FINANCING, LIQUIDITY AND GROWTH CAPITAL TOOLS
FROM TRADITIONAL LENDING TO PRIVATE EQUITY AND
VENTURE CAPITAL

Kenneth R. Costello
Bryan Cave LLP
and
H. Scott Pressly
Van Ness Capital Advisors, Inc

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I. INTRODUCTION.

From conventional bank debt to complex securitizations to private equity and venture capital, financing plays an important role in franchising, not only in facilitating large scale acquisitions, but also in providing liquidity and growth capital for franchisors and franchisees. This paper will focus on financing expansion and acquisition of franchisors and large multi-unit franchisees, primarily. The authors will highlight why a franchisor or multi-unit franchisee may consider an outside capital investment (such as from a private equity firm); what major capital options are available (in addition to private equity); the advantages and disadvantages of each type of outside capital; and how an outside investor values a franchise business (franchisor and franchisee). The paper will also discuss specific legal considerations in situations where lenders to franchisees seek to take a security interest in the franchise agreements under which they operate, as well as due diligence, disclosure and documentation. Finally, it will describe what to expect in the financing process (including financings involving the sale of the business).

II. PRIMARY REASONS FOR CONSIDERING OUTSIDE CAPITAL.

There are three primary reasons a franchisor or multi-unit franchisee might consider an outside capital investment:

A) Liquidity for founders and shareholders
B) Capital to accelerate the growth of the company
C) Combination of liquidity and growth capital

A. Liquidity.

For established franchisors and multi-unit franchisees, the ultimate reason to seek outside capital is for liquidity, though it is also necessary to fuel growth along the way. Whether for the original founders or subsequent investors that have helped fuel the growth of the company, outside capital can provide the ‘big payday’ rewarding years of hard work. In addition, often times, owners and senior executives have all or a substantial portion of their net worth tied into the franchise business and may want to consider asset diversification. An outside investment can allow the owner and shareholders to ‘cash out’ partially or completely from the company in an effort to diversify their own investment portfolio. Outside capital can also allow for an orderly transition of generational ownership within a family.

B. Growth Capital.

On the other hand, for emerging companies, outside capital can allow the franchisor or multi-unit franchisee to build and expand its infrastructure in areas such as senior management, training, marketing, operations, and technology. In addition growth capital can provide the resources for the construction or acquisition of new units for a multi-unit franchisee or to help facilitate the strategic acquisition of a competitor or new line of business for a franchisor. And in many instances, bringing in outside capital means bringing in a ‘partner’ that can provide many additional benefits such as developing stock option plans for senior management, hiring key employees and new relationships via access to their Rolodex.

C. Combination.

In many cases, franchisors seeking outside capital are looking for a combination of growth capital and liquidity. In franchising, it is frequently the case that the franchise concept is born,
nurtured and matured under the leadership of the founder, but there comes a time when the founder’s skills, vision or resources become taxed, and the need arises for a combination of liquidity and additional growth capital. Quite often, the founder is looking to take ‘some chips off the table’ while still maintaining a meaningful equity position for a ‘second bite at the apple’ in a future liquidity event. Often this is the best scenario for the founder and the outside investor – the founder can diversify his personal holdings and bring on a partner that can accelerate the growth of his business, while the outside investor can back an experienced entrepreneur to even further expand the concept. Each deal is as unique as the entrepreneur who developed the brand.

III. CONSIDERING THE OPTIONS.

With the capital markets so robust, franchisors and multi-unit franchisees have numerous options for growth capital and liquidity. But it is essential to consider every investment and the sources very carefully – there is no standard approach and each option carries its own pros and cons. The following are the major buckets of outside capital for franchisors and franchisees:

- A) Seed money / Venture capital
- B) Bank debt
- C) Public equity markets (IPO)
- D) Strategic buyer
- E) Private equity

A. Seed Money / Venture Capital.

Accessing outside capital for emerging franchisors or multi-unit franchisees has historically been, and unfortunately remains, the most challenging stage for most franchise companies. A franchisor’s or multi-unit franchisee’s early stage is, by definition, inefficient and unpredictable, and institutional equity (i.e. from traditional venture capital firms) is reserved for a special few. Even with the surge in private equity, small franchisors and franchisees still struggle to get the critical growth capital to invest in their concept.

Venture capital garners its fame from the technology boom in the 1990s. Many venture capital firms provided ‘seed’ money to promising internet start-ups. However, since the technology bubble burst, venture capital is not so easy to find, especially for franchise concepts. Even today, start-up monies in the franchise sector are more likely to come from the owner’s personal savings, friends and family, and local angel investors in the entrepreneur’s community. For single unit franchisees friends and family are generally the only option available but multi-unit operators can occasionally access the local angel community. While there is rarely a defined list of angel investors one can pull down off the internet, networking within the legal community and through successful private bankers who target high-net worth individuals are good places to start.

Unfortunately, in many instances, founders of franchise concepts are reluctant to bring in outside capital for fear of ownership dilution. Our observations suggest that maximizing long term shareholder value has more to do with execution than ownership percentages. The fear of dilution has caused many common capitalization mistakes which severely restrict future growth and liquidity options. Venture capital firms generally do not require a majority position in the company (whereas, private equity firms generally, do) but will hold the entrepreneur accountable for his or her actions. The combination of external accountability and access to
new contacts and resources often gives an emerging company a better chance of success than otherwise would be the case if they were to continue to develop on their own.

B. Bank Debt.

Bank debt is the cheapest form of capital to obtain, if available, since there is no equity dilution. It is a direct loan made by a bank granted based on the company’s assets and cash flow. As long as monthly payments are timely made, banks require limited reporting and correspondence and their due diligence process is typically not as intensive as that of an equity investor.

Although a straightforward process, timing and access can be somewhat challenging, and the borrower needs to have sufficient immediate cash flow to pay interest (whereas equity investors may be more patient). One of the greatest paradoxes is it is much easier to get a loan when you need it least and more difficult when you need it most. This again suggests that, if available, taking slightly more capital than you think you may need from an outside source, even at the risk of equity dilution or additional interest payments, is usually worth considering.

In addition, lenders usually require restrictive covenants and/or personal guarantees from an owner and they rarely bring more to the table than cash. They also may not understand the franchising (in most cases the assets of the franchisor are franchise agreements versus typical bricks and mortar and “hard assets” that they are more comfortable lending against) causing a longer due diligence process, more conservative debt levels and decreased certainty of funding. Even though franchisees acquire hard assets, they are of substantially less value when separated from the rights granted by the franchise agreement. And finally, remember bank debt cuts both ways; aptly-termed ‘leverage,’ it can work well when times are good but can cause problems when trends are not so positive.

C. Public equity markets.

The public equity markets are the most understood and publicized form of outside capital but also historically the hardest to access. With limited numbers of initial public offerings (IPOs) each year (only 155 operating companies went public in 2006 across all industries, with 28% of those being technology companies1), statistically speaking, it is an improbable option for most franchisors and multi-unit franchisees. In addition, public offerings are generally limited to larger companies – from 2001 to 2006 (i.e. post internet bubble), 68% of all IPOs involved companies whose trailing twelve month revenues exceeded $50 million2, which is generally larger than most franchisors.

For those who can successfully access the public markets, and whose concept stays in favor with investors, they can have an unlimited source of growth capital to fuel future expansion. In addition, they can attract top managerial talent with lucrative stock options and equity packages. Companies such as McDonald’s, Burger King, IHOP, Starbucks and Chipotle have been very successful as public companies and have grown into iconic brands in the marketplace.

Although the public markets generally have been reserved for franchisors because of their higher sustainable growth potential, an IPO exit is a potential option for a large multi-unit franchisee as evidenced by the recent IPO of Carrols Restaurant Group (NASDAQ:TAST), the

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2 Id. at 14.
largest Burger King franchisee with over 300 locations. In addition, Morgan’s Foods (NASDAQ:MRFD.OB) is a public Taco Bell and KFC franchisee that has experienced material share appreciation over the past two years.

Unfortunately the public markets can also be unpredictable and very unforgiving. Investors are overly focused on quarterly earnings with short-term results sometimes clouding long-term corporate reinvestment decisions. And when performance does not meet projections, fickle investors can lose confidence, immediately impacting the company’s stock price. Recovery, even if the reason for missing projections was out of your control, can take multiple quarters, if at all.

In addition to the short-term focus of public shareholders, there are other issues to consider before going public (and these same considerations are driving many public companies to go private). Sarbanes-Oxley continues to impose increased compliance costs (e.g., internal compliance expenses, auditing fees, investor disclosure, and public relations costs) and is also creating an increasing mental distraction for senior management. As a result, CEOs and CFOs are spending a disproportionate time on compliance, analyst calls and conferences, and preparing quarterly and annual reports instead of doing what they do best – running their businesses. In addition, directors and officers of public companies continue to be exposed to increased personal liability (i.e., continuing corporate scandals involving AIG, Healthsout, and Refco).

