said that, if any deficiencies that are unacceptable to the purchaser are identified in the due diligence process, they should be dealt with by way of remedial steps taken during negotiation (pre-signing) or, at worst, included as covenants to undertake such remedial work and conditions to closing, as opposed to relying on representations and warranties.

It is also important during the due diligence phase to identify any intercompany ownership and licensing arrangements, together with any restrictions on use, that relate to the intellectual property rights and to ensure that they are appropriately documented prior to completion of the purchase transaction. A comprehensive corporate chart that clearly depicts intercompany intellectual property ownership and licensing arrangements is an invaluable tool for ensuring that the various provisions, including the representations and warranties, correctly reflect the true state of affairs as they pertain to the intellectual property rights. While these considerations are often overlooked in purchase transactions, it should be borne in mind that failure to properly control ownership and use of intellectual property can lead to its irrevocable loss—with corresponding losses in business value and advantage.

Intellectual property may be a single asset class, but it is not a single asset. Different forms of intellectual property should and, often must, be treated and protected differently.[11] Where a purchaser intends to take an alternative approach to categorization and protection of the intellectual property, preparing a chart depicting the current categorization and protection on one sheet with the proposed modified categorization and protection scheme will make a great tool to aid with post-closing rectification work. In crafting the representations and warranties, attention must be given to these differences and nuances.

One of the most significant types of intellectual property within a franchise system is a franchisor's trade secrets. Trade secrets refer to the information and know-how that give unique life to a franchise system and that are intended to be disclosed to franchisees only. This includes, by way of example, operations manuals, training programs, unwritten instructions, formulae, store designs (pre-construction), business strategy, and curriculums. Unlike trademarks, trade secrets are not protected through registration but through covenants in franchise agreements and conduct (by carefully maintaining non-disclosure to the public). If appropriately protected, trade secrets can potentially be protected in perpetuity.

Generally, representations and warranties dealing with intellectual property will:

- Reference a complete and accurate list of all of the seller's intellectual property across all jurisdictions (often in a schedule). Prudent purchasers

11. Andrae J. Marrocco, *Adopting a Strategic Intellectual Property Program*, 16:3 Franchise Voice 34 (2015), http://www.dickinson-wright.com/~/media/Files/News/2015/10/FV_Summer2015_AdoptingStrategicIP.pdf.

ensure that the schedule includes, at minimum, registration or application numbers, country of protection, filing and expiration dates, classes, and any information with regard to unregistered intellectual property.

- Confirm that the seller franchisor has the right to transfer the intellectual property free from any restrictions (or at least unacceptable restrictions).
- Include a statement that the intellectual property is free of all liens and that the franchise business has the right to use, without restriction of any kind, all of the owned intellectual property.
- State that the seller has taken all necessary and appropriate steps to protect and preserve the confidentially of all of the owned intellectual property not otherwise protected by patent or copyright across all jurisdictions, e.g., confidentiality agreements with other stakeholders and consistent treatment of the relevant information as trade secrets.
- Confirm that there are no intellectual property disputes, more particularly, that the seller has not infringed a third party's intellectual property and that the seller's intellectual property has not been infringed by third parties.

B. *Material Contracts*

The supply chain arrangements and agreements of a franchise system have been referred to as the lifeblood of a franchise system.[12] Many franchise systems rely heavily on such relationships for their success. They rightly form part of the material contracts of the business, although there may be reason under certain circumstances for them to be defined independently in the purchase agreement, as is the suggested approach for franchise agreements. Due diligence on the supply chain may reveal concerns and vulnerabilities with respect to a number of matters, including: (1) undesirable term and renewal clauses in important supply agreements; (2) lax termination rights in favor of the supplier; and (3) potentially dangerous or poorly drafted price increase mechanisms in critical distribution contracts or, more acutely, no documentation for key purchase arrangements.

In an ideal world, a purchaser would address these sorts of issues by requiring execution of new agreements with the purchaser as a condition of closing. However, there are a myriad of reasons, including the fact that the counterparties may have little or no incentive to enter into new agreements, why this is not often achieved in practice. In the case of large transactions, it may be simply too unwieldy an undertaking to attempt in advance of the closing of the transaction. Charts prepared during due diligence may reveal matters for which it is best to pursue new agreements, such as agreements that are near end of term and undocumented arrangements. Purchas-

12. John Baer, Mark Kirsch & Beata Krakus, *Due Diligence on Franchise Systems*, *in* Mergers and Acquisitions of Franchise Companies 101 (Leonard D. Vines & Christina M. Noyes eds., 2014).

ers should endeavor to put in place new agreements for those matters that they believe are critical to the operation of the system going forward. These types of issues also call for well-drafted representations and warranties supported by specific on-point indemnities.

