HOW FAR UP THE OWNERSHIP
CHAIN CAN LIABILITY GO?

FRANCHISE INVESTOR
CLAIMS AND LIABILITY

William K Whitner
Paul Hastings LLP
Atlanta, GA

Elliot Ginsburg
Garner & Ginsburg, P.A.
Minneapolis, MN

October 14-16, 2015
Sheraton New Orleans Hotel New Orleans, LA
Private Equity and Venture Capital Investment in Franchise Systems

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I. INTRODUCTION AND BACKGROUND

The franchise system is a proven method of starting, growing, and leveraging a business concept. Over time, the operation of a franchise system creates expectations for its stakeholders, and tensions develop between participants about a wide range of issues, among many others: royalties, control, compliance, and expansion. Altering those expectations can quickly meet with resistance of increasing magnitude—and claims asserted in litigation. But, what occurs when the disruption to the franchise system is investment by a private equity or venture capital firm (“PE/VC”)? The short-term goals of a PE/VC firm, namely a sizable or rapid return on investment, are in obvious conflict with those of other members of the franchise system, who generally are more concerned about stable growth or a way of life.

As private equity and venture capital investment in the franchise industry continues, these investing firms must be aware of the litigation risks associated with their business strategies and emerging arguments for upstream investor liability. This article, developed in five parts, explores the impact of private equity and venture capital investments in the franchise system with a focus on the potential for increasing litigation risk and direct claims against investors. Part I explores the growth of PE/VCs in the franchising industry. It then examines the tensions between ‘traditional’ franchising and PE/VC interests. Part II analyzes the current bases for PE/VC liability. Part III offers evolving theories for potential PE/VC accountability—irrespective of the corporate structure of the franchise investment. Part IV suggests avenues for PE/VCs to proactively manage their potential liability. Finally, Part V identifies recent litigation attempting inroads against traditional notions of limited liability and separate corporate identity.

A. Growth of Private Equity/Venture Capital Franchise Involvement & Alluring Return on Investment

Private equity firms and venture capitalists are increasingly purchasing franchises and making impressive returns. During 2013 and 2014, over 250 PE/VC firms invested in the franchise industry or actively expressed interest in so doing. A prime example of this investment strategy, and its potential payoff, is Bain Capital LLC’s acquisition and later divestment of Domino Pizza Inc. (“Domino’s”). In 1998, Bain Capital acquired 90% of Domino’s for $1.1 billion. Bain Capital did not have a strategic plan to change the company, and instead simply adopted Domino’s existing strategy. Bain reaped a 500% return on its investment over twelve years, and paid out an $897 million “monster dividend” to investors.

1 Brett Lowell et al., Merger and Acquisition in Franchising Strategies for 2014 and Beyond, https://www.dlapiper.com/~/media/Files/Insights/Publications/2014/05/MAinFranchisingWhitePaper.PDF.
3 Id.; see also Beth Healy, Domino’s delivered for Bain Romney’s Bain made big profit from the pizza chain, but left it saddled with debt, THE BOSTON GLOBE, Jan. 29, 2012, http://www.bostonglobe.com/business/2012/01/29/dominodelivered-for-baincapital/kyMA0fIwPYvg2pa0UK1UfI/story.html?camp=pm.
4 Healy, supra note 3.
The acquisition of Burger King is another example of the emergence and success of PE/VC firms in the franchise industry. Brazilian banker Jorge Paulo Lemann’s private equity firm (3G Capital) acquired Burger King for a total purchase price of $3.4 billion. Of that amount, 3G Capital deployed only $1.2 billion in cash, achieving a nearly 70% debt ratio in a 2010 highly-levered buyout. Unlike Bain’s acquisition of Domino’s, 3G Capital’s investment strategy involved operational changes for franchisees aimed at dramatically slashing operational costs and increasing profit margins. Two years after the acquisition, 3G Capital sold roughly 30% of its stake in Burger King to a special purpose acquisition corporation (“SPAC”) for $1.4 billion, with plans that ultimately led to the return of the company to public stock exchanges.

Through consortiums, PE/VC firms also have joined forces to effectuate large acquisitions, as occurred when PE/VC firms Caryle, Bain, and Lee Partners purchased Dunkin’ Donuts for $2.425 billion from Pernod Ricard S.A. in December 2005. The firms overhauled the existing management team. They also refined the beverage and food options to keep pace with current trends and an increasingly health conscious target market. They hired a new management team and devised a new business strategy that focused on quick, quality service. The PE/VC consortium expanded the number of stores in the United States and overseas by 36.9%. In August 2012, the consortium firms sold their shares in Dunkin’ Donuts, bringing a $600 million profit for each of the PE/VC firms—amounting to nearly three times each firm’s initial investment.

PE/VC firm Sentinel Capital Partners (“Sentinel”), also has taken great interest in investing in the franchising industry over the years. In 1999, Sentinel acquired Falcon Holdings, one of the largest Church’s Chicken franchisees. In 2005, Sentinel sold Falcon to its management team. During Sentinel’s approximate five-year ownership, Falcon’s sales grew substantially and its profits more than tripled. Five years later, Sentinel acquired Massage Envy. Sentinel made a “successful exit” just two years later, selling the franchise for $1 billion to Roark, another PE/VC firm. During Sentinel’s two years of ownership, Massage Envy grew rapidly, expanding from 600 clinics operating in 42 states to 800 locations in 45 states. No concrete data regarding Sentinel’s return on its investments in Falcon and Massage Envy exists.


6 Id.


10 Id.

11 Id.


13 Id.
because they are private companies; however, in both instances, Sentinel deemed the ventures to be “successes.”

Such resounding returns on investment have no doubt piqued the PE/VC industry’s interest in franchise systems, as reflected by recent transactions involving TGI Friday’s, CEC Entertainment, and Frisch’s Restaurants Inc. (“Frisch’s Big Boy”). Sentinel and TriArtisan Capital Partners joined forces and acquired TGI Friday’s in July 2014 for $800 million, a brand with roughly 900 restaurants operating in 60-plus countries, generating combined sales of $2.7 billion in 2013. Apollo Global Management acquired CEC Entertainment which now consists of Chuck E. Cheese’s and Peter Piper Pizza in January 2014 and October 2014, respectively. As a result, CEC Entertainment was transformed into a privately-held, wholly-owned subsidiary of Apollo’s affiliates. CEC Entertainment’s first quarter total revenues for 2015 increased by 3.8%, or $9.7 million, over the prior year to $265.5 million. The company attributes the increase to additional revenues resulting from the Peter Piper Pizza acquisition. In May 2015, PE/VC firm NRD Partners I LP purchased all of Frisch’s Restaurants Inc.’s outstanding shares for $34 each, totaling $175 million, and paying a premium of 21% over market price. And, as a recent example of a franchise system passing from one PE/VC owner to the next, Sun Capital sold Fazoli’s, a quick service Italian restaurant group acquired in 2006, to Sun Capital in July 2015.

As long as the trend of high return on investment in the franchise industry continues, franchise systems will continue to be attractive targets for PE/VCs.

B. Typical PE/VC Investment in the Franchise System

1. Buying Control: Investment in Franchisors

Franchisors are appealing target companies for PE/VC investment because of their established nature and historical financial performance. Specifically, PE/VCs are most interested in, and willing to pay higher valuation multiples for, franchisors with an established brand and track record. Royalty streams are another enticing franchise attribute. Further, debt


17 Id.


financing availability makes franchising more attractive to PE/VCs for reasons of leveraging capital, i.e., investing less of their own capital and borrowing the balance to increase their total returns on invested capital. Obviously, lenders are more willing to finance, and may offer better terms in, transactions where the franchisor has a stable record of growth, profitability, and a recognizable and valuable brand. For franchisors operating their own stores (in addition to franchised units), historically steady cash flows from operations can be an additional incentive for PE/VC investment and persuasive in attaining transaction financing. Other PE/VC investors take a different approach, seeing investments in franchisors as another form of leverage, alleviating the need to deploy significant amounts of capital into the investment since the franchisor is typically not responsible for the overhead costs of running the franchisees’ businesses.

Some PE/VCs have developed expertise in certain industries that widely utilize the franchise model, and as a result, have made a business of acquiring franchisors. Roark Capital Group for example, an Atlanta-based firm, has become one of the biggest players in the quick-service dining industry. In its fourteen-year existence, it has acquired three of the twenty-five most well-known quick-service restaurants, namely Arby’s, Auntie Anne’s, Cinnabon, and Moe’s Southwest Grill. Collectively, Roark Capital controls 45 franchise/multi-unit brands globally that have generated $17 billion in system-wide annual revenues.

2. PE/VC Investment in Large Franchisees and Master Franchisees

PE/VCs are not solely interested in acquiring franchisors; they also are active in acquiring multi-unit franchisees—presenting different opportunities, and challenges, than investment in franchisors. In 2014, PE/VCs aggressively bid on large restaurant franchisees with positive reputations and legacies, driving up valuation multiples above historical averages. This category of investors may view franchisees with high rates of return or cash flow generation as comparatively safer investments than franchisors. Franchisee acquisitions are promising because costs are both known and fixed, and the franchisor’s core business model is a proven and stable one. In contrast to acquisition of franchisors, however, franchisee investors are not “buying” control of the entire franchise system, only the contractual rights to participate in the existing status quo. Still, PE/VC purchases of multi-unit franchisees may pose potential conflicts with the franchisor’s power dynamic and established operational standards, amplified by the PE/VC’s investment objectives and greater sophistication. As the demand for multi-unit franchise ownership increases—now at over 75% of franchised restaurants—so, too,

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does a PE/VC firm’s ability to demand compromises and restrictions that possibly undermine the long-term viability of the brand. A lack of shared vision may disrupt the entire system.

Nevertheless, the potential for conflict has not been a deterrent for PE/VC investment in franchisees. For example, in 2013, RMH Franchise Corp., a company backed by ACON Investments, a PE/VC firm, acquired 40 Applebee’s units in the Midwest. Today, RMH owns 140 Applebee’s restaurants in fifteen states. Another example is Berkshire Hathaway Inc.’s acquisition of Van Tuyl Group. Van Tuyl Group is the largest private U.S. automobile dealership, with seventy-eight dealerships around the United States.

PE/VC firms can also invest in franchisees through master franchisor operator transactions. Master franchisor relationships are common internationally but are relatively rare in the United States. Specifically, the master franchisor and the master franchisee enter into an agreement whereby the master franchisor grants to the master franchisee, for a finite time and/or within a specific geographic area, territorial exclusivity over the brand and the development of the franchise system. Consequently, the master franchisee becomes the franchisor’s “delegate” for the granted geographical area. PE/VC firms often invest in master franchisees, paying entry rights and royalty fees in exchange for the exclusivity over the brand and development rights.

C. The Trouble with Change: PE/VC Investment Goals May Intensify Conflicts Underlying the Franchise System

A PE/VC’s likely primary consideration when investing in a franchise system is generating a relatively quick return through capital appreciation. Both the means and the end, or exit, to achieve this goal may be in conflict with settled expectations within the franchise system. Some PE/VC firms prefer not to overhaul all aspects of the target business and, instead, emphasize the quality of the target’s existing management team. Many others, however, find franchise targets most appealing because they have a solid business foundation.


28 James J. Goodman et al., supra note 19, at 8.

29 Id.

30 Id.

31 Joel R. Buckberg et al., The Franchise System Post-Private Equity Investment, INT’L FRANCHISE ASSOCIATION LEGAL SYMPOSIUM (2011), at 28; Turitto, supra note 8.