More recently CEOs of public companies have had a new distraction to deal with – hedge funds. Hedge funds are similar to private equity funds in many respects. Both are lightly regulated, private pools of capital that invest in securities and compensate their managers with a share of the fund’s profits. Most hedge funds invest in very liquid assets (i.e., public securities), and permit investors to enter or leave the fund easily while private equity funds invest primarily in very illiquid assets (i.e. private companies) and so investors are ‘locked in’ for the entire term of the fund.

Hedge funds have gained notoriety recently for their investments in public restaurant companies such as Wendy’s and Outback Steakhouse. Their demands usually center around a short-term liquidity solution that could potentially result in an increased stock price or one-time dividend through selling real estate for company owned locations or selling off emerging concepts. For example, Norman Peltz’s group, Trian Fund Management LP, pressured Wendy’s to spin off its Tim Hortons coffee-and-doughnut shop chain. Once a hedge fund extracts its payout from the company it usually sells its shares and moves on to the next target – leaving senior management with the challenges of actually running the day-to-day operations, potentially in a more challenging environment or capital structure than before the hedge fund invested.

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D. Strategic Buyer.

Another form of outside capital is to be purchased by a ‘strategic’ buyer. Strategic buyers usually have an existing presence in the target company’s industry (they could be a competitor or have a complementary product line or distribution channel) or in the case of a multi-unit franchisee have material ‘back office’ synergies such as purchasing, accounting, information systems and human resources, sometimes associated with other franchised concepts that the strategic buyer already operates.

Historically, strategic buyers have paid the highest price for franchisors and multi-unit franchisees because of the ‘synergies’ they can realize from the acquisition. They also generally provide immediate liquidity for shareholders and usually require less due diligence than investments from private equity firms.

Unfortunately, synergy is usually another word for overhead reduction and in most cases the target’s management team is materially decreased or eliminated. In addition, interest by strategic buyers is very cyclical. In the early 2000s, Wendy’s and McDonalds were on a buying spree providing full liquidity for owners of concepts such as Baja Fresh, Pasta Pomodora, Donato’s, Fazzoli’s and Chipotle. Today is just the opposite – the large burger chains are selling off these investments (usually at a substantial discount to the original purchase price – Baja Fresh was purchased for $275 million and recently sold for $31 million) and focusing on their core brands. Of all of these purchases, arguably only Chipotle turned out to be successful.

E. Private Equity.

And then there is private equity. Until recently, private equity was unknown to most outside of New York and most people associated it with the ‘corporate raiders’ of the 80’s. But today private equity is an accepted alternative source of capital that does not carry the burden of the short term demands of the public markets.

Private equity firms pool capital contributions from institutional investors such as pension funds and endowments, as well as high, net-worth individuals with the primary purpose of making investments in private, mature companies or going-private transactions for publicly traded companies. Now, hearing about a private equity transaction on the front page of the USA Today is a regular occurrence. Recent franchisor investments include such household brands such as ServiceMaster8, Schlotzsky’s Deli9, and Dunkin Brands (Dunkin Donuts, Baskin Robbins and Togos).10 But private equity investments have not been limited solely to franchisors, over the past several years the franchisee community has felt the impact (and reaped the benefits) of private equity investors. NPC International11 (the largest Pizza Hut franchisee), K-MAC12 (a

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YUM! Brands franchisee), and FMS Management Systems\textsuperscript{13} (a IHOP franchisee) were all recently sold to private equity firms.

Along with the increase in private equity investments, owners and senior management are learning that private equity firms can bring much more than money to the table. Private equity firms can provide:

A) A sounding board and confidant for the CEO
B) Assistance in recruiting and hiring key executives and board members
C) Help in developing equity plans for management
D) Aid in seeking complementary acquisition companies

In addition, private equity investment allows the company to maintain privacy as there are no public disclosure requirements. This allows the private equity firm to make tough or controversial decisions without having to answer to or release sensitive information to shareholders or the general public. Privacy paired with the private equity investor's longer-term investment horizon (ranging from three to seven years), insulates the company from the whims of the public markets and allows franchisors and multi-unit franchisees to survive and thrive when the inevitable bumps in the road are felt in the business or industry.

But there are some important issues to consider before soliciting a private equity investment. Most, but not all, private equity firms prefer to purchase a controlling stake of the company. While the private equity firm has no intention of running the company day-to-day, in most cases they will want a say in significant decisions such as capital allocation, board member selection and exit decisions. An entrepreneur must determine if he or she will be comfortable with this 'shared' level of decision making.

Additionally, the due diligence process is typically much more extensive and time consuming for a private equity investment than a strategic buyer or bank financing. Due diligence provides a thorough look 'under the hood' to assure the buyer's confidence in the franchise. It is an expensive and time consuming process but no buyer will consider a transaction without it. The challenge for the owner and management team is to balance responding to detailed information requests while continuing to manage day-to-day operations.

Also, there is a definitive time to exit. While investment time horizons may vary, ultimately the limited partners of the private equity firm will want their capital back (in addition to a nice return on their investment) and so the company must be sold. Management should make sure their time horizon is in synch with the private equity firm's before they enter into a transaction.

In today's market, transaction multiples (defined as a multiple of cash flow) are at the peak of the cycle. The following chart illustrates how multiples have increased materially since 2002. In addition, it shows that, all other factors being equal, larger companies will sell for higher multiples than smaller companies. Typically, banks will lend more aggressively to larger businesses thus allowing the private equity firm to pay a higher purchase price for the same effective equity returns.

Based on information supplied by database made available to subscribers of FactSet Mergerstat, LLC.

IV. PRIVATE EQUITY.

The $26 billion proposed sale of Hilton Hotels Corp to the private equity firm The Blackstone Group highlights the increasingly powerful role private equity firms play in today’s economy. With over $200 billion of ‘dry powder’ to invest and with leverage on top of that, private equity firms have approximately $400 billion of ‘buying power’ creating significant pressure to put money to work.

What has caused this surge in private equity investing? One main driver is the lackluster expectations of the public equity markets for the next five to ten years. Greenwich Associates projects expected annual returns of 8% over the next five years. By contrast, during the 25 years from 1980 to 2005, the top-quartile private equity firms generated annualized returns to investors of 39.1% (net of all fees and expenses) versus 12.3% a year from the S&P 500 during the same period. The result is that large pension funds and major endowments are allocating increasing percentages of their assets from the public equity markets to ‘alternative investments’ which includes private equity. The result is a substantial increase in the number and size of private equity firms today.

16 Assuming a 1:1 debt/equity ratio for acquisitions.
With capital readily available, the number of new private equity funds has exploded with more than 1,800 buyout funds currently soliciting and managing investments. And the dollars under management at these firms continues to increase – today there are more than 200 firms with over $1 billion in capital under management as compared to only five private equity firms in 1989 with comparable resources.

And the party is not over yet. Private equity firms continue to raise money at a record pace with Goldman Sachs Capital Partners recently assembling the largest private equity fund in history, $20.0 billion, and firms such as Apollo Management LLC and Bain Capital LLC, raising funds of $10.0 billion and $8.0 billion, respectively in the past year. In addition, Texas Pacific Group and Kohlberg Kravis Roberts & Co. are currently each raising funds in excess of $14 billion.

The increased number of firms and investment dollars available has spurred a buying frenzy that is being felt across all sectors of the economy with private equity firms investing in industries such as healthcare, manufacturing, technology, hospitality, service, automotive and retail. It has also created a highly-competitive investment environment within the private markets and very favorable economics for the selling companies. There has never been a better time for owners and shareholders of companies to consider selling a portion or all of their holdings.

In recent years, franchising has also ridden the wave of private equity to allow founders and investors of franchisors to obtain liquidity on a scale historically reserved for more glamorous industries such as telecom, media and technology. Franchisors such as Burger King, AAMCO, The Dwyer Group, Wyndham International, and Domino's have been purchased by private equity firms. Private equity investors have become educated on the favorable cash flow characteristics of franchisors (especially in light of the dot-com fallout) and are prospecting the sector for opportunities. When run properly, franchisors can enjoy a long-term, diversified revenue stream with little capital expenditures making them attractive, long-term cash flow investments.

Investments by private equity firms have not been limited to franchisors, but have also extended to large multi-unit franchisees. For example, in July 2007, an affiliate of private equity firm Argonne Capital Group, LLC, acquired the assets and development rights of an IHOP area licensee, FMS Management Systems, Inc., which owned and sub-franchised 148 IHOP restaurants in Florida and parts of Georgia. In August 2004, another Argonne affiliate had previously acquired the assets and development rights of another 35 unit IHOP franchisee in Texas.

