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# Advisory | Restaurant Industry

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# Preparing for a Restaurant Financing or Sale Transaction: Considerations for 2025

**Go-To Guide:**

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Restaurant leaders and investors enter 2025 with cautious transaction optimism. As expected, 2024 proved a challenging year for many restaurant groups. Inflation, new legislation in parts of the country (i.e., the FAST Act in California and elimination of the tip credit in some markets), cost-conscious consumers, and escalating labor and food costs kept operators scrambling on multiple fronts.

Although challenges may persist in 2025, the prevailing sentiment among some operators and investors is that the business climate will improve and transaction activity may increase.

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This may serve as welcome news for restaurant businesses seeking to engage in a sale or financing process.

As we focus on our New Year's resolutions, for those restaurant businesses contemplating a transaction in 2025, a commitment to getting your company in "transaction shape" is a worthy goal.

## The Importance of 'Restaurant Transaction Fitness'

As restaurant investors, buyers, and sellers know, a sale or financing transaction is more "marathon" than "sprint." Running a marathon without proper training and preparation is a recipe for failure, and the same is true for a restaurant finance or sale transaction process. Without proper preparation, the experience can be painful, and the transaction may stop short of the finish line.

In a sale or financing transaction process, a faster pace typically benefits the seller (the "seller" being restaurant operator raising funds or selling the business). After signing a letter of intent or similar document, leverage may shift to the investor/purchaser, and unexpected things could occur with the business or matters outside of its control that may impair or prevent the transaction.

Transaction efficiency has been particularly important in restaurant transactions the past several years. COVID-19 fundamentally altered the restaurant business like no other event since the Great Recession. Other factors, including rising interest rates, inflation, increasing labor, food and occupancy costs, the proliferation of third-party delivery, and intensified competition from other restaurants and non-restaurant food providers have dramatically changed how consumers enjoy and spend on food.

These significant changes, and others, have created additional risk and uncertainty for investors and purchasers, which has resulted in tempered investment enthusiasm and increased due diligence scrutiny in many transaction processes.

In sum, the past several years has further reinforced the benefits of "getting in shape" to transact. The more prepared a business is when it enters into a transaction, the greater the likelihood of the transaction closing, and on the desired terms.

- *Transaction Fitness Consideration #1: Assemble an Experienced Advisory Team*

An experienced advisory team, which often consists of an investment bank, accounting firm, and law firm, can help a restaurant business prepare for and navigate aspects of a transaction.

As with any industry, restaurant transactions present a variety of industry-specific and related business, legal, and operational issues.

Advisors with deep and relevant restaurant industry experience (including franchising experience when applicable) can provide a business with valuable support and help facilitate the desired outcome.

Assembling an advisory team at an early stage (i.e., before engaging in any substantive conversations with prospective investors and/or committing to a financing strategy) may yield transaction benefits.

- *Transaction Fitness Consideration #2: Be Proactive About Due Diligence*

Those experienced with transactional matters know that due diligence can be time-consuming and frustrating. It is similar to being on the receiving end of a home inspection, only more invasive.

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Instead of having a single inspector in your house for an afternoon, multiple attorneys, accountants and financial professionals, operational auditors, and others scrutinize every aspect of your business in a process that may take weeks or months.

Fortunately, due diligence is not a mystery. By anticipating the diligence information that an investor or buyer may request, businesses can assemble such information in advance, be prepared to address known concerns or issues, and be well-positioned to work expeditiously through a diligence process.

In restaurant transactions, investor/purchaser-side due diligence typically covers three areas: legal, financial, and operational.

This GT Advisory focuses on select areas of legal diligence. Businesses should consider discussing all aspects of diligence with their own advisory teams when exploring a transaction process.

If the business is working with an investment bank, the banking team would likely help assemble a diligence data room while planning to launch the financing or sale process.

The data room is often constructed around a comprehensive due diligence request, enabling the business to proceed efficiently with a populated data room once the process is underway. Note, a business can organize its own data room regardless of whether it has engaged an investment bank.

*Big Picture Pre-Transaction Process Diligence Considerations and Objectives*

- identify material issues pertaining to the business that may concern a buyer or investor;
- resolve or mitigate any such issues prior to launching a financing or sale process;
- develop and implement a strategy to address any such material issues that cannot be resolved before launching a process.

- *Transaction Fitness Consideration #3: Is Your Business Structure "In Shape" to Transact?*

A business structure that enables efficient and minimally complicated transactions is essential to facilitating a smooth transaction process. A business that is not structured to efficiently transact may create problems for both investors/buyers and sellers as it may cause significant delays, increase transaction costs, and lead to deal failure, among other things.

Accordingly, before embarking on a financing or sale process, it is important to understand if the business is structurally suited to facilitate the desired transaction.

