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We Gotta Get Out of this Place: Exploring Refranchising Options and Issues for the Franchisor

David W. Oppenheim
Partner
Greenberg Traurig LLP
New York, NY

Paul V. Russell
Associate General Counsel
7-Eleven, Inc.
Irving, TX

Richard L. White
Partner
Baker McKenzie LLP
Dallas, TX

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A franchisor's decision to offer for sale and concurrently franchise (or "refranchise") corporate-owned and operated units on a large- or small-scale basis involves a number of strategic, financial, relationship, and regulatory considerations. While the specific factors a franchisor should weigh will naturally vary depending on its industry, size, and franchising experience, there are many common issues that franchisors and their counsel ought to consider when evaluating, planning, and executing a refranchising initiative.

This paper will explore many of these issues, beginning with a high-level discussion of several strategic, franchise relationship, and other business considerations, including: (1) franchisor competencies and capital considerations; (2) potential franchisee candidates for refranchised units; (3) potential impacts on the franchise relationship and franchisee perceptions of refranchising projects; (4) unit remodeling expectations and requirements; (5) project scope and geographic considerations; and (6) project timing.

Next, this paper will more closely examine the refranchising transaction and documentation common in refranchising corporate units, including: (1) pre-sale due diligence; (2) nondisclosure agreements and letters of intent; (3) purchase agreements and certain key considerations in such agreements; (4) real estate documentation; (5) interim management agreements; and (6) franchise and development agreements.

Lastly, this paper will dive into the regulatory and pre-sale franchise disclosure issues that franchisors must consider and address when selling and refranchising corporate units, including required FDD disclosures, state registration requirements and potential disclosure and/or registration exemptions or exclusions.

I. STRATEGIC, FRANCHISE RELATIONSHIP, AND OTHER BUSINESS CONSIDERATIONS

Refranchising is not a novel concept, and it has in fact been used successfully over the years by brands to transition to an “asset light” model by selling business assets and shedding liabilities in exchange for a franchise or license agreement. For example, well-known brands such as Pizza Hut, Taco Bell, Burger King and TGI Fridays, have successfully engaged in refranchising over the years. A franchisor's executive team primarily drives the evaluation of potential refranchising projects, but legal counsel—both in-house and outside—can play influential roles in encouraging thoughtful evaluation of issues beyond deal formation, documentation, and regulatory compliance. Counsel can guide early and ongoing discussion to ensure that franchisors weigh and balance often competing priorities and issues before launching and executing refranchising projects.

From the franchise relationship itself to the franchisor support structure, to augmenting existing competencies, to identifying one or more refranchising models, a seemingly simple refranchising endeavor can have numerous tentacles that—when combined—can nonetheless be easily overlooked by the business team and counsel alike. It is critical to have a well-defined plan that is driven by a thoughtful process. What follows is a brief examination of many, though certainly not all, strategic, franchise relationship, and other business considerations that franchisors may wish to consider before moving forward with refranchising initiatives.

A. Franchisor Competencies and Capital Considerations

1. Reallocating Capital

The impetus behind a franchisor's decision to refranchise corporate units varies, yet one of the most common rationales is to reallocate or redeploy capital. As the number of corporate units grows, the amount of capital invested in real estate, equipment, and other tangible assets increases. Over time, a franchisor may conclude that it has achieved a suboptimal allocation of capital, leading it to consider selling and franchising many, most, or even all corporate units. What the franchisor does with that capital, however, can have broad and varied implications for the company's franchise system going forward. Does the franchisor or its parent intend to use that capital to pay down debt or deliver returns to its shareholders or owners? Or does the company intend to pursue reinvestment or reallocation of the capital elsewhere in the system?

The more the franchisor reinvests capital raised through refranchising corporate units back into the brand and system, the more the franchisor will be able to tout the potential benefits to the franchise system overall, particularly where there is an existing base of franchisees who might otherwise perceive a franchisor's limited-scale or even long-term exit from corporate operations as a sign of troubling underlying business dynamics. Reinvesting capital within the company in a way that reassures rather than alarms franchisees can include commitments to expanded brand development, increased marketing efforts, new product development, and even development of new brands that may augment or enhance existing brands.

2. Reducing or Reallocating Headcount and Overhead

a. Franchising Field Support and Training

Just as the franchisor's decision to reinvest capital raised from refranchising units back into the system can reassure franchisees or assuage concerns, the franchisor's decision whether to reallocate or reduce its headcount and overhead can have significant implications. This issue has less to do with the unit-level employees that will naturally shift to franchisee employees and far more to do with the level of field support, training, site development, and other personnel that may be needed to support the additional and expanded franchisee presence in one or more markets.

A franchisor may need to supplement or modify its existing franchisee field support, particularly if refranchised units are heavily clustered in areas with little or no prior franchisee presence. Franchisors should evaluate whether existing field support structures and the ratio of field support personnel to franchised units continues to fit the new franchisee presence where corporate units previously operated. A consistent franchisee support structure may properly fit the expanded franchise system. However, where the refranchising program will introduce changes in the makeup of the franchisee base, more flexible and varied franchisee support structures are likely appropriate, with larger franchisees likely requiring less hands-on support than smaller existing franchisees.

Significant refranchising projects may also serve as an opportune time to reassess the franchisor's support of its franchisees, including the optimum density, distribution, and ratio of field support personnel. The more experienced the franchisor, the more likely that stasis has set in with how the franchisor supports its franchisees. On the other hand, the more a refranchising initiative will significantly alter the franchise system, the more likely a franchisor should assess whether the franchise system has outgrown its prior support structure.

Franchise training personnel may also need to be modified or expanded. A training system that previously served a franchise system effectively may be ill suited to a significant and possibly rapid expansion of franchisees introduced through refranchising programs, each of which will need initial and possibly ongoing training. The more that the franchisor envisions bringing new franchisees into the system through refranchising, the more likely the franchisor will need to reallocate head count to franchise training. And the more the target refranchising candidate will differ from the typical existing franchisee, the more likely the franchisor will need to reassess its existing training system and tailor it to the changing franchisee candidates.

b. Retraining Field Support Personnel

Beyond deciding whether to reduce or reallocate head count to franchise support and training roles, franchisors will likely also need to assess the qualifications of its personnel who are reallocated to franchise support and training. More importantly than ever, franchisor employees who previously operated in a corporate support and training structure will need proper training on the differences between supporting corporate units and supporting franchised units.

Understanding how supporting and training franchisees differs from supporting and training corporate unit managers will not only lead to a healthier franchise system, it will also help reduce the risk of employee misclassification, joint employment, and vicarious liability. Franchisee support personnel will need proper training on: (1) how to support and consult with franchisees vs. dictate and manage; (2) understanding franchisee rights and responsibilities under the franchise agreement; (3) proper vs. improper interactions with franchisee employees; and (4) similar issues that are often scrutinized by courts when examining a franchisor's perceived, actual, or contractual controls over its franchisees.

3. Quality Assurance

Refranchising projects may also give rise to a reassessment of a franchisor's quality assurance program. Hands-on management of corporate units by a sophisticated and experienced franchisor may have effectively ensured excellent customer service and product quality, with less of a need for formal quality assurance or mystery shopper programs. Expanded franchise operations through refranchising, however, may create an increased need for quality assurance and mystery shopper programs to ensure that brand standards do not slip as operations shift from corporate to franchised hands and as franchisors take a more hands-off approach to supporting franchised units.

Franchisors can use large refranchising projects to also assess not only the scope of its quality assurance program but whether the quality assurance program would best operate in-house or through outside services. Particularly where a franchisor is pressured to achieve savings through reduced headcount as part of the refranchising projects, franchisors can look to outside quality assurance services to ensure that brand standards do not suffer in its newly expanded franchised world.