The choice of a private equity firm can have a material impact on the long-term value and growth prospects of a franchise business but the choice can be challenging as firms come in many shapes and sizes. Clearly defining the selection criteria and approaching the process...
with patience will help to make this important business decision more straightforward. This is a relationship that will last for many years and have an impact on the franchise reaching far beyond the transaction closing date. The following is a list of important evaluation points to consider when picking a private equity partner:

A. Size.

Private equity investments may range broadly from as little as $5 million to, in some high-profile investments, as high as $5 billion and above. Some firms specialize in smaller concepts (up to 100 locations) while others invest in more mature, larger concepts (1,000+ stores), and many in between. Choosing a firm that has invested in comparably-sized franchisors or multi-unit franchisees may yield a stronger partnership and more strategic advantages. The issues and opportunities faced by a franchise of 50 units often vary greatly with that of 500 units.

B. Industry focus.

Certain firms invest in one or a limited number of industries while others invest in a wide range of business types. An investment firm with a track record of franchise company investments may be desirable as the franchise market has specific and specialized dynamics. Choosing a firm that understands and has experience in a particular industry, also allows access to their network of advisors, strategic partners and board members to help grow the company.

C. Style.

A more difficult criteria to ascertain for selecting a private equity firm is matching the personality, culture and approach to doing business. It is important find a firm that shares the franchisor’s values, business philosophy and ethics. This requires time, patience and effort, similar to that of making a key senior management hiring decision.

D. Exit Strategy.

While private equity investments do have a long-term investment horizon of three to seven years, it is important for the franchisor’s and franchisee’s, and the private equity firm’s exit strategies to complement one another. Backed by institutional investors who have timelines on their returns, a sale must be made at some point in the future.

As with any important business decision, the selection of a private equity firm should be investigated thoroughly well in advance of the actual decision. The relationship will last for many years and, in the case of a franchisor, have an impact on the franchise system reaching far beyond the firm’s exit. It must be approached with clearly defined selection criteria, and the franchisor or multi-unit franchisee should speak with senior executives of the private equity firm’s portfolio companies, interview several partners of the firm and review their investment track record. Only when all arrows are pointing in the right direction, should a deal be initiated.
V. HOW DOES A PRIVATE EQUITY FIRM VIEW MY FRANCHISE BUSINESS?

Understanding how a firm will value a franchisor or multi-unit franchisee is essential to considering an outside investment. For a franchisor, typically, a buyer will evaluate the following criteria:

A) Attractive unit-level economics  
B) Quality of senior management  
C) Competitive position  
D) Franchisee satisfaction  
E) Proven business model in multiple markets  
F) Sound infrastructure

A. Attractive unit level economics.

A meaningful part of the due diligence process is spent digging into true store level performance. No other measurement is as critical - if the franchisees (or unit operations in the case of a multi-unit developer) are not successful, nothing else matters. The two key aspects of franchisee economics are the turn-key development costs (franchise fee, build out costs, working capital, inventory, initial marketing) and the annual cash profits an owner/operator can generate. The best franchisors continually find new ways to improve both metrics in order to provide the franchisee with the best chance of success. When the underlying store-level performance generates cash-on-cash returns that spurs continued expansion everyone wins - franchisee, franchisor and investors.

B. Quality of senior management.

The leadership behind a franchise concept determines the overall success of the franchisor. Many exciting, emerging franchise operations never fulfill their potential because of lack of leadership and execution. The senior level executive’s philosophies on franchising, their desire and capacity to drive meaningful growth and the credibility to execute their plan will have a great impact on the buyer's investment decision.

C. Competitive position.

Why does the franchisor exist and who is its target customer? Within a crowded franchise market, the buyer wants to ascertain whether the franchisor can maintain its competitive position even as copy-cats or imitators emerge. What is it that the company does well that will differentiate it and create a unique, defensible position?

D. Franchisee satisfaction.

Closely tied to unit-level economics, the relationship between the franchisees and franchisors is important to the investor, whether investing in a franchisor or a multi-unit franchisee. The franchisee's confidence level and trust in the leadership of the brand are a strong indicator of the health of the system. In due diligence, the buyer will want to interview a number of franchisees regarding their view on new product development, marketing, store design, and systems support. A good investment partner will want to know what the franchisor does well and where are the areas of improvement to help improve overall franchisee performance.
E. Proven business mode in multiple markets.

This doesn’t mean the franchise needs a presence across the country, but it must show broad appeal across multiple markets within the same region. More or less, the buyer wants to see promising expansion prospects – that the concept has ‘legs’ to continue expansion.

F. Sound infrastructure.

It takes more than just a good idea to successfully grow a franchise chain. In most cases, having built a solid operating platform in areas such as training, marketing, real estate, and technology are as crucial to development of the concept as the original idea itself. Franchisors with a strong commitment to infrastructure will be better positioned as a prospect.

No investor expects perfection in all six of these valuation categories, but they are looking at the overall health of the franchise chain and prospects for continued growth. Reviewing internally these areas of valuation in advance of calling a private equity investor will greatly enhance the franchise chain’s ability to position its business favorably.

In addition, there are also specific criteria private equity firms look at when buying franchisee businesses.

G) Superior human resource management
H) Opportunity for meaningful unit expansion
I) Strong information systems and controls
J) Health and support of the franchisor

G. Superior human resource management

Human resource management is a critical ingredient to the success of a multi-unit franchisee organization and an important consideration for a prospective investor. In general, a multi-unit franchisee will employ comparatively more people than a franchisor because all of the store-level employees are part of the company whereas for a franchisor, franchised units typically comprise 50% to 100% of the system, requiring far fewer employees on average. Therefore, ability of management to continually recruit, train and motivate the employee base (which is most cases consists of hourly employees) is essential to drive everyday performance.

H. Opportunity for meaningful cash flow growth.

All other factors being equal, private equity firms become more interested in a multi-unit franchisee investment where there are identifiable and realistic opportunities for growth and improved profitability, whether through operational improvements, organic growth, or via acquisition. A typical candidate would include multi-unit franchisees with additional development rights or the right to subfranchise. Not surprisingly, the highest purchase price multiples are also those with the most credible growth opportunities. A private equity firm can also help capitalize on the growth opportunities by making additional infrastructure investment to drive revenues or control costs and to provide the capital to build new locations or to opportunistically acquire additional units from other franchisees.
I. Strong information systems and controls.

Multi-unit franchisees run complex business that achieve success by counting every penny, controlling every cost and monitoring every transaction with accurate, real-time and reliable information systems. Having high quality systems and financial controls in place give comfort to a potential acquiror by providing assurance that senior management truly understands the fundamental drivers of the business and can react very quickly to any variances that may occur. In addition, sound information systems and controls can facilitate a more rapid and successful expansion by allowing for the consistent integration and monitoring of additional units.

J. Health and support of the franchisor.

Just as a private equity firm will perform due diligence on the franchisees in a system before investing in the franchisor, a private equity firm will want to understand the health of the franchisor before buying into a multi-unit franchisee. Some of the questions they will ask are:

Who owns the franchisor and what is the track record of the franchisor and its owners in growing and supporting franchise systems?

What is the relationship between the franchisor and the target multi-unit franchisee under consideration and with other franchisees in the system generally?

What is the franchisor’s view of having a private equity firm being a franchisee in their system?

What is the franchisor’s attitude towards having large franchisees, and will they support, or to the contrary, inhibit or limit the future growth of the franchisee?

All of these factors will impact the decision of a private equity firm, in becoming a multi-unit franchisee.

VI. CONVENTIONAL BANK FINANCING.

Bank debt comes in a variety of flavors, including the following:

A. Senior Debt.

Conventional senior debt financing, in the form of term loans and revolving credit facilities, is among the most common financing available to franchisors and franchisees. Senior bank debt is secured debt that carries a first security interest on all or most of the assets of the company or the assets being financed in the case of a purchase money interest and carries the lowest rate of interest. In the case of franchisor indebtedness, this could include a security interest in the royalty stream payable by the franchisees, and the franchisor's interest in the franchise agreements themselves. Were the franchisor to default and the lender to foreclose, there would likely be a significant disruption in the day to day operations of the franchisor, with a corresponding impact on franchisees. The greater the franchisee’s reliance on the franchisor for day to day support (e.g., in a retail business reliant on the franchisor’s manufacture and/or supply of specialty products), the greater the impact.

In the case of franchisee indebtedness, it would typically include a security interest in the franchisee’s hard assets but many or most franchisors resist lender requests to take a security
interest in the franchisee’s interest in the franchise agreement. See Section VII for additional
discussion of intercreditor agreements.

B. Sale/Leaseback and Other Loans.

Other options include sale/leaseback arrangements (for franchisors which own real estate
underlying company-owned or franchised outlets and for franchisees who own their own real
estate), construction loans, equipment financing, and unsecured lines of credit where cash flow
is healthy. Lenders in franchising include commercial banks, major commercial finance
companies, private equity funds, national sale/leaseback companies, and mezzanine lenders.

