PERSPECTIVES ON NON-TRADITIONAL FRANCHISE OWNERSHIP STRUCTURES

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I. INTRODUCTION

The form of entity used to establish and operate franchised units runs the gamut of available forms. Most typically, they take on the traditional forms of ownership – corporations, limited liability companies, general partnerships, and limited partnerships. In rare instances, franchisees even operate as sole proprietorships. In some cases these franchise owning entities have parent entities to further shield individuals from the franchise entity liability. And, in the case of multiple unit ownership, all of the multiple units may be owned by one entity, whereas in other instances (in order to create greater shields and segregation of liability), each unit may be owned by a separate entity.

There are also situations in which the franchise-owning entity, in whatever form it takes, has inherent restrictions or needs that are not traditional. This is the case when the franchisee entity is owned by a private equity firm or by a publicly-held company. It is also the case when the franchisee entity is itself a joint venture, especially one owned partially by the franchisor and partially by the franchisee.

Franchisees have also embraced certain other non-traditional forms of ownership. In some instances, for example, the franchisee is a trust – either because the trust initially acquired the franchise rights or because a traditional franchisee entity (or the owner of a traditional franchisee entity) transferred its, his, or her rights in the franchise to a trust. Another example would be if the franchise were owned by a not-for-profit entity. And, as yet a further example, the franchise could be owned by an Employee Stock Ownership Plan or ESOP.

II. DISCUSSION

This paper will discuss the structural considerations for the non-traditional forms of franchise entities, namely, private equity, publicly-held company, joint venture, trust, not-for-profit entity and ESOP, as well as the Franchise Agreement and policy considerations associated with each of them. The perspectives provided herein will be largely from the franchisor point of view.

A. Private Equity Owned Franchisees

Long ago, private equity firms noted the desirability of owning franchisors. Franchising provided a known brand, a proven business model, predictable revenue and profitability, and a built-in executive team. Unfortunately for private equity, however, there were not enough franchisors to satisfy their demand. As a result, auctions for franchisors that are conducted by investment bankers became “feeding frenzies,” and the multiples of earnings paid by private equity for franchisors skyrocketed.

1 The authors sincerely appreciate and give credit to G. William Joyner, a corporate partner at Kilpatrick Townsend LLP, for his invaluable assistance and guidance in preparing the sections of this paper discussing the corporate structures for non-profit and joint venture entities who are considering franchising. The authors also wish to thank John Dwyer, of counsel, and Abhishek Dube, associate, at DLA Piper LLP (US), for their invaluable assistance and guidance in preparing the section of this paper discussing private equity owned and publicly-held franchisees.
Private equity has therefore turned, in some cases, to the acquisition of franchisees, instead of franchisors. Of course, private equity needing to deploy significant monies, and to significantly leverage such transactions, is only interested in multiple-unit franchisees.

In a typical transaction involving a multiple-unit franchisee, the acquisition process will be in accordance with the transfer provisions of the seller’s existing Franchise Agreements. These transfer provisions may all be identical (or nearly so). Or, especially if the Franchise Agreements (and, if applicable, Development Agreements) were entered into at different points in time, the requirements of these provisions may vary. In general, these transfer provisions will require (as is relevant to the private equity perspective) the following:

i. approval by the franchisor of the private equity firm (or its proposed portfolio entity) to be the “Franchisee,” including of its capitalization, direct and indirect ownership, management structure, and personnel to be trained;

ii. execution by the new multiple-unit franchisee of new current forms of Franchise Agreement (or, in some cases, assumption by the new franchisee of the old franchisee’s Franchise Agreements);

iii. a guarantee of payment and performance by an owner, parent, or other affiliate of the franchisee; and

iv. execution by owners of the franchisee of confidentiality commitments and of covenants not to compete.

