

## Due Diligence: The Key Ingredient in Restaurant M&A

***Due diligence on restaurant companies should factor in industry-specific legal and operational risks.***

Buyers acquire restaurant companies to access new brands, expand and diversify, or vertically integrate. Attractive target companies will have demonstrated an ability to weather pandemic-related closures and social-distancing limitations, as well as more recent inflationary pressures, supply chain disruptions, and a tight labor market. Determining whether a given company will meet both a buyer's and seller's objectives and enhance value in a sale requires an understanding of industry-specific legal and operational risks.

### Common Due Diligence Issues

Below is a summary of common due diligence issues in restaurant company acquisitions. Given the prevalence of representations and warranties insurance (RWI) in private company acquisitions, the summary highlights areas of heightened insurer underwriting relevant to restaurant M&A so that parties are better able to minimize policy exclusions that could undermine coverage of key risks.

#### Franchise Operations

Many restaurant companies franchise a significant number of their stores.<sup>1</sup> Franchisors are subject to federal and state franchising regulations, including the Federal Trade Commission's Franchise Disclosure Document (FDD) requirements.<sup>2</sup> Where the company is a franchisor, its revenues may largely consist of franchise royalties and ancillary fees (e.g., advertising or payment processing fees). The seller's representations and warranties will cover an array of topics regarding the business of the company, but generally do not extend to the operation of the restaurant business by franchisees (although the franchisees operate essentially the same restaurant business into which the buyer is investing indirectly).

Buyers and sellers will want to pay special attention to the company's franchise operations and the seller's representations and warranties regarding the company's franchisees. RWI insurers will focus on the information that is available regarding the company's franchising practices and franchisees to confirm there is a reasonable basis for the representations and warranties. The restaurant company may obtain important information from franchisees in due course, including, among other things, annual financial statements, proof of insurance, and inspection results. Buyers and sellers should work closely with each other to understand this information, as well as the representations and warranties that may be obtained (and insured) under the circumstances.

In addition to matters pertaining to the franchisor (such as regulatory compliance of the franchisor and its FDDs), representations and warranties may cover, among other things: (i) insolvency of franchisees, (ii) violations of franchise agreements, (iii) notification of termination of franchise agreements, (iv) litigation or other disputes with franchisees, and (v) labor strikes or similar labor disputes affecting franchisees. These representations and warranties may be limited to a specified number of top franchisees, and may be subject to knowledge qualifiers. Buyers should work closely with legal counsel experienced with RWI to determine and negotiate the insurability of key representations and warranties.<sup>3</sup>

Buyers and sellers should pay particular attention to the company's franchise royalty and fee stream structure. From a commercial perspective, a buyer will want to ensure that either the company's existing structure aligns with its expectations or that the buyer will be able to change the structure to suit its needs after closing (including by evaluating whether required franchisee consents could inhibit such changes).<sup>4</sup> Both parties also should review the accounting treatment of franchisee payments (e.g., whether any advance payments for franchisor services are accounted for as deferred revenue and the treatment of advertising fund contributions), including as part of negotiating working capital or other purchase price adjustments.

### **Supply Contracts**

A typical restaurant company will have entered into contracts with vendors of food ingredients, beverages, and other restaurant supplies. A buyer will want to understand the cost structure of the company's material supply contracts, as well as other terms (such as whether the contract includes exclusivity, most favored nation, or other restrictive provisions that could apply to other of the buyer's businesses). However, a given supply contract may include confidentiality provisions that limit the target company's ability to disclose the terms. A supplier may be especially concerned that a potential (or current) customer could learn about the terms it has provided to another party — which may be the case if the buyer already owns a restaurant business.

In addition, antitrust concerns may arise if the buyer and seller share competitively sensitive cost or other information. The buyer and seller will need to carefully consider the available approach to addressing confidentiality provisions and potential antitrust concerns, which, depending on the circumstances, could include entering into so-called "clean team agreements" (which limit disclosure of detailed information to certain parties uninvolved in pricing decisions), providing information in an aggregated fashion or seeking a waiver of the confidentiality provisions from suppliers.

### **Data Privacy and Security**

Restaurant companies are increasingly enhancing the dining experience and their connection to customers through a variety of methods, including through website ordering and mobile apps, which allow customers to order online and collect points that may be used for future orders. Various laws and regulations relating to the collection, use, and disclosure of information about individuals exist at both the federal and state levels and continue to be proposed and adopted. For example, a recent California law requires companies that handle information about state residents to make disclosures about their data collection, use, and sharing practices, and allow individuals the right to request copies of and deletion of personal information as well as to opt out of certain data sharing with third parties.<sup>5</sup> Several other states also have adopted, or are in the process of adopting, similar laws and regulations that will become effective in 2023 and onward.