The usual representations and warranties regarding the supply chain begin with a description of all of the arrangements and agreements in a schedule, including all rebate/commission/discount arrangements that exist on a verbal or documented basis. A purchaser should ensure that the due diligence is thorough enough to reveal all supply chain arrangements, particularly because undocumented arrangements often exist. This was demonstrated in a recent acquisition transaction (on which the author was advising) where many of the arrangements were verbal. To address this issue, the relevant definition was modified to capture "material contracts and arrangements" and the representations and warranties applied to undocumented arrangements. Additional representations and warranties typically provide that: (1) such contracts and arrangements are in full force and effect, are in good standing, and have no amendments or intended modifications, except as disclosed; (2) no current dispute, proposed termination, outstanding defaults, or violations by any party to the contracts or arrangements exist; and (3) there are no pending negotiations with respect to the renewal or repudiation of the contracts or arrangements.

Preparation of a chart summarizing the pertinent information for these material contracts is helpful in identifying and exposing the issues that need to be captured in the representations and warranties. A typical issue is whether the material contracts require consent to a change in control (for a stock sale) or assignment (for an asset sale) in respect of the proposed transaction. If the circumstances warrant (e.g., there is a risk that the supplier may not be in a position to continue supplying products/services), a specific indemnification against the loss of a supply chain relationship or a significant modification of the terms of the supply chain relationship can be included in the purchase agreement, together with holdback/escrow/earn out mechanisms.

C. *Human Capital*

Both strategic and financial purchasers assess the quality of the human capital of a target franchise system and create a plan of what the senior management team will look like following the acquisition. Post-acquisition integration plans are critical to a successful transaction. The existing senior managers are also a critical resource for a purchaser because of their knowledge of the current state of affairs as pertains to the system, as well as valuable insight with respect to a potential combination of multiple brands under the one umbrella. Allowing the purchaser to consult with key managers is often a controversial matter. The purchaser should insist on at least speaking with the head of franchise sales, the head of franchise compliance (administrator), and the general counsel.[13] Separately, keeping some or all of the key

13. Greenstein & Buckberg, *supra* note 9, at 28.

senior management may be absolutely essential for the purchaser to continue operating the franchise system. Of the intangible assets of a franchise system, human capital may be the most uncertain and potentially volatile for the purchaser. It is very difficult to ensure that key employees remain with the company post-closing. For this reason, it is typical for purchasers to make it a closing condition that key management enter into new employment contracts of sufficient term.

It may be reasonable to have senior management sign new employment agreements on closing, but it may be unreasonable or unmanageable to have middle managers do the same. Even those who sign contracts upon closing may not remain if the post-acquisition culture is unpalatable to them. The representations and warranties in this regard should reflect the precise matters that the purchaser is looking to cover off given its plans for post-closing management. It should be noted that there will always be a degree of vulnerability with respect to human capital. The purchaser should also look out for a number of other potentially detrimental arrangements with senior managers, including golden parachutes, relief from non-competition clauses, and change of control provisions in their employment contracts. Such arrangements could result in the purchaser taking on payment obligations or other liabilities and risks that may be triggered by one or more of these arrangements.

The representations and warranties regarding human capital generally begin with disclosure of all employee information, (e.g., employment records, evaluations, and performance records with commentary), in a schedule. It is important to have the seller represent and warrant that it has no reason to believe that any of the key managers would terminate their employment contract as a result of or in anticipation of the transactions contemplated by the purchase agreement. It may be desirable to also include a statement that the general relations between the seller and the key managers, and, in fact, all employees, are in good standing and that there is no present, pending, or threatened labor strike, dispute, slowdown, or work stoppage. The purchaser will want the seller to represent and warrant that the franchise business is not liable to any employee or former employee for damages under any law or any agreement relating to that employee's employment with the franchise business and/or their employee benefits. Although the purchase agreement will normally have a representation and warranty dealing with the seller's compliance with applicable laws in a general way, it is prudent to specifically include a representation and warranty that the seller has complied in all material respects with all applicable laws and orders relating to the employment of its employees.