32 See Turitto, supra note 8.
and would benefit most from financing and/or operational improvements brought by the PE/VC firm.\textsuperscript{33} New policies and strategies may present significant short-term financial opportunities for investors, but definite tensions often follow between the PE/VC firms, franchisors, and franchisees. New executives and operational teams installed by investors can also precipitate disruptive behaviors, moving from stability and familiarity to a growth-driven platform and alterations of the proven franchise model:

> [D]epending on the opportunities presented, fund managers might focus on selling off company-owned units to be operated as franchises, encouraging existing franchisees to add more outlets, recruiting new franchisees, offering franchises in new places to fill market gaps, or “rolling up” independent operators under the franchise brand through acquisitions.\textsuperscript{34}

Even enduring the changes implemented by new ownership, in most cases,\textsuperscript{35} the PE/VC firm’s relationship with the franchise system will end in relative short order—it was never intended to be a perpetual holding. Ultimately, the portfolio company is to be sold and liquidated when the PE/VC’s investment criteria have been met.\textsuperscript{36} This is in conflict with the traditional model of franchising built on long-term growth and development. Franchisees are often attracted to the franchise model by the promise of lasting independent ownership measured with business guidance and support from others. A key benefit of the franchise system—its sustainable, successful, and stable business model—may be viewed as jeopardized by changes in ownership, management, and/or business strategy. While the injection of PE/VC capital has the potential to enhance the brand and benefit the entire franchise system, a PE/VC investor’s typical emphasis on monetizing assets before making an exit is an inherent conflict with traditional notions of franchising.\textsuperscript{37}

This tension and distrust can lead to litigation concerns, threatened and real. For example, in the case of Burger King, some operational demands by the franchisor incited franchisees to file a lawsuit, which began in 2009 and continued after 3G’s acquisition.\textsuperscript{38} The suit challenged the trajectory of Burger King’s relationship with franchisees and new direction for the brand. Franchisees were ordered to sell the double cheeseburger for $1 as part of a plan to increase customer traffic with new deals on the Value Menu and, with it, total restaurant sales volume.\textsuperscript{39} According to the franchisees, however, a $1 cheeseburger was not just a loss leader—it was a loss creator. After two years of legal warfare, the company and its franchisees

\begin{itemize}
  \item \textsuperscript{33} See e.g., supra Part I.A (discussing PE/VC firms specializing in the restaurant industry).
  \item \textsuperscript{34} Turitto, supra note 8, at 3.
  \item \textsuperscript{35} But see Barney Wolf, \textit{Inside Roark Capital}, QSR Magazine, http://www.qsrmagazine.com/growth/inside-roark-capital ("In its 13 years in existence, Roark [Capital] has sold only three companies. None were restaurants.").
  \item \textsuperscript{36} Buckberg, supra note 31, at 28.
  \item \textsuperscript{37} Buckberg, supra note 31, at 19.
  \item \textsuperscript{38} Nat’l Franchisee Ass’n v. Burger King Corp., No. 09-23435-CIV-MOORE/SIMONTON, 2010 WL 2102993 (S.D.Fla. 2010) (order summarizing dispute).
\end{itemize}
settled the case. In the end, franchisees gained more power in determining prices and new rights to vote on company proposals.40

As PE/VCs continue to make acquisitions and investments across the franchise industry, awareness of litigation risks and novel theories of liability should be an important consideration in both valuation and overall investment decisions.

D. Conflicts and Tensions Between “Traditional” Franchising and PE/VC Interests

As the number of PE/VC transactions escalate, due concern must be given not only to the traditionally diverging incentives of franchisors and franchisees but also to how PE/VC firms’ quest for ever-higher and quicker returns may polarize those interests. Often, a conflict exists between the interests of the ‘traditional’ franchising model as an opportunity for franchisees to run a steady business with an established concept and brand, and the PE/VC interests to monetize quickly the franchise brand and increase the value of their investment.

1. Conflicts Arising from New Control

In some cases, the emergence of a PE/VC firm with its new business initiatives and desired structural changes ruptures the existing franchise business strategy. PE/VCs not only must understand the existing franchise system and any contractual restrictions in place, but also the nuances of the franchisor-franchisee relationship to which they are the successor. The archetype investment strategy and “top down” management of the portfolio company may be met with resistance in the franchise context. In addition to investing in the franchise model, franchisees have invested in the existing franchisor/franchisee relationship and may resist “new management’s” changes in its exercise of control over certain business decisions and responsibilities for such things as “consumer level pricing and service” deliveries. When PE/VC firms acquire franchises, new firm initiatives that alter this established relationship as a result of a new management philosophy might be viewed as injecting unwanted risk into what franchisees view as an established, satisfactory system.

PE/VC acquisitions are motivated, at least in part, by a belief that the target company’s value can be increased, or cash flow improved, often with investor-imposed changes. When a PE/VC enters the scene with a strong franchisor management team, more flexibility is typically awarded to the management team. On the other hand, when the franchisor appears to be struggling with capital deprivation in the franchise, business planning, and innovation, the PE/VC firm may take a more involved approach, and franchisees may be offended if their status quo is hastily ruptured. In the latter case:

Franchisee relationships with the new owner will surely commence and progress in the wrong direction if change viewed as negative by franchisees is drastic, dramatic and autocratically imposed without consultation or discussion. To be sure, a troubled system with the need for significant change may benefit from such

40 Id.

41 Buckberg, supra note 31, at 18.
an approach, but those are not usually the target of private equity.\textsuperscript{42}

Consortiums present another potential complication. Consortiums occur when investors unite to raise the requisite capital for the deal, but once the transaction is consummated, the “collaboration ends and the group members pursue their own interests as independent equity investors in the portfolio company.”\textsuperscript{43} Group members’ pursuits of their diverse interests can create strategic disaccord in the target moving forward. Consortium members may, for example, disagree about the appropriate time to exit the investment or whether the original operational strategy may need revamping post-acquisition.

2. Conflicts Arising from PE/VC’s Exit Strategy

The capital that PE/VC investors utilize may be subject to a variety of restrictions, but an end, or exit, to the investment is almost universally contemplated. Several factors might impact the timing or pathway selected for that exit. In some cases, the PE/VC’s limited partnership agreement and the terms of repayment of the acquisition financing might dictate the amount of time that the firm holds the investment.\textsuperscript{44} Generally, however, PE/VC managers have flexibility in determining the duration of an investment. Still, “the liquidity needs of the PE/VC . . . investors may produce some pressure to deliver proceeds”\textsuperscript{45} or, in highly leveraged acquisitions, debt repayment may also trigger the need to sell.\textsuperscript{46}

PE/VC firms typically employ three exit strategies. One option is a liquidation event through a public stock offering. IPOs are time-sensitive and their success depends heavily on the state of the IPO market, and the stock market more broadly at the time of the sale.\textsuperscript{47} A second exit strategy is to sell the franchise system investment, possibly to a strategic buyer or to another PE/VC firm.\textsuperscript{48} In either of these two paths, the PE/VC firm’s relationship with the franchise system largely, or entirely, terminates. A third “partial exit” strategy is the refinancing of the company’s preferred debt or the issuance of special payouts to investors, thereby harvesting a portion of the accrued return on investment while retaining ownership.

PE/VC exit strategies may create potential conflicts with the franchise system. When exit is via IPO, franchises are made public companies and are made accountable to their shareholders. In this case, the top priority for the company becomes increasing shareholder value. For franchisors, this may be at the expense of investments or experimentation that might be in the company’s long-term interests. Franchisees may also be adverse to the increased regulation and the constant hassle of the financial reporting necessary for the franchisor’s quarterly reports to the Securities Exchange Commission.

\textsuperscript{42} Id.

\textsuperscript{43} Turitto, supra note 8, at 3 (citing Buckberg, supra note 31, at 4).

\textsuperscript{44} Buckberg, supra note 31, at 28.

\textsuperscript{45} Id.

\textsuperscript{46} Id.

\textsuperscript{47} Turitto, supra note 8, at 4.

\textsuperscript{48} Turitto, supra note 8, at 4.
When a PE/VC firm exits the franchise system by selling a franchisor to a strategic buyer or another PE/VC firm, franchisees are faced with the challenge of adapting to new management, yet again. The next owner may bring with it different priorities, a new management style, or a (further) revamped business model—all designed to generate a relatively quick return on investment. Franchisees may not be welcoming to another ownership change, especially if they endured turmoil only several years earlier. Additional changes or mandated capital outlays by the new owner, which carry inherent risks of disruption or undermining the operational benefits achieved (or attempted) by the selling firm, may only worsen this sentiment.

Finally, further-leveraging the investment to cash out the PE/VC interest and accrued gains, carries risks for the entire franchise system. The high degree of interdependency in franchising may cause unease when an important component of the overall system—be it the franchisor or large multunit operator—takes on a level of debt perceived as perilous. For example, after a leveraged buyout, Quizno's entered bankruptcy in hopes of shedding hundreds of millions of dollars of debt, perplexing its franchisees in the process.49 Likewise, franchisors might also fear the consequences of a large, multunit franchisee’s crushing debt load—potentially hampering growth and expansion, if not jeopardizing the overall brand if cost-cutting measures implemented to service debt adversely impact operations and customer satisfaction.

E. Structure of Investment and Controls

1. Corporate Structure and Layers of Liability Shields

One of the most desirable attributes of the corporate structure is limited liability—the fundamental notion that an investor's liability is limited to the amount invested. Typically, only in extreme circumstances can a corporate entity’s separate corporate existence be discarded in order to hold the corporation's owners and shareholders personally liable for the corporation's debts and liabilities. Many of the types of PE/VC deals detailed in this article are tailored to limit liability. Given these shields, complainants seeking to access manager or investor wealth will encounter complicated barriers specifically structured to eliminate liability, and will likely need to pierce several “layers” to reach the top of the ownership chain. Complex corporate relationships and multiple layers of liability are used to shield against and minimize liability. Importantly, however, no structure can immunize against sufficiently egregious conduct.

PE/VC firms aggregate and deploy capital through vehicles known as an “investment fund.” Each PE/VC firm usually manages any number of separate funds, with each individual fund generally structured as a limited partnership.50 In a basic form, a limited partnership agreement may have a ten-year lifespan during which the firm will invest in various portfolio companies with the sole goal of making a relatively rapid return on investment.51 Two types of partners, general and limited, are essential to the organization of a fund. With respect to liability, the general partners (“GPs”) are each liable for all debts of the partnership. By design, the PE/VC firm organizes a distinct entity to serve as the general partner of the PE/VC fund, usually another limited partnership or a limited liability company. Limited partners (“LPs”) are not


50 Turitto, supra note 8, at 2; Buckberg, supra note 31, at 3.

51 Turitto, supra note 8, at 3.
liable for debts of the partnership beyond the amount they have contributed. Adding another layer to the organization is the creation and control of a special-purpose acquisition corporation (“SPAC”), used to acquire actual investments. Within this structure, the PE/VC firm typically contributes 1% to 5% of the overall capital as the general partner. In serving as the “sponsor” of the fund, the firm raises the remaining capital from various wealth management vehicles that become limited partners. The general partner of the PE/VC fund retains the authority to make decisions, including managing daily operations and investment elections.

This complex corporate structure is a difficult barrier for complainants to bypass in order to attach liability to higher level ownership, including the PE/VC firms themselves. Subsequent sections of this article demonstrate, however, that discontented franchisees and franchisors are attempting to do so and have a myriad of legal theories to advance their pursuits.