Investors and acquirers typically prefer or require a "clean" structure for investment or acquisition. This may sometimes require a restructuring as a condition of investment or purchase, which could take considerable time and come at significant expense.

Common scenarios that suggest a restructuring and/or major changes may be needed before or in connection with a transaction include

- a restaurant business has multiple entities with varying ownership,
- a restaurant business has one or more entities taxed as an S corporation,
- a restaurant business needs critical assets transferred into it or excluded from it,
- a restaurant business utilizes a "cash flow" model as opposed to a "growth model," and

- a restaurant business includes a "management company" entity that is being compensated for "management services" by one or more operating entities.

If any of the above scenarios exist, an investor or purchaser may request or require some form of restructuring or major change before the transaction closes, and/or a restructuring may be desirable to the business and its existing stakeholders.

This assumes that the investor or purchaser is investing into and/or purchasing interests in the business enterprise (i.e., into a restaurant/restaurant group and not investing into and/or purchasing a single restaurant location).

### *Business Has Multiple Entities with Varying Ownership*

In the case of restaurant concepts utilizing multiple entities with diverse ownership, investors will often want the business "consolidated," with the individual entities becoming wholly owned by the investing or acquiring entity in connection with the transaction. Consolidation creates simplicity, efficiencies, and better positions sophisticated investors to achieve desired objectives in some growth-brand financing scenarios.

Absent such consolidation, underlying entities may be required to distribute operating profits to entity-level investors/partners. Most sophisticated growth-minded investors prefer that cash available for distribution be re-invested into the business to facilitate growth (i.e., toward opening new locations) and not distributed to investors. In a growth-minded business, the return to investors typically comes in a liquidity event (i.e., an IPO, subsequent purchase of equity in the business through the sale of the company, secondary equity sale, or similar event).

In addition, a structure with various entities with varying ownership presents administrative requirements and other potential challenges and conflicts that an investor/purchaser may not wish to inherit. In this case, a potential investor/ purchaser may require that the existing entities' equity holders have their interests rolled up and/or purchased in connection with the transaction.

A "roll up" and/or repurchase transaction involving existing investors implicates numerous critical legal and business issues that require careful planning and consideration. Not only do such efforts generate contractual, securities law, tax, accounting investor relations, valuation, and other considerations, but timing is also a key factor.

"Roll up" and/or repurchase transactions can often take several months or more to plan and implement. If a business has difficult and/or adversarial existing investors, additional time and effort may be required. A business with multiple entities of varying ownership contemplating a transaction process should consult with its advisory team well in advance of launching a financing or sale process.

### *Business Has One or More Entities Taxed As an S Corporation*

If a business has one or more operating entities taxed as an S corporation (including any LLCs that have elected to be taxed as S corporations), it is important to consult with legal and accounting tax advisors before engaging in a transaction process.

Businesses that have elected S corporation status come with a variety of limitations, including the inability to issue more than one class of equity, have entity investors (other than limited types) or have foreign investors. Given that some sophisticated restaurant financing/purchase transactions include both entity investors and a preferred class of equity, an S corporation is generally not viable for such investment. As

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such, an investment in and/or purchase of an entity taxed as an S corporation may come with undesirable tax consequences to the business and both the buying and selling parties. If a business has one or more entities that has elected S corporation status, a restructuring may be required before or in connection with the transaction to mitigate undesired tax consequences.

As with a "roll up" or repurchase transaction, whether and how to proceed with such a restructuring requires careful planning and analysis. While it is often possible to restructure an S corporation to facilitate a sale or investment transaction in a tax efficient manner, such a restructuring may add time and complexity to a transaction and may require the business to address items common to asset transfers, such as landlord consents and regulatory approvals (i.e. for transfer of licenses and permits), among others.

Businesses with S corporations in their structures should consult their advisory teams well in advance of any financing or sale process.

*Business Needs Critical Assets Transferred in Or Excluded*

Sophisticated investors/purchasers commonly want to own a portion of, or in the case of a 100% purchase, all the critical assets of the business being invested in or acquired. This means that such investors/purchasers are typically not receptive to any key assets being excluded from ownership.

As noted above in the section on consolidation, such exclusions can create a variety of complicated and undesirable issues for an investor/purchaser and impair or prevent the investor/purchaser's ability to achieve the desired objectives.

In addition to requesting or requiring restaurant entities with varying ownership to consolidate prior to closing a transaction, investors/purchasers may require that all other material assets, if not owned by the business being invested in or purchased, be transferred before closing. For example, absent rare circumstances, growth restaurant investors/purchasers will want to own all trademarks and other intellectual property of the business they are seeking to invest in or purchase.

However, investors and purchasers do not follow a uniform approach with respect to included and excluded assets. In some cases, an investor/purchaser may be willing to exclude certain assets or require that assets be excluded.