B. Candidates for Refranchised Units

Refranchising projects can represent moderate or even significant change to the existing franchise community, depending on the current makeup of the franchise community and the target refranchising candidate.

There are several questions that each franchisor should consider before launching a refranchising project.

- Is the franchisor looking to target small, medium, or particularly large and sophisticated refranchising candidates, and how might the ideal refranchising candidate differ from the system's existing franchisee base?

- If the target refranchising candidate differs from the typical existing franchisee, is the franchisor planning to make this a temporary strategy or a long-term strategy?

The more the franchisor plans for long-term strategic changes in its target franchisee candidates, the more the franchisor may need to evaluate how that strategy fits with its existing franchisee base and support structure, how it plans to effectively support both existing and new franchisees, and whether and how it plans to communicate these changes to existing franchisees.

Refranchising projects can be especially ripe opportunities to attract franchisee candidates that some franchise systems may have previously been unable to attract. Some sophisticated franchisees prefer entering a franchise system through purchasing a group of existing units with known historical financial performance. Just as some franchisors pursue an expansion strategy of developing units or purchasing franchised units from existing franchisees and bundling units to attract sophisticated franchisees, refranchising projects present opportunities to attract candidates that might otherwise be less inclined to develop new units and operate in a given franchise system. This avenue can also serve as an orderly vehicle for facilitating the sale and transfer of struggling units from the hands of less sophisticated or underperforming franchisees to more capable hands with elevated operational and financial wherewithal.

As attractive as refranchising may be to franchisor owners that are looking to reallocate capital or to shift from a heavily corporate to heavily franchised operations, significant pitfalls exist for franchisors that turn a blind eye to qualifications of refranchising candidates, even among candidate with deep pockets or robust operations. Business teams must be committed to ensuring that the refranchising candidates are qualified to operate in a way that meets and even enhances brand standards. Among issues that franchisors should carefully evaluate when evaluating refranchising candidate qualifications are:

- Does the candidate understand what it means to operate a franchised business using someone else's brand, with a focus on meeting brand standards, cooperating with quality assurance inspections, consultation and cooperation with a franchisor, and even embracing recommended procedures?

- Is the candidate likely to embrace franchisor-initiated promotions and following product/service pricing recommendations or requirements?

- Does the candidate have operational experience in the industry? Experience in one industry may not translate to successful operations in another industry.

- Is a full-service restaurant franchisor confident that even a deep-pocketed and experienced limited-service hotel franchise operator will likely succeed in the full-service restaurant space?

The more that the franchisor intends to refranchise corporate units to prospective franchisees that represent departures from the makeup of the existing franchisee community, the more the franchisor may want to dip its toe in the water and first observe initial results with the new profile of franchisee. Waiting to observe even a limited track record of success and mutual satisfaction between the franchisor and the new profile of franchisee may be prudent before committing to large refranchising and development deals with even the most sophisticated and well-heeled refranchising candidates.

C. Franchise Relationship Implications and Franchisee Perceptions

Franchisors should carefully consider how refranchising projects could impact the existing franchise relationship it has with its current franchisee base. Positive, negative, or neutral impacts on the relationship with the existing franchise community will likely depend on a variety of factors, including access to refranchising opportunities, targeted refranchising candidates, franchisee communications and franchisee perceptions, financial incentives for refranchised units, and other factors.

Refranchising projects that present expansion opportunities for existing franchisees, new access to markets that may have previously been unavailable (or within which there was limited opportunity or available trade space), turn-key expansion opportunities, or even accelerated expansion opportunities that may not otherwise have been available or would have been difficult for existing franchisees to execute are much more likely to positively impact the franchise relationship. Similarly, as discussed above, the more that a franchisor can demonstrate a commitment to reallocating headcount and capital to supporting franchisees, the more existing franchisees are likely to perceive refranchising as a neutral or positive development.

Conversely, refranchising projects can sometimes risk sending negative signals to the existing franchisee base, particularly where refranchising efforts result in a significant or even complete departure by the franchisor from corporate unit operations. Existing franchisees may perceive that franchisors will become less sensitive to operational and profitability concerns, including less sensitivity to cost of goods and profitable retail prices, and undue franchise system focus on promotional pricing, value menus, and aggressive customer loyalty programs. While franchisors may nonetheless proceed with refranchising initiatives despite these potential negative signals, they should be mindful about how to respond to these concerns or even proactively reassure franchisees that the franchisor remains committed to the health of the franchise system and franchisee profitability.

As discussed above, refranchising projects may include a marked change from the existing size and profile of franchisee in the system. How might new refranchising candidates change the makeup of the franchisee community? The answer may depend on the maturity of the franchisor, the extent to which the franchisor has been actively expanding franchise operations and routinely brings new franchisees into the fold, and the stability of the existing franchisee base. Consider the strength of the existing franchisee base and whether new franchisees introduced through refranchising projects will constitute a good mix with the existing franchisees.

How might refranchising candidates influence and impact the brand's direction, franchisor-led advisory councils, and franchisee-led associations? Because refranchising projects frequently involve selling a large number of bundled units to new franchisees, will the new franchisees have an immediate and outsized impact on the existing franchisee community? With that outsized impact comes the potential for changes in the overall relationship between franchise associations or councils with the franchisor, impacts on any franchisee co-op or buying groups, and issues on

which the franchisees focus their time and energy. Would the franchisor welcome potential changes in these areas, or is the franchisor pleased with the current situation and reluctant to introduce significant or wide-ranging change in the franchise relationship?

Refranchising projects frequently include financial incentives to accelerate the refranchising of corporate units and to increase unit attractiveness, including: (1) reduced or waived initial fees; (2) reduced royalty rates or ad fund contribution obligations; (3) greater autonomy on suppliers, vendors, and development approval requirements; (4) modified remodeling obligations; and (5) other requirements and obligations that may differ from the standard franchise offering. Franchisors should weigh the pros and cons of offering these incentives, including how the existing franchise community will perceive these incentives and the extent to which those incentives and opportunities will be made available to them.

Finally, in nearly all franchise systems, franchisees are attuned to the value of their investment, including what they can expect to gain in a sale or transfer. Refranchising corporate units will likely send strong signals to the existing franchisee base about the perceived and actual value of their franchised enterprises. Aggressive pricing of units by franchisors to accelerate refranchising projects may result in downward pressure on the value of existing franchisees' units, including through the impact of flooding the market with available units.

D. Unit Remodeling Expectations and Requirements

Refranchising projects can often present an opportunity for remodeling and refreshing a significant number of units. Just as franchising itself provides an opportunity for a brand to expand more quickly through another's capital, refranchising can provide an opportunity to refresh or significantly update a material number of units through third-party franchisees' capital.

Franchisors that choose to require refranchised units to be remodeled as part of the transaction should also determine whether those remodeling obligations or updated standards currently apply to other new and existing franchisees. How might existing franchisees perceive those remodeling obligations—will they perceive themselves as next in line for the same remodeling requirements and, if so, will franchisees express concern about the timing or costs associated with the remodel? Did the franchisor previously obtain buy-in from franchisees about these remodeling developments, or will this come as a surprise to existing franchisees?

If the franchisor elects not to require the remodeling or refreshing of refranchised units as a condition for purchase, consider whether the refranchised units are up to par with current brand standards that apply to new and even some existing franchisees. Will existing franchisees perceive this development as preferential treatment for refranchised unit operators? If other franchisees are required to remodel or develop according to a given brand schematic but refranchised units are given exceptions or deviations, how will that impact the relationship?

