

## Get Your Restaurant Business Fit to Transact in 2023

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2023 is expected to be a stronger transaction market than the past few years for mergers, acquisitions, and majority and minority investments. Indicators suggest that the market for restaurant transactions is starting to return to some semblance of normal following the material impact of the COVID-19 pandemic. However, some concerns and headwinds are still in play, impacting how investors and buyers view the market, including inflation, supply chain issues, workforce and labor issues, and newly enacted or pending legislation (such as the California FAST Act).

### The Importance of ‘Transaction Fitness’

As business investors, buyers, and sellers know, a transaction can be more like a marathon than a sprint. In the running world, one would be ill-advised to jump underprepared into a race of any length, especially a long one. The same rings true for transactions.

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In transactions, time typically is not on anyone's side, especially sellers. After signing a letter of intent or similar document, leverage can shift to the buyer, and unexpected things can happen. This has been apparent in restaurant transactions over the past three crazy years. COVID-19 materially impacted the transaction market, but a variety of other occurrences also created deal challenges. The latter half of 2022 saw numerous transactions stall, fall apart, or get re-traded due to the financial impact of commodity increases (e.g., chicken), inflation generally, and a more cost-conscious consumer, among other things.

In sum, the past three years have further reinforced the benefits of "getting in shape" to transact. The more prepared you are before a letter of intent is signed, the greater the likelihood of the deal closing, and on favorable terms.

- *Fitness Consideration #1: Be Proactive About Due Diligence.*

Those experienced with transactional matters know due diligence can be time-consuming, frustrating, and unnerving. It's similar to signing a contract to sell your house, only on a larger scale. Instead of having a one or two home inspectors looking for problems after you reach terms, you have multiple attorneys, accountants/financial professionals, operational auditors and others looking into every aspect of your business. An initial comprehensive diligence request may lead to multiple supplemental diligence requests, which take additional time and resources to respond to.

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

In restaurant transactions, diligence typically covers three principal areas: 1) legal, 2) financial, and 3) operational. This GT Alert focuses on legal diligence. It does not purport to cover all areas of legal diligence; rather, it covers a select number of key areas particular importance in restaurant transactions.

If you are working with an investment bank, your banker will likely help you assemble a diligence data room while you are planning to launch the financing or sale process. The data room is often constructed around a comprehensive due diligence request, so you can hit the ground running with a populated data room once the process is underway. You do not need to be working with a banker to organize a data room.

#### Overarching Considerations:

- Identify any material issues that may concern a buyer or investor;
- Resolve or mitigate any issues that you can before launching a financing or sale process;
- Have a strategy to address any material issues that cannot be resolved prior to launching a

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process; (i.e., a recently filed class action employment lawsuit).

- *Fitness Consideration #2: Understand if the Structure of your Business is “In Shape” to Transact.*

Prior to embarking on a financing or sale process, it is important to understand if your business is structurally suited to facilitate the desired transaction. Investors and acquirers prefer a clean structure for investment or acquisition and will sometimes require a restructuring to occur as a condition of investment or purchase. If a business is structured to include multiple legal entities with diverse ownership (as is common with many restaurant groups) or has one or more entities taxed as S-corporations, a pre-transaction restructuring may be necessary or recommended.

In the case of restaurant concepts utilizing multiple entities with diverse ownership, investors may want the business consolidated with the individual entities becoming wholly owned by the investing or acquiring entity in connection with the transaction. This typically means that the equity holders of the existing entities must have their interests rolled up and/or bought out in connection with the transaction. The foregoing may be facilitated by language included in a business’ underlying documents. Some businesses have governing documents that provide a clear path for a larger transaction (i.e., drag-along rights or other similar provisions), but many do not. Regardless of provisions in the underlying documents, a buyout and/or roll-up can trigger sensitive investor relations and implicate a number of legal and tax issues that require careful analysis and a sound strategy to ensure that a restructuring can be accomplished most efficiently.

- *Fitness Consideration #3: Focus on Your ‘Core’*

In sports, an important focus is one’s core. A strong core supports the health and ongoing success of an athlete. Similarly, in the context of restaurants, there are certain core areas of particular importance in restaurant transactions. As noted above, this GT Alert does not purport to cover all areas of legal diligence.

## **A. Corporate/Company Documentation**

Corporate/company documentation is not only critical to one’s operating business but also central to any transaction and diligence request. Make sure you have complete, accurate, and signed agreements with all owners/equity holders. Undocumented relationships with any equity holders (or any people who may have been promised equity) can create deal problems, including with respect to fundamental representations the business (and often key principals) will be required to make in the transaction documentation. Along the same lines, make sure your capitalization table is up to date, complete, and indisputably accurate as supported by signed agreements. Typically, ownership and capitalization are categorized as fundamental representations with no expiration date and uncapped indemnification obligations.