For example, if a growing fast casual restaurant business also operates full-service restaurants and a consumer packaged-goods business, an investor/purchaser may or may not want to acquire either of the other businesses, depending on the investor/purchaser's objectives and a variety of factors.

In the case of multi-concept restaurant companies, businesses and investors often struggle to decide whether to include all concepts in the transaction. If the investor/purchaser's primary and ultimate objective is to grow and sell one of the concepts in the brand portfolio, the other brands may have limited value. On the other hand, excluding other concepts from the transaction could create undesired consequences for both the investor/purchaser and the business.

If the businesses' key management team is managing day to day operation of all the brands, and the investor/purchaser would be relying on that management team to run and scale the growth brand following the transaction, excluding the other brands may create undesired operational complexities and issues.

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An investor/purchaser who desires existing management's full time and attention may want to include the other concepts in the transaction, or have a plan in place to wind down or sell those concepts following the transaction.

The transfer of key assets in and out of a business may implicate business and legal issues and warrants careful analysis and consideration. Businesses should consult with their respective advisory teams to develop a strategy around such assets before embarking on a financing or sale process.

*Business Utilizes a 'Cash Flow Model' As Opposed To a 'Growth Model'*

In a growth restaurant transaction with a sophisticated investor/purchaser, a restaurant business that utilizes a "cash flow model" may be required to transition to a "growth model" following the transaction's closing. Under a "cash flow model," the business makes regular profit distributions to investors. This is common with restaurants that have location-level investors.

As noted above in the section discussing pre-closing consolidation of businesses with varying investors across multiple entities, sophisticated growth-minded investors/purchasers prefer—and will often require—that the business follow a "growth model."

Under a "growth model," profits available for distribution to owners are not distributed to owners, but instead invested into the business' growth. While some sophisticated investors/purchasers may display some flexibility on profit distribution based on various factors, a "growth model" is the rule and a "cash flow model" the exception when it comes to investment in growth restaurant businesses.

Such a transition can create significant changes for a business operating under a "cash flow model," especially with respect to existing owners' compensation and income. Founders and owners who enjoy significant and predictable profit distributions under their current "cash flow model" may be required to sacrifice some or all such predictable payments under a "growth model." The prospect of such a dramatic change has caused some restaurant leaders/owners to elect not to proceed in a transaction with a growth-focused investor or buyer.

Many restaurant leaders and owners, on the other hand, may find comfort with the switch to a "growth model," especially if the transaction economics could meet impacted individuals' short and longer term personal financial needs.

Such "comfort" often comes from selling existing equity to the investor/purchaser, accompanied by a significant payment at closing. This payment could help mitigate the impact of cash distributions that may not be forthcoming until the business experiences another liquidity event, either from a public offering or sale to another investor.

*Business Includes a 'Management Company' Entity That Is Compensated For 'Management Services' by One Or More Operating Entities*

Many restaurant groups utilize a "management company" structure, which typically involves a separate legal entity engaged to provide services across one or more individual restaurants. This structure is common with restaurant businesses that operate multiple restaurants with varying ownership (i.e., restaurants with passive investors who own limited interests in the entities that own such restaurants). It is also common with restaurant businesses that utilize a "cash flow model" as discussed above.

The "management company" usually charges the restaurant entity a fee for such services (i.e., 5% of gross revenues), which serves as a compensation vehicle for the non-restaurant level personnel (i.e., the senior

management personnel/owners who provide services across multiple restaurants and do not work full time in any individual restaurant).

In a transaction with sophisticated restaurant investors/purchasers, the business will often be encouraged or required to discontinue a “management company” model and transition to employing (or engaging as consultants) individuals providing services to the business at market compensation (i.e., market salaries and bonuses). Sophisticated investors/buyers may prefer a more conventional and transparent general and administrative expense structure to ensure that key personnel are dedicated to the business being invested in or purchased.

For some restaurant businesses, such a transition is a non-issue. For others, especially when “management fee” compensation is above market standards, a transition to market compensation may be unattractive for individuals who are being compensated above market through this model.

- *Transaction Fitness Consideration #4: Getting Your House Ready for Inspection May Yield Benefits*

In residential real estate, buyers often pay a premium for a “move in ready” home—one that is free of material issues, where all systems are in good shape and functioning properly. The same rings true for restaurant finance or sale transactions. A business that is in good shape and passes financial, operational, and legal diligence inspection stands a better chance of attracting a higher price than a “fixer.”

Like making sensible investments in repairs and improvements before listing a home for sale, a restaurant business, without considerable expense or effort, can get best situated to “hit the market.”

With respect to legal diligence preparation for a restaurant business, certain parts of the “house” warrant significant pre-listing attention.