E. Unit Characteristics and Geographic Considerations

Refranchising initiatives come in all shapes and sizes. Franchisors should take into account the economic and other characteristics of the corporate units to be refranchised, the ideal number of units to sell to any one franchisee, and the franchisor's patience in proceeding at a deliberate and cautious pace.

What constitutes the ideal package of refranchised units, and whether the franchisor even elects to package refranchised units in bundles, will depend on the system and the franchisor's

tolerance for change from the status quo. In assembling potential packages of refranchised units, how does the franchisor choose to mix and match the units per package? Should the franchisor target a mix of strong-performing units with weaker ones? Should the weaker ones instead be packaged and sold to a particularly strong operator with turnaround experience? Should the weakest of units even be refranchised, or should franchisors close those units with an understanding that even the strongest operators are unlikely to achieve reliable profitability at those sites? Many of the negative connotations with refranchising come from franchisors that elect to sell only the worst performing units.

Beyond financial characteristics, there are a variety of geographic factors that may influence a refranchising project. Among these factors include the franchisor's desire to partially or completely exit a market. Yet if the driving factor to exit a particular market is due to a particularly challenging business climate, does the franchisor have a sound basis for believing that a franchisee is going to be more successful than the franchisor was with corporate operations? How will the brand be served in a market if a franchisee with fewer financial resources suddenly finds itself struggling to achieve profitability? And if that occurs, how will the franchisee's failure or financial struggles impact the brand's reputation not only that market but in neighboring markets and beyond?

Franchisors may also pursue refranchising in a geographic area due to the area or jurisdiction's regulatory environment. A regulatory climate that might be particularly difficult for a franchisor may be less so for a franchise operator. Conversely, a regulatory climate may be hostile to franchise operations but nonetheless more feasible for ongoing corporate operations. Perhaps not all jurisdictions suit franchised operations.

As discussed above, franchisors should evaluate the franchise support infrastructure, particularly where geographic areas are poised to flip from largely or entirely corporate operations to franchised operations. Is the franchisor properly resourced to pivot from a corporate operational focus to a franchisee focus in training and ongoing support? Is the geographic area conducive to franchised operations, particularly in systems that rely on franchisee-led buying co-ops, commissaries, and other supply chain elements, or will refranchising the area require ramp-up efforts with or without franchisor involvement? If the franchisor has an integrated distribution system, is that system readily amenable to supporting franchisees instead of corporate units?

F. <u>Timing Considerations</u>

Lastly, not all refranchising projects must initially proceed on a large scale. Franchisors may elect to refranchise on a trial basis, with a focus on experimenting with geographic locations, unit economic profiles, and franchisee experience and size. Just as a limited refranchising project can provide the franchisor with the opportunity to experience, learn, and adapt the offering based on early returns, the timing of a refranchising project has the potential to significantly impact the franchisor's returns and the health of the franchise system overall.

While timing considerations will likely be influenced if not dictated by one or more financial objectives, franchisors should bear in mind pitfalls of rushing the completion of the refranchising project. The longer the timeframe to complete the refranchising project, the more opportunity the franchisor has to observe and evaluate early operational and financial returns. With that opportunity to observe and evaluate comes the opportunity to modify the project's direction and address areas that need additional support or attention. The quicker the franchisor aims to complete the project, the less the franchisor can mitigate or avoid potential negative impacts on the system.

Beyond the time in which the franchisor aims to complete the project, franchisors should also assess whether the current business climate that is emerging from the COVID-19 pandemic is the right time to pursue refranchising. Project timing and whether to wait or proceed until more time has passed since the worst of COVID-19 business interruptions may depend on the industry and franchisor. Has sufficient time passed for the franchisor to draw reliable conclusions about how the system weathered the COVID-19 storm? Is the franchisor confident that it can price corporate units appropriately in light of COVID-19's impact on unit performance? While there are certainly no one-size-fits-all answers to these and other COVID-19-related questions, allowing even a small amount of additional time to pass before moving forward may provide a more stable environment within which to proceed.

II. THE REFRANCHISING TRANSACTION PROCESS AND DOCUMENTATION

A. The Pre-Sale Process

1. Organizational Alignment

As noted above, a critical component of any successful refranchising program is for the franchisor to have a specific, well-defined plan for accomplishing the objectives of the proposed program. Further, for the program and proposed plan to be successful, both the executive team leading the initiative as well as the managers and field support personnel with detailed knowledge of the proposed units to be refranchised must be aligned. For example, while the task of setting and implementing strategic objectives – including the vision for the franchisor's business post refranchising program – will necessarily be the responsibility of the executive team, the required in-depth knowledge of the specific units and markets to be refranchised will often reside with various managers and field support personnel that work day-to-day in the applicable markets. Thus, ensuring the organization is aligned regarding overall purpose and relevant issues that may affect the refranchising program is critical.

Additionally, ensuring that the franchisor has a specific plan for communications and relevant work streams is also critical for affecting a successful refranchising initiative. Typically the franchisor will appoint one member of senior management as the "point person" through whom all communications with potential buyers will flow. Further, given the potential impact of a refranchising transaction on the franchisor's organization and staffing needs, particular sensitivity must be exercised in determining the relevant franchisor personnel that will be made aware of and be involved in the transaction. Finally, to the extent the refranchising transaction requires the consent of third parties (e.g., lenders, landlords, etc.), the organization must have a detailed and clear plan for communicating with those stakeholders in an appropriate manner.

As discussed in more detail in Section III below, one additional item required of franchisor early in the pre-sale process is a determination regarding the necessity of pre-sale disclosure to the potential purchaser with a Franchise Disclosure Document (FDD) or, alternatively, whether an applicable exemption or exclusion exists. As discussed in further detail below, if FDD disclosure is required, an analysis of the franchisor's current FDD will be required.

2. Pre-sale Due Diligence

In addition to ensuring the franchisor's organization is aligned on transaction objectives and approach, a second, but equally important task is to ensure that the designated refranchising team has a thorough understanding and plan with respect to key issues that may affect the sale

of the proposed markets and units to be refranchised. As with any transaction, ensuring that outstanding diligence issues are identified and addressed in advance of discussions with third parties is critical, as such issues can – and often do – affect the price that a purchaser is willing to pay for the refranchised units to be refranchised and/or may result in closing delays or even derail a proposed refranchising transaction. While such diligence issues can vary widely depending on the nature of the units being refranchised, common categories of diligence issues include (i) real property control issues, including leases and the ability of franchisor to freely assign such leases, (ii) overdue maintenance items that affect the condition and potential salability of the units to be refranchised, and (iii) relevant licensing and permitting issues, especially alcohol and liquor licenses ("liquor licenses"), that can affect the proposed timing of a scheduled refranchising closing.[1]

With respect to real property and lease issues, the assignability of a subject lease is a critical diligence item that should be ascertained before commencing discussions with third parties. Similarly, as licensing regulations vary widely by jurisdiction (especially liquor licensing laws), the franchisor's refranchising team should understand the applicable licensing regime well in advance of the transaction and have a proposed plan for license transfer and/or submission of necessary applications by the proposed purchaser. With respect to deferred maintenance issues, since such issues are likely to be discovered by the buyer in connection with its due diligence review and/or preemptively disclosed by the franchisor eventually, the franchisor's refranchising team should have a plan for how it will disclose such issues in advance of closing (if franchisor intends to address such issues) and/or understand the potential impact on purchase price once such issues are discussed with the purchaser. Franchisor's managers and field support personnel are critical at this stage of the transaction as they typically have the most current and detailed information regarding these issues and can escalate such issues in advance of discussions with a potential purchaser. Further, to the extent any of the assets to be sold are subject to liens or security interests under franchisor’s credit facility or other loan documentation, the franchisor will necessarily be required to closely coordinate with its lenders to ensure the assets can be conveyed free of any such liens. Ultimately, given the potential for such diligence issues to affect the final purchase price for the refranchised units, these items are relevant concerns for both the franchisor's executive and transaction teams seeking to effect a successful refranchising initiative.