C. Subordinated/Mezzanine Debt.

Financing may also entail several layers. Apart from the secured senior debt facility, the overall
financing used by a company may also involve unsecured debt, which carries greater risk to the
lender and therefore a higher, above-market-rate, interest rate than what the senior lender
would require. Mezzanine loans bridge the gap between the senior loan and the owner's equity
investment and characteristically have a shorter term, usually three to five years, and a higher
interest rate than the senior debt due to the inherently higher risk involved. The loan may also
include an equity component, combining subordinated debt with warrants that allow the
investor/lender to acquire shares in the business at a predetermined price. Mezzanine or
subordinated lenders typically secure the indebtedness with a pledge of the stock of the
borrower or a parent company, and may hold a subordinated security interest in the assets of
the business, but this is commonly unacceptable to senior lenders. Such credit is subordinate
to the senior lender and the senior lender may impose various conditions restricting, for
example, the subdebt holder’s right to collect payments when the borrower is in default under
the senior debt facility. Subordinated debt holders may also seek the right to step in and take
over the senior lender’s debt and secured position in the event of a default. From the
franchisor’s perspective (in cases where a franchisee employs both senior debt and subdebt)
the multiple layers of indebtedness may increase the prospects of a franchisee default, and
some franchisors impose bank-like financial covenants triggering a franchise agreement default
if the covenants are violated (see discussion below regarding various types of financial
covenants).

D. Securitizations.

Another, if more exotic, form of financing that a relatively few, but increasing number of,
franchisors have employed either to raise additional capital or to take advantage of favorable
interest rates to refinance existing debt, are securitizations. Examples of franchisors which
have used this approach in recent years include Arby’s, Athlete’s Foot, Quiznos, Dunkin
Donuts, Sonic Corp. and IHOP. In these types of transactions, a franchisor uses its
anticipated royalty cash flow to serve as security for the financing.

Securitizations are complicated and because the method is designed to mitigate the lender’s
risks by spreading the risk of franchisee defaults over a large group of units, and because a

25 JAY EISBRUCK, MOODY’S INVESTOR SERV., INTRODUCTION, ROYAL(TY) SUCCESSION: THE EVOLUTION OF IP-BACKED
securitization was securitized by the franchise royalties from the Dunkin’ Donuts, Baskin Robbins and Togo’s Chains
for a total financing of approximately $1.7 billion, which was used to replace the bank financing that had been
incurred when the chain was acquired by private equity firms.

26 The authors are unaware of any securitization having been used by any multi-unit franchisee.
securitization involves a complete restructuring of the franchisor’s corporate enterprise to create a bankruptcy remote borrower, it tends to be used infrequently and only in very large transactions. Because the lender is counting on a steady non-defaulting flow of royalties, it is important that the lender investigate the franchisor’s franchise system to confirm the absence of any significant risk of substantial franchisee defaults or lawsuits, or other or matters interfering with the continuing stream of royalties.

In concept, the securitization contemplates restructuring the franchisor’s subsidiaries and affiliates so that, typically, the trademarks, service marks, and other intellectual property rights relating to the sale of goods and services under the brand will be isolated in a newly formed entity that will in turn license the franchisor to use and sublicense franchisees to use the intellectual property. Some franchisors have undergone sequential securitizations whereby new franchisor entities are created so as to isolate the franchises into groups, each serving as security for a different debt facility. Inter-creditor agreements in acquisitions of large multi-unit franchisees.

E. SBA Loan Programs.

Although not typically used in the context of acquisitions of franchisors or large franchisees, loans facilitated by the Small Business Administration ("SBA") may be a source of capital to fund the continued growth of smaller franchisees and multi-unit franchisees. The SBA has several programs under which it agrees to guaranty a large portion of the loans issued by private lenders, including the 7(a) Loan Guarantee Program, 504 Certified Development Company (CDC) Program; and Small Business Investment Company (SBIC) Loan Programs. Each of these programs will be described briefly below. The SBA can guarantee up to 85% of loans up to $150,000 and 75% of loans exceeding that amount, up to a total guaranty not exceeding $1,000,000.

1. SBA 7(A) Loan Program.\(^{27}\)

The law does not permit the SBA to guarantee loans in cases where the borrower can obtain funds on reasonable terms from a bank or other private source. A list of SBA-approved lenders can be found in the franchisee's area by consulting a local SBA office or visiting www.sba.gov. The SBA will review the franchise agreement to ensure that it does not contain certain provisions objectionable to the SBA and which fail to meet SBA eligibility standards. Included among the types of provisions the SBA finds objectionable are provisions whereby the franchisor controls the franchisee, directly or indirectly, or under which the franchisee lacks the independent right to profit from its efforts and bear the risk commensurate with ownership. In assessing the eligibility of the franchise system for an SBA guaranteed loan, the SBA looks at franchise agreement provisions to confirm the following: (i) franchise fees and other fees are not excessive; (ii) the franchisee is in control of its finances and accounts, deposits and withdrawals; (iii) the franchisee is in charge of managing day to day operations (except upon illness or disability); (iv) the franchisee is in charge of controlling, hiring and firing employees; (v) the franchise cannot be terminated without cause before the end of the specified franchise term; (vi) the franchisee has the right to transfer its interest in the franchise business without unreasonable restrictions.

\(^{27}\) Small Business Administration, Basic 7(a) Loan Program, http://www.sba.gov/services/financialassistance/sbaloantopics/7a/index.html.
SBA 7(a) guaranteed loans may be used for working capital, to purchase an existing business, or machinery, equipment, furniture and fixtures, supplies and materials, land and building (including purchase, construction, expansion or conversion of existing facilities), leasehold improvements and under certain conditions for refinancing existing debt.\(^{28}\)

In recent years, as a means for reducing the burden of regional SBA review of proposed franchise loans, which resulted in inconsistent lending decisions and long processing time, the SBA established an official SBA franchise registry under the auspices of FRANdata,\(^{29}\) which allows franchisors to be listed on the franchise registry, greatly facilitating the processing of SBA loan applications, essentially pre-qualifying the franchisor’s program for SBA guaranteed financing. Franchisors complete a worksheet certifying that the franchise agreements meet SBA eligibility guidelines, along with an electronic copy of all agreements and a $2,000 application fee. FRANdata reviews and submits recommendations to the SBA. Once approved, FRANdata lists eligible systems on a public website, identifying the date of eligibility. Prospective franchisees provide SBA lenders with a certification from the franchisor saying that there have been no revisions to relevant provisions in the agreements a franchisee must sign since the agreements were deemed eligible by SBA. The franchisor must certify, however, what these non-material changes are to the local SBA office, and these changes are subject to review. The SBA lender relies on this certification on the website listing, without any further review or time delay. If the franchise agreement is subsequently amended, a revised copy must be filed with FRANdata, together with an additional $2,500 fee if the changes are material.

2. **SBA 504 Loan Program.**\(^{30}\)

The SBA’s 504 Certified Development Company (CDC) Program provides long-term fixed rate financing for major fixed assets, such as land and buildings. CDC’s work with the SBA and private sector lenders to provide financing to small businesses. Typically, 504 programs involve three types of funding, (a) a secured loan from a private sector loan for up to half of the total project cost, (b) a CDC-backed second lien secured loan (100% guarantied by the SBA) for up to 40% of the project, and (c) at least 10% equity by the owners of the business being financed.

Use of 504 loan proceeds are restricted to financing fixed asset projects such as purchasing land and improvements, including existing buildings, grading, street improvements, utilities, parking lots and landscaping; construction of new facilities, or modernizing, renovating, or converting existing facilities; and purchasing long-term machinery and equipment, and cannot be used for working capital or inventory, consolidating or repaying debt or refinancing. Like the 7(a) loans, the 504 loans are limited to small businesses. However, to be eligible for a 504 program loan, the borrower must have a tangible net worth of $6 million or less, with an average net income not exceeding $2 million after taxes for the preceding two years. Owners of 20% or more must guaranty are also required.

The SBA also licenses small business investment companies, or SBICs, which are privately owned and managed investment firms operated for profit. SBICs have more financing options and flexibility because the government itself does not make direct investments or target specific industries, and portfolio management and investment decisions are left to qualified private fund managers.


3. **SBIC Loan Program.**

SBIC financing is available only to companies having a net worth of $18 million or less and average after tax net income for the prior two years not in excess of $6 million. All of a company’s subsidiaries, parent companies and affiliates are considered in determining the size standard and for certain industries alternative size standards may apply. SBICs may not invest in, among other things, finance and investment companies or finance-type leasing companies, unimproved real estate, companies with less than 51% of assets and employees in the United States, passive or casual businesses (those not engaged in a regular and continuous business operation), or companies which will use the proceeds to acquire farm land.

There are over 400 licensed SBICs in operation. Some SBICs invest in a particular field or industry in which their management has expertise, while others invest more generally. Most SBICs concentrate on a particular stage of investment (i.e. start-up, expansion or turnaround) and identify a geographic area in which to focus. The form of SBA funding that a particular SBIC uses can vary and will have an impact on the type of investments they can make.