- *Top Considerations:*

— Make sure each legal entity of the

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business is 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 you expand operations over time);
- Confirm that underlying corporate documentation is updated, complete, and properly executed (i.e., LLC operating agreements, shareholder agreements, stock purchase agreements are on file and signed);
- Confirm that any equity (i.e., stock options/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. This is an area where there is no tolerance for risk or error. If arrangements need to be documented, get them signed sooner than later (lest any party exert undue leverage upon realizing they could hold up a valuable transaction by not cooperating);
- Make sure the assets of your business are held by the proper entity(s) (e.g., if trademarks are in the name of a founder and should be transferred to the company, make sure the assignment is finalized before embarking on the transaction process);
- Ascertain whether your current entity/tax structure will create transactional complexity or undesired tax consequences (i.e., pay particular attention if one or

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more of your entities is taxed as an S-corporation);

- Does your business have any S-corporations in its organizational structure? Per the bullet above, S-corporations can present unique issues in transactions. Most of these can be addressed satisfactorily, but proper steps need to be taken in advance to prevent undesired consequences and surprises.

## **B. Intellectual Property/Trademarks**

Intellectual property consists of four primary categories: 1) trademarks; 2) trade secrets; 3) patents; and 4) copyrights. With restaurants, trademarks typically are of the greatest significance. A trademark is any word, slogan, symbol, design, or combination of those devices that identifies a restaurant and distinguishes it from other restaurants. Typically, a restaurant has many trademarks in its brand identity: the name of the restaurant, its logos, its slogans, and the names of its specialty food items. Even the interior design of a restaurant and shapes or colors of food packaging may function as trademarks.

Registering key aspects of your brand identity with the United States Patent and Trademark Office (USPTO) is an essential step in securing potentially perpetual rights in your brand's identity, because trademarks never "expire" – they remain an exclusive right for as long as they are used. Given the hyper-competitive nature of the restaurant industry, trademarks play a critical role in protecting the value and public perception of your brand. If you are a franchisor, the absence of federal registration of your 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 your trademark rights is also important in maximizing the value of your brand. Investors want confirmation that there is no ongoing infringement of a mark by copycats or dilution of brand significance by too many coexisting similar brands. Having a commercial watch service in place is a simple step that most restaurants overlook but would benefit from incorporating into their overall intellectual property strategy.

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 are protected as trade secrets, mobile applications, websites, or 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 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 will be compromised, and a once promising deal may fall through unless the situation can be rectified.

- *Top Considerations:*

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- Don't delay evaluating your intellectual property and pursuing rights. The current wait time for trademark registration through the U.S. government is approximately one year to 18 months, but these rights can be obtained on an intent-to-use basis, well before a mark is ever used.
  - Engage trademark counsel to conduct an audit of your trademark portfolio to identify strengths and weaknesses and advise where additional or more efficient registrations are needed to capture value and protect your brand identity.
  - Make sure your most important trademarks are federally registered. Typically, this means at least the name and logo of the restaurant, but it can also mean securing rights to the names of signature dishes, slogans, or even 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 your most important trademarks are not currently capable of obtaining federal registration, work with trademark counsel on the best strategy given the circumstances preventing registrations. There are a variety of reasons that can prevent a trademark from being registered (e.g., conflicts with one or more existing marks, the descriptiveness of the trademark,

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etc.). A customized approach for each business is necessary to work through these issues.

- Even if your key trademarks are federally registered, consider performing a comprehensive trademark search in advance of a diligence process, especially if you are aware of similar marks in areas where the business may expand. This will enable the business to identify potential issues in the 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, giving the brand owner the ability to take early appropriate action to avoid an erosion of rights and maximize an efficient maintenance of its valuable scope of rights.
- Work collaboratively with trademark counsel in advance of rolling out new products or services to “clear” candidate names and proactively seek trademark protection on an intent-to-use basis before the marks are used.
- Audit your 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 of your valuable intellectual property (absent any rights agreed upon and documented by contract). If your business engaged independent contractors to help

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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**

Restaurant location is critical, and a restaurant's real estate portfolio can be one of the most important and valuable assets. In most cases, a restaurant's premises is leased and not owned. If the business owns the real estate, a buyer may expect the real estate to be included as a part of the transaction. At a minimum, a buyer will want a lease on market terms. Profitable locations with long-term leases containing reasonable occupancy costs will be viewed favorably by the buyer in any transaction. On the other hand, locations that are unprofitable or with poor margins and are stuck in expensive leases will 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.

Also, leases can present important timing and contractual issues. Depending upon the transaction and the language contained within the lease, the landlord's consent may be required for an investment or purchase, and other landlord rights may be triggered including recapture rights and other termination rights. While some leases contain language that help facilitate transactions (e.g., "permitted assignment" or "permitted transfer" provisions), many do not, and it is important to understand whether consent may be required under the lease before entering a transaction process.