B. Transaction Approach and Initial Documentation with the Purchaser

1. Transaction Approach

A refranchising transaction includes many of the typical hallmarks of a "standard" acquisition transaction, such as a purchase agreement that includes customary provisions such as representations and warranties, covenants, and indemnities. However, a refranchising transaction necessarily requires a modified approach from a standard M&A transaction as the parties will be entering into a 5, 10 or even 20-year franchise relationship simultaneously with the closing of the purchase transaction.[2] Given this unique dynamic, it is especially critical for a franchisor and purchaser franchisee to clearly understand their respective rights and responsibilities in the context of the refranchising transaction. From the franchisor's perspective this is particularly important because post-closing it is entrusting the franchisee with the refranchised units (and perhaps an entire market) as its representative of the brand to its

[1] Kevin E. Maher & Richard L. White, *Not Just Another M&A Deal*, 16 THE FRANCHISE LAWYER 4 (2016).

[2] Mark A. Kirsch & Charlene York, *Who You Gonna Call: The Role of Franchise Lawyers in Mergers & Acquisitions*, ABA 43rd Annual Forum on Franchising W-22 (2020).

customers. Thus, while a "scorched earth" approach whereby a seller seeks to insulate itself from all post-closing contact (especially indemnity claims) may benefit a seller in the typical M&A transaction, in the context of a refranchising transaction the parties will necessarily be required to communicate and cooperate for their mutual benefit for many years to come. This reality will necessarily require a unique approach to negotiating and documenting the refranchising transaction.[3]

2. Nondisclosure Agreement

The initial purchase transaction document most commonly executed between the franchisor and a potential purchaser is the nondisclosure agreement (confidentiality agreement). From the franchisor's perspective, ensuring there are appropriate confidentiality protections is critical for numerous reasons, including that sensitive financial and other revenue and cost information regarding company-owned units that will be shared by franchisor and, in many cases, existing franchisees and new potential business partners may be bidding for the same assets.[4] Ensuring appropriate confidentiality regarding the transaction is also important because, among other reasons, knowledge of the proposed refranchising transaction can affect (i) existing franchisee perceptions of the franchisor's commitment to the brand as well as the franchisor's relationship with its franchisee community, and (ii) the relationship of the franchisor with certain key employees and management. Given these important considerations, any nondisclosure agreement should include a clear no-contact clause requiring the potential purchaser to direct all communications relating to the transaction to a designated employee along with an express provision prohibiting the purchaser from contacting the franchisor's employees, suppliers, vendors and other key parties except with franchisor's prior written consent.[5] The nondisclosure agreement typically expressly prohibits disclosure of the fact that the parties are considering the specific transaction, and therefore in most cases the potential purchaser is prohibited from discussing the proposed transaction with existing or former franchisees absent express written consent of the franchisor (which a franchisor may decide to grant when/if the negotiations have entered a sufficiently advanced stage). Further, given the importance of key employees to the successful operation of a franchised business (including the franchisor's business post-refranchising), the nondisclosure agreement should also include an appropriately scoped non-solicitation clause preventing the purchaser from soliciting for employment certain key management personnel.

3. Letter of Intent

As a potential refranchising transaction progresses from initial discussions to initial due diligence, franchisors and the potential purchaser typically move to the next stage of negotiations and documentation – a non-binding letter of intent ("LOI") outlining key business and legal terms. Like any "standard" M&A or similar commercial transaction, the LOI should include customary terms such as agreement on responsibility for costs, dispute resolution and governing law, and express acknowledgment that the LOI is non-binding and no transaction will be deemed to have been agreed unless and until definitive documentation is executed.[6]

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[3] Maher and White, *supra* note 1, at 12.

[4] Kirsch and York, *supra* note 2, at 7.

[5] Maher and White, *supra* note 1, at 13.

[6] Kirsch and York, *supra* note 2, at 8.

However, in addition to these customary terms, in the context of a refranchising transaction the LOI also typically addresses key terms that impact the franchise relationship post-closing. Such terms include, among others:[7]

(i) the specific markets / company-owned units to be refranchised and acquired by the purchaser,

(ii) the franchise and development agreements to be entered into in connection with closing,

(iii) the royalty, advertising fund and similar fees included in such agreements,

(iv) any territorial protections and/or development obligations of purchaser,

(v) remodel or renovation requirements that will be required post-closing (often described in terms of minimum and/or maximum capital expenditures required),

(vi) required guarantor parties, and

(vii) the scope of required franchisor representations and warranties and indemnity (if applicable).

If a proposed transaction and related discussions are progressing expeditiously and (seemingly) smoothly there can be a temptation to bypass the LOI stage and move quickly to definitive documentation; however, spending the time to negotiate a non-binding LOI often saves both parties time in the end because such negotiations can reveal whether the parties are truly aligned on the critical business and legal issues that ultimately become part of the purchase agreement and franchise documentation. This is particularly important when – as is often the case – timing for closing is of the essence and/or the franchisor is considering competing offers for a portfolio of units.

C. The Purchase Agreement

1. General Approach

While it is possible to document a refranchising transaction with a stock purchase agreement if the applicable market and/or company-owned units (and related assets) are owned by one or more segregated franchisor-owned entities, because of tax and potential successor liability reasons purchasers usually prefer asset purchase transactions. For these and other reasons, parties typically document refranchising transactions via an asset purchase agreement ("APA").[8] When a franchisor is conducting a refranchising "program" that involves the sale of multiple unit portfolios, it is typical for the franchisor and its counsel to draft and utilize a "form" APA that is customizable for specific markets, transactions and issues affecting particular portfolios. Additionally, if a single buyer is purchasing multiple units, a single APA would typically be used for the overall transaction; however, each transaction and the relevant documentation must take into account the particular organizational and ownership structure of both franchisor and franchisee. For example, (i) in the event multiple franchisor-entities own assets required to

[7] Maher and White, *supra* note 1, at 13-14.

[8] Maher and White, *supra* note 1, at 14.

be conveyed in connection with a refranchising transaction, then there may be multiple selling parties that are party to the APA(s) and (ii) if there are multiple purchasing entities (perhaps for regional or territorial purposes or because of differing ownership), the parties may choose to utilize a single APA that delineates the specific units to be purchased by each purchasing entity or the parties could choose to utilize multiple substantially similar APAs based upon the applicable region or purchasing entities. While an APA executed in connection with a refranchising transaction generally appears similar to an APA executed in connection with an ordinary non-franchise corporate transaction, there are some important considerations and potential differences that both parties must be aware of. The following paragraphs highlight some key considerations in the context of an APA executed in connection with a refranchising program.