D. *Franchise Agreements*

Franchise agreements record the terms and conditions of the relationships that are at the heart of the franchisor's business and the franchise system. It is important to note that in no case should representations and warranties replace due diligence with regard to franchise arrangements.[14] In this regard, there are a significant number of key terms that a prospective purchaser should consider carefully in view of its objectives following the acquisition. These include provisions dealing with royalty payments and their abatement; term and renewal obligations; transfer and assignment rights; and territories, including options, rights of first refusal, and termination rights, to name a few. It is often the case, especially in larger transactions, that only a sample of franchise agreements can be reviewed at the due diligence stage. This sample will generally be a cross section of franchise agreements from different jurisdictions and different kinds of franchisees in an attempt to capture a clear snapshot of the franchise system. Robust and comprehensive representations and warranties can be a valuable tool to support and reinforce due diligence in such circumstances.

The representations and warranties in relation to franchise agreements will typically include the following:

- A complete list of all current franchisees and franchise agreements attached in a schedule and acknowledgment that true and complete copies have been made available to the purchaser. Some purchasers insist on including a summary of key terms as part of the list, e.g., territorial rights, including options and rights of first refusal; royalty rates and other fees; terms; system modification provisions; termination rights; and permissibility of assignment, change of control, or both.
- All versions of franchise agreements that have been disclosed to the purchaser and, depending on the number of different versions and the extent of the differences between versions, a schedule that summarizes the key terms of the different versions and how they compare to the current standard form.
- Acknowledgment that no amending agreements, side letters, or other arrangement affect the terms of the franchise agreements and, furthermore, that no assignment or pledge agreements or other encumbrances affect title to the franchise agreements.
- The franchise agreements are valid, binding, and enforceable and, except as disclosed in the schedule, there are no subsisting breaches by either party, i.e., no default notices, forbearance arrangements, workout plans, and so forth, and no grounds for rescission or termination.
- The franchisees are in compliance with "system requirements," i.e., operating manuals, training materials, directives, and other standards, and there are no inconsistencies between the franchise agreements and the system requirements.
- The franchise agreements (and the underlying grants) comply with applicable laws.

14. Kurtz, *supra* note 5.

- With respect to all expirations, terminations, and other non-renewals, the franchisor has complied with the agreements and all applicable laws, including franchise and business relationship laws.
- The execution and delivery of the purchase agreement and the transactions contemplated under it are not inconsistent with any provision of the franchise agreements nor will they trigger any rights of rescission or termination (e.g., assignment or change of control provisions).
- The seller has no knowledge of any intention on behalf of a franchisee to rescind, terminate, abandon, improperly transfer, or to not renew the arrangement.
- The exclusive territories granted to respective franchisees are discrete and there are no encroachment issues, including options for additional territories and rights of first refusal. In addition, there are no encroachment issues when factoring in corporate units.

An interesting matter in this regard arose in a transaction (on which the author was advising) pursuant to which a master franchisee was selling its rights back to the franchisor. In this case, it was discovered that certain franchise arrangements granted by the master franchisee to franchisees were automatically renewable in perpetuity. This was a delicate issue given that the franchisor intended to roll out its new form of agreement (which included a finite term, post-acquisition). Some of these arrangements had already come due for renewal on the automatic and indefinite basis. Accordingly, the seller was potentially liable by not renewing prior to the sale. Ultimately, a covenant was included in the purchase agreement stating that the purchaser would honor the current terms of the franchise agreements, notwithstanding the new form of the agreement. The main point is that purchasers may want to include a representation and warranty regarding the term of the franchise agreements, particularly when only a sample of agreements has been reviewed, to protect from lengthy or minimal terms. This is a poignant example of how representations and warranties must reflect the actual issues and concerns of the purchaser (indefinite renewal terms in this case).

Many of the above considerations (and the representations and warranties associated with them as described above) also apply to ancillary agreements such as guarantees, trademark agreements, and loan agreements.