2. Board Seats & Executive Management

An intriguing paradox exists between a PE/VC firm’s desire to exert control over its investment (sometimes every aspect of the acquired company), while simultaneously projecting an image of separateness and distinction for liability purposes. The layers of the corporate form that exist between the investors and managers of a PE/VC fund or firm and the acquired entity at the bottom of the chain may disguise the exercise of a remarkable degree of control and overlap of key personnel. Corporate structure may create the appearance that the system is not being tightly controlled from above when, in fact, it is. For example, the majority ownership of the target company enables the fund to exert significant control, notably over board seats and the option to choose preferred stock in the target. Often, the PE/VC firm’s overwhelming presence on the franchise’s board facilitates its ability to achieve the fund’s business objectives. As majority board members, the PE/VC firm approves major decisions and has significant discretion under the business judgment rule.

In their capacity as board members, PE/VC firms select high ranking (C-level) officers who run the day-to-day business of the acquired company. In situations in which the PE/VC becomes the franchisor, this undertaking is another way for PE/VC firms to control the entire franchise system. This control is potent because management conducts the franchise’s business, deciding critical issues varying from strategic initiatives to decisions such as whether to implement technology upgrades or to install a new accounting system.

When acquiring a franchise, PE/VC firms generally prefer not to overhaul all aspects of the target business, including replacing executives, but in certain cases, it may be deemed necessary to do so. Successful existing management teams are typically not dismantled.

When a target management team has proven to be a failure or seems reluctant to implement the PE/VC firm’s new strategy for success, however, the fund may find it necessary to hire a new management team that is willing to align with the PE/VC firm’s vision, goals, and timeline. Whether the PE/VC firm retains or replaces the management team, a certain degree of

52 Turitto, supra note 8, at 2 (citing Buckberg, supra note 31, at 4.).

53 Turitto, supra note 8, at 2.

54 Preferred Stock in Private Equity Transactions: Significant Tax Issues, Practical L. Co.

55 See, e.g., supra Part I.A (discussing past returns for PE/VC investments in the franchise industry).
control over the franchise management system is integral to a successful venture, but may lead to certain theories of liability as discussed throughout the paper.

3. Corporate Objectives and Directives

Critics of PE/VC investment in franchises often argue that as PE/VCs emerge, they heavily burden the target company with debt, and implement shortsighted, cost-cutting measures. However, the other side of the argument reveals that PE/VC ownership may have positive sustainable benefits, particularly when these firms have greater control and influence in the franchise. Shai Bernstein and Albert Sheen’s findings in The Operational Consequences of Private Equity Buyouts: Evidence from the Restaurant Industry support this notion. Their research revealed that the “effects are strongest in stores over which PE/VC firms have complete control and bigger influence. Franchisees, which are otherwise identical, do not see the same initial improvement, suggesting that PE/VC firms cause these changes.”

While PE/VC firms’ participation in the management and operation of the investment does not always rise to the level of a highly involved strategic investor, they are much more active than a typical passive investor who takes a back seat from daily business, merely ensuring that financial targets are met and reports issued. Along the spectrum of control:

Most PE/VC Fund GP’s and Asset Managers fall in between these poles, taking an active role on the portfolio company board of directors, approving C-level hiring and firing decisions, and monitoring financial performance monthly. The success of many PE/VC Funds depends on the GP acting as a resource and facilitator for target management, assisting with obtaining operational advantage through the affiliation with the PE/VC Fund sponsor.

As subsequent sections of this paper reveal, the various levels of control discussed above may have liability consequences under various legal theories.

II. CURRENT BASES FOR LIABILITY – CORPORATE GOVERNANCE AND EXISTING STATUTES

A. Corporate Veil/Alter Ego

PE/VC firms often design portfolio companies’ ownership structure in such a way that the PE/VC firms (or their affiliates or subsidiaries) extract money from their portfolio companies by charging substantial (and often hidden) fees. The problem, as shown below, is that the PE/VC firms extract money from portfolio companies that could have been re-invested in the

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57 Buckberg, supra note 31, at 14.

58 Id.
portfolio companies or could have been used to pay the portfolio companies’ creditors.\textsuperscript{59} This is becoming a more important topic for creditors of PE/VC firms’ portfolio companies because PE/VC firms often leave such creditors with no recourse.\textsuperscript{60} For example, in 2004, Wasserstein & Company, a private equity firm, bought the successful mail-order fruit retailer Harry and David.\textsuperscript{61} The following year, Wasserstein & Company, along with other investors, took out over $100 million in dividends, recovering their initial investment, plus a twenty-three percent profit, and charged Harry and David millions of dollars in “management fees.” Additionally, Wasserstein installed a new CEO that worked out of Atlanta, not Oregon where Harry and David was based. This new CEO received a pay package of $9.4 million (seven times the previous CEO’s pay package), and was permitted to fly first class to Oregon and lease private jets for travel.\textsuperscript{62} Harry and David eventually defaulted on its debt and failed to meet its obligations to creditors.\textsuperscript{63}

Harry and David entered into bankruptcy. As part of the Chapter 11 bankruptcy, Harry and David bondholders converted roughly $200 million in debt into equity to become new owners, and Harry and David received additional loans from creditors to fund operations, hoping that a stronger company would emerge from bankruptcy. In the end, “All of Wasserstein original investors got their money out of [Harry and David] and left [Harry and David’s hometown] with a shell of a company with gigantic debt.”\textsuperscript{64} Another consequence of the bankruptcy was that 2,700 Harry and David workers and retirees had their pensions terminated and shifted to the government sponsored Pension Benefit Guaranty Corp, which Wasserstein & Company and other bondholders required as a condition of investing $55 million in the company after it emerged from bankruptcy.\textsuperscript{65} The authors have not been able to locate any litigation against Wasserstein & Company related to its ownership of Harry and David.

In a similar situation, Buffets Restaurant chain owned and operated more than 600 restaurants. Its PE/VC owner, CI Capital Partners (“CI”), bought Buffets in 2000 and collected an annual service fee of two percent of Buffets’ earnings.\textsuperscript{66} Even as business was declining, the


\textsuperscript{60} Franchisees may end up in the role of a judgment creditor as a result of conduct of the PE-owned franchisor, but the franchisor may be unable to pay out any judgment or award to the franchisee judgment creditor if the PE owner of the franchisor raided the franchisor’s coffers and rendered the franchisor judgment proof.


\textsuperscript{63} Id.

\textsuperscript{64} Id.

\textsuperscript{65} Id.

\textsuperscript{66} Id.
PE/VC owner continued to extract the fees. By 2008, Buffets was bankrupt, yet CI made a profit in its eight year ownership, generating roughly $100 million in management fees and special dividends.\(^67\) As a result of the bankruptcy, thousands of employees were laid off, and unsecured creditors were left with pennies on the dollar. When CI exited, it left Buffets with six times the debt it had prior to CI’s takeover.\(^68\) While Buffets had an executive team in place, CI still collected significant “service fees.” The trustee in Buffets’ bankruptcy case sued CI for, among other things, unjust enrichment. Ultimately, that lawsuit settled for more than $23 million.\(^69\)

In yet another example, PE/VC firms purchased Mervyn’s, a department store chain, in 2004. The PE/VC firms allegedly engaged in fraudulent transactions when they split off Mervyn’s valuable real estate assets and later sold them to entities controlled by the PE/VC firms without compensating Mervyn’s for the loss of its property, resulting in Mervyn’s insolvency. Creditors also accused the PE/VC firms of breaching their fiduciary duties to Mervyn’s and its creditors by requiring Mervyn’s to pay its owners fees and dividends, despite its insolvency.\(^70\) Creditors sued the PE/VC firms in Mervyn’s bankruptcy proceedings for this conduct and the lawsuit settled for $166 million,\(^71\) despite an estimated $493 million in claims.\(^72\)

Similarly, Cambridge Industries, a Michigan-based plastics supplier, was owned by Bain Capital, a large PE/VC firm. In 2000, Cambridge was in serious financial trouble, yet Bain Capital continued to collect $1 million per year in “advisory fees.” After collecting more than $10 million in such fees from 1995 to 2000, Bain Capital took the company into bankruptcy, forcing creditors to take a substantial haircut.\(^73\)

In the franchise context, a franchisee may have valid claims against a franchisor rendered insolvent by PE/VC firm practices like those described above. In these situations, a franchisee may have to sue the PE/VC owner(s) if it hopes to recover anything. In order to do so, a franchisee may have to pierce the franchisor’s corporate veil to subject the PE/VC owners to liability.

In a recent case, franchisees’ attempt to pierce the corporate veil\(^74\) to assert claims against a PE/VC firm that owned a franchisor proved unsuccessful. The PE/VC firm purchased the franchisor, extracted fees, paid affiliated persons substantial salaries, and paid significant

\(^{67}\) Id.


\(^{69}\) Id.

\(^{70}\) Id.


\(^{74}\) This situation occurred in a case in which one of the authors represented a franchisee.
travel expenses (e.g., private planes) for its affiliated persons to travel to the franchisor's headquarters.\textsuperscript{75} The franchisor had few, if any, remaining assets. Plaintiffs argued that the franchisor's corporate veil should be pierced and that the PE/VC firm should be liable for the franchisor's fraud and breaches of contract. Had the corporate veil been pierced, the PE/VC firm would have had to arbitrate the franchisees' claims despite having not signed the contract containing the arbitration provision. The plaintiffs offered the testimony of an employee illustrating the degree of control that the PE/VC firm exerted over the company's management. The employee testified that when the PE/VC firm acquired the company, "it was like there [was] a new sheriff in town." The employee also claimed that the franchise's president was "just a puppet." The employee divulged that the president and staff were frustrated because they were unable to take the company in "a different direction . . . or add something [to the company]" because the president was "not able to make corporate decisions." Finally, the employee testified that "it seemed like ‘they, and who ‘they’ were was always the Pilot Group [made the corporate decisions]." The degree of control that the PE/VC firm exerted is also evident in the fact that the PE/VC firm paid the portfolio company's employees, and some portfolio company employees were directly appointed by the PE/VC firm.\textsuperscript{76}

Kentucky law governed the dispute, under which courts look to several factors when deciding whether to pierce the corporate veil: (1) inadequate capitalization; (2) failure to issue stock; (3) failure to observe corporate formalities; (4) nonpayment of dividends; (5) insolvency of the debtor corporation; (6) nonfunctioning of the other officers or directors; (7) absence of corporate records; (8) commingling of funds; (9) diversion of assets from the corporation by or to a stockholder or other person or entity to the detriment of creditors; (10) failure to maintain arm's-length transactions among related entities; and (11) whether the corporation is a mere façade for the operation of the dominant stockholders.\textsuperscript{77} The arbitrator held that some facts weighed in favor of piercing the corporate veil, but that there were insufficient facts to pierce it and, in any event, it was for a court to decide\textsuperscript{78} whether the PE/VC firm could be forced to arbitrate. Plaintiffs were not in a position to pursue this argument further at that time.