2. **Key Considerations and Provisions**

a. **Scope of Purchased Assets and Liabilities**

As with any asset purchase transaction, clearly defining the assets to be purchased and sold is one of the most critical tasks. To ensure an appropriate meeting of the minds and avoid post-closing surprises and disputes, it is important to ensure that both the franchisor and prospective franchisee understand which assets are being acquired (and which assets are not). From the franchisor's perspective, the "purchased assets" should be clearly defined and limited to those assets used "solely" in connection with the operation of the units to be refranchised.[9] Ideally, the purchased assets will be limited to a list of assets included on a disclosure attached to the APA. Typical assets included within the definition of purchased assets include, among others, the following assets relating to the refranchised units: (i) furniture, fixtures and equipment, (ii) franchisor's interest in the applicable real estate lease (or underlying real estate in the case of an owner location), (iii) certain assignable contracts with third parties necessary for operations, and (iv) various permits and licenses that can be transferred at little or no cost to the franchisor.[10]

Clearly and adequately defining the assets that are expressly excluded from the purchased assets (i.e., the "excluded assets") is also a critical element in any asset purchase transaction. From the franchisor's perspective, any assets that are not *solely* used in connection with the operation of the units to be refranchised are excluded assets. For example, the excluded assets typically include the franchisor's trademarks and goodwill in connection with the operation of the refranchised units and/or the franchise system, employee records and employee benefit plans, insurance contracts, corporate records, and proprietary hardware and/or software owned by the franchisor.[11] Additionally, many franchisors have enterprise contracts that apply to all their corporate-owned units, and unwinding or removing refranchised units takes some time and care.

b. **Representations and Warranties**

While a franchisor selling company-owned units often has ample knowledge regarding the purchased assets and units to be refranchised, as with any APA transaction, as the seller the franchisor will seek to provide only limited representations and warranties regarding the refranchised units and purchased assets, typically qualified by a material adverse effect standard. However, a rational purchaser will seek more fulsome representations and warranties covering a

[9] *Id*.

[10] *Id*.

[11] *Id*.

broad range of items, including the title, condition and encumbrances affecting the purchased assets along with specific representations regarding employment, environmental and financial matters.

As highlighted above, given that the franchisor and the purchaser will be entering into a long-term franchise relationship simultaneously with closing, it is important that the parties have mutual agreement regarding certain key items, including the specific representations, warranties and other exceptions pertaining to the purchased assets. From the franchisor's perspective, the APA should include an express provision whereby the purchaser expressly acknowledges that it is purchasing the purchased assets on an "as-is, where-is, and with all faults" basis.[12] Similarly, the franchisor should also include an express provision in the APA whereby the purchaser acknowledges that, except as expressly provided for in the APA, the franchisor has not (and has not) made any implied or express representations or warranties regarding the purchased assets.[13]

Another issue related to the representations and warranties to be negotiated in the context of the APA concerns the survival period for the representations and warranties. While a franchisor typically seeks to limit the survival period for such representations to a minimal period (e.g., until closing), the purchaser will often seek to have the representations and warranties expressly survive for a longer period post-closing (e.g., the applicable statute of limitations or another agreed period).[14] Given this issue has the potential to increase the likelihood a franchisor will be subjected to liability in the event any of representation or warranty proves false, misleading or untrue, such issue will necessarily require careful negotiation and consideration by counsel for both parties.[15]

c. <u>Permits, Licenses and Other Key Items</u>

Depending on the nature of the refranchised units, certain key permits and licenses may be required for the continued operation of the business. Moreover, depending on the nature of such permits and licenses, they may or may not be directly transferable to the buyer. Consequently, in the context of a refranchising transaction, it is critical that the franchisor's regulatory and licensing teams be consulted early with respect to the applicable provisions of the APA addressing licensing and permitting issues. To the extent licenses and permits are transferable to the proposed purchaser at no cost to franchisor (or at minimal cost consented to by franchisor), such licenses and permits should be included within the list of purchased assets and included on the appropriate disclosure schedules attached to the APA.

If the sale of alcoholic beverages is critical to the financial results of refranchised units, franchisor and the purchaser will need to cooperate and plan for an orderly transition of operations that complies with all liquor licensing rules and regulations.[16] In such instances, certain license application, timing and other issues can arise that have the distinct potential to cause closing delays. Consequently, liquor licensing counsel in the applicable jurisdiction(s) should be

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[12] *Id*.

[13] *Id*.

[14] Jeff Brams, Brian Schnell & Phyllis Alden Truby, *Buying and Selling Company-Owned Units*, ABA 27TH ANNUAL FORUM ON FRANCHISING, at 33 (2004).

[15] *Id*.

[16] Maher and White, *supra* note 1, at 14.

consulted well in advance of the initial draft of the APA to assist with the franchisor's planning efforts and in setting reasonable timing expectations. For example, in jurisdictions where temporary or conditional liquor licenses are not available to the purchaser, applicable liquor licensing regulations can preclude simultaneous signing and closing of refranchise transactions and/or result in the parties having to enter into temporary arrangements (e.g., interim management agreements).[17]

d. <u>Employee Matters</u>

Subject to the franchisor seeking to retain certain specified employees, in a typical refranchising transaction all or almost all of employees of the refranchised units cease to be employees of the franchisor immediately before closing and become employees of the purchaser and new franchisee simultaneously with the closing of the transaction.[18] While a detailed and in-depth discussion of applicable employment law implications is beyond the scope of this paper, appropriate employment counsel should be consulted early in the transaction to ensure an orderly transition of employees to the purchaser of the refranchised units that complies with all applicable laws and regulations. Such employment counsel can assist in structuring a proper transition of employees from the franchisor to the purchaser, including the applicable terms of employment offered to transitioning employees (e.g., transfer of accrued benefits such as vacation and PTO and whether generally equal pay and benefits will be offered).[19] Further, the applicable provisions of the APA should expressly specify that the employment-related aspects of the refranchising will be structured so as to avoid the applicable provisions of the federal Worker Adjustment and Retraining Notification Act ("WARN") as well as any state equivalents or, to the extent any such employment laws apply, the purchaser covenants that it will comply with all such laws and regulations. Such WARN act laws generally mandate prior written notice to employees in the event of certain "plant closings" or "mass layoffs" and the penalties for noncompliance can be substantial; consequently, franchisors are strongly advised to obtain advice from competent employment counsel early in the refranchising process.

e. <u>Service and Other Contracts</u>

To the extent such contracts are freely assignable, the parties will typically seek to include in the definition of purchased assets certain specified contracts that are necessary and/or useful in connection with the operation of the units to be refranchised. Such contracts are generally smaller value contracts that relate to typical goods and services, equipment contracts, and other items required in connection with operations and are freely transferable upon notice to the counterparty.[20] In some cases a franchisor may have negotiated a systemwide / nationwide contract for the supply of certain critical goods and services necessary for the operation of the refranchised units. In such instances, the APA typically includes an express obligation requiring the purchaser to execute a contract addendum with the national supplier assenting to the system supply contracts and thereby agreeing to purchase such goods and services from the national supplier. Evidence of such contract execution can also be included as a condition to closing of the franchisor.

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[17] *Id*.

[18] Brams, et al., *supra* note 14, at 40.

[19] Maher and White, *supra* note 1, at 14.