Debenture SBICs focus primarily on providing debt or debt with equity features, and typically focus on mature companies able to make current interest payments on the investment so that, in turn, the SBIC can meet its interest obligations to SBA. Participating Securities SBICs focus on pure equity investments but can make debt investments as well. Specialized Small Business Investment Companies (“SSBICs”) are a type of SBIC that provide assistance solely to small businesses owned by socially or economically disadvantaged persons.

**VII. INTERCREDITOR AGREEMENTS IN ACQUISITIONS OF MULTI-UNIT FRANCHISES.**

Special considerations may apply in acquisitions where the purchaser, whether a private equity firm or other party, wishes to utilize secured credit facilities to help finance part of the transaction. For example, in situations where a secured lender finances the acquisition of a large multi-unit franchisee, the lender will often seek to obtain a security interest not only in the real property and physical assets owned by the franchisee, but also in the franchisee’s franchise agreements. In doing so, upon a borrower default, the lender preserves the option of foreclosing upon the business as a going concern, which may offer substantially more value than the bare assets, without the continuing right to operate them after foreclosure under the franchisor’s brand.

Historically, franchisors have commonly prohibited the taking of any security interest in a franchisee’s unit franchise agreements, or related agreements such as license agreements, area development agreements, subfranchise, sublicense agreements and master franchise agreements. However, UCC-9 was amended in recent years and renders unenforceable any contractual prohibition against a secured party filing a security interest in general intangibles, including franchise agreements. Nevertheless, obtaining a naked security interest is still not particularly useful to a lender for several reasons. First, in the event of a loan default, the lender will still be subject to the assignment consent requirements of the franchise agreement and will not be able to foreclose on the agreement without the franchisor’s consent. Second, if there is a loan default, it is also highly likely that there will be a default of the franchise agreement, and the franchisor typically will be able to terminate the agreement on relatively short notice, which will

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cause security interests held by the lender to vanish along with the terminated franchise agreement.

It is for this reason that lenders will seek an intercreditor agreement with the franchisor pursuant to which mechanisms will be put into place to deal with the events that arise upon a franchisee default under the franchise agreement or the credit facilities. The following are some of the typical provisions of an intercreditor agreement:

A. Term.

The term of the intercreditor agreement will often be limited in time. For example, it will typically terminate upon satisfaction of all of the borrower’s obligations under the credit agreement and termination of all further lender commitments under the credit agreement. The franchisor may also insist that the arrangement last for only a stated number of years so as to insure that the franchised units will not be operated indefinitely by an “absentee” lender-owner. Further, in the event of a breach of or default under the intercreditor agreement by lender or its agent which is not cured within a stated time after receipt of notice, the franchisor will typically be able to terminate the intercreditor agreement. Upon termination the franchisor will have no further duties to the lender.

B. Consents.

The intercreditor agreement will provide that the franchisor consents to the collateral assignment and pledge by the borrower of all of its right, title and interest, as franchisee, in and to the franchise agreement for the benefit of the secured party, as security for the loan obligations, and will not constitute a breach of or default under the franchise agreement. If the lender also takes a pledge by the franchisee’s stockholders of their interest in the franchisee entity, the franchisor will also consent to, and agree that the pledge and any subsequent foreclosure will not constitute a breach of or default under, the franchise agreement.

C. Typical Provisions.

The intercreditor agreement, may have some of the following characteristics and agreements:

1. The franchisor agrees to provide the lender copies of all default notices given by the franchisor to the borrower under the franchise agreement, and the lender agrees to provide the franchisor with copies of all notices of default, acceleration or foreclosure given by the lender to the borrower under the credit and related agreements. The lender will have the right, but not the obligation, to cure or cause the borrower to cure any default under the franchise agreement, thereby precluding the franchisor from terminating the franchise agreement which will, if timely cured, remain in full force and effect. If the breach is not timely cured, the franchisee may have the right to proceed to terminate the franchise agreement and the Intercreditor Agreement.

32 An alternative to an intercreditor agreement, particularly common in the hotel industry, is a so-called “comfort letter” which essentially accomplishes the same thing. A comfort letter is a letter from the franchisor in which it agrees not to terminate the franchise agreement if a lender exercises its remedies on a default of the credit agreements. Because changes in control of a franchisee typically require a franchisor’s consent, the comfort letter includes a consent to the lender stepping into the shoes of the borrower under the franchise agreement if the lender forecloses and acquires title to the business. It would also typically require the franchisor to provide the lender with copies of any default notices of default sent to the franchisee, and sometimes vice versa.
2. The lender may agree to limitations on its right to amend or waive certain provisions of the credit agreement which might increase the franchisor’s risk.

3. The franchisor consents in advance, which may be subject to a variety of conditions, to the lender exercising its remedies under the collateral assignment and becoming the “franchisee” under the franchise agreement, or foreclosing on the pledged shares it holds in the franchisee entity, on an interim or long term basis, during which period it typically must continue to comply with the terms of the franchise agreement, subject to potential exceptions negotiated by the parties. The franchisor may seek to limit the time during which the lender may step in and act as the interim franchisee.

4. If the lender, pursuant to the exercise of its rights under the collateral assignment, seeks to propose the public or private sale of any of the franchised units (or the foreclosed upon stock in the franchisee entity) to a proposed third party purchaser, that purchaser may need to be approved in advance by the franchisor.

5. The franchisor may condition the lender’s right to step in as franchisee, on the lender assuming the franchisee’s obligations and engaging the franchisor to manage the units at an agreed upon charge, or engaging the services of a qualified restaurant manager or management company to manage the units, which manager or management company must be approved in advance by the franchisor.

6. If the franchisee has the right to subfranchise, the lender must assume and comply with the obligations of the borrower under the applicable master franchise agreement and the existing subfranchise agreements and similarly engage the services of the franchisor or a qualified manager to handle any necessary duties as subfranchisor. The lender may or may not be permitted to continue to offer and sell subfranchises while standing in the franchisee’s shoes, and if so, subject to terms and conditions set forth in the intercreditor agreement, and the master franchise or other applicable agreements with the franchisor.

It is important to understand that in the relatively likely event of a bankruptcy filing by or against the defaulting franchisee the duties of the franchisor and the lender under the intercreditor agreement may be subject to the effect of bankruptcy law and any insolvency proceeding relating to the borrower and the rights of third party creditors of the borrower, including any judicial or statutory stay, order, restraint or injunction.

VIII. GETTING THE DEAL DONE.

Whether a transaction involves conventional bank credit facilities, an initial public offering, a securitization, private equity or venture capital investment, or a combination of these, the lender or investor, or underwriter in the case of a public offering, will engage in due diligence of the company before making the loan or investment. The amount of diligence conducted by a lender in connection with conventional bank financing tends to be more limited, whereas transactions involving securitizations or investments by private equity and venture capital firms customarily involve substantial due diligence.

It is important to understand as well, that a transaction may involve multiple parties, and multiple layers of financing. For example, in the recently announced IHOP acquisition of Applebee’s, IHOP announced that it intends to finance the all-cash, $2.1 billion transaction through a whole business securitization backed by Applebee’s assets, additional borrowings under IHOP’s pre-existing securitization structure completed in spring of 2007, an interim bridge facility
commitment to fund the transaction pending the completion of both securitizations, and, upon
the closing of the acquisition, the issuance by IHOP of new preferred stock through a private
placement.\footnote{IHOP Agrees to Buy Applebee’s for $2.1B, KAN. CITY BUS. J., July 16, 2007.}

A. Due Diligence – Franchisor Financings.

The due diligence typically required in the case of a securitization or an acquisition of all or a
part interest in a franchisor, or large multi-unit franchisee, includes a number of franchise-
specific issues the lender or acquirer needs to study. Some or all of the same issues will be
important to the lenders who assist in financing such acquisitions or who finance securitization
transactions, and to underwriters in connection with initial and follow on public offerings of
securities. In the case of a franchisor financing, the lender or investor is counting on the
continued payment of royalties and other payments by franchisees, and the continued growth of
the chain. In the case of a franchisee financing, the lender or investor will want to get
comfortable with the strength and viability of the franchisor and the franchise system, as well as
the franchisee’s business itself. So the primary function of due diligence is to confirm that there
are no major circumstances presented which might disrupt or jeopardize cash flow and growth
potential. It is beyond the scope of this paper to address all of the potential issues of
importance in conducting a due diligence investigation, but the following overview is instructive.