### A. Corporate and Company Documentation

Corporate and company documentation is the equivalent a home’s foundation. These are the agreements, records, and filings upon which the business is constructed. These documents memorialize the relationships between the businesses’ owners, set forth the governance structure, and establish the requirements and conditions for which all critical decisions are made.

Corporate and company documentation is central to any transaction diligence request. Among other things, investors/buyers need to confirm the business’ legal existence and good standing, understand that all consents and approvals have been obtained to proceed with the transaction, and otherwise guard against any unpleasant surprises.

Many restaurant businesses prioritize day to day business needs over aiming for a “gold star” in corporate documentation. But in some cases, deferred documentation matters could be handled with relative ease during the diligence preparation process.

- *Top Considerations*
  - Confirm the existence of complete, accurate, and signed agreements with all owners and equity holders. Undocumented relationships with any equity holders (or any people who may have been promised equity) could create significant problems during or after a transaction, including with respect to fundamental representations the business (and often key principals) will be required to make in the transaction documentation.

- Confirm the business' capitalization table(s) is up to date, complete, and accurate as supported by signed agreements. Typically, ownership and capitalization are categorized as fundamental representations with no expiration date and uncapped indemnification obligations.
- Make sure all the business' legal entities are current and in good standing in each applicable state.
- Take care of any additional entity filings that may be needed (including any foreign state authorizations, etc., as operations expand over time).
- Confirm that underlying corporate documentation is updated, complete, and properly executed (i.e., LLC operating agreements, shareholder agreements, and stock purchase agreements are on file and signed).
- Confirm that any equity (i.e., stock options and equity grants) or non-equity grants are complete and properly executed.
- Confirm that the company's capitalization chart is up to date, complete, and indisputably accurate.
- If arrangements with any individuals or equity holders need to be documented, document them as soon as possible. Failure to document could lead to many significant problems during and after a transaction process.
- Make sure the proper entity(s) hold the business assets (for example, if trademarks are held in the name of a founder and should be transferred to the company, make sure the assignment is finalized before beginning the transaction process).
- Confirm whether your current entity and tax structure will create transactional complexity or undesired tax consequences (i.e., pay particular attention if one or more of your entities is taxed as an S corporation).
- Does your business have any S corporations in its organizational structure? As discussed above, S corporations could present unique issues in transactions. Most issues can be addressed satisfactorily, but proper steps should be taken in advance to prevent undesired consequences and surprises.

## B. Intellectual Property/Trademarks

For a growing restaurant business, its intellectual property portfolio is typically one of its most valuable assets. Savvy investors and purchasers understand this and will want to ensure that the businesses' intellectually property is sufficiently protected and does not present undue risks or vulnerabilities for the business.

Intellectual property consists of four primary categories: 1) trademarks; 2) trade secrets; 3) patents; and 4) copyrights. With restaurants, trademarks typically have the greatest significance. A trademark is any word, slogan, symbol, design, or combination of those devices that identifies a restaurant and distinguishes it from others.

Typically, a restaurant business has many trademarks in its brand identity, including the name of the restaurant, its logos, its slogans and taglines, and often names of distinctive menu items. Even the interior or exterior design of a restaurant and shapes or colors of food packaging may function as trademarks.

Registering key aspects of a business' brand identity with the United States Patent and Trademark Office (USPTO) is an important step in securing potentially perpetual rights in a business' brand identity. Unlike patents and copyrights, trademarks never "expire" – they remain an exclusive right of the owner for as long as they are used.

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Given the hyper-competitive nature of the restaurant industry, trademarks play a critical role in protecting the value and public perception of a brand. For brands that franchise to third parties, the absence of federal registration of the business' principal marks may create liabilities, and investors and potential franchisees may be inclined to walk away (or demand indemnification) unless the marks are registered.

Enforcement of trademark rights is also important in maximizing the value of a business' brand. Investors want confirmation that copycats are not infringing a mark or that too many coexisting similar brands are not diluting brand significance. Incorporating a commercial watch service into the business' overall intellectual property strategy is a simple step that many businesses overlook, but one that may generate value.

Depending on the business, there may be important assets in the other intellectual property categories. For example, a restaurant concept may have proprietary recipes or confidential operations manuals that could be protected as trade secrets; mobile applications, websites, cookbooks, or other publications protected by copyright; or patented inventions related to the production of food items or services.

An investor in or acquirer of a restaurant brand will want confirmation – typically in the form of representations and warranties in binding agreements – that they are buying into an exclusive right to any critical intellectual property tied to the restaurant. If the restaurant does not own or clearly possess the right to use critical intellectual property, the value of the business could be compromised. As a result, a deal may fail unless the situation with the intellectual property can be rectified to the buyer/investor's satisfaction.