[20] Brams, et al., *supra* note 14, at 26.

f. Indemnification

The APA provisions relating to indemnification, including applicable cap, baskets and other limitations, are typically some of the most intensely negotiated because of the "zero-sum" nature of indemnity claims in the typical M&A transaction.[21] While such realities are present in any APA negotiation, in the context of a refranchise transaction the dynamic is often quite different given the parties are simultaneously entering into a long-term franchise relationship. Nonetheless, the typical franchisee purchaser of refranchised units will often seek to take the view that it is purchasing a "turnkey" operation where all assets "should" be in good condition. Conversely, the franchisor seller will seek to ensure the APA clearly states that the purchaser is purchasing the assets "as-is, where-is and with all faults" and take the view that the purchased assets are being sold with little to no future liability.[22]

As a practical matter, given the nature of the transaction and the ongoing franchise relationship being entered into in connection with closing, in a typical refranchising transaction the parties often compromise and agree on reasonable indemnity caps, baskets and other limitations. Given the importance of the ongoing relationship and necessity of close cooperation for the successful transition and operation of the refranchised units, it is, however, important for the parties to have a meeting of the minds with respect to the scope, nature and purpose of post-closing indemnification responsibilities.

g. Lease Obligations

As discussed briefly above, in many refranchising transactions the most valuable asset (or contract) to be purchased and sold in connection with the refranchise transaction is a real property lease where the refranchised unit is being operated. Except in unique circumstances where a sublease and potential take back rights are desired, for many franchisors the ideal situation is an assignment of the lease to the purchaser and receipt of a full release of liability from the landlord of the franchisor and its affiliates under the lease. However, in many (if not most) instances, the assigning tenant under a lease is not released from future liability under a lease upon assignment, thereby resulting in the franchisor becoming in effect an indirect guarantor of the purchaser's obligations under the assigned lease.[23] In such cases, selling franchisors often require that the purchaser (and/or its principals or another creditworthy corporate affiliate) execute a lease guaranty guaranteeing to the franchisor the full performance of the obligations under the assigned lease. While such guaranty only has value to the extent the guarantor remains creditworthy, in instances where the franchisor is not entitled to, or is unable to negotiate, a release from the landlord it can provide potential leverage for the franchisor in the event of a default by the franchisee under the assigned lease.[24]

Where assignment of a real property lease is not desirable or possible, subletting the premises to the purchaser of the franchised units is another potential solution for the franchisor. Of course, perhaps the most obvious disadvantage of such structure is that the franchisor remains

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[21] Kirsch and York, *supra* note 2, at 27.

[22] Maher and White, *supra* note 1, at 14-15.

[23] Brams, et al., *supra* note 14, at 25.

[24] Maher and White, *supra* note 1, at 14.

primarily liable to the landlord on the lease in the event of a purchaser default.[25] However, one advantage of such structure is that following such default it is often a fairly straightforward process for the franchisor to terminate the sublease and reclaim the premises. Moreover, similar to the structure utilized in connection with an assigned lease, in such instances many franchisors will require the purchaser (and/or its principals or another creditworthy corporate affiliate) to execute a sublease guaranty guaranteeing to franchisor the full performance of the obligations under the sublease.[26]

D. Other Documentation Executed in Connection with the Refranchising

1. Standard Purchase Transaction Documentation

As with other standard asset purchase transactions, the franchisor and purchaser of the refranchised units will execute certain customary ancillary agreements. For example, the franchisor and the purchaser should execute a bill of sale document evidencing the purchase and sale of the purchased assets. Such bill of sale typically includes an attached schedule listing all of the assets acquired under the APA. Similarly, the parties also typically sign an assignment agreement expressly evidencing the assignment and transfer of the transferred contracts, transferred licenses and permits and similar items. Finally, certain other closing certificates and other closing documents are customarily executed in connection with closing under an APA (e.g., buyer and seller closing certificates where the applicable party represents and warrants that certain conditions have been satisfied and that representations and warranties are all true and correct).

2. Real Property and Other Special Documentation

Since most refranchise transactions involve the transfer of either owned or leased real property where the refranchised unit is operated, franchisor and the purchaser will need to execute and obtain appropriate real estate documentation to transfer all rights and responsibilities relating to the location where the refranchised unit is located.

a. Deeds, Lease Assignments or Sublease Agreements, and Guaranties

In refranchise transactions it is critical that competent real estate counsel is consulted early in the process to advise on general real estate matters, including title work (in the case of owned real property) as well as critical diligence items involving the assignability and transferability of real estate leases. Further, such counsel can provide invaluable assistance in connection with certain long lead-time items, such as negotiations with landlords to permit the assignment of leases and/or the release of franchisor lessees and guarantors. In most refranchise transactions, discussions and negotiations with landlords over leased real property is one of the most critical, sensitive and time-consuming items for the franchisor's refranchise deal team.

In most cases, the ideal situation for the franchisor is a free and clear assignment of the real property lease to the refranchise purchaser with a full release of franchisor and its affiliates for any continuing obligations under the lease. When this is not possible, depending on the

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[25] Brams, et al., *supra* note 14, at 26.

[26] Maher and White, *supra* note 1, at 14.

language in the real property lease, a franchisor may choose to require that the refranchise purchaser (i) execute a sublease for the leased premises and in such sublease the franchisor would retain an option to take back the property in the event the refranchise purchase defaults under the sublease or (ii) execute an assignment of lease whereby the refranchise purchaser becomes primarily liable under the real property lease. In situations where the lease is assigned to the refranchise purchaser and the franchisor is unable to secure a full release from the landlord regarding future liabilities, the franchisor should seek a lease guaranty or other security from the franchisee and its principals (or another credit worthy corporate affiliate of franchisee) to protect itself from exposure under the lease should the refranchise purchaser ultimately default.[27]

b. Interim Management Agreements

As discussed above, in the context of a refranchising transaction where the refranchised units sell alcoholic beverages, the parties will need to consider the liquor licensing regulation regime, including the potential transferability of such liquor licenses and/or the required application and registration process in all applicable jurisdictions. In certain jurisdictions liquor licenses can be transferred to the purchaser after complying with relevant regulatory requirements while in others temporary or conditional liquor licenses can be obtained by the refranchise purchaser.

However, depending on the closing timeline of a particular transaction, there are situations where a refranchise purchaser is unable to obtain the relevant liquor licenses on the parties' desired timeline and/or there are timing issues from a regulatory perspective. In such instances, depending on the applicable jurisdiction, it may be possible for the parties to enter into interim management agreements whereby the refranchise purchaser essentially receives the benefit of the franchisor's existing liquor licenses during the term of the interim management agreement.[28] As the rules in this particular area of the law are particularly detailed and can vary by jurisdiction (e.g., city, town or locality, and not only at the state level), engaging competent liquor licensing counsel early in the process can help to avoid missteps and assist with aligning the parties' expectations regarding the timing for transfer of refranchised units.

3. Lien Release Documentation

If all or a portion of the assets to be transferred in connection with the refranchise transaction are subject to liens held by the franchisor's lenders or other creditors, the franchisor's refranchising team will need to coordinate with the lender and lender's counsel in advance of any proposed refranchise closing. Typically, as long as the proposed assets sales are permitted under the franchisor's existing credit arrangements (or otherwise if the lender consents to the proposed transaction), the franchisor and its lender will execute lien release documentation in connection with closing to allow for the free transfer of the assets to the refranchise purchaser. A prudent refranchise purchaser will also request such documentation as well. Although different lenders have varying documentation requirements, the release of the lender's liens is typically evidenced by a (i) lien release letter executed by the franchisor and the lender and (ii) a UCC-3 termination statement filed by the lender in the applicable secretary of state office listing the assets for which lender's liens are being terminated in connection with closing.

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[27] *Id*.

[28] *Id*.