1. Forms of Agreement.

As a preliminary matter, it is important to review the current forms of franchise agreement and
related agreements (such as area development agreements, master franchise agreements, and
international agreements) to get an understanding of the current terms being offered by the
franchisor. It will also be important to identify and compare the various forms of franchise
related agreements used historically both to understand the evolution of the company’s
franchise program but also to understand the agreements currently in effect with existing
franchisees who have signed at various times in the past. Often the lender will review the
franchisor’s current form disclosure document and franchise agreement and make the incorrect
assumption that all of the outstanding agreements are on substantially the same terms as
presently being offered. Such a review would typically include an assessment of selected rights
and obligations of the parties under the various forms with a view to determining or verifying (if
the target has provided a schedule) the applicable royalties, advertising fees and other payment
obligations in effect under the franchise agreements, territorial rights, term, renewal rights, and
negotiated terms (if determinable) under the various agreements, and any other material
changes which vary from version to version.

2. Actual Franchise Agreements.

Where practicable, it is also useful to review the actual files of franchisees to determine whether
there are any particular terms that have been negotiated with that franchisee and whether there
is any correspondence that indicates that there may be disputes with this franchisee. In the
case of a company with a large number of franchisees, it may be necessary to look at files
randomly, or focus only on the largest franchisees. It is useful to determine whether such
franchise agreements have been amended, and whether and which franchisees are delinquent in
the payment of sums due to the franchisor, and whether royalties or required advertising
contributions have been waived, reduced, or deferred.

What are the franchisor’s policies, procedures and programs affecting how close units may be placed to one another? Does the franchisor use market impact studies in making new store site approval decisions? The lender or investor may assume that there is room for incremental growth by adding numerous additional units in various markets, but on closer scrutiny, it may discover that the franchisor’s policies or promises impose greater restrictions than may at first be apparent.


The franchisor’s franchise disclosure documents should be reviewed (including a determination of whether there is a single ‘wrap around’ disclosure document used in all states, or whether the franchisor uses different forms of disclosure documents in various states). A review of historical disclosure documents will help identify the material changes in the system that have occurred over time. For example, the franchisee information in Item 20 covers only a three year window, so by looking at older disclosure documents, one can piece together a bird’s eye view of the franchise system over a longer time period. If the franchisor has included Item 19 financial performance representations or ‘earnings claims’ in its historical UFOCs, this will also help determine how the franchised units have performed over time. If the franchisor is a publicly traded company, one should also review current and past securities filings filed by the target to examine whether they contain disclosures of any material issues. Careful scrutiny may yield valuable insight on how the system has fared over time, perhaps disclosing negative trends that would affect the viability of the system in the long term.

5. Legal Compliance.

Another important area to study in due diligence is to review the franchisor’s compliance with state and federal (and even international) franchise disclosure and registration laws. Failure to comply poses substantial risk of litigation, franchise rescission, and corresponding disruption of cash flow from royalties. This analysis can be accomplished by reviewing the target’s state franchise (and if applicable, business opportunity) registration, exemption, amendment and renewal filings to identify any sales having occurred during periods in which the company was not lawfully able to sell. A review of the files of franchisees will disclose whether the franchisor timely delivered disclosure documents (e.g., at the first personal meeting and 10 business days, or 14 calendar days, prior to the franchisee making any payments or signing any binding agreements) and whether the franchisor delivered the execution ready agreements to the franchisee the required time period before execution by the franchisee (e.g., five business days or, under the recently amended FTC Rule, seven calendar days prior to execution).

This review may be limited to transactions occurring within applicable statute of limitations, e.g., the past three to five years. In the case of a large company, a thorough review of all the recent transactions may not be feasible, and a random review may be necessary. Interviews with the franchisor’s personnel in charge of franchise sales and franchise registration and disclosure compliance will provide a general sense of the company’s compliance program and whether it has procedures and tools in place, that if followed, would keep it in compliance with franchise registration and disclosure laws.
6. Termination, Nonrenewals, Closures and Relations.

The franchisor’s procedures for terminating or not renewing franchisees may also present legal concerns. Does the franchisor have procedures in place to insure compliance with state franchise relationship laws? If not, there may be extant legal claims. What is the company’s general process and philosophy with respect to its franchisees? Does it strictly enforce its franchise agreements, or does it give franchisees ‘soft defaults’ with wide latitude to cure? Does it give franchisees concessions and waivers of franchise provisions or allow delays in payment of royalties, or grant additional rights to franchisees? Particularly for investors who expect to effect cost savings and increased revenue through tighter enforcement, a long history of lax enforcement may present a real impediment to achieving these objectives. Interviews with appropriate franchisor personnel may be the best way to quickly identify potential issues. A review should include a list of stores (both franchisor-owned and franchised) considered non-viable and those which have closed or are expected to close, and whose year-over-year gross revenues have significantly declined for comparable prior periods, as well as a list of franchisees or units involved in workout or financial restructuring arrangements or which have been involved in insolvency or bankruptcy.

7. Litigation and Claims.

A diligence review should also identify the types of claims and litigation that current and recent franchisees have alleged and brought against the target, including the types of claims that franchisees have alleged in matters which have been settled before litigation. This may spotlight areas of exposure with respect to franchisees who have claims which have not yet been asserted.

8. Franchisee Associations.

The investigation should identify all franchisee associations (including foreign associations) which exist, the number of franchisees members; leadership, and any formal or informal arrangements and agreements allowing them to participate in or influence the franchisor’s decisions on issues. Understanding whether these organizations have acrimonious or harmonious relations with the franchisor can provide clues to a franchisor’s long term prospects for success.


Franchise sales advertising materials, whether print, broadcast, Internet, or other, used by the franchisor to recruit franchisees should be reviewed and confirmed whether they have been filed, where required, with applicable state agencies for prior review. If not, there may be legal exposure that the lender or investor should understand. As with franchisee associations, if the franchisor’s historical relations with these groups has been troubled, it can signal potential impediments to future growth and success.


All existing and recent (e.g., in effect during the past 3-5 years) franchise broker, sales agent or similar agreements entered into by the franchisor should be reviewed and a determination reached as to whether all required disclosures and broker registrations were made and obtained.
11. Franchisee Advisory Councils.

If there are any franchisee groups involved in franchisor decision-making, they should be explored.

B. Due Diligence – Franchisor and Franchisee Financings.

For either a franchisor or franchisee financing transaction, the lender or investor will in the course of investigating the target, explore and be alert for other relevant issues. Without going into detail, any major acquisition or financing will involve a detailed due diligence investigation of all aspects of the target's business and operations. The following is bullet point summary of some of the matters typically covered:

(a) Corporate Organization Documents

(b) Identify all Subsidiaries and affiliates.

(c) Owner Agreements (e.g., agreements governing voting rights, right to dispose of stock, issuance of additional securities, payment of dividends or distributions, and registration rights; options, warrants, convertible or exchangeable securities).

(d) S.E.C. Related Filings (if applicable)

(e) Credit and Related Documents (e.g., outstanding debt securities and other borrowings, guarantees - including of franchisee obligations, bank lines of credit, etc.

(f) Material Contracts

(g) Intellectual Property (Patents, copyrights, trademarks, service marks, trade secrets, know-how and proprietary information – U.S. and international)

(h) Tax Matters

(i) Permits

(j) Insurance Coverage

(k) Benefit Plans and Arrangements; Labor

(l) Permits and Government Regulation

(m) Real Property

(n) Personal Property. (e.g., personal property leases or subleases, and material fixed assets owned by the Company)

(o) Environmental

(p) Correspondence with Auditors
C. Loan Documentation.

Whether the borrower is a franchisor or a franchisee, and whether the loan is for a senior loan, mezzanine financing, or a securitization, the loan documents will typically enumerate numerous potent affirmative and negative covenants, reporting duties and events of default. The following is a high level summary of some typical provisions than can go on for many pages in the agreements, in elaborate detail:

1. Reporting Obligations.

The borrower may be required to deliver periodic financial reports, such as monthly quarterly and annual financial statements; compliance certificates by corporate officers and/or outside accountants certifying that there are no actual or potential events of default; financial forecasts; notices of the occurrence of any actual or potential event of default or material adverse effect, or any change to or inaccuracy of any of the borrower’s representations or warranties in any loan documents; notices of any litigation, arbitration, investigation or other proceeding affecting the borrower and other additional information regarding collateral or the financial condition, assets, business or prospects of the borrower or its related parties.

2. Affirmative Covenants.

The loan documents will typically contain a variety of covenants, such as those requiring the borrower:

   (a) to preserve its existence and all rights, licenses, contracts, permits and franchises necessary for the proper operation of its business;

   (b) to remain engaged solely in particular types of business;

   (c) to maintain all essential properties good repair, working order and condition;

   (d) to maintain specified types of insurance coverage; to comply with all material agreements and file all tax returns and pay all taxes;

   (e) to comply with applicable laws; and

   (f) to preserve all intellectual property rights and related trademark, copyright and patent protections and governmental filings.