In \textit{IMG Fragrance Brands, LLC v. Houbigant, Inc.}, the ownership structure of various companies, including a PE/VC firm and its portfolio company, made it difficult if not impossible for a creditor to collect on a judgment against a portfolio company. In this case, a licensor, Houbigant, Inc. ("Houbigant") filed counterclaims against a licensee, sub-licensee, and the licensee’s parent company and PE/VC owners and managers.\textsuperscript{79} Houbigant was in the business of licensing fragrance product trademarks. Counter-Defendant IMG Fragrance Brands, LLC ("IMG Brands") was a wholly owned subsidiary of Counterclaim-Defendant IMG Holdings, Inc. (IMG Holdings). IMG Brands sub-licensed certain trademarks to Counterclaim-Defendant Dana Classic Fragrances, Inc. (DCF). Counterclaim-Defendants Zohar CDO 2003-1 Limited, Zohar II

\begin{footnotesize}
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\item \textsuperscript{75} Lindley Contours, LLC \textit{v.} Contours Express, LLC, American Arbitration Association, Case No.: 52 114 Y 00030 12, Memorandum in Response to Defendants’ Motion to Dismiss (Dec. 23, 2012).
\item \textsuperscript{76} Id.
\item \textsuperscript{77} Weingartner Lumber \& Supply Co. \textit{v.} Kadant Composites, LLC, Civil Action No. 08-181-DLB, 2010 WL 996473, at *8 (E.D. Ky. Mar. 16, 2010).
\item \textsuperscript{78} Lindley Contours, LLC \textit{v.} Contours Express, LLC, American Arbitration Association, Case No.: 52 114 Y 00030 12, Procedural Order #5 (Mar. 7, 2013).
\item \textsuperscript{79} 679 F. Supp. 2d 395 (S.D. N.Y. 2009).
\end{itemize}
\end{footnotesize}
2005-1 Limited, and Zohar III Limited (the Zohar Funds) were PE/VC funds that owned a majority of IMG Holdings, and Counterclaim-Defendant Patriarch Partners, LLC (Patriarch) was the collateral manager for the Zohar Funds, and its CEO was counterclaim-defendant Lynn Tilton.\(^\text{80}\)

Pursuant to Houbigant’s license with IMG Brands, IMG Brands was given the right to use various trademarks and was required to pay royalties and obtain the approval of sub-licensees. Houbigant alleged that in October 2008, IMG Brands and DCF engaged subcontractors to manufacture the products. It also alleged that the manufacturing facilities and subcontractors used were not specified or authorized in the license agreement.\(^\text{81}\)

Houbigant asserted a claim for breach of contract against IMG Brands, DCF, Patriarch, and IMG Holdings, and one of the Zohar Funds.\(^\text{82}\) The claims against IMG Brands and DCF survived their motion to dismiss.\(^\text{83}\) With respect to Houbigant’s claims against the Zohar Funds and Patriarch, Houbigant alleged that they were liable for the breach of the license agreement through their respective interest and control over IMG Brands.\(^\text{84}\) Under New York law, however, the court held that a corporate parent is not necessarily liable for the acts of its wholly owned subsidiary, even where the parent and subsidiary corporations have interlocking directorates.\(^\text{85}\) Thus, Houbigant’s claims against the PE/VC firm entities were dismissed.

\(^{80}\) Id. at 399.

\(^{81}\) Id.

\(^{82}\) Id. at 402.

\(^{83}\) Id. at 403.

\(^{84}\) Id.

\(^{85}\) Id. at 404 (citing Beck v. Conrail, 394 F. Supp. 2d 632, 637 (S.D. N.Y. 2005)).
Nonetheless, a parent may be liable for a subsidiary’s breach of the contract if a plaintiff can show that the parent corporation “exercised complete domination of the subsidiary corporation in respect to the transaction attacked; and . . . that such domination was used to commit a fraud or wrong against the plaintiff which resulted in the plaintiff’s injury.” 86 In considering whether a parent corporation exercised complete domination over its subsidiary, courts consider several factors, including: (1) disregard of corporate formalities; (2) inadequate capitalization; (3) intermingling of funds; (4) overlap in ownership, officers, directors, and personnel; (5) common office space and telephone numbers; (6) the degree of discretion shown by the allegedly dominated corporation; (7) whether the dealings between the entities are at arm’s length; (8) whether the corporations are treated as independent profit centers; (9) payment or guaranty of the corporation’s debts by the dominating entity; and (10) intermingling of property between entities.87

The multiple corporate layers insulating the Zohar Funds from liability complicated matters for Houbigant. IMG Brands was the allegedly breaching party, and IMG Brands was a wholly owned subsidiary of IMG Holdings. The Zohar Funds owned a majority of IMG Holdings, not IMG Brands. Thus, Houbigant would have had to allege that IMG Holdings dominated and controlled IMG Brands and that the Zohar Funds in turn dominated and controlled IMG Holdings to subject the Zohar Funds to liability. The court held that Houbigant alleged no facts that would justify piercing IMG Brands and IMG Holdings’ corporate veil; the claims against the Zohar Funds were dismissed.88

Therefore, Houbigant was unable to sufficiently plead facts to pierce IMG Brand’s corporate veil, but even if it had, it would have had to pierce IMG Holdings’ corporate veil to get to IMG Holdings’ PE/VC fund owners, which in turn owned IMG Brands. Franchisees with claims against PE-owned franchisors that are in dire financial straits should strongly consider whether there is a possibility of collecting from the PE-owned franchisor or if there is any chance of piercing the corporate veil to reach the PE/VC firm. If there are dim prospects for both, it may not be worth the expense of pursuing a claim to proceed with an action.

Presenting a similarly complex corporate structure resulting in a challenge for a plaintiff asserting claims up the ladder is Supply Chain Associates, LLC v. ACT Electronics, Inc. In that case, ACT manufactured electronic devices and components. Sun Act was the majority ACT stockholder, Sun Capital Partners II, LP (Fund II) owned Sun Act, SCA II was the general partner of Fund II, and SCP, LLC was the general partner of SCA II.89 ACT, Sun Act, Fund II, SCA II, and SCP, LLC were all named as defendants in a case in which the plaintiffs, Supply Chain Associates, LLC and Estream, alleged that ACT breached the contract for failure to pay commissions.

86 Id. (quoting Banks v. CORR. Services Corp., 475 F. Supp. 2d 189, 196 (E.D. N.Y. 2007)).
87 Id. (quoting Freeman v. Complex Computing Company, 119 F.3d 1044, 1053 (2nd Cir. 1997)).
88 Id.
Additionally, Sun Management had previously entered into a management services agreement with ACT in which Sun Management provided services to ACT’s management in exchange for an annual fee equal to the greater of $300,000 or eight percent of ACT’s EBITDA. Between 2002 and 2008, ACT paid Sun Management more than $2 million.90 Steven Liff (“Liff”) executed that agreement on behalf of both Sun Management as its vice president, and also on behalf of ACT as its vice president.91 Sun Advisors had also entered into an agreement with Sun Management in which Sun Advisors contracted to provide services to ACT.92

Plaintiff Estream was a manufacturer’s representative that brokered the sale of electronic products, and Edward Duffy (“Duffy”) was Estream's managing member from 2003 until its dissolution in 2005.93 In 2003, Estream entered into a sales representative agreement with ACT that provided Estream with commissions on sales to certain customers.94 Between August 2004 and March 2006, ACT reduced Estream’s commission percentage from five percent to four percent, and between 2003 and 2005 ACT failed to pay Estream commissions on its sales.95 Then, on September 30, 2004, ACT terminated the Estream agreement, and Estream was dissolved in 2005. In April 2006, ACT entered into a

90 Id. at *2.
91 Id. at *3.
92 It seems that Sun Management sub-contracted advisory services to Sun Advisors to create another corporate layer between the management fees collected and ACT. Instead of piercing the corporate veil of ACT to try and recover money from Sun Management, a claimant would likely have to pierce ACT’s corporate veil, and then pierce Sun Management’s corporate veil.
93 ACT Electronics, at *3.
94 Id.
95 Id.
sales representative agreement with Supply Chain Associates, LLC ("Supply Chain"), the other plaintiff along with Estream, on terms substantially similar to those of the Estream contract.96

The plaintiffs argued that from May 2006 through April 2008, ACT paid Supply Chain a commission for sales based on a four percent commission rate rather than a five percent commission rate, and there were several instances in which Supply Chain solicited business for ACT for which ACT failed to pay Supply Chain for its services.97

In 2008, however, ACT realized it was over-extended. Consequently, its board voted to file for bankruptcy. Thus, the plaintiffs sued ACT, Sun Act, Fund II, SCA II, SCP LLC, Sun Management, Sun Advisors, and Sun Capital, for breaching the contract that obligated ACT to pay Estream and Supply Chain sales commissions, violating Massachusetts’ Unfair and Deceptive Trade Practices Law, and interfering with Estream and Supply Chain’s contractual relationships with ACT.98

The defendants moved for summary judgment. The court considered twelve factors when determining whether to pierce ACT’s corporate veil and hold the Sun defendants liable: (1) common ownership; (2) pervasive control; (3) confused intermingling of business activity assets or management; (4) thin capitalization; (5) nonobservance of corporate formalities; (6) absence of corporate records; (7) no payment of dividends; (8) insolvency at the time of the litigated transaction; (9) siphoning of corporate assets by the dominant shareholders; (10) nonfunctioning of officers and directors; (11) the use of the corporation for transactions of the dominate shareholders; and (12) use of the corporation in promoting fraud.99

The court held that there was some common control of ACT because Sun Act owned 70 percent of ACT’s shares but there was evidence that they operated at arm’s length which weighed against piercing the corporate veil. Courts will find that a corporation is pervasively controlled when one corporation is carrying out tasks pursuant to another corporation’s command. In other words, the question is whether the corporation has a separate mind or not. The court held there was no evidence that the Sun entities ran ACT because ACT maintained its own headquarters, minute books, accounting records, bank accounts, and budgets separate from the Sun entities and ACT filed its own tax returns.

With respect to intermingling of activity assets or management, courts consider whether a business is clearly defined. The Supply Chain court held that this factor weighed against piercing the corporate veil because ACT maintained separate headquarters, books, accounting records, bank accounts, and budgets. With respect to capitalization, the court held that ACT was sufficiently funded because it was capitalized with over $7 million. Additionally, ACT observed corporate formalities, maintained its own corporate records, and declared dividends. Further, the court reasoned that the veil should not be pierced because there was no evidence of ACT’s insolvency during operations. Also, the dominant shareholder did not siphon corporate funds or channel excessive payments. The court also considered that the Sun entities did not use ACT to transact business for the dominant shareholder, and the fees to Sun Management

96 Id.
97 Id. at *5.
98 Id.
99 Id. at *9 (quoting Pepsi Cola Metro Bottle and Company, Inc. v. Checkers, Inc., 754 F.2d 10, 16 (1st Cir. 1985)).
were not extravagant or beyond any reasonable business amount. Finally, the court found that there was no evidence that the Sun entities used ACT to promote fraud. Thus, the court held in favor of the Sun entities on their motion for summary judgment.\textsuperscript{100}

This is another case exploring the difficulty in obtaining liability over PE/VC firms through piercing the corporate veil. In this case, even where ACT paid millions of dollars to one of the PE/VC entities and even though the same person on behalf of Sun Management and on behalf of ACT entered into the management services agreement on behalf of both parties, the court refused to pierce the corporate veil. Thus, the PE/VC entities were able to generate revenue by charging management fees, but reduce the risk of liability through various corporate layers. As a result, ACT's creditors were left with no recourse when the portfolio company failed.

When a PE/VC-owned franchisor defaults and has insufficient assets to cover a judgment, a franchisee can hope that it has sufficient evidence to pierce the franchisor's corporate veil to hold PE/VC firms liable. Even then, however, given the layers of protection, a franchisee may have to pierce several corporate veils in order to recover. Franchisors, of course, should also be wary of this issue when dealing with PE/VC-owned franchisees.