4. Franchise Documentation

Simultaneously with the closing of the APA the franchisor, refranchise purchaser and relevant affiliates will enter into the documentation that will govern the franchise relationship post-closing. The below describes the most commonly executed documents that govern the post-closing franchise relationship.

a. Franchise Agreements

The franchise agreement of course governs the ongoing franchise relationship between the franchisor and the refranchise purchaser (now franchisee) following the closing. As mentioned above, the franchise agreement (or multiple franchise agreements depending on the franchisor's requirements and/or the franchisee's organizational structure) incorporates the key business terms underlying the franchise relationship and also includes the remaining terms typically found in all franchise agreements. As with any other franchising transaction, absent special circumstances the franchisor will want to ensure that the entity purchasing the refranchised unit and the applicable assets necessary to operate the unit is the party executing the franchise agreement.

b. Development Agreement

As noted in Section I above, many franchisors undertake a refranchising program with the complementary goals of (i) focusing on brand development and (ii) relying on the capital of its new business partners to accelerate growth of the franchise system. Development agreements taken many forms and can vary widely, but common features include agreed timeframes for development (e.g., 5 or 10 years) and a requirement to develop an agreed number of franchised units each year during such timeframe. Many development agreements include certain territorial and development rights benefitting the franchisee; however, such rights are typically able to be modified or rescinded in the event of a development failure by the franchisee. Further, in many cases the franchisor includes an express cross-default provision between the development agreement and the franchise agreement(s) such that a default under one agreement will result in a default under the other.

c. Omnibus Relationship Agreement (Multi-Unit Franchisees)

For particularly large franchise portfolios and/or transactions involving a sophisticated franchisee, the franchisor and the franchisee may agree to enter into an omnibus relationship agreement and/or consent agreement to govern certain special rights and responsibilities of the parties. For example, in such cases, the franchisor and franchisee may agree to execute franchisor's "standard" form of franchise agreement or development agreement but will simultaneously agree to enter into a separate omnibus relationship agreement that effectively amends and supersedes the underlying franchise documentation. Possible issues covered in an omnibus relationship agreement could include: (i) specific covenants and conditions governing any proposed change of control, (ii) modified transfer rights for franchisees with sophisticated ownership structures (e.g., private equity fund or similar structures), (iii) modified and/or enhanced confidentiality and non-compete obligations to take into account the franchisee's ownership structure as well as interests held by affiliates in potentially competitive concepts, (iv) enhanced financial requirements and protections, such as leverage tests, financial requirements, letters of credit, etc., (v) specific capital spending / renovation requirements with respect to the refranchised units; and (vi) future development obligations.

d. Other Franchise Documentation

In addition to the "standard" franchise documentation executed in connection with almost all franchise transactions (personal/corporate guarantees, confidentiality agreements, etc.), a franchisor may want to require that the franchisee enter into separately documented agreements to govern special relationship issues. For example, a franchisor may require separate documentation evidencing participation in special incentive programs (royalty ramps, advertising fund holidays, etc.) or documenting the franchisor's consent for the franchisee to close certain refranchised units if they do not meet certain agreed financial performance metrics. Further, in cases where the parties agree to certain deviations from franchisor's standard form of franchise agreement, the franchisor may require that such agreement be documented via a side letter that is non-transferable and personal to the franchisee and expressly states that such deviations are "one-time concessions being offered in connection with the refranchising program.

III. FRANCHISE REGULATORY ISSUES

Franchisors must address franchise and business opportunity regulatory issues in a refranchising transaction. For a company with no pre-existing franchise operations, or offer and sales activities, which is entering the franchise arena by refranchising, it must comply with all franchise and business opportunity laws for the first time. The more common scenario, however, is that the company is an established franchisor with existing franchise and business opportunity registrations that has decided to sell certain of its company owned and operated assets through refranchising. Typically, the established franchisor will have a current Franchise Disclosure Document (FDD) prepared in accordance with federal and state franchise laws and will have obtained registrations in those states that require franchisors to register before the offer and sale of a franchise or business opportunity. But even for those established franchisors, refranchise transactions, by their nature can lead to unique considerations.

A. Disclosure

First and foremost, the franchisor must determine whether pre-sale disclosure with a FDD will be required. Unless the transaction qualifies for an exemption from disclosure under the FTC Franchise Rule, and exemption from registration and disclosure under applicable state laws, a FDD will be required.[29] For franchisors that have an established refranchising program (i.e., are regularly offering and selling company owned locations perhaps as part of a company initiative to transition to a franchise/asset light model), they likely have an FDD which adequately discloses the refranchise transaction. For the vast majority of franchisors, however, their FDDs make no mention of a refranchise transaction and do not properly disclose the nature of the investment and material agreement terms throughout. Thus, even if a franchisor is selling a single refranchised unit, it will likely be required to amend its FDD to disclose the unique characteristic of the refranchise transaction such as a requirement to purchase the business assets under an asset purchase agreement, resulting in changes to Item 5 and 7 of the FDD as well as Item 22, which requires franchisors to include as an exhibit each agreement that the franchisee will be required to sign in order to obtain the franchise.

Since each refranchise transaction is unique, the best practice is to review each of the items and disclosures in the FDD to confirm that they are accurate and meet all legal requirements

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[29] *See Section III. B., infra.*

with the specific transaction in mind. The following chart lists, generally, the material FDD changes that a company must consider in a refranchise transaction.

FDD ITEM	DISCLOSURE REQUIREMENT	NECESSARY CHANGE
Table of Contents	Attach a copy of all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.	Add a reference to forms of agreements that the franchisee will be required to sign, including, for example, the form of asset purchase agreement that a franchisee will be required to sign to acquire a franchise for the refranchised location, along with financing documents and subleases, if any, as exhibits to the FDD.
Item 1	Disclose the business the franchisee will conduct and a description of the franchise offering.	Add a brief description of the franchise offer for a refranchised location, including disclosure of the asset purchase agreement and ancillary agreements that must be signed.
Item 5	Disclose the initial fees and any conditions under which these fees are refundable. If the initial fees are not uniform, disclose the range or formula used to calculate the initial fees paid in the fiscal year before the issuance date and the factors that determined the amount.	Disclose (i) the formula used for determining the purchase price, if applicable (e.g., a multiple of cash flow), and the range of purchase prices paid in the last fiscal year, (ii) the payment terms for the purchase price (i.e., whether payable in lump sum, deposit/installments); (iii) whether any part of the purchase price is refundable; (iv) whether there is any additional cost/expense associated with entering into the asset purchase agreement; and (v) whether any of the other initial fees listed in Item 5 are different for franchisees of refranchised locations.
Item 7	Disclose, in tabular form, the franchisee's estimated initial investment. List each type of expense, beginning with pre-opening expenses.	Add a new Item 7 table disclosing the estimated initial investment for refranchised locations. Most notably,, this will include a line item for the purchase price range. Also include one or more explanatory notes to the table describing the unique characteristic of the investment in the refranchised business. .
Item 8	Disclose the franchisee's obligations to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, or comparable items related to	Add a description of the additional items that the franchisee will purchase from the franchisor under the asset purchase agreement.

FDD ITEM	DISCLOSURE REQUIREMENT	NECESSARY CHANGE
	establishing or operating the franchised business either from the franchisor, its designee, or suppliers approved by the franchisor, or under the franchisor's specifications. Include obligations to purchase imposed by the franchisor's written agreement or by the franchisor's practice.	
Item 9	Disclose in tabular form, by way of cross-reference to each listed obligation with any applicable section of the franchise or other agreement, the franchisee's principal obligations.	Add in the existing Item 9 table cross-references and brief descriptions of the prescribed list of principal obligations under the asset purchase agreement. .
Item 11	Disclose the franchisor's principal assistance and related obligations of both the franchisor and franchisee.	Note which of the franchisor's pre-opening obligations and already existing disclosures may not apply to refranchised transactions.
Item 17	Disclose a table that cross-references each enumerated franchise relationship item with the applicable provision in the franchise or related agreement. Describe briefly each contractual provision.	Add in the existing Item 17 table cross-references and brief descriptions of the prescribed subjects.
Item 19	Disclose whether the financial performance representation relates to the performance of all of the franchise system's existing outlets or only to a subset of outlets that share a particular set of characteristics (for example, whether the outlets are franchised or franchisor-owned or operated). Disclose the characteristics of the included outlets that may differ materially from those of the outlet that may be offered to a prospective franchisee.	Disclose the number of included locations that are refranchised locations, along with statement that performance could be stronger for those locations since they were already established and operated by the Franchisor. Notably, the Franchisor may elect to provide operating results for the locations being franchised, outside of Item 19, because federal and state franchise laws permit the delivery of financial information to a prospective franchisee with respect to an existing company-owned outlet whether or not the franchisor has an Item 19 disclosure. A franchisor in a refranchising transaction can provide actual historical operating results (but not projections or pro formas related to anticipated future performance) for the outlet(s) so long as the information (i) only contains the operating results of the specific outlet(s) being offered for sale; (ii) is only given to potential

FDD ITEM	DISCLOSURE REQUIREMENT	NECESSARY CHANGE
		purchasers of the particular outlet(s) being offered for sale; and, (iii) is accompanied by the name and last known address of each owner of the outlet being offered for sale during the prior three years (to the extent the outlet was previously owned by other third parties).
Item 22	Attach a copy of all proposed agreements regarding the franchise offering, including the franchise agreement and any lease, options, and purchase agreements.	Add a reference to the FDD exhibit that will contain the form of purchase agreement a franchisee would have to sign to acquire a franchise for a refranchised location.