In addition, storage of information about individuals increases a company's data security risks. Many companies encounter security breaches and other incidents, and disclosure of information about individuals such as customer data can lead to statutory, contractual, and other obligations to make

notifications to affected individuals, companies, insurers, and regulators as well as fines, lawsuits, reputational damage, and other negative consequences. Franchise agreements also may obligate a franchisor to provide its franchisees with the infrastructure to manage customer data. If a franchisor does not comply with these obligations, it may be required to refund the service fees franchisees paid for the management of such customer data. When acquiring a restaurant business, buyers must wade through a patchwork of overlapping but different laws relating to data privacy and security, as well as a variety of policies, contracts, and other documents that implicate data privacy issues. The parties should review the available information about the company's data security measures and any historic or ongoing security incidents.

### **Third-Party Delivery**

During the pandemic, many restaurants were forced to limit or prohibit dining-in due to public health restrictions. In response, many restaurant companies sought to bolster their revenues by fulfilling online orders through third-party delivery platforms. Companies incur fees or pay commissions for delivery orders, which may not be fully offset by increased pricing or additional fees that are passed on to the customer. Buyers and sellers should understand the cost structure of a company's agreements with third-party delivery platforms. As is the case with supply contracts, as noted above, third-party delivery platform companies strive to ensure that their commission rates are not shared.

### **Key Performance Indicators, Inflation, and Growth Strategy**

Among the key performance indicators for a restaurant company, a buyer may review the company's store profitability, store margins, average unit volumes (AUVs), same-store sales, and net new store openings. As discussed above, during the pandemic, restaurant companies increased sales through online orders. Buyers will compare AUVs and same-store sales performance for recent periods against those prior to the pandemic, keeping an eye on margin performance during the pandemic after taking into consideration the cost impact of third-party deliveries and other alternatives to dining-in. Parties also will review more recent margin performance, given that many restaurant companies have increased prices but nonetheless have faced margin compression due to inflation. A buyer and seller will want to discuss the company's growth strategy, including its plan for new store build-outs, addressable market, and financing plan. As a rationale for the acquisition, a buyer may seek to enhance the company's growth strategy by leveraging access to a lower cost of capital than the company is able to.

### **Lease Consents**

A restaurant company may be party to a significant number of real estate leases (for its stores, corporate offices, or other locations). Landlord consent may be required under the terms of various leases as a result of the acquisition of the restaurant company (e.g., due to the change of control of the lessee or assignment of the lease). Buyers and sellers will need to discuss the most appropriate approach to lease consents in the context of the acquisition. It may be impractical to obtain all lease consents prior to closing. Depending on the time between signing and closing, a buyer may require the target company to use commercially reasonable efforts to seek the lease consents and/or require that the receipt of lease consents under the more material leases is a condition to closing (e.g., in the case of the crown jewel restaurant locations or the headquarters).

In addition, the parties should consider obtaining estoppels from landlords under material leases to provide greater comfort on current terms, payment of rents, and absence of defaults. For transactions in which the buyer receives an indemnity, a buyer may request to be indemnified in the event issues arise with the landlord after closing due to the failure to obtain a lease consent. The parties may simply agree to forego

the receipt of consents, elect to close, and have the buyer discuss the matter with the landlords post-closing, especially in cases in which the buyer believes it can rely on its reputation for creditworthiness.

## **ESG**

Investors are placing a greater emphasis on environmental, social, and governance (ESG) issues. Buyers are increasingly conducting ESG reviews of target companies in connection with acquisitions. In the restaurant industry, ESG issues include energy and water consumption; food and packaging waste; product quality, safety and sourcing (e.g., GMOs and obesity concerns); nutritional transparency; human capital (e.g., livable wages, educational benefits, and other meaningful development opportunities for employees); diversity, equity, and inclusion; and humane treatment of animals.<sup>6</sup> A buyer that is a public company (or that may seek to take itself or the target company public) may want to pay special attention to the ESG dimensions of the target company. While RWI insurers do not currently cover “ESG” as a stand-alone category of loss, that practice may change over time.

## **Wage and Hour**

Because restaurant companies have a high number of non-exempt employees, they may be susceptible to government audits and class action wage and hour claims that allege that the employees were not properly paid for all hours worked and other wage and hour violations. RWI carriers tend to hone in on wage and hour compliance, including with respect to timekeeping, tip credits, tip pooling, exempt classifications, minimum wage, overtime pay, and meal and rest breaks. Absent assurances that such practices and materials were thoroughly reviewed and no potential issues or claims were uncovered, RWI carriers may exclude wage and hour matters from coverage. Buyers and sellers should focus on wage and hour compliance and keep an eye out for this exclusion, especially in cases in which RWI is the sole recourse.

## **Food Safety and Quality**

A restaurant company depends heavily on its reputation for food safety and quality. Restaurants are subject to state and local laws concerning food safety, including laws pertaining to employee hygiene, illness reporting, food handling practices, sanitation, and store inspections. A buyer will want to review inspection results and customer complaint logs to understand whether there are any concerning patterns as well as the terms of supply contracts to confirm that the company has adequate indemnity protection from suppliers of food products (e.g., in the event of a recall or quality issues). Parties should also review any assertions the company has made about its foods or ingredients that could be a source of false advertising or similar claims as well as whether it has complied with required caloric disclosures, if applicable.