Some franchisors will take the position that these contractual obligations cannot be met by multiple-unit franchisees that are owned by private equity firms. The “NewCo” that is established to be the franchisee could be said to have “no track record.” This “NewCo” will also have no historical financial statements and its capitalization is likely to be highly leveraged to the point where the franchisor finds financial wherewithal to be inadequate. Also, while an operator or manager can likely be agreed upon, the level of equity that the franchisor may wish for the operator/manager to have in the franchised business may not reconcile with the private equity firm’s goals. Moreover, the typical franchisor requirement for all controlling or otherwise significant equity holders (or their beneficial owners) to attend and successfully complete training is unlikely to be met, as the private equity firm owners (e.g., the general partners, investors, and shareholders) are unlikely to be willing to attend training. Similarly, the private equity firm owners are unlikely to be willing to sign personal guarantees, adhere to strict confidentiality commitments, or agree to covenants not to compete that will preclude them from completing other acquisitions of “add-on” or “bolt-on” companies, or of companies that operate in the same or similar space. These franchisors therefore may take the position that existing franchisees simply cannot sell to private equity firms.

There are both legal and practical reasons, however, for franchisors to not be so hardlined against private equity firm acquisitions of multiple-unit franchisees.

From a legal perspective, there are general principles of law that make it unlawful to restrain without proper justification. As a “franchise” is a contractual grant of rights to a franchisee,
the unreasonable withholding of consent to transfer could be the basis for a breach of contract claim.²

Also, the lack of clarity in the transfer provision in the seller’s Franchise Agreement could lead to a claim for a breach of the covenant of good faith and fair dealing. The seller, in this instance, would assert that it had a reasonable expectation based on what was said or otherwise presented at the time the Franchise Agreement was signed that the franchisor would, in fact, be reasonable in granting consent to transfer to a private equity firm or to one of its portfolio companies.³

Additionally, a franchisee (and prospective purchaser) may bring claims for tortious interference with business relations as a result of a franchisor withholding of consent to transfer without justification.⁴

Of course, it is notable that these legal claims (other than for tortious interference) belong to the selling franchisee – the party that has an agreement with the franchisor. As a general matter, the buyer (i.e., the private equity firm) – especially in the face of a no-third-party-beneficiary clause – could be expected to have a difficult time asserting a claim as a result of the franchisor’s withholding of consent to transfer.

From a practical perspective, franchisors who would deny approval to transfer to a private equity firm may be foolhardy owing to the potential for extensive capital to come into the system due to the private equity firm involvement. Even if leveraged, the private equity firm in its effort to improve upon its investment is likely to provide capital to improve the purchased units, as well as capital to expand the number of units that it owns. Moreover, the private equity firm’s financial knowledge and capabilities may be extensive and, as a result, could lead to success not only for itself but also for the franchisor (e.g., in the form of higher royalties) and for the system (e.g., due to increased and enhanced brand recognition) as a whole.

² See Picktown Foods, LLC v. Tim Hortons USA, Inc., No. 17-21072, 2017 U.S. Dist. LEXIS 186107 (S.D. Fla. Nov. 8, 2017) (franchisees adequately stated claims for breach of contract where franchise agreements were contradictory on franchisor’s ability to withhold consent to transfer); Popeye’s, Inc. v. Tokita, Nos. 87-3011, 90-1179, 1993 WL 386260 at *11 (E.D. La. Sept. 21, 1993) (allowing franchisee’s claim that consent to transfer was unreasonably withheld to go forward where sufficient evidence had been presented that franchisor’s decision was based on a dislike of franchisee); but see KFC Corp. v. Kazi, No. 11-475, 2012 WL 6645701 (W.D. Ky. Dec. 20, 2012) (upholding franchisor’s withholding of consent to transfer on ground that transferee did not meet franchisor’s financial requirements); Dunkin’ Donuts, Inc. v. Sharif, Inc., 177 Fed. App’x 809 (10th Cir. 2006) (franchisor did not unreasonably withhold consent to transfer where transferee was in default under its own franchise agreement with franchisor); Hanigan v. Wheeler, 504 P.2d 972, 975 (Ariz. Ct. App. 1972) (provision in franchise agreement conditioning assignment of agreement on approval by franchisor was a proper and valid limit on freedom of alienation).