B. Exemptions from Disclosure/Registration which may apply

Both the FTC and the franchise regulating states acknowledge that there are certain circumstances where even though an arrangement between two parties will meet the definitional elements of a franchise, there is a reduced risk (whether due to the size of the investment, the sophistication of the franchisee or other factors) that the franchisee will need the protections of franchise disclosure and relationship laws. As a result, the FTC and the most franchise regulating states have established a number of exemptions which apply to the pre-sale disclosure obligations required under the FTC Rule and the pre-sale registration (and possibly disclosure) obligations under state laws. It is important to note, however, that the FTC Rule does not entirely preempt state laws. Thus, even if a transaction is exempt under applicable federal law, registration and/or disclosure may still be required under state laws.

Exemptions often play a critical role in refranchising transactions.[30] After all, if there is an available exemption from disclosure, a franchisor need not update its current FDD to provide additional disclosure that might be required for the refranchise transaction. Because refranchise transactions tend to involve large initial investments since the franchisee is purchasing an existing business, the following sophisticated franchisee exemptions will often apply to the transaction:

1. Large Investment Exemption

Section 436.8(a)(5) of the FTC Rule exempts from its pre-sale disclosure requirements the sale of a franchise to an investor where the total initial investment (excluding financing from the franchisor) exceeds $1,233,000 and the franchisee acknowledges in writing that the initial investment will in fact exceed $1,233,000.[31]

The large investment exemption should be calculated by reviewing the prospective franchisee's initial investment as would be set forth in Item 7 of an FDD prepared in accordance

[30] For a thorough analysis of franchise exemptions see *Exemptions and Exclusions Under* Federal and State Franchise Registration and Disclosure Laws, ABA Press, Leslie D. Curran and Beata Krakus, Editors (2017).

[31] 16 C.F.R. § 436.8(a)(5). It is important to note that the FTC adjusts the monetary amounts required under each exemption every 5 years. These amounts were last adjusted in July 2020.

with the FTC Rule to determine whether the exemption has been met.[32] Also, the required $1,233,000 investment necessary for a franchisor to take advantage of the FTC Rule's exemption "… need not be limited to a single unit… . A multi-unit franchisee investing the threshold amount (or more) in a number of units is just as sophisticated as another franchisee investing a like amount in a single unit."[33]

Under his exemption, the value of all of assets which are the subject of the refranchise transactions will count when computing the required threshold.[34] It is important to note, however, that the application of the large investment exemption is more difficult when the franchisee entity is comprised of multiple investors because the exemption will apply only if at least one individual in the investor group invests enough money to meet the required level of investment.[35]

2. <u>Sophisticated Franchisee Exemption</u>

In addition to the large investment exemption, the FTC Rule also recognizes an exemption based on the net worth and sophistication of the franchisee, which is frequently referred to as the "sophisticated franchisee exemption" or "large franchisee exemption." This exemption applies to entities (including any parent or affiliates) which have been in business for at least five years and have a net worth of at least $6,165,500. A large franchisee need not have five years of business experience in franchising or in the industry that the franchisee will enter as a result of the franchise. Five years of business experience in any business will suffice.[36] California, Maryland, South Dakota, and Wisconsin also have similar exemptions available under their laws which exempt from their respective registration and disclosure requirements, the offer and sale of a franchise to a "sophisticated franchisee."[37]

3. <u>Fractional Franchise Exemption</u>[38]

Fractional franchise exemptions may also play an import role in large, multi-unit refranchise transactions because the purchaser/franchisee is usually a sophisticated investor with experience operating similar businesses.

The FTC Rule defines a "fractional franchise" as "a franchise relationship that satisfies the following criteria when the relationship is created: (1) franchisee, any of the franchisee's current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business; and (2) parties have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total

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[32] *Id.*

[33] *Id.* at 15,526.

[34] *Id.* at 15,527.

[35] *Id.* at 15,526.

[36] *Id.* at 15,528.

[37] California Franchise Investment Law, CAL. CORP. CODE § 31106 (2011); MD. CODE REGS. 02.02.08.10(E) (2011); Wisconsin Franchise Investment Law, WISC. STAT. § 553.235 (2011).

[38] *See, e.g.,* New York Franchise Act which requires, *inter alia*, that the franchise business be operated from the same business location as the prospective franchisee's existing business. N.Y. CODE REGS, Title 13, §200.10(b)(3).

dollar volume in sales during the first year of operation."[39] "Fractional franchisees" are exempt from the disclosure requirements of the FTC Franchise Rule.

California, Illinois, Minnesota, New York, South Dakota, and Wisconsin[40] also exempt the offer and sale of "fractional franchises" from their respective pre-sale registration and disclosure requirements. However, some state laws define "fractional franchises" more narrowly than the FTC Rule and as a result, the fractional franchise exemption might not be available for the refranchise transaction.

IV. CONCLUSION

Refranchising is a useful tool for companies to transition to an asset light model, but there are important business and legal considerations. Depending on scope, refranchising can be quite complicated with many moving parts, requiring a business commitment to support the franchisees and sophisticated corporate and franchise counsel to navigate the myriad legal issues involved in these transactions.

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[39] 16 C.F.R. §436.1(g).

[40] *Id.* at § 436.2(a)(3)(i); California Franchise Investment Law, CAL. CORP. CODE § 31108 (2011); Illinois Franchise Disclosure Act, ILL. COMP. STAT. § 705/3; Ind. Code § 23-2-2.5-1(a) (2011); MINN. STAT. § 80C.03(f) (2011); Virginia Retail Franchising Act, VA. CODE ANN. § 13.1-559 (2011); Wisconsin Franchise Investment Law, WISC. STAT. § 553.22.

About the Authors

David W. Oppenheim is a Principal Shareholder at Greenberg Traurig, LLP. He concentrates his practice on domestic and international franchising, licensing and distribution matters. He advises both emerging and mature companies with respect to planning, structuring and implementing national and international franchise, distribution and licensing programs. David also represents private equity firms and public and private companies in the acquisition of franchise, licensing and distribution systems.

Paul Russell is Associate General Counsel with 7-Eleven, Inc. in Dallas, Texas. Paul has been with 7-Eleven since 2013 and currently oversees the company's domestic and international franchising legal matters covering approximately 49,000 franchised, licensed, or master franchised convenience stores.

Richard White is a Partner at Baker McKenzie LLP in Dallas, Texas. Richard has been with Baker McKenzie since 2011 and routinely advises and counsels clients on corporate transactions, with an emphasis on cross-border business transactions, commercial contracts, structuring international and domestic franchise transactions, and other corporate matters.