- *Top Considerations:*

- Create abstracts for each lease with key business terms. This will help you best understand each lease and facilitate a 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;
- For successful locations with short



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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 Related People/Labor Matters**

People are one of the most important assets of any restaurant group, including both executive and store-level personnel. While some investors or buyers will want to make new hires in connection with a transaction, many will 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 ongoing needs of the business. 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 the employment ranks, oversized executive-level general and administrative and store-level labor costs, and employment disputes/litigation (including efforts by locations to unionize) may present material challenges to closing a transaction.

- *Top Considerations:*

- 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 (PAGA) 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 can benefit a transaction materially;
- Assess if the business has taken

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steps to mitigate risk and cost of employment litigation (i.e., through the use of “at-will” employment agreements with class action waivers and arbitration clauses with all key employees, where permitted by law);

- Determine whether the business is compliant with all applicable federal, state, and local employment laws (e.g., wage and hour laws including payment of overtime, meal periods, and rest breaks, proper classification of employees (i.e., exempt vs. non-exempt and employee vs. contractor), and leaves of absence (i.e., Family Medical Leave Act (FMLA), Americans with Disabilities Act (ADA), etc.). Compliance with applicable law is a standard representation the business will be required to make in any transaction; therefore, it is important to identify any areas of non-compliance and rectify them where possible before entering a transaction;
- 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;
- 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 retention terms to stay on after a sale);

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- 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 and competing with the business and raiding its talent;
  - Ensure that any equity or non-equity incentive agreements with employees are current, documented, and accurate. Any investor or acquirer 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 finalized properly;
  - Ensure employee handbooks and any state-required forms are up-to-date and all locations are compliant with record-keeping and posting requirements;
  - Assess the risk of potential unionization and ensure management has reported any potential unionizing activity.

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

## **E. Tax**

Every investment or purchase agreement will include language requiring the business to make comprehensive tax-related representations and warranties. Buyers naturally prefer to acquire or

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invest in businesses that are current with all tax obligations with no material outstanding or looming tax issues. Whether the buyer ultimately accepts any pre-closing tax liabilities or risks depends on the circumstances of the transaction and negotiations, but a business may wish to proactively take a number of steps to avoid surprises and complications in a transaction.

- *Top Considerations:*

- Prepare an organization 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 any investor or acquirer will require them to provide tax returns and other diligence materials.
- Ensure that all pre-closing tax returns are timely filed.
- Assess with tax accountants whether the business has fully complied with all tax reporting requirements.

## **F. Licenses & Permits**

Every purchase agreement will require a business to generally represent and warrant that it is operating with required licenses and permits, and that no necessary licenses or permits are at risk of loss. In most cases, the business will 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 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 don’t 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, many other states may preclude such activity, hindering expansion plans (along with valuation and the market for investors).

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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/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 that your 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;
- If you wish to get ahead of the game, create a schedule listing all of your licenses and permits, as this will likely be required in a transaction;
- If your business sells alcohol, ascertain any pre- or post-sale conditions that may exist in the states where you are conducting business;
- If your business manufactures and sells its own alcohol (including if any alcohol is produced by a manufacturer with commonly held interests) consult with experienced alcohol counsel about the applicability of tied house laws prior to embarking on the transaction process;
- If your 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 likely to list them in a disclosure schedule. The definition of what constitutes a “material contract” can 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, etc. This

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can include real estate leases, equipment leases, franchise and license agreements, music and video streaming services, joint venture agreements, loan/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 some agreements may be seen as a liability by prospective investors, consider what may be required to terminate them before the deal process;
- If you use a contract template repetitively, consider updating that template to include best-practice terms that will not raise red flags in a perspective 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.” Often this is defined along the lines of “all laws applicable to the [Business] that govern the privacy and security of Personal Information” (meaning personally identifiable information in the custody or control of the business pertaining to an individual that is regulated or protected by one or more federal or state information privacy or security

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laws, including “Protected Health Information” as that term is defined under HIPAA, including the California Consumer Privacy Act.)

It’s important to note that in practice this covers a wide breadth of information, including types you may consider “low risk” (like names and emails) and types not intuitively personal information (such as IP address, device ID, and other technical information).

Compliance with such laws has taken on greater transactional significance the past several years, a trend expected to continue. The restaurant industry recently has observed many high-profile data breach cases, which have cost businesses large sums to resolve as well as untold reputational harm. Additionally, non-compliance can lead to significant regulatory financial penalties. Investors and buyers 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:*

- Implement or review your privacy and security practices, as compliance is complex. Smaller entities will also benefit from implementing basic practices;
- Update your privacy policy and website terms of use to comply with new laws and best practices;
- Review your mobile app to ensure compliance with all app store rules and prevent your app from being pulled from the app store;
- Review your marketing practices (including email and SMS messaging) to ensure compliance;
- Document your information security practices in writing.

*Kelsey E. Lam, Kellen G. Luey, Jacob M. Abdo, Joseph J. Curran, Alicia Sienne Voltmer, and Tyler J. Thompson also contributed to this article.*

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