\textbf{B. Control Person Liability Under State Franchise Laws}

One wonders what purpose the management fees described above serve, and if a connection can be made between those fees and PE/VC firms' control over franchisors, so that PE/VC firms and their principals may be held liable pursuant to state franchise laws that provide for liability of persons that "directly or indirectly control a person liable under the statute."\textsuperscript{101} For example, if a PE/VC firm purchases a franchisor and accepts a management fee in exchange for management services, depending on the services provided in exchange for the fee, the PE/VC firm may have sufficient control to be liable under franchise statutes imposing control person liability.

Many state franchise laws include a provision that provides for control person liability.\textsuperscript{102} This type of statute was at issue in \textit{EV Scarsdale Corp. v. Engel & Voelkers North East LLC},\textsuperscript{103} where a franchisee sued a franchisor and other entities that owned and were affiliated with the franchisor. The New York Franchise Sales Act provision providing for control person liability states:

\begin{quote}
A person who directly or indirectly controls a person liable under this article, a partner in a firm so liable, a principal executive officer or director of a corporation so liable, a person occupying a similar status or performing similar functions, and an employee of a person so liable, who materially aids in the act of transaction
\end{quote}

\textsuperscript{100} Id. at *10-3.

\textsuperscript{101} \textit{E.g.}, Mich. Comp. L. § 445.1532.

\textsuperscript{102} Some of these statutes require that the control person "materially aid" in the unlawful conduct to be subject to liability, but others subject control persons to liability unless the control person had no knowledge of or reasonable grounds to believe the existence of the facts giving rise to liability. \textit{E.g.}, compare \textit{Kohr v. Gropp & Lehman Enters.}, 718 F.2d 1099 (6th Cir. 1983) (citing Mich. Comp. L. § 1532), with \textit{Cherrington v. Wild Noodles Franchise Co., LLC}, No. 04-4572 (MJD/JJG), 2006 WL 1704301, at *5 (D. Minn. June 15, 2006) (citing Minn. Stat. § 80C.17, Subd. 2).

constituting the violation, is also liable jointly and severally with and to the same extent as the controlled person, partnership, corporation or employer.\textsuperscript{104}

In \textit{EV Scarsdale}, a franchisee sued a franchisor for violations of the New York Franchise Sales Act, including the making of fraudulent financial performance representations, and the failure to provide the plaintiff with the FDD prior to the parties’ first personal meeting.\textsuperscript{105} Pursuant to \textsection 691(3), which provides for control person liability, the franchisee also sued the entities that owned and were affiliated with the franchisor. The ownership chain was structured as follows:

\begin{center}
\begin{tikzpicture}


\node (f1) at (0,0) {Engel & Voelkers AG};
\node (f2) at (-2,-2) {Engel & Voelkers IT-Services GmbH};
\node (f3) at (2,-2) {Engel & Voelkers Residential GmbH};
\node (f4) at (0,-4) {Engel & Voelkers U.S. Holding GmbH};
\node (f5) at (-2,-6) {Engel & Voelkers N.Y. LLC};
\node (f6) at (2,-6) {Engel & Voelkers U.S. Holdings, Inc.};
\node (f7) at (0,-8) {Engel & Voelkers Northeast, LLC};
\node (f8) at (0,-10) {Engel & Voelkers Scarsdale Corp.};


\draw[->] (f1) -- (f2); \draw[->] (f1) -- (f3);
\draw[->] (f2) -- (f4); \draw[->] (f3) -- (f4);
\draw[->] (f4) -- (f5); \draw[->] (f4) -- (f6);
\draw[->] (f5) -- (f7); \draw[->] (f7) -- (f8);
\draw[->] (f6) -- (f7);

\node (t1) at (-2,-7) {Owns}; \node (t2) at (2,-7) {Owns};
\node (t3) at (0,-5) {Owns & Licenses to}; \node (t4) at (-2,-3) {Owns & Licenses to}; \node (t5) at (2,-3) {Licenses to};
\node (t6) at (0,-1) {Licenses to}; \node (t7) at (0,-1.5) {Transferred Licenses};

\end{tikzpicture}
\end{center}

The franchisor’s related entities moved to dismiss the claims against them on the grounds that the franchisee did not allege any facts suggesting that the non-franchisor defendants played any role in the franchise sales process.\textsuperscript{106} The court denied the motion to dismiss, however, because the corporate structure suggested varying degrees of control over the franchisor by the related entities.\textsuperscript{107} The court did not discuss how the non-franchisor entities controlled the franchisor. The complaint, however, alleged that each of the related entities, through ownership or affiliation, and by providing services to companies in the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{104} N.Y. Gen. Bus. Law \textsection 691(3).
\item \textsuperscript{105} \textit{EV Scarsdale Corp.}, 2015 WL 3548361, at *6.
\item \textsuperscript{106} \textit{EV Scarsdale Corp. v. Engel & Voelkers North East, LLC}, Index No. 651608/2011, Omnibus Memorandum of Law in Support of Motions to Dismiss Plaintiffs’ Amended Complaints, Dec. 8, 2014, Doc. No. 124.
\item \textsuperscript{107} \textit{id.} at *11.
\end{enumerate}
\end{footnotesize}
ownership chain, directly or indirectly controlled the franchisor for purposes of control person liability. 108

While EV Scarsdale is not a private equity case, the ownership structure of the franchisor related entities is similar to the ownership structure of PE/VC firms that own franchisors – one holding company owned another holding company that licensed rights to yet another holding company, then licensed rights to a franchisor to sell franchises. This is similar to the ownership structure in Houbigant where several PE/VC funds owned a holding company that owned a separate company that was a licensee of a separate entity and that sublicensed its rights to yet another company. Thus, EV Scarsdale is instructive for franchisees with claims against PE-owned franchisors under statutes that provide for control person liability. Where a PE/VC firm owns a franchisor and the franchisee wants to sue the PE/VC firm with deeper pockets, it may be able to assert direct or indirect control by the PE/VC firm or related entities over the franchisor, such that those PE/VC entities may be liable under a state franchise statute.

Reaching a different conclusion, the court in Berglund v. Cynosure, Inc., held that franchisees’ attempt to obtain liability over an insolvent franchisor’s shareholder for fraud and violations of various state franchise laws109 failed. The court held that the allegations of control were insufficient to establish liability under Minn. Stat. § 80C.17, Subd. 2, which provides for control person liability, because the plaintiffs merely alleged: (1) Cynosure owned a forty percent interest in the franchisor; (2) Cynosure guaranteed some of the franchisor’s leases; (3) Cynosure had an exclusive purchasing contract with the franchisor; and (4) Cynosure’s founder was on the franchisor’s board.110 The court refused to hold Cynosure liable under the Minnesota Franchise Act because there was no allegation of Cynosure’s participation in the franchisor’s general operations or that Cynosure had the power to control the fraud in which the franchisor allegedly engaged.111

Franchisees seeking judgments against franchisors’ private equity owners may find state franchise laws providing for control person liability a fruitful avenue. As the Cynosure case shows, however, a franchisee that can show actual participation in the unlawful conduct on the part of the private equity owner is more likely to be successful on such a claim. While the court in EV Scarsdale did not require allegations of actual participation on the part of the owners of the franchisor for possible control person liability, that case was decided only on the pleadings and the court has not yet issued a final judgment in that case.

C. RICO

Typically, it is difficult for plaintiffs to sufficiently plead RICO claims. In some cases, however, it may be the best approach in trying to hold PE/VC firms accountable because RICO statutes provide for liability over any parties involved in the RICO enterprise. The RICO statute provides, in part, “[i]t shall be unlawful for any person employed or associated with any


110 Id. at 958.

111 502 F. Supp. 2d at 958.
enterprise engaged in, or the activities of which affect, interstate or foreign commerce to conduct or participate, directly or indirectly, in the conduct of such enterprise’s affairs through a pattern of racketeering activity.” 18 U.S.C. § 1962(c). To show liability, a plaintiff must allege: (1) conduct; (2) of an enterprise; (3) through a pattern; (4) of racketeering activity.¹¹²

RICO claims are becoming more common in the franchise context. For example, in *Giuliano v. Everything Yogurt, Inc.*, yogurt store franchisees brought a RICO claim against their franchisor and its principal.¹¹³ The franchisees alleged predicate acts of mail and wire fraud in violation of 18 U.S.C. § 1962(c), that the defendants conspired to violate 1962(c), and that the defendants invested income from racketeering activity in an enterprise in violation of 1962(a).¹¹⁴ Fraudulent conduct allegedly giving rise to the plaintiffs’ claims included understating expenses to be incurred, overstating gross income to be realized, and failing to supply franchise disclosure documents to some plaintiffs.¹¹⁵

The plaintiffs sufficiently alleged mail fraud by specifying the documents sent by mail that were part of the scheme to defraud. They pled intent to defraud through allegations that the defendants were motivated to obtain franchise fees and had an opportunity to defraud the plaintiffs by manipulating financial figures.¹¹⁶ The plaintiffs also sufficiently pled an enterprise by alleging that the defendants, together with a franchisor affiliate, shareholders, directors, and employees, engaged in a pattern of racketeering to defraud prospective franchisees.¹¹⁷ The plaintiffs’ claim for violations of 1962(c) were upheld, but their other RICO claims were dismissed because they failed to allege a conspiracy (or an actual agreement to commit the predicate acts), and because they did not plead injury arising from the investment of proceeds derived from prior racketeering activity.¹¹⁸ Thus, *Giuliano v. Everything Yogurt, Inc.* illustrates how RICO claims may provide franchisees or franchisors with arguments that PE/VC owners of franchisors or franchisees are subject to liability—where a franchisor delivers a fraudulent FDD to induce a prospective franchisee to purchase a franchise, depending on a PE/VC firm’s (or its principals’) involvement in the fraud, the PE/VC firm could find itself or its executives as RICO defendants. A complicating factor, however, is the decision in *Copperweld Corp. v. Independence Tube Corp.*, in which the Supreme Court held that a parent and its subsidiaries lack the capacity to “conspire” in the antitrust context;¹¹⁹ this doctrine has been expanded to forbid the finding of a conspiring enterprise between a parent and wholly owned subsidiaries in the RICO context.¹²⁰ In other words, where a PE/VC firm is the parent of a wholly owned

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¹¹⁴ Id. at 243.

¹¹⁵ Id. at 243-44.

¹¹⁶ Id. at 245-46.

¹¹⁷ Id. at 247 (holding that a corporation and its employees, officers, or directors may constitute a RICO enterprise).

¹¹⁸ Id. at 248-49.


¹²⁰ See, e.g., *Fogie v. THORN Americas, Inc.*, 190 F.3d 889, 898 (8th Cir. 1999).
subsidiary franchisor, showing an “enterprise” for RICO purposes between the two may not be possible.

In Westerfield v. Quizno’s Franchise Company, LLC, a franchisee class asserted claims against the franchisor and several other entities, including a VC firm, Cervantes Capital, LLC. Cervantes Capital, LLC (or one of its related entities) owned a portion of Quizno’s, and it appeared to have entered into a management services agreement with Quizno’s.\(^{121}\) This management relationship served as a basis to allege that the Cervantes defendants played such a role in Quizno’s business as to justify including them in the RICO claim for violations of 1962(c). Two individuals also served as officers and/or directors for Quizno’s and were employed by and/or owned an interest in Cervantes.

These cases illustrate attempts to include PE/VC firms as defendants in RICO claims. The fact that PE/VC firms (or affiliates) may be reaping fees for management services, suggests, at the very least, the PE/VC firm’s involvement in controlling the portfolio company. While such management agreements may not be enough to pierce the corporate veil, as described above, it may be sufficient, at least at the pleading stage to assert RICO claims to the extent there are facts supporting the existence of a RICO enterprise between the franchisor and the PE/VC firm and/or its principals. It also points to a line of inquiry that claimants can pursue in discovery with a PE/VC owned franchisor or franchisee.