- *Top Considerations*
  - Ensure the business' intellectual property rights are protected. If new U.S. or international trademark filings are needed, explore clearance and registration as appropriate. The current wait time for trademark registration through the USPTO is approximately 12 to 18 months, but these rights can be obtained on an intent-to-use basis before a mark is used in commerce.
  - Work with intellectual property counsel to conduct an audit of the business' trademark and general intellectual property portfolio to identify strengths and weaknesses and advise where additional or more efficient registrations are needed to capture value and protect brand identity. This also includes a review of domain name registrations, social medial sites, and other-brand related matters that will be important to any investor/purchaser conducting diligence.
  - Confirm the business' most critical trademarks are federally registered. Typically, this means at least the name and logo of the restaurant, but it could also mean securing rights to the names of signature dishes, slogans, or the commercial look and feel of the restaurant, including restaurant design and food packaging. If the most important trademarks are not federally registered, work with trademark counsel to conduct a trademark clearance search and determine whether to file for federal registration.
  - If the business' most important trademarks are not currently capable of obtaining federal registration, work with trademark counsel on the best strategy, given the circumstances. There are a variety of reasons that may prevent a trademark from being registered (e.g., conflicts with one or more existing marks, the descriptiveness of the trademark, etc.). A customized approach for each business is necessary to work through these issues.
  - Even if key trademarks are federally registered, consider performing a comprehensive trademark search before a diligence process, especially if the business is aware of similar marks in areas where the business may expand. This would enable the business to identify potential issues in the

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landscape before diligence occurs and be positioned to resolve and/or speak intelligently about them during the diligence process.

- Initiate a tailored trademark watch program to be informed when third parties seek to register confusingly similar marks, to be able to take early appropriate action to avoid rights erosion and maximize an efficient maintenance of the business' valuable scope of rights.
- Work collaboratively with trademark counsel before rolling out new products or services to "clear" candidate names and proactively seek trademark protection on an intent-to-use basis before using the marks.
- Audit agreements with third parties and any past work to create intellectual property to ensure no other person or companies can claim any right, title, or ownership in any valuable intellectual property (absent any rights agreed upon and documented by contract).
- If the business engaged independent contractors to help create intellectual property (e.g., logos, design work, trade dress, etc.), catalog and confirm that any agreements with such contractors included work for hire provisions that vest ownership of all intellectual property in the business.

### C. Leases/Real Estate

Sophisticated restaurant investors and purchasers understand that in addition to intellectual property, real estate interests (often in the form of leasehold interests) may be some of a restaurant business' biggest assets-- or liabilities.

In most cases, restaurant locations are leased and not owned. If the business owns the real estate, a buyer may or may not expect the real estate to be included as a part of the transaction. At a minimum, a buyer may want a lease on market terms.

Generally, an investor/purchaser would favorably view profitable locations with long-term leases with reasonable occupancy costs in any transaction. On the other hand, expensive leases for unprofitable locations would typically be viewed unfavorably.

Before embarking on a sale or financing process, a business should objectively assess the strength of its real estate portfolio and measure that against market expectations.

Leases can also present important timing and contractual issues. Depending upon the transaction and certain lease provisions, the landlord's consent may be required for an investment or purchase. The proposed transaction may also trigger certain landlord rights, such as recapture rights and other termination rights.

While some leases contain clear and unambiguous language that help facilitate transactions (e.g., "permitted assignment" or "permitted transfer" provisions), many do not. It is important to understand whether landlord consent is required as early as possible in a transaction process.

- *Top Considerations*
  - Create abstracts for each of the leases with key business terms. This may help highlight each lease and facilitate the diligence process for the investor or buyer.
  - Assess each lease for any landlord notice or consent requirements. If consent is required, in addition to understanding any timing and information requirements, determine if seeking consent provides the landlord with the opportunity to renegotiate important terms or obligations under the lease.

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  - For successful locations with short remaining term length, consider negotiating an extension with the landlord prior to entering the transaction process.
  - For unprofitable locations, or locations with low margins, consider renegotiating terms with the landlord or negotiating a lease termination prior to launching the transaction process. If a lease can be terminated with little or no expense (i.e., no guarantees or parent company liability), termination could be a good option.

## D. Employees and Labor-Related Matters

Savvy investors and purchasers typically view both executive and store-level personnel as some of the most important assets of any restaurant business.

While some investors or buyers will want to make new hires in connection with a transaction, some may want to work with current executive talent in some form and for some period of time, depending upon the role, the type of investor (i.e., financial vs. strategic), and importance to the business' ongoing needs.

At the store level, an engaged and motivated workforce at a market labor cost will be viewed favorably in a transaction. On the other hand, high turnover in employment ranks, oversized executive-level, general, administrative, and store-level labor costs, and employment disputes or litigation (including locations' unionization efforts) may present material challenges to closing a transaction.