3. Negative Covenants.

Negative covenants may include things such as agreeing:

   (a) not to incur any additional indebtedness other than as permitted under the loan documents (e.g., capital leases, unsecured debt or liabilities incurred in the ordinary course of business up to a stated amount or for stated types of obligations);

   (b) not to suffer or permit any liens on any of its income, property or assets other than certain defined “permitted encumbrances”;
The credit agreements may restrict or prohibit certain events and actions by the franchisor while the loan remains outstanding such as:

(a) issuing additional securities except for stated purposes and within stated limits;

(b) making significant investments,

(c) any fundamental change in structure,

(d) any merger or consolidation,

(e) selling or disposing of any significant part of its assets,

(f) any dissolution or liquidation;

(g) selling or disposing of notes, accounts receivable or other obligations owing to the borrower except collection in the ordinary course of business;

(h) sale / lease back arrangements;

(i) any transaction with an affiliate except on arms length terms and conditions;

(j) delegation of the day-to-day management, supervision or control of its business;

(k) payment of bonuses to any of its employees except within stated limits and upon satisfaction of stated performance levels; and

(c) not to permit the borrower to violate certain financial covenants stated in the loan documents, such as:

(d) minimum interest coverage ratios;

(e) leverage ratios comparing senior indebtedness to tangible effective net worth;

(f) maintaining certain minimum levels of EBITDA, and tangible net worth;

(g) maintaining certain ratios of total indebtedness and contingent obligations to tangible net worth;

(h) ratios of current assets over current liabilities; and

(i) restrictions on any dividend, distributions, purchases, redemptions or retirement of any shares of the equity owners, or payment or prepayment of principal or interest on subordinated indebtedness (except to the extent provided and typically in no event when there exists any default under the senior loan).
5. **Representations and Warranties**

(a) **General**

The loan documents, whether for a franchisor or a franchisee financing, will typically contain a variety of representations and warranties. The following is an overview of the types of matters as to which lenders will often seek representations and warranties. They include representations and warranties that:

(i) the borrower is duly incorporated, formed and/or organized, validly existing and in good standing in the jurisdiction of organization or incorporation;

(ii) the borrower is qualified to do business and in good standing in all other jurisdictions where its business or assets require qualification and has the power and authority to own its assets and conduct its business;

(iii) the execution and performance of the documents have been authorized by all corporate action and the execution, delivery and performance of the documents do not conflict with the borrower’s corporate documents, material contracts, or any laws applicable to borrower;

(iv) the documents have been duly executed and delivered and are legal, valid and binding agreements enforceable against the borrower in accordance with the terms of the documents;

(v) the borrower has obtained all consents necessary or required to execute, deliver and perform the documents;

(vi) there are no actions, suits, investigations, proceedings or arbitrations pending or threatened that would affect the validity or enforceability of the documents;

(vii) the borrower is not in default under any material agreement which it or its property is bound;

(viii) the borrower’s assets (or the assets to be pledged to the lender) are free and clear of all liens and encumbrances (except permitted encumbrances), and are in good working order;

(ix) the borrower’s financial statements are accurate and fairly reflect the status of the borrower and there are no undisclosed liabilities;

(x) the borrower maintains sufficient insurance;

(xi) the borrower has paid its taxes and filed all returns;

(xii) the borrower (and all applicable plans) are in compliance with ERISA;
(xiii) the borrower is in compliance with all applicable laws;

(xiv) the borrower’s material contracts are in full force and effect and no events of default exist, and no events have occurred that with notice or the laps of time, or both, would constitute a default under such agreements;

(xv) the borrower owns, leases or licenses all of its assets, and its assets constitute all of the assets it needs to operate its business;

(xvi) the borrower is in compliance with, and has been in compliance with, labor and employment laws, environmental laws, foreign corrupt practices laws;

(xvii) the borrower has owns or licenses all intellectual property and has maintained the intellectual property appropriately;

(xviii) the borrower maintains complete books and records;

(xix) except as disclosed, the borrower has no contracts with affiliates or related persons;

(xx) the borrower has disclosed all material facts and matters and has not omitted any material facts;

(xxi) the borrower has scheduled a true, correct and complete list of all currently-effective oral and written franchise and related agreements;

(xxii) all of the identified franchise and related agreements are in full force and effect and are binding and enforceable in accordance with their respective terms; no franchise agreement is subject to any right of rescission, set-off, counterclaim or defense, and neither the franchisor nor, any franchisee is in breach of or in default under any of the franchise agreements;

6. Representations – Franchisor Loans

For franchisor securitizations and other types of loans, there are likely to be a variety of representations and warranties concerning the franchisor and its system general, which may include representations and warranties that:

(a) the franchisor has scheduled a true, correct and complete list of all currently-effective oral and written franchise and related agreements and amendments for the system’s franchisees (including development agreements, subfranchising agreements, options for additional territory);

(b) all of the identified franchise and related agreements are in full force and effect and are binding and enforceable in accordance with their respective terms; no franchise agreement is subject to any right of rescission, set-off, counterclaim or defense, and neither the franchisor nor, any franchisee is in breach of or in default under any of the franchise agreements;
(c) the borrower has scheduled a true, correct and complete list of all currently-effective oral and written franchise and related agreements;

(d) all of the identified franchise and related agreements are in full force and effect and are binding and enforceable in accordance with their respective terms; no franchise agreement is subject to any right of rescission, set-off, counterclaim or defense, and neither the franchisor nor, any franchisee is in breach of or in default under any of the franchise agreements;

(e) the franchisor has provided a true and correct list of all United States and foreign jurisdictions in which the franchisor, since a given date (e.g. a 3 to 5 year period), has been, and, currently is, registered or authorized to offer and sell franchises, and in which the franchisor has offered, sold or entered into franchise agreements;

(f) since a stated date, the franchisor has made on a timely and accurate basis all required additional filings (e.g. renewals and amendments) under applicable state and foreign registration and disclosure laws;

(g) since a stated date, the franchisor has maintained proper and complete records of all franchising activities and all material dealings and transactions in relation to their franchise activities;

(h) since a stated date (e.g. a 3 to 5 year period), the franchisor has prepared and maintained each disclosure document in compliance with applicable law;

(i) since a stated date, the franchisor has not, in any UFOC or other franchise disclosure document, or in applications and/or filings with any US or foreign jurisdictions, made any untrue statement of a material fact, omitted to state a material fact required to be stated therein, or omitted to state any fact necessary to make the statements made therein, taken as a whole, not misleading;

(j) except as disclosed, the franchisor has not, and has not authorized any person to furnish to prospective franchisees any materials or information that could be construed as an ‘earnings claim’ or ‘financial performance representation’ in violation of applicable law;

(k) except as disclosed, the franchisor and its affiliates do not receive rebates, commissions, discounts or other payments or remuneration of any kind from suppliers selling products or services to franchisees;

(l) the franchisor is not subject to any currently effective order or injunction, with respect to the offer or sale of franchises in any jurisdiction and there are no proceedings pending or threatened against the franchisor alleging failure to comply with any applicable franchise laws; and

(m) except as disclosed, no franchisee has a protected territory, exclusive territory, right of first refusal, option, or other similar arrangement with respect to a franchised Business, or any right or option to operate, develop, or locate a franchised Business, or to exclude the franchisor, or its affiliates or others from operating or licensing a third party to operate a franchised Business, in any geographic area or at any location.
D. Events of Default.

The loan documents typically enumerate in lengthy detail various events of default which can trigger default and acceleration of the indebtedness, and foreclosure rights and other remedies, such as failure to pay any principal or interest when due, failure to observe, perform or comply with any covenant, condition or agreement contained in the loan documents; breach of any representation or warranty; incurring or failing to discharge money judgments, writs or liens involving stated amounts, occurrence of any material adverse effect, any failure of the lenders security interest, failure of any guaranties, any change in ownership or control, loss of key employees (e.g. President and Chief Executive Officer).

IX. DISCLOSURE ISSUES.

In any financing transaction by a franchisor, some thought must be given to whether the proposed financing will trigger a need to amend the franchisor’s franchise disclosure documents. This inquiry can be complex and multifaceted.

A. Senior Debt Financing.

Ordinary senior debt financing through commercial lenders may not present immediate franchise disclosure issues because whether considered under the Uniform Franchise Offering Circular Guidelines or the new FTC Franchise Rule requirements, a franchisor’s borrowings are not required to be disclosed to prospective franchisees except as part of its Item 21 financial statement disclosure requirements. However, if the indebtedness would impact the financial statements, an amendment to the disclosures might be necessary. A traditional bank loan might not impact the franchisor’s balance sheet, because at the same time as the indebtedness is incurred, there will be an equal and offsetting increase in cash, or elimination of existing indebtedness if the purpose of the financing is to refinance existing debt. Of course, if the loan proceeds are used to buy out minority owners or to pay dividends, the impact on the financials could be significant. Also, over time, it is possible that the interest incurred in connection with the financing could impact the franchisor’s profitability and eventually result in a material adverse change that would trigger the need to amend the disclosure document to include interim financial statements. However, it is unlikely that this type of impact would occur in the near term following establishment of an ordinary senior credit facility.