III. EVOLVING THEORIES FOR POTENTIAL PRIVATE EQUITY/VENTURE CAPITAL ACCOUNTABILITY

A. Aiding and Abetting – Breach of Duty

An “aiding and abetting” claim provides a method of expanding liability beyond defendants owing a duty to the potential plaintiff. A 2014 California appellate decision, American Master Lease LLC v. Idanta Partners, Ltd., illustrates application of this concept as a vulnerability for PE/VC firms—particularly where a dispute is existing or expected surrounding an acquisition or investment.\(^{122}\) Outside investors, who likely view themselves as negotiating at arm’s length, should evaluate whether their proposed conduct might run afoul of fiduciary standards owed by the other negotiating party. If, for example, an investor’s proposed terms or consummation of a contemplated deal would force a breach of a fiduciary duty by a corporate insider, the outside investor may be forced to defend a claim for aiding and abetting a breach of fiduciary duty in their own capacity.

Although the business sector at the heart of American Master Lease LLC is outside the franchising arena, the conduct of a captioned defendant—Idanta Partners, Ltd. ("Idanta")—could be repeated in any context, including within the franchise system. Idanta was a more than 40-year old venture capital firm founded and managed by David J. Dunn, who was featured as owning “San Diego’s Most Expensive Home” at $41 million, and invests on behalf of the billionaire Bass family.\(^{123}\) As a sophisticated firm specializing in “helping entrepreneurs create

\(^{121}\) Westerfield v. Quizno’s, Case No. 06-C-1210, Docket No. 136, ¶ 200 (E.D. Wis. May 30, 2008).


and finance new companies,” Idanta viewed American Master Lease LLC (“AML”) as an investment opportunity.  

AML’s business allowed investors in real estate to avoid adverse tax consequences associated with property sales by acquiring interests in a larger real estate entity and holding property as tenants in common—all under Section 1031 of the Internal Revenue Code.  

AML’s majority owners rejected a proposed transaction with Idanta, while the minority owners wanted to pursue it. The minority owners and management, in cahoots with Idanta, created a new entity, FORT Properties, Inc. (“FORT”), licensed AML’s business method, and sold a $2.3 million interest in FORT to Idanta. In response to the majority owners’ objection, Idanta’s counsel attempted to distance the firm, citing “disputes between . . . members of AML . . .” to be “resolve[d] among themselves without the involvement of Idanta Partners.” AML later filed claims against Idanta, and its principals, among others, including the Dunn Family Trust, for aiding and abetting breach of fiduciary duty, inducing breach of contract, conspiracy to induce breach of contract, interference with contractual relations, conspiracy to interfere with contractual relations, unfair competition, and unjust enrichment. 

The California appellate court rejected the defendants’ argument that they could not be liable for aiding and abetting a breach of fiduciary duty because the defendants did not themselves owe a fiduciary duty to the plaintiff. “[U]nder California law a defendant can be liable for aiding and abetting a breach of fiduciary duty in the absence of an independent duty owed to the plaintiff,” and that “liability may properly be imposed on one who knows that another's conduct constitutes a breach of duty and substantially assists or encourages the breach.” While “conspiracy to breach a fiduciary duty, requires that the aider and abettor owe a fiduciary duty to the victim and requires only that the aider and abettor provide substantial assistance to the person breaching his or her fiduciary duty . . .,” “aiding and abetting a breach of fiduciary duty arises when the aider and abettor commits an independent tort . . . [by] mak[ing] a conscious decision to participate in tortious activity for the purpose of assisting another in performing a wrongful act” or “enabl[ing] the primary violator to commit the underlying tort.” Accordingly, PE/VC firms considering investments in franchise systems must consider their potential liability for “aiding and abetting” a breach of fiduciary duty by others involved in the transaction—particularly where a dispute within the target entity over the propriety of sale or investment may develop.

125 Id.
126 Id. at 1461-63.
127 Id. at 1462-63.
128 Id. at 1465.
129 Id. at 1466.
130 Id. at 1476 (citations and quotations omitted).
131 Id. at 1477-77 (citation and quotation omitted) (emphasis added).
132 Id. at 14776 (citation and quotation omitted).
Franchisor organizations planning for, or optimistic toward, an eventual PE/VC transaction can increase their appeal, and dissuade the dangers of aiding and abetting liability, by configuring their operating agreements with LLC members to eliminate any fiduciary duties amongst LLC members. For example, Delaware’s LLC Act expressly allows the practice:

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.\(^{133}\)

**B. Aiding and Abetting – Breach of Franchise Agreement & Interference with Contractual Relations**

As discussed in Part I, PE/VCs should be cognizant of the amount of control they exercise in the target to mitigate liability. Additionally, they must understand the existing franchise system, any contractual restrictions in place, and the nuances of the franchisor-franchisee relationship to which they are the successor. They need to be particularly diligent when tensions are high between the franchisor and franchisees at the time of the transaction. Failure to do so can possibly subject them to direct liability for a claim for aiding and abetting a breach of franchise agreements. The Fourth Circuit illuminates, in *Broussard v. Meineke Discount Muffler Shops, Inc.*,\(^{134}\) the circumstances in which new controlling entities can be held liable for breach of contract through piercing the corporate veil while fighting claims of aiding and abetting a breach of fiduciary duty.

Franchisees brought a case against Meineke’s Discount Muffler Shops, Inc.’s (“Meineke”) and its corporate parents, GKN PLC (“GKN”) and GKN Parts Industries Corporation (“PIC”). The franchisees alleged, among other things, that franchise advertising breached the Franchise and Trademark Agreements (“FTAs”) that Meineke had entered into with every franchisee. Franchisees were required to pay Meineke ten percent of weekly revenues to fund national and local advertising. The funds were sent to a central account managed by Meineke, the Weekly Advertising Contribution (“WAC”) account. Meineke did not notify the franchisees when it dismantled the account and created a wholly owned subsidiary (New Horizons) to handle its advertising in-house. After a seven-week trial in the United States District Court for the Western District of North Carolina, the jury found in favor of the plaintiffs on all counts, including breach of contract, breach of fiduciary duty and aiding and abetting such a breach, and interfering with the plaintiffs’ contractual relations with Meineke. The plaintiffs demonstrated that Meineke, New Horizons, and PIC were “mere instrumentalities” of their parent with evidence that GKN was aware New Horizons was financed with WAC funds and that GKN “secretly encouraged Meineke to maximize New Horizons’ profitability.”\(^{135}\)

133 Del. Code Ann. Tit. 18, § 1101(c).


135 id. at 336.
$197 million compensatory damages award, totaling a $390 million final judgment against Meineke and its parents.

The appeal of this judgment highlights the strength of the corporate veil when subsidiaries are maintained as truly distinct entities. The distinctions are important for PE/VC firms to keep in mind as they consider how to structure and manage the target company, post-acquisition. The Fourth Circuit reversed the District Court, dismissing PIC and GKN from the case. Specifically, the Court of Appeals held that the corporate veil should not have been pierced to allow for judgment against the franchisor’s parent. The court asserted that disregarding the corporate form to impose vicarious liability on PIC and GKN was “impermissible,” highlighting the fact that corporate parents cannot be held liable for the acts of their subsidiary unless the subsidiary is nothing but a “mere instrumentality” of the parent. In order to find that a subsidiary is a mere instrumentality, the parent must dominate the subsidiary, making it the alter ego of the parent. Here, the Fourth Circuit found no proof of that. Additionally, Meineke was adequately capitalized and maintained an independent identity. The court underlined the fact that Meineke had always been managed by its own officers, and employees were not Meineke puppets. Also, GKN did not have a presence on the board. The Fourth Circuit also rejected the existence of any fiduciary duty that could be breached between Meineke and its franchisees.

As discussed in Part I, this distinction in management and ownership does not always exist in the traditional PE/VC structure used in franchise system investments. When PE/VC firms acquire franchises, the majority ownership of the target company enables the fund to exert significant control, notably board seats and the option to create preferred stock in the target. Often, the PE/VC fund’s overwhelming presence on the franchise’s board facilitates its ability to achieve the fund’s business objectives and approve major decisions with the entitlement of the business judgment rule, but it also opens the doors to potential liability.

In Meineke, the court also held that GKN and PIC had qualified privileges precluding suit against them for tortious interference with contractual relations. The five elements of intentional contractual interference are: (1) a valid contract existed between the plaintiff and a third person; (2) an outsider had knowledge of the plaintiff’s contract with the third person; (3) that the outsider intentionally induced the third person not to perform his contract with the plaintiff; (4) that in so doing the outsider acted without justification; and (5) that the outsider’s act caused the plaintiff actual damages.

The court found that the fourth element was not satisfied because GKN and PIC were justified in their actions. The court recognized that GKN and PIC were in fact interested in increasing profitability by handling the advertising funds from franchisees in house. Evidence was required that GKN and PIC acted without any legal justification in order for the acts to be considered unjustified. The court held that under North Carolina law, a justification existed because GKN owned all of Meineke stock. Consequently, GKN was protected by a form of qualified privilege for “non-outsiders.” The court reasoned:

In the context of interference with contract by an insider . . . the element that the defendant acted without justification is potentially vitiated by the defendant’s corporate position. Officers, directors, shareholders, and other corporate fiduciaries have ‘a qualified

\[^{136}\text{See supra note 54.}\]
privilege to interfere with contractual relations between the corporation and a third party.\textsuperscript{137}

Ultimately the court noted that, “[p]ublic policy demands that so long as these parties act in good faith and for the best interests of their corporation, they should not be deterred by the danger of personal liability.”\textsuperscript{138} This decision illustrates the corporate veil’s strength and shareholders’ qualified protection to interfere with contractual relations when justified. Although wielding control in the franchise system has undeniable operational benefits, it is not without the danger of increased litigation risk.

C. WARN Act – Employment Law Violations

Although litigation is an ever-present risk in modern business, the frequency with which claims are asserted often increases when businesses—whether franchisor or franchisee—are on the verge of failure. Although the gauntlet of potential plaintiffs may seem endless, many potential litigation targets may be focusing too narrowly on private contract rights when evaluating risks and taking action to mitigate potential losses. Public duties, imposed by law, can also lead to liability for PE/VC firms—especially because of their capacity to satisfy a judgment in the wake of a post-mortem business enterprise. The WARN Act is an example.

The federal WARN (Worker Adjustment and Retraining Notification) Act requires statutory advance notice of plant closings and mass layoffs.\textsuperscript{139} The WARN Act has been in effect since 1989, but recent cases demonstrate its lengthy reach to entities beyond a workers’ “payroll” employer. In 2013, the Second Circuit issued \textit{Guippone v. BH S&B Holdings, LLC},\textsuperscript{140} which emanates from the failed retailer Steve & Barry’s. Steve & Barry’s filed for Bankruptcy under Chapter 11, and several investment firms formed “a series of interrelated entities to purchase and manage” the company after that filing.\textsuperscript{141}

An entity known as “HoldCo” acted as the holding company and sole managing member of another entity, known as “Holdings.” The latter was funded with nearly $200 million to purchase Steve and Barry’s assets with approval of the Bankruptcy Court, thus, becoming the class-action plaintiffs’ employer. Holdings, however, had no board of directors and employed just two senior managers, a President and COO. HoldCo retained an accounting firm to serve as Holdings’ CFO. Holdings’ assistant secretary was on HoldCo’s board and one of the

\begin{center}
\begin{tikzpicture}
  \node (holdco) at (0,0) {HoldCo};
  \node (holdings) at (0,-2) {Holdings};
  \draw [->] (holdco) -- (holdings);
\end{tikzpicture}
\end{center}

\textsuperscript{137} \textit{Broussard}, 155 F.3d at 331.