- *Top Considerations*
  - Conduct a privileged audit(s) to determine whether the business complies with all applicable federal, state, and local labor and employment laws, such as:
    - immigration and background check laws;
    - wage and hour laws, including payment of overtime, proper handling of meal periods, and rest breaks; and proper employee classification (i.e., exempt vs. non-exempt and employee vs. contractor);
    - sick leave and other paid/unpaid leaves;
    - bonuses and commission payments,
    - registrations to do business in all states in which the business has employees to ensure, for example, appropriate unemployment/workers' compensation coverage;
    - required record retention;
    - proper handling of tips and service charges as well as tip credits, where applicable;
    - accommodations and leaves of absence (i.e., Family Medical Leave Act, Americans with Disabilities Act, etc.);
    - non-competes and other restrictive covenants;
    - restaurant closings and mass layoffs (i.e., Worker Adjustment and Retraining Notification (WARN) Act); and
    - federal and state employee reporting laws (e.g., EEO-1 reporting and similar requirements under state law).
  - Compliance with applicable laws is a standard representation the business would be required to make in any transaction; therefore, it is important to identify any areas of potential non-compliance and seek to rectify them where possible before entering into a transaction. Conducting

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privileged audits on a routine basis (and not just in advance of a transaction) is not only a best practice, but it may be beneficial when the right business opportunity comes along, as any compliance issues or concerns would have already been identified (as opposed to being "surprised" during the due diligence process).

- Assess if the business has taken steps to mitigate risk and cost of employment litigation (i.e., by implementing strong lawful policies, and by using "at-will" employment acknowledgments, arbitration agreements with class action waivers, and timekeeping attestations).
- Assess the status of the existence of at-will or term employment agreements with any executives or other key personnel. If key personnel are not parties to a written employment agreement, work with employment counsel to document the relationship(s) where necessary.
- Evaluate any active, pending, or threatened employment litigation. If litigation is active or on the horizon, work with employment counsel to quantify the potential cost and timing of resolution. This is particularly important if any litigation is not covered by insurance, such as California-based Private Attorneys General Act claims, or uninsured wage and hour class actions. Costly and uninsured litigation will be of concern to any investor or purchaser, and steps a business takes to resolve the matter or mitigate the effect may not only mitigate legal risk and exposure, but also benefit a transaction materially.
- If any executive or other key persons will be active in the transaction process, consider whether any customized arrangement should be negotiated in advance of the process (i.e., any change-in-control and/or retention terms to stay on after a sale).
- Determine which employees are covered by any important restrictive covenants, including non-competes and non-solicitation provisions. Restrictive covenants are subject to regulation on a state-by-state basis, but can be particularly important with key executive personnel, as an investor or acquirer will have concerns over important employees departing, competing with the business, and raiding its talent.
- Ensure that any equity or non-equity incentive agreements with employees are current, documented, and accurate. Investors or acquirers will want to review the terms of any such agreements during diligence, and the failure to properly document such arrangements can have a material impact on a potential transaction, the employees at issue, and the business. Work with benefits and tax counsel to make sure such arrangements are properly finalized.
- Ensure employee handbooks and any federal, state, or city-required notices, forms, and mandatory disclosures are up-to-date and all locations comply with record-keeping and posting requirements.
- Assess potential unionization risk (if the business is not unionized) and ensure management has reported any potential organizing activity.

Purchasers will want to know they are not inheriting employment-related liabilities that could tarnish the brand's image, damage public relations, or bankrupt the company.

### E. Tax

Investment or purchase agreements include language requiring businesses to make comprehensive tax-related representations and warranties.

Buyers typically prefer to acquire or invest in businesses that are current with all tax obligations and have no material outstanding or looming tax issues. Whether the buyer ultimately accepts any pre-closing tax

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liabilities or risks depends on the transaction and negotiations circumstances, but a business may wish to proactively take a number of steps to avoid any tax surprises or complications.

- *Top Considerations*
  - Prepare an organizational chart of each legal entity and its tax classification (e.g., partnership, C corporation, S corporation).
  - Communicate with accounting and tax advisors regarding the transaction, as investors or acquirers will require the business to provide tax returns and other diligence materials.
  - Ensure that all pre-closing tax returns are timely filed.
  - Analyze with tax accountants whether the business has fully complied with all tax reporting requirements.

## F. Licenses and Permits

A purchase agreement will require a business to generally represent and warrant that it is operating with required licenses and permits, and that it is not at risk of losing any necessary licenses or permits. The business may also be required to include a list of all licenses and permits in a disclosure schedule that accompanies the purchase agreement.

With restaurants, licenses and permits generally include a number of important items, including licenses from the applicable health department, general business licenses, and, if alcohol is sold (and in cases of brewpubs or wine-focused restaurants that sometimes manufacture on- or off-site), necessary alcohol licenses.