³ See Taylor Equipment, Inc. v. John Deere Co., Bus. Fran. Guide (CCH) ¶ 10,575 (D.S.D. 1994) (holding that “under the contract language as written, the implied covenant of good faith and fair dealing is necessary as an aid to interpreting the assignment clause”); but see De Walsh v. Togo’s Eateries, Inc., 567 F. Supp. 2d 1198, 1204 (C.D. Cal. 2008) (franchisor did not breach implied covenant for withholding consent to transfer due to transferee’s failure of English language proficiency test where franchise agreement expressly required passing the test).

While the practical considerations are likely to weigh in favor of private equity involvement, there are certain unfavorable aspects associated with private equity. These relate to the short-term perspective of most private equity firms that seek to return investor money and earnings (and seek an “exit strategy”) within about 7 years. They also relate to the extreme financial scrutiny that private equity will bring to its investment. This scrutiny may, for example, result in the opening and closing of units in order to achieve short term (e.g., 7 year) financial gains, without regard to effects on the brand or commitments that have been made in the form of a Development Schedule.

Recognition of the legal and practical consequences of failing to approve transfers to private equity leads most franchisors to permit such transfers subject to compliance with certain modifications to the new form of Franchise Agreement (or the assumed existing Franchise Agreement) and to the franchisor’s normal transfer policy requirements. These transfer policies may, for example, be set forth in the franchisor’s Operations Manuals.

The extent to which change will need to be made to agreements and policies will depend upon the starting point for those agreements and policies. For some franchisors, little change will be needed. For others, more extensive modifications will need to be made. Here, we will assume the latter, so as to address the likely totality of changes that may be needed.

Required modifications to agreements and policies may, for example, take the form of:

1. **Owner/Operator Modifications**

   Some franchisors require an individual to be the 100% owner of the franchisee and the operator of the franchised business. Private equity will likely establish an entity to be the multi-unit franchisee, with ownership of that entity held by a fund, which is a limited partnership that has both general and limited partners. In addition, private equity firms will arrange for existing management or new management to be the operator. Franchisors willing to allow for transfers to private equity firms will typically accept such an “ownership” structure. This may require certain agreement and policy modifications.

   In permitting sales to private equity firms, franchisors also typically need to change their “operator” or “principal operator” requirements. The franchisor will typically be heavily focused on approval of the day-to-day operator (who, normally, will be an individual) and of the percentage of equity interest that the individual will hold in the private equity firm’s portfolio franchisor company. For example, the franchisor may require the principal operator, an individual with control over day-to-day management and operation of the franchises, to hold at least a ten percent (10%) equity interest (both financial and voting) in the franchisor.

   The Franchise Agreement and policies will also need to address requirements pertaining to a change in the principal operator. The same issues pertaining to franchisor approval rights and equity ownership rights initially will need to be dealt with in the context of a change in the principal operator.

2. **Training**

   Often franchisors require all owners to be trained, or at least all owners that hold controlling or a minimum percentage (e.g., ten percent (10%)) of equity in the franchisor. In the case of private equity, and other than the principal operator (and other non-equity owning management personnel), the private equity executives are unlikely to be willing to attend training (or at least
extensive training). As a result, modifications to the Franchise Agreement and policies likely will be needed.

3. **Confidentiality**

Franchisors often demand strict confidentiality from owners and operators. This can be obtained through execution of the Franchise Agreement or through a separate confidentiality agreement. Individuals at the private equity firm, however, are unlikely to personally sign the confidentiality agreements. And, confidentiality obligations may need to be tailored in a manner that allows private equity executives to oversee other portfolio companies that may operate in a same or similar field.

4. **Financing**

Franchisors often seek to approve franchisee financing agreements, particularly where the Franchise Agreements (or other assets), or equity in the franchisee, is pledged as security for the loan. Private equity, however, is unlikely to be able to be so constrained in its financing arrangements. In all likelihood, provisions requiring franchisor approval of franchisee financing arrangements will need to be changed and, at most, the franchisor will receive notification of new franchisee financings.