\textsuperscript{139} 29 U.S.C. §§ 2101–2109.

\textsuperscript{140} 737 F.3d 221 (2d Cir. 2013)

\textsuperscript{141} \textit{id.} at 223.
investment firms. Following discussions of a “liquidation plan,” HoldCo replaced Holdings’ President and COO with an advisor firm for purposes of “the wind-down.” HoldCo also passed a resolution acknowledging that Holdings had informed HoldCo that a “staff reduction” was mandated and stating that the HoldCo’s board:

has determined in good faith that it is in the best interests of the Company to authorize Holdings to effectuate the Reduction in Force and to authorize Holdings to provide notice in respect of the Reduction in Force to each affected employee, as soon as reasonably practicable, in consideration of any potentially applicable U.S. federal, state or local laws.

The plaintiff filed claims against two of the investment firms that formed HoldCo and HoldCo itself. The District Court granted the investment firms’ motion to dismiss for failure to plead facts sufficient to bring those firms within the ambit of an “employer” under the WARN Act, and later granted HoldCo’s motion for summary judgment. An appeal followed to the Second Circuit, which acknowledged an “open question” in the circuit “as to what test governs whether a related or parent entity can be considered an employer under WARN.” Through Guippone, the Second Circuit resolved that issue by adopting the Department of Labor’s non-exhaustive five-factor analysis in determining whether related entities—including parent companies—are “single employers” under WARN:

independent contractors and subsidiaries which are wholly or partially owned by a parent company are treated as separate employers or as part of the parent or contracting company depending upon the degree of independence from the parent. Some of the factors to be considered in making this determination are (i) common ownership, (ii) common directors and/or officers, (iii) de facto exercise of control, (iv) unity of personnel policies emanating from a common source, and (v) the dependency of operations.

Although the Second Circuit acknowledged that “[t]hese factors are also sensibly applied to determine whether WARN liability is to be imposed on an equity investor, who may similarly exercise control over the termination decision,” it ultimately affirmed the district court’s grant of the investment firms’ motion to dismiss. However, HoldCo was not entitled to judgment as a matter of law. Instead, a sufficient question of fact existed as to whether “HoldCo exercised de facto control over Holdings,” i.e., “whether one company was the decision-maker responsible for the employment practice giving rise to the litigation.” Because Holdings could be viewed as

142 Id. at 223.
143 Id. at 224.
144 Id. at 226.
145 Id. at 226 (quoting 20 C.F.R. § 639.3(a)(2)).
146 Id. at 226.
147 Id. at 227.
lacking “the ability to make any decisions independently” and “not free to implement its own
decisions,” the case was remanded to the District Court as to HoldCo’s liability under WARN.\textsuperscript{148} The \textit{Guippone} decision also suggests that a single factor of the Department of Labor test can be
dispositive, “even in the absence of the other factors,” where any single factor is “particularly
striking.”\textsuperscript{149}

\textit{Guippone} is most likely to impact PE/VC firms investing in franchisees that directly
employ workers, and, franchisors to the extent company-owned stores are operated by the
target company. More generally, it also serves as a further reminder to respect corporate
formalities and a caution to maintain an appropriate separation vis-à-vis the employment
decisions of their investments. Because solvent targets for liability will be at a premium when
WARN Act claims ripen, potential defendants for these claims must evaluate their own
exposure, if and when, drastic employment measures are authorized.

\textbf{D. Trustee Claims}

Bankruptcy trustees may be able to pursue PE/VC firms to provide at least some
recourse for franchisee judgment creditors with judgments against bankrupt franchisors. In the
\textit{Buffets} case discussed in Part II, Buffets went into bankruptcy, despite its PE/VC owner’s
considerable profit, generating roughly $100 million in management fees and special dividends
over CI’s eight year ownership reign. While Buffets had an executive team in place, CI still
collected significant “service fees.” The trustee in Buffets’ bankruptcy case sued CI for, among
other things, unjust enrichment as a result of the receipt of those “service fees.” Ultimately, that
case settled.

Similarly, in \textit{Kipperman v. Onex Corporation}, a trustee brought an action against a
PE/VC firm and its affiliates that had acquired the debtor’s subsidiaries.\textsuperscript{150} The trustee claimed
that the debtor’s transfer of management fees to the PE/VC firm’s affiliates constituted a
fraudulent transfer. In order to prove the existence of a fraudulent transfer, the trustee had to
demonstrate that the debtor received less than reasonably equivalent value in consideration for
the payment of management fees, and that the debtor was insolvent at the time of transfer or
was rendered insolvent as a result of the transfer.\textsuperscript{151}

The defendants moved for summary judgment on the grounds that the debtor received
reasonably equivalent value for the management fees, in the form of management services. A
principal of one of the PE/VC affiliates testified about general services provided in exchange for
the management fees, but the PE/VC affiliates could not point to a single record or document
indicating what services they provided to the debtors in exchange for the management fees, or
when the services were provided.\textsuperscript{152} Additionally, the management agreement required the
defender to pay large sums for investment banking services despite the fact that none of the

\textsuperscript{148} \textit{Id.} at 227-28 (“[W]e find that there is a material question of fact as to whether HoldCo was a single employer with
its closely held subsidiary within the meaning of WARN.”).

\textsuperscript{149} \textit{Id.} at 228.

\textsuperscript{150} 411 B.R. 805 (N.D. Ga. 2009)

\textsuperscript{151} \textit{Id.} at 828.

\textsuperscript{152} \textit{Id.} at 852-3.
PE/VC affiliates employed an investment banker, and the debtors had independent investment bankers.\textsuperscript{153} Thus, the defendants’ motion for summary judgment on the trustee’s claims for fraudulent conveyance was denied because there were issues of fact as to whether the debtors received reasonably equivalent value for the management fees.

In the same case, the trustee sought to avoid millions of dollars of transfers as preferences.\textsuperscript{154} To avoid a transfer as a preference, a trustee must prove for each transfer: (1) the debtor has transferred an interest of the debtor in property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt owed by the debtor to the creditor before such transfer was made; (4) the transfer was made when the debtor was insolvent; (5) the transfer was made on or within 90 days before the date of the filing of the petition or was made to an insider between ninety days and one year before the date of the filing of the petition; and (6) the transfer enabled the creditor to receive more than it would have in a hypothetical Chapter 7 liquidation if the transfer had not been made.\textsuperscript{155} In this case, the management agreement was for an initial five year period, and the debt was incurred on the date of entering the agreement. Therefore, the transfers were for an antecedent debt. The court also held that the PE/VC entities (Onex Corporation ("Onex"), Onex ABCO Limited Partnership ("Onex LP"), and Onex American Holdings, LLC ("Onex American")) were “insiders” of the debtor because Onex American owned more than 50 percent of the debtor and controlled more than 50 percent of the debtor’s voting stock, Onex indirectly owned all of Onex American’s stock and Onex American was an insider, and Onex LP owned all of Onex American’s stock. While the issue of insolvency was left for trial, the trustee’s summary judgment motion with respect to each other element was granted.\textsuperscript{156}

These cases show that trustees may have a degree of success in pursuing PE/VC firms, depending on the particular facts involved. The law of fraudulent transactions and the law prohibiting preferences are strong creditor tools. Where a judgment creditor franchisee finds itself with a judgment against a PE-owned franchisor that cannot pay the judgment, that franchisee may be able to recoup its award from the PE/VC firm and its affiliates through claims relating to fraudulent transfers. These types of claims may be one way to address the problem associated with PE/VC firms charging their portfolio franchisor companies substantial management fees for little or no benefit and may provide relief to aggrieved franchisee creditors.

\textbf{IV. DEFENDANTS AND PROACTIVE LIABILITY MANAGEMENT}

The most obvious method of reducing the risk of liability as a PE/VC owner of a franchisor is to ensure complete separation between the franchisor and any PE/VC firm related entities. While this will likely hinder any attempts to pierce the corporate veil of the franchisor, as described above, it is at odds with PE/VC owners’ need to have some control over portfolio companies in order to maximize profit or realize an investment’s full potential.

PE/VC firms may, however, want to take on a more passive investment role when purchasing a franchisor. Instead of installing its own principals as executives in the franchisor,

\textsuperscript{153} \textit{id.} at 853.

\textsuperscript{154} \textit{id.} at 859.

\textsuperscript{155} \textit{id.} at 860.

\textsuperscript{156} \textit{id.} at 862-3.
they should consider simply using their power as a shareholder to elect board members (assuming such a power exists) that would install an outsider as an executive. It may mean that their principals miss out on some opportunities to earn exorbitant salaries, but it would also limit some of the overlap of officers and directors that can sometimes result in a pierced corporate veil. Incidentally, this may also result in more trust among franchisees towards the PE/VC owner to the extent franchisees believe an independent executive would not be subservient exclusively to the PE/VC owner’s interests.

PE/VC firms also may be able to choose to have more beneficial states’ laws apply to veil piercing claims. “[W]hen analyzing veil-piercing claims, the general rule dictates that the law of the state in which the portfolio company is incorporated determines whether to pierce the company’s corporate veil.157 Because veil piercing standards vary across jurisdictions, it is important for PE/VC firms to consider where incorporation will reduce the risk of liability through veil piercing. For example, California’s veil piercing standards tend to be more lax than many other states, and its standards have been described as “fact-specific, incoherent and unpredictable.”158 Wyoming and Connecticut also have relatively lax veil piercing standards.159 Other jurisdictions, however, are more restrictive about piercing the corporate veil. Delaware, for example, requires that the party seeking to pierce the corporate veil must show fraud would result from the use of the corporate structure before its courts will disregard the corporate veil. In other words, it would not be enough to pierce the corporate veil of a Delaware corporation if a subsidiary disregarded corporate formalities and was undercapitalized, because there is the additional requirement of some sort of “fraud.”160 Similarly, Nevada generally will not pierce a corporate veil unless a plaintiff can demonstrate that the corporation was set up only as a sham and only if such sham corporation caused an injustice.161 Thus, PE/VC firms may want to consider the veil piercing laws of various states when choosing a state of incorporation for their entities.

Contractual dispute resolution is another hurdle that franchisees may face when seeking to recover against a PE/VC firm. Most likely, a claimant franchisee would want to bring a franchisor and its PE/VC firm owner, if one exists, into the same dispute – why litigate the same issues in two separate matters? Most franchise agreements have mandatory arbitration provisions that bind signatories and are very difficult to avoid.162 The PE/VC owner of the franchisor, not having signed the franchise agreement, may contend it is not subject to the arbitration provision except in limited circumstances, such as when the corporate veil can be pierced or when the PE/VC firm has incorporated the arbitration provision by reference in another contract, assumed the contract containing the arbitration provision, acted as the agent.

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158 Id.

159 Id.

160 Id.

161 Id.

of the signatory, or is otherwise estopped from denying its application.\textsuperscript{163} Thus, an easy
defensive mechanism that PE/VC firms can implement is to require some sort of alternative
dispute resolution in its portfolio companies’ franchise agreements, such that a claimant
franchisee would have to fight in two separate forums in order to assert claims against both the
portfolio company and the PE/VC owner.