E. *Area Representative/Developer Agreements and Master Franchisee Agreements*

Most of the matters that a purchaser should consider with respect to franchise agreements also apply to area representative, area developer, and master franchise agreements. The purchaser will want comfort on the status of these relationships as they relate to their specific obligations under their particular agreements. For example, a purchaser will want to know that area developers or masters are on track with development schedules (or perhaps more realistically, how far off the development schedules they are), and that the terms of their agreement allow the franchisor to take action where regions and jurisdictions are tied up with little or no development, e.g., the right to remove exclusivity or reduction of geographic region in circumstances of breach. While these issues may be a far cry from being deal breakers in the grand scheme of the proposed transaction, the purchaser in negotiation with the seller will need to determine how to deal with them. There may be reasons to have at least some of these contracts novated with the relevant counterparty (e.g., where there is significant non-compliance with the terms of existing agreements). The representations and warranties referred to above should be extended to deal with the additional layer in these circumstances. For example, in addition to the master franchisee's compliance with its agreement with the franchisor, there should also be a representation and warranty that the sub-franchisee agreements are also being complied with by both parties.

F. *Franchisee Satisfaction*

Franchisee satisfaction (or lack thereof) within a franchise system generally, and with respect to the proposed transaction in particular, is often a major concern in any proposed transaction. The future of the franchise system and the prospective purchaser's ability to increase its return on investment is tied to the state of the franchisee population.[15] The conundrum for the purchaser is how to take the temperature of the franchisee community as a whole. Speaking with a sample of franchisees would likely provide some guidance, but sellers often resist access to franchisees, particularly in the early stages of the transaction. A large number of franchisees recently having left the system and stagnation of new sales can provide some clues as to the franchisees' dissatisfaction with the system, pinpointing areas of concern. Franchisor advisory councils and franchisee associations are also a great source of information with respect to franchisee satisfaction because they are convenient venues for franchisees to voice both their satisfaction and dissatisfaction regarding the franchisor's conduct and the system generally. By reviewing the minutes of the meetings (if available), speaking to the franchisees on the board/committee of the franchisee association, and looking at the correspondence between the franchisee association and the franchisor, a purchaser can get a realistic view of how content franchisees are with the franchise system.[16] Franchisee files may reveal troubled relationships and provide valuable insight on the franchisor's effectiveness in communicating/dealing with its franchisees. It should also be noted that the existence of a franchisee association often may indicate franchisee unrest, although not every franchisee association is hostile. However, the above sources of information may not provide any guidance as to the franchisee's impression or acceptance of the proposed transaction, particularly where it has not yet been disclosed to franchisees.

15. Greenstein & Buckberg, *supra* note 9, at 23.
16. *Id.* at 24.

Consider whether: (1) franchisee satisfaction can be addressed through the representations and warranties in the purchase agreement; (2) the purchaser can shift some of the risk of disgruntled franchisees onto the seller; and (3) the selling franchisor is even in a position to know, let alone provide, representations and warranties on franchisee satisfaction. It is not uncommon for franchisees to challenge a purported acquisition transaction on a number of grounds.[17] For obvious reasons, it would be highly unusual to have a representation and warranty that speaks to the subjective state of mind of the franchisees' attitude toward the franchise system or the proposed transaction. However, there may be reasons to include certain representations and warranties that address the existence of any franchisee association or franchisor advisory council, whether informally or formally constituted. Separately, the purchaser may include a representation and warranty on specific matters such as the franchisor not having received written or verbal notification of any franchisee discontent with the proposed transaction(s).

III. Conclusion

With the advent of increased and more sophisticated franchise M&A transactions, it is critical that transaction parties have a solid understanding of the unique critical considerations that apply in the context of an acquisition of a franchise system. These considerations shape the entire transaction process and culminate in the negotiation and crafting of specific representations and warranties. An interesting juxtaposition is created by the current seller's market; the majority of representations and warranties in a purchase agreement are given by a seller in favor of the purchaser, and yet increasingly sellers are curtailing and limiting the due diligence and the scope of representations and warranties. The result is that purchasers are often less protected and take on more risk than would otherwise be acceptable—potentially one of the catalysts for the increased use of representations and warranties insurance. By using the best practice principles described in this article, together with the discussion of underlying rationale, tools of analysis, and informal checklists covering representations and warranties, parties and their counsel will be in a better position to navigate a franchise M&A transaction.

17. Newton et al., *supra* note 6, at 70.