Alcohol licenses present important and often unique transactional issues, including pre- or post-sale notice or transfer requirements with applicable licensing authorities. To make matters trickier, alcohol matters are regulated differently in each of the 50 states, making requirements varied and nuanced.

While many states have similar regulatory schemes, no state is the same. This includes the notorious "tied house" laws, designed during Prohibition and still in effect in every state today. Tied house laws serve in primary part to prevent alcohol manufacturers from also being alcohol retailers.

This is why we do not see venues branded with an alcohol brand selling that brand's products in the United States, absent specific circumstances and conditions. If a business is making and selling its own alcohol under a tied house exception that exists in one or more states, other states may preclude such activity, hindering expansion plans (along with valuation and the investor market).

For franchisor restaurant brands, licenses and permits are particularly important. Purchasers or investors will want to ensure, among other things, that the franchisor is properly registered and permitted in all states that require franchise registration (where the franchisor conducts business) and/or has filed for all exemptions or notices where required.

- *Top Considerations*
  - Confirm the business is operating under all required licenses and permits, and that all licenses and permits are current and in good standing with the applicable authority.
  - Create a schedule listing all business licenses and permits, as this may be required in a transaction.

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- If the business sells alcohol, ascertain any pre- or post-sale conditions that may exist in the states where it conducts business.
- If the business manufactures and sells its own alcohol (including if any alcohol is produced by a manufacturer with commonly held interests), consult with alcohol counsel about the applicability of tied house laws prior to embarking on the transaction process.
- If the business franchises, work with franchise counsel to ensure all necessary permits have been obtained and all filings are in order.

## G. Material Contracts

Diligence will require any selling party to provide signed copies of all "material contracts" and list them in a disclosure schedule. The definition of what constitutes a "material contract" could vary, but it typically means an agreement that requires a certain level of expenditure, cannot be terminated without paying a meaningful penalty, and has a term length beyond a certain time period.

This could include real estate leases, equipment leases, franchise and license agreements, music and video streaming services, joint venture agreements, loan or debt agreements, supply agreements, soda contracts, linen agreements, sanitation contracts, and a variety of different technology contracts.

- *Top Considerations*
  - Save time in advance of a transaction by organizing all agreements. This includes any agreements that may have been signed electronically (such as online by agreeing to terms and conditions).
  - Create a list of these agreements. As with permits and licenses, scheduling material agreements during a transaction can be time-consuming, taking attention and resources away from more important transaction items.
  - Assess the relative importance of the different agreements and the status of the business relationship with the counterparty. To the extent prospective investors see some agreements as a liability, consider what may be required to terminate them before the deal process.
  - If the business uses a contract template repetitively, consider updating that template to include best-practice terms that would not raise red flags in a prospective diligence process. Also consider standardizing negotiated fallbacks to ensure consistency across agreements.

## H. Information Privacy and Security Laws

Any investment or purchase agreement will require the business to represent and warrant that it is generally compliant with "information privacy and security laws." This is often defined along the lines of "all laws applicable to the [Business] that govern the privacy and security of Personal Information." Personal information includes details that can identify someone, such as names, addresses, or medical records. This also includes health information protected by HIPAA and data covered by state laws like the California Consumer Privacy Act.

In practice, this covers a wide breadth of information, including types businesses may consider "low risk" (like names and emails), and types not intuitively associated with personal information (such as IP addresses, device IDs, and other technical information).

Compliance with such laws has taken on greater transactional significance the past several years, a trend that may continue. A couple factors have contributed to the increased focus on privacy and security risks.

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First, most modern privacy laws require companies to maintain documentation that memorializes compliance with data privacy laws in the form of "data protection impact assessments" or "DPIAs." Some state laws, such as New Jersey's new privacy statute, mandate that any restaurant that accepts credit cards perform a DPIA. Many modern state privacy laws require DPIAs for the collection of precise location information or the use of targeted advertising technologies.

Second, the restaurant industry has experienced numerous high-profile data breaches, which have cost businesses large sums to resolve, as well as reputational harm. Additionally, non-compliance can lead to significant regulatory financial penalties. Investors and buyers may want to ensure that a business is not only compliant with these laws, but also has taken steps to best protect itself from costly liabilities.

- *Top Considerations*
  - Complete all required Data Protection Impact Assessments. For most restaurants, this may mean that at a minimum, DPIAs have been completed in order to use tracking technologies (e.g., cookies and pixels), collect credit card information, and use location-finder features on apps or websites (e.g., precise geolocation collection).
  - Update privacy policy and website terms of use to comply with new laws and best practices.
  - Review the business' mobile app to enhance compliance with all app store rules and prevent it from being pulled from the app store.
  - Review marketing practices (including email and SMS messaging) to enhance compliance.
  - Document information security practices in writing.