## **Gift Cards**

Gift cards are commonly offered by restaurant companies. A number of state and federal laws govern gift cards, including laws relating to gift card expiration dates, dormancy fees, and transferability. The parties should confirm that the target company has carefully complied with these requirements. A restaurant company may also have significant unclaimed property or escheatment obligations and liabilities associated with unclaimed gift card balances. It is common for restaurant companies to engage service providers to manage their gift card programs. The parties should review the agreements with such providers to ensure that they do not include restrictive covenants or exclusivity obligations that would limit the buyer's ability to modify the gift card program after closing or apply to the buyer's other operations. Gift cards also may allow holders to redeem the gift cards at different restaurants, some of which may not be within the scope of the acquisition. In these cases, the buyer and seller may need to agree to honor

the gift cards at both sets of restaurants after closing, and to allocate the costs and expenses of gift card redemptions and administration as between the parties.

### **Liquor Licenses and “Tied-House” Laws**

A restaurant company that sells alcoholic beverages will be required to maintain licenses from applicable state governmental agencies (i.e., “liquor licenses”). Buyers will want to confirm the company’s compliance with laws relating to the sale of alcoholic beverages, including (a) whether the company’s liquor licenses are in full force and effect and the company is in compliance with the terms of the liquor licenses, (b) the absence of pending or threatened actions or proceedings by governmental agencies seeking to suspend, revoke, or cancel liquor licenses, and (c) whether the approval of governmental agencies is required with respect to liquor licenses as a result of the consummation of the acquisition. An analysis of a company’s liquor licensure compliance will vary by state. A buyer also should confirm the licensing requirements applicable to its directors and officers and that they are prepared to submit for licensing as required under applicable state law.

Each state has adopted “tied-house” laws that restrict certain investments between the three tiers of the alcoholic beverage industry: the manufacturing or supply tier, the wholesale tier, and the retail tier. Accordingly, under tied-house laws, an owner of a retailer of alcoholic beverages (such as a restaurant) generally is precluded from owning a producer or distributor of alcoholic beverages (and vice versa). For certain buyers (such as a private equity firm), tied-house laws could significantly limit the ability to acquire a restaurant company and therefore should be considered carefully (including whether an applicable exception applies).

### **Founder Matters**

Many restaurant companies are founder-led, and may bear the name of the founder. The founder also may be a key chef or have heavily inspired the company’s culinary offerings. If the founder will continue to be an important part of the business going forward, buyers should consider the means by which the founder will stay incentivized to assist the company after closing, including through rollover equity, re-vesting and holdback structures, employment agreements, morality clauses, and non-compete covenants. Founders should pay careful attention to the scope of the covenants that will apply to them after closing, given that the restaurant industry is vast and the covenants should not be overbroad. Buyers should consult legal counsel familiar with RWI for any impacts to coverage arising from material rollovers or similar structures. The parties should consider whether the company has the right to use the name, image, and likeness of the founder (even if only limited to references to the company’s history) and any other intellectual property of the founder, such as signature recipes. The parties also should consider the appropriateness of the use by founders of their name in competing or adjacent products or services to the extent doing so could cause consumer confusion.

### **Conclusion**

The key ingredient in restaurant M&A will differ case by case, and can be uncovered only through effective due diligence. The list of due diligence issues described above is not intended to be exhaustive. Buyers should consult experienced legal counsel for a full menu of potential issues.

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**Endnotes**

<sup>1</sup> According to the US Census Bureau 2021 report on franchising, there were 124,898 franchise organizations that were fast-food or limited-service restaurants in 2017.

<sup>2</sup> While FDD requirements differ by jurisdiction, they generally require that a franchisor provide potential franchisees with adequate disclosure regarding, among other things, the franchisor, the franchise, its business, operations and territories, fees and franchisor financial statements. Failure to provide franchisees with compliant FDDs may expose a franchisor to liability in the form of franchisee lawsuits, regulatory investigations or enforcement actions and may result in disgorgement of royalties.

<sup>3</sup> In addition to conducting due diligence on the operations of the target company and its franchisees separately, a buyer also should examine the company's and its franchisees' practices to determine whether they could have joint employer liability. If a franchisor and franchisee are determined to be joint employers, each could be held liable for the other's labor and employment violations under the Fair Labor Standards Act.

<sup>4</sup> Although acquisitions of franchisees generally are beyond the scope of this Client Alert, note that buyers of restaurant franchisees should analyze any consents that are required under applicable franchise agreements. For example, in addition to franchisor consent for the sale of the franchisee, a franchise agreement may place restrictions on the franchisee that could be inconsistent

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with the buyer's post-closing plans, including limitations on the incurrence of indebtedness, restrictions on re-branding the business, non-competition provisions, and other restrictions.

<sup>5</sup> See the California Privacy Act of 2018.

<sup>6</sup> See Looking at Restaurants Through an ESG Lens, available at <https://ca.rbcwealthmanagement.com/documents/361977/361993/Looking+at+Restaurants+through+an+ESG+lens.pdf/bf422507-5082-4ec4-bc7f-f6c8e96e5a18>.