B. Securitization Financing.

On the other hand, if the indebtedness is incurred in connection with a securitization, potential franchise disclosure issues may be presented. A securitization financing may involve a substantial restructuring of the franchisor’s operations. In a securitization, the franchisor’s intellectual property will typically be isolated in a bankruptcy remote special purpose entity which could require changes to its disclosures in Item 13 (trademarks) and Item 14 (copyrights and patents). There may also be a number of new entities formed, possibly even the creation of a new franchisor entity, or the functions of existing entities may change or there may be created new entities such as a servicing entity which will provide services to the franchisor and franchisees, any or all of which may render the disclosures in its existing disclosure document inaccurate, requiring changes to the disclosure document. Possible items affected may include

34 Of course if the franchisor itself will be a new and different entity, it will require an entirely new disclosure document for the new entity, but even the creation of a servicing entity will trigger disclosures in Items 1 and 8 concerning affiliates providing goods and services to franchisees.
Item 1 (parents and affiliates), Item 2 (officers and directors), Item 8 (goods and services provided), Item 12 (territory and whether any affiliates franchise or operate similar businesses under a different mark), and Item 21 (financial statements). Securitizations can come in a variety of structures and in some securitizations, a new franchisor may be created to sell future franchises while franchisees under contract at the time of the securitization may remain behind in the existing franchisor entity and serve as security for the credit facility. The successor franchisor may also undergo a subsequent securitization itself, triggering disclosure amendments once again.

C. Multi-unit Franchisee Acquisitions

Financing of acquisitions of large multi-unit franchisees may involve extensive negotiations by the franchisor of intercreditor agreements, with the acquiror’s lenders, but unless the franchisor is offering or arranging the financing, in which case the arrangements require disclosures under Item 10 of the franchisor’s disclosure document, such arrangements would not typically be expected to trigger franchise pre-sale disclosure obligations to the buyer.

D. Franchisor Acquisitions.

If the franchisor is being acquired by a third party, this fact may need to be disclosed, depending on the structure and effect of the acquisition. If the transaction is structured as an asset sale, or a merger in which the existing franchisor is not the survivor, the acquiror would be a new franchisor which would need its own disclosure document and, on a state level, would have to register or qualify under applicable state exemptions. Where the franchisor is exempt under a state “large franchisor” exemption, it will be necessary to study the transaction carefully to determine whether the successor entity will be able to qualify under the exemption. These exemptions typically require the franchisor to have had a specified number of franchisees, or for it or its parent company to have operated the business being franchised, for five years, and the acquirer may have to wait another five years to achieve the requisite experience.\(^{35}\)

In the case of a stock acquisition, an amendment may be necessary under the new FTC Franchise Rule requirements, which requires that all direct and indirect parent companies be identified\(^{36}\). Of course if the change in owners also results in a change in officers or directors, that will trigger the need to amend as well.

If the franchisor is acquiring another franchisor, the disclosure documents of both entities may need to be amended. Item 1 of the Uniform Franchise Offering Circular Guidelines and the new FTC Franchise Rule require disclosure of all affiliates that offer franchises in any line of business.\(^{37}\) and at least in some circumstances, the acquisition of another franchisor may arguably be material to a prospective franchisee of both the acquired and acquiring chain. Acquisitions often involve layers of both equity and debt which could affect the franchisor’s financials, requiring an amendment to Item 21.

Even under common law there may be a duty to disclose plans to sell the chain. In one recent case, the court refused to dismiss the franchisees’ cause of action for common law fraud under New York law, which alleged that a franchisor knowingly made material misrepresentations and

\(^{35}\) See, e.g., CAL. CORP. CODE § 31101(b), Bus. Franchise Guide ¶ 3050.25, § 31101.


\(^{37}\) Id.
false statements about its plans to sell a hotel chain shortly after the two prospective franchisees purchased their franchises.  

Assuming that the financing or acquisition requires disclosure, the next question is when is disclosure required. Under the concepts expressed in the leading securities law case, Basic vs. Levinson, materiality in a merger context is assessed with reference to the probability that the transaction will close. Accordingly, assuming one concludes that a proposed sale of a franchise chain is material to prospective franchisees, it would certainly need to be disclosed (or all franchise sales activity ceased) at least by the time a definitive agreement has been executed, but quite possibly even earlier, depending on the facts and circumstances. The Basic decision suggests that once a company decides to proceed with a merger, the duty to disclose this fact to prospective franchisees arises. Disclosure may be triggered upon approval by the company’s board of directors or upon execution of a letter of intent.

X. CONCLUSION.

Financing plays an important role in franchising, facilitating liquidity and providing capital to fund the growth of both franchisors and franchisees. There are numerous options for a franchisor and franchisee to consider, and each type of financing vehicle has its advantages and disadvantages. There has been increased interest by private equity firms in acquiring franchisors and large multi-unit franchisees; and in the case of acquisitions of multi-unit franchisees, the involvement of such sophisticated private equity firms purchasers has tended to increase the complexity of these transactions. Likewise, securitizations are relatively new in the franchise sector, with only a handful of such transactions having been completed to date, but their use is increasing both in frequency and size of transaction, and more such financings can be expected.

What is clear is that negotiating and documenting a franchise financing is complex and involves many steps and considerations. This paper has covered only the tip of the iceberg in terms of the issues and factors to be taken into account in selecting and documenting a financing transaction, including how to choose the right financing partner (private equity firms, venture capital firms, traditional commercial lenders, among them); the advantages and disadvantages of each type of outside capital; understanding how the business will be evaluated by an outside investor/lender; specific legal considerations in dealing with lenders seeking a security interest in a franchisee/borrower’s franchise agreements; due diligence; franchise disclosure issues and deal documentation.


40 The original FTC Rule defined materiality, but in the new FTC Rule the FTC determined a definition was not necessary and it was expressly omitted. It determined that an understanding of materiality can be had by referring to long-established FTC jurisprudence, and in interpreting Section 5 of the FTC Act, a representation, omission, or practice would be deceptive if: “(1) it is likely to mislead consumers acting reasonably under the circumstances; and (2) it is material; that is, likely to affect consumers' conduct or decisions with respect to the product at issue.” In the franchise context, “materiality” is determined by the reasonable prospective franchisee standard. Bus Franchise Guide 6060 (CCH). 16 C.F.R. 436.1 (Definitions).

Kenneth R. Costello

Kenneth R. Costello is a partner in the Santa Monica office of Bryan Cave, LLP. He has practiced for almost 30 years in U.S. and international franchise and intellectual property law, including franchise, copyright, trademark and technology law, and represents businesses that use franchising and licensing in the distribution of goods and services.


He has served on the International Franchise Association’s Supplier Forum Advisory Board, and on its Legal Legislative and Membership Committees, as an Articles Editor on the ABA Franchise Law Journal and he serves on the Advisory Boards of Leader's Franchising Business & Law Alert and Andrews Franchise & Distribution Litigation Reporter.

Mr. Costello is recognized as one of the 22 “Most Highly Regarded” franchise lawyers globally by International Who’s Who of Franchise Lawyer’s (Law Business Research, Ltd., London), and by Chambers USA, he has testified on franchise trade regulation issues before the Federal Trade Commission and has been consulted on franchising issues by the Wall Street Journal, New York Times, Los Angeles Times, CBS News, Forbes and Entrepreneur Magazine, among other media.
H. Scott Pressly

H. Scott Pressly is the Founder and Managing Partner of Van Ness Capital Advisors, Inc.. With a unique background as both an operator and principal investor, Mr Pressly has experienced first-hand the challenges and opportunities of operating, growing and capitalizing franchise businesses.

Before founding Van Ness Capital Advisors, Mr. Pressly was a Managing Director at Roark Capital Group, a private equity firm with $550 million of capital under management. At Roark, he evaluated hundreds of franchise companies for potential acquisition and was directly responsible for sourcing and closing multiple investments. He also was actively involved post-close as a board member for brands such as Schlotzsky's, McAlister's Deli, Fastsigns, Money Mailer, Cinnabon, and Carvel Ice Cream.

Mr. Pressly also has significant direct operating experience. Currently, he is a multi-unit franchisee for Edible Arrangements and was previously Vice President of Acquisitions and Development for U.S. Franchise Systems, a multi-brand hotel franchisor. He has also held leadership roles with The Walt Disney Company and Dow Chemical USA.

With extensive relationships in the franchise community, Mr. Pressly is active on several franchise related Boards including being a founding member and Director of the Atlanta Franchise Alliance, a Director on the International Franchise Association Supplier Forum Advisory Board, and a Trustee for the IFA Educational Foundation. Additionally, he is a frequent expert writer and speaker addressing capitalization alternatives for franchisors.

Mr. Pressly received his Masters of Business Administration from Harvard Business School and a Bachelor of Science, Magna Cum Laude, in Chemical Engineering from the University of Florida.