## I. Franchisors

Investing in or purchasing a restaurant business with franchised or licensed locations involves unique, additional due diligence considerations, especially if the revenues derived from the franchised restaurants are significant to the overall business. The primary assets in a franchised restaurant concept are the franchise agreements and the franchisees who own and operate the locations. Thus, the relationship between the franchisor and its franchisees is critical to the success of the franchise system, and a seller must be able to demonstrate that it has the infrastructure in place to establish and maintain a thriving franchised business that supports franchisees and is focused on franchisee compliance and profitability.

- *Top Considerations*
  - **Regulatory Compliance**: The offer and sale of franchises is regulated domestically and internationally. Failure to comply with franchise pre-sale registration and disclosure laws can expose a franchisor to liability and may even afford a franchisee a right to terminate its relationship with the franchisor.
  - **Franchise Disclosure Documents**: Federal and certain state laws require franchisors to provide a franchisee with an offering prospectus referred to as a franchise disclosure document (FDD) before offering or selling a franchise, unless an exemption applies. Likewise, many international jurisdictions have similar requirements. Therefore, sellers should organize copies of their current FDD and all historical FDDs used in connection with franchise offers and sales, including any international pre-sale franchise disclosure materials. Further, a seller must be able to show that it produces a FDD to a prospect in advance of the franchise sale. The seller should confirm that it has a signed FDD receipt from each current franchisee as presumptive evidence of timely disclosure in connection with each sale.

– **Franchise Sales Compliance**: In addition to the FDDs and pre-sale disclosure requirements, some jurisdictions in the United States and abroad also require some form of pre-sale registration with a governmental authority in advance of the offer or sale of a franchise. Buyers will evaluate whether the franchisor has maintained sound franchise sales practices and complied with all applicable pre-sale franchise and business opportunity laws, as well as international registration laws. Sellers should organize copies of registration orders from franchise registration states, exemption filings, and registration orders in any foreign jurisdictions and be prepared to produce a chart showing regulatory compliance in each jurisdiction over the past five years.

– **Franchise Agreements**: The franchisor's most valuable assets include its trademarks and intellectual property, which are licensed to the independent franchisees pursuant to a franchise agreement. Sellers should assess franchise agreements to ensure they provide broad rights for a franchisor to introduce new programs and system modifications, enforce compliance, and allow assignment without franchisee consent. A seller should review each franchise agreement to confirm that the agreements (and the exhibits) are fully executed. Expired or unsigned agreements should be addressed before going to market.

– **Royalty Stream/Revenues**: Buyers will assess the franchise system's economic health, including the royalty stream's viability. Sellers should prepare summaries of current royalty rates, account receivables, and any waived or reduced fees.

– **Development Pipeline and Growth Opportunities**: Buyers will evaluate the franchisor's sales and development pipeline. Sellers should identify growth opportunities and organize copies of agreements with franchise brokers or agents, summarize the franchisee sales pipeline, and detail any multi-unit franchisee development obligations, including an assessment of multi-unit operator compliance with the development obligations.

– **Franchisee-Franchisor Relationships, Defaults, and Terminations**: Buyers will assess the health of the franchise system, including the franchisor-franchisee relationship. Sellers should provide materials on terminated or voluntarily closed locations, franchisees in default and any franchisees planning to sell or close their franchises. Sellers should conduct one or more independent franchisee satisfaction surveys to identify any relationship issues and take steps to remedy them in advance of the sale process. If there has been an unusually high turnover rate in the system, the seller should be prepared to address this issue as part of the sale process. Finally, communications with franchisee associations and franchise advisory councils (FAC), if any, are also critical. If the system includes an association or FAC, the seller should compile notes and materials from meetings with these groups, as well as any recent correspondence between the association and the seller.

– **Franchisee Litigation and Arbitration**: Buyers will review the franchisor's litigation history, including types of claims and their outcomes. Sellers should organize copies of any litigation, claims, demands, complaints, or threats from franchisees or regulatory authorities.

– **Other Miscellaneous Franchise Diligence Items**: Additional areas include

- *Advertising Fund*: Sellers should provide a clear accounting of expenditures from the advertising fund over the last four years and confirm that all expenditures from the fund have been used for a lawful purpose.
- *Supply Chain Management*: Sellers should maintain a list of all mandatory suppliers and a schedule of commissions, discounts, rebates, or other remuneration it or any affiliates have received from suppliers or directly from franchisees based on franchisee purchases.
- *Insurance Compliance*: Sellers should collect certificates of insurance demonstrating franchisee compliance with required policies.

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- *Lease Step-In Rights*: Sellers should maintain leases for franchised locations, including lease riders granting the seller step-in rights under leases in situations where the franchise agreement has been terminated or expires. Control over the real estate is essential to maintaining a presence at the location long after the franchise relationship ends.

Organizing and addressing these areas may effectively prepare a franchisor for a due diligence process and address potential buyer concerns.

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