V. RECENT CASES

The number of reported cases involving “up the ownership chain” liability for PE/VC firms
and investors is limited, much less when narrowed further to franchise systems. This may be
explained, in part, by the prevalence of arbitration agreements that compel the private resolution
of these disputes. In \textit{Lindley Contours, LLC v. AABB Fitness Holdings, Inc.},\textsuperscript{164} a Contours
Express franchisee filed suit against its franchisor and additional “Non-Franchisor Defendants,”
including the PE/VC firm that owned the franchisor and individual executives of the franchisor
that overlapped with board of that PE/VC firm. Although the Non-Franchisor Defendants were
non-signatories of the arbitration clause, Defendants nonetheless moved to dismiss and argued that

The Non-Franchisor Defendants were sued as
management/control persons of the franchisor under Oregon statutory law. See O.R.S. § 650.020. Although these defendants
are not signatories to the Franchise Agreements, they too may invoke the arbitration clause in the Franchise Agreements as
alleged agents/former employees of the franchisor.\textsuperscript{165}

The District Court subsequently granted that motion to dismiss,\textsuperscript{166} although the decision was
later reversed for lack of subject matter jurisdiction by the Ninth Circuit and remanded to the
state court from which it was removed.\textsuperscript{167} The Circuit Court then “grant[ed] Defendants’ Motion
to Dismiss for Arbitration,” reasoning that “[a]lthough Defendants are non-signatories to the
franchise agreements, defendants may invoke the arbitration provisions because Plaintiff’s
claims are based on Defendants’ status as alleged agents or ‘control persons’ of the franchisor”
and that “[s]ince Plaintiffs’ claims against the non-signatory Defendants are based on the
alleged misconduct of the franchisor, they should be subject to the franchise agreements’
arbitration provision.”\textsuperscript{168}

Two recent cases, however, are illustrative of franchisees and franchisors increasingly
attempting to hold PE/VC firms accountable in the courts.

\textsuperscript{163} See, \textit{Bridas S.A.P.I.C. v. Gov’t of Turkmenistan}, 345 F.3d 347, 356 (5th Cir. 2003).
\textsuperscript{164} No. 6:08-cv-06408-TC, Complaint (Dec. 29, 2008 D. Or.) (Doc. 1).
\textsuperscript{165} Id., Defendants Memorandum of Law in Support of Their Motion to Dismiss for Arbitration or, in the Alternative,
Motion to Dismiss for Lack of Personal Jurisdiction over Certain Defendants, at 25-26 (Jan. 16, 2009) (Doc. 7).
\textsuperscript{166} Id., 2009 U.S. Dist. LEXIS 49314 (June 11, 2009) (adopting Magistrate Judge’s Report and Recommendation,
Doc. 30).
\textsuperscript{167} \textit{Lindley Contours, LLC v. AABB Fitness Holdings, Inc.}, 414 Fed. App’x 62, 65 (9th Cir. 2011).
\textsuperscript{168} \textit{Lindley Contours, LLC v. AABB Fitness Holdings, Inc.}, No. 08CV5933CC, Memorandum Opinion at 7-8 (Or. Cir.
In Soto v. AAMCO, American Capital (a publicly traded PE/VC firm) and American Driveline purchased AAMCO for $112 million. At the time of the transaction, American Capital and American Driveline had already invested $46 million in the acquisition of Cottman Transmission ("Cottman"), AAMCO’s rival. American Driveline and American Capital originally intended to merge the two rivals, to no avail.

In November 2014, thirty-three current and former AAMCO franchisees filed complaints against American Capital and American Driveline. They represent forty-seven AAMCO franchise locations (thirty-seven of which opened after American Capital purchased a controlling interest in American Driveline, AAMCO’s parent company). The franchisees’ claims arose out of the financial composition of the acquisition that ultimately left AAMCO insolvent. They believe that American Driveline’s financial dealings prevented it from assisting franchisees and devalued the brand. The franchisees allege that American Capital conducted an:

illegal business scheme of AAMCO and its web of affiliated entities and individuals who control and operate AAMCO (collectively, all the Defendants). Through this scheme, Defendants fraudulently induced Plaintiffs and the Class to purchase a franchise and/or continue to operate their franchise, and thereafter exploited their control and economic power in order to extract exorbitant and unjustifiable payments and expenditures from their franchisees.

Because of this "illegal operation," franchisees claim to have lost hundreds of thousands of dollars, and consequently, many are going bankrupt, according to their attorney Jonathan Fortman:

I don’t think the private equity firms fully understand how a franchise system works. They look at the bottom line number of the franchisor . . . they think they can use their sales power to jack up the number. They forget that as part of that they have to support the franchisees.

It should be noted that this is not the first time Fortman has filed complaints on behalf of discontented AAMCO franchisees against investors, seeking to take liability up the chain of

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171 Owen, supra note 169.

172 Soto v. AAMCO, No. 3:14-CV-01287-MJR-PMF, (S.D. Ill.) Complaint ¶ 21

173 Owen, supra note 169.

174 Id.
ownership. He filed two complaints in 2013 on behalf of franchisees, but dropped the suits after AAMCO filed motions to dismiss. This latest attempt is also slated for dismissal, with the District Court entering an order stating “this case will certainly be dismissed one way or another,” given a “live dispute as to whether voluntary dismissal by the Plaintiffs should be with or without prejudice.” Fortman, however, has vowed to press forward: “[r]ather than proceeding with this case while utilizing arbitration for certain members of the putative class, Plaintiffs and their counsel chose to devote their time and resources to presenting claims in arbitration.” If Fortman’s prior battles with PE/VC franchisors are any indication, AAMCO and its owners face a long road ahead. Fortman was involved in the earlier discussed suit involving Contours Express, LLC (“Contours Express”), a fitness chain that was bought from its founder in 2005 by a PE/VC firm. Beginning in 2007, Fortman filed fifty-two cases on behalf of Contours Express franchisees against the private-equity owned franchisor and its franchise sales representative, resulting in $1.3 million in judgments for eight franchisees.

Another recent franchise case involving a PE/VC firm is Black Donuts et al. v. Sumitomo Corp. According to the plaintiffs, issues began when a Japanese conglomerate, Sumitomo, acquired TBC Corporation (“TBC”), their franchisor’s (Big O) parent corporation. The franchisees filed complaints alleging that Sumitomo, “owns, controls, directs, and dominates the activities and business performances of TBC and consequently Big O,” in their attempt to pierce the corporate veil. Specifically, they claim that Big O is Sumitomo’s alter ego because of the presence of common officers and directors, financial intermingling between the two companies, and Sumitomo’s financial support of Big O.

The franchisees are advancing breach of contract, breach of implied covenant and fair dealing, interference with contractual obligations, and fraud in the inducement claims. To support their claims, the franchisees contend that “Big O concealed from the franchisees the true cost of manufacture and distribution” and “charged franchisees higher prices.” Additionally, they allege that Big O showed favoritism toward larger franchisees, offering “secret, discriminatory payments, rebates, refunds, commissions, unearned discounts, special services, privileges and/or their equivalent” to favored franchisees but not others. They claim that the


177 For a discussion on of arbitration proceedings and litigation against Contours Express see page 12 supra.


181 Black Donuts Inc. v. Sumitomo Corp., supra note 179, Complaint ¶ 27.

182 Black Donuts Inc. v. Sumitomo Corp., supra note 179, Complaint ¶ 41.

183 Id.
favoritism of some franchisees over others created a two-tiered franchise system, resulting in unfair competition between franchisees. Finally, the franchisees allege that Big O did “not develop any innovative and new marketing systems . . . nor has it developed systems of operation that are unique or proprietary.” Sumitomo Corp. has not yet been decided; further proceedings are scheduled for late 2015.

Sumitomo, Big O’s acquire, is a corporation, protected by the many shields of limited liability between it and the franchisor. Nevertheless, the fact that the case surfaced is an example of franchisees increasingly attempting to hold firms accountable, especially when a high degree of control is involved, despite the layers of liability protection in place.

VI. CONCLUSION

The trend of PE/VC firm investment in the franchise industry shows no indication of deceleration because franchises have been historically cash-rich targets. The franchise industry’s high operational performance, cash flows, and overall high return on investment promises to make the franchise industry attractive targets in the foreseeable future. Nevertheless, PE/VC firm involvement in the franchise system can disrupt prior operational methods and established relationships, causing conflicts within the franchise system. This tension has galvanized the creation of franchise associations and increased the participation of similarly-situated franchisees in franchise association lawsuits.

It is important for PE/VC firms to be cognizant of the different theories of liability that may arise as some lawsuits are managing to pierce the corporate veil, and courts are increasingly holding PE/VC firms liable. PE/VC firms must be knowledgeable of emerging arguments for upstream investor liability. Being aware of the liability theories and taking appropriate precautionary measures can help avoid costly litigation.

Franchisees should recognize that PE/VC firms often extract money from portfolio companies for management fees and other expenses, reducing the portfolio companies’ assets that may otherwise have been re-invested in the businesses. Additionally, they should be cognizant that when PE/VC firms acquire companies and become franchisors, the PE/VC firms’ chief priority is to monetize assets to make the biggest return on their investment. This priority has the potential to rupture a franchise system with which franchisees have become very comfortable. Also, PE/VC firm exit strategies pose potential conflicts within the franchise system.

Finally, when PE/VC firms acquire companies and become large multi-unit franchisees, a power shift occurs, putting the multi-unit franchisees on equal footing or surpassing the franchisors whose business models they follow. This shift allows PE/VC firms to demand compromises that possibly damage the long-term viability of the brand.

184 Id.
185 Id.
186 See, e.g., supra Part I.C (discussing a lawsuit filed by a Burger King franchisees’ association challenging implementation of new franchisor policies).
PE/VC investment undeniably has impacted the franchise industry landscape and can dramatically improve franchise system operations for significant ROI. PE/VC firms, franchisors, and franchisees should each manage their interactions intentionally, however, as conflicting priorities, financial pressures, and shifting operational dynamics can easily undermine an otherwise lucrative system.
William K Whitner is a business litigator whose focus is on complex civil corporate matters. His wide-ranging substantive commercial experience includes franchise and contract disputes, business tort litigation, and intellectual property litigation. He has represented large global, national, and local franchisors and manufacturers in state and federal courts and arbitrations around the country on matters involving claims such as trademark and trade dress infringement, wrongful termination, false advertising, breach of restrictive covenants, and misappropriation of trade secrets.

Mr. Whitner is an active member of the Franchising and Litigation Sections of the American Bar Association, a charter fellow of the Litigation Counsel of America, and a fellow of the Lawyers Foundation of Georgia. He was named Best Lawyers’ 2014 “Atlanta Franchise Lawyer of the Year” and has been repeatedly recognized in *The Best Lawyers in America* for franchise law, as a “Legal Eagle” by *Franchise Times Magazine*, by Georgia Super Lawyers as one of the “Top 100 Attorneys in Georgia,” and as a leading litigation lawyer in *Euromoney’s Benchmark; America’s Leading Litigation Firms and Attorneys*.

Mr. Whitner graduated with honors from Georgetown University and completed his law studies at Yale Law School.
Elliott Ginsburg is a partner at Garner & Ginsburg, P.A. where he represents franchisees and dealers. On behalf of his clients, Elliott has dealt with a variety of legal issues including fraud, breach of contract, statutory violations, and violations of the covenant of good faith and fair dealing. He has helped clients recover damages, get out of franchise agreements, obtain releases from covenants not to compete, and cure alleged defaults. He also represents a growing number of brewers and distillers in various areas, including trademark, regulatory, and other business matters.