5. **Non-Competition**

Franchisors often require franchisees to agree to not compete, both during the term of the Franchise Agreement and for a period of time after the termination (including as a result of a transfer) of the Franchise Agreement or of an owner’s interest in the franchisee. Private equity owners, however, are unlikely to be willing to be so constrained. At a minimum, private equity firms are likely to want to do “bolt-on” acquisitions of businesses that they can add to their franchise portfolio. This can likely be agreed upon with the franchisor if these are acquisitions of other system franchisees or of independents that will become system franchisees. More contentious is likely to be the desirability of the private equity firm to be able to acquire other businesses that operate in the same space as its franchises (be they franchisees of other systems, franchisors, or independents), especially after it exits the franchise and, perhaps, through a subsequent fund.

6. **Transfer**

Some Franchise Agreements restrict transfers by requiring franchisor approval, plus the satisfaction of certain conditions (e.g., approval of the buyer, execution of a release, execution of a new agreement, etc.). Private equity firms may wish to negotiate the Franchise Agreement in order to diminish the franchisor’s approval rights, and to be relieved of some such obligations, related to transfers.

At the exit time for the private equity firm (e.g., approximately 7 years after the initial investment), the private equity firm will want the freedom to choose a buyer (e.g., another private equity firm) without the franchisor having the ability to block that sale. A “not unreasonably withheld consent” provision may provide the private equity firm with the comfort that it needs, but even more unrestrained freedom to transfer may be requested.

Of potentially greater concern to private equity would be provisions in the Franchise Agreement that restrict minority transfers, transfers of beneficial interests (i.e., interests in the
fund that owns the portfolio company franchisee). These types of restrictions the private equity firm is unlikely to be able to accept, as transfers of stock to new executives in the franchisee, transfers to new general and limited partners, and transfers by and among the existing general and limited partners in the fund cannot readily be subject to franchisor approval. Similarly, provisions calling for franchisor approval of heirs and representatives of such persons upon death or disability are unlikely to be acceptable to the private equity firm.

7. **Guarantees**

Franchise Agreement provisions that require a personal guarantee from the owners (e.g., general partners) of the private equity firm are unlikely to be acceptable. Potentially, the principal operator with equity ownership will sign such a guarantee. In lieu of a guarantee from the private equity firm, the franchisor may instead be willing to negotiate the terms of a letter of credit, or simply rely upon a strong balance sheet.

8. **Other**

Depending upon the terms of the Franchise Agreement, and circumstances such as the financial performance of the franchised units, the private equity firm may wish to negotiate other provisions of the Franchise Agreement. For example, if the Franchise Agreements contain cross-default provisions, and it is the intent of the private equity firm to shutter certain non-performing units, the private equity firm may seek Franchise Agreement changes that allow for such closures without risking the existence of a default under Franchise Agreements other than the one that corresponds to the closure.

Allowing private equity to invest in a franchise system by the acquisition of multiple-unit franchisees can provide significant system-wide benefits. It is an involvement, however, that changes the landscape of the system. And, of course, all private equity firms are not the same and their capabilities and goals are not the same. The negotiations pertaining to the needs and desires of the private equity firm in relation to the Franchise Agreement and policies of the franchisor will be telling. Equally telling will be conversations, which should be undertaken early, about the private equity firm’s goals – be they to build or acquire new units, or to grow the revenue from the existing units, or both. In all cases, private equity is likely to bring to the table sophisticated business techniques, astute financing capabilities, and a team of professional managers.

B. **Trust Ownership of the Franchise Business**

The trust is an oft-overlooked but valuable alternate form of franchise ownership, its chief benefits deriving from estate and succession planning. By transferring ownership of the franchise to a trust, franchisees can avail themselves of wealth planning tools commonly used in other businesses. Thus, allowing this form of ownership can help franchisors attract and retain qualified franchisees. Moreover, trust ownership helps ensure a smooth transition between generations of family members, avoiding delays and disruptions associated with probate, particularly if a will or distribution is contested.

1. **Case Study No. 1: The NFL**

Recognizing the value of the trust vis-à-vis franchise ownership, the National Football League voted in May 2015 to allow trust ownership of teams, dropping the minimum percentage
an owner is required to control to just 5 percent. The move paved the way for owners to keep their franchises in the family, rather than forcing their heirs to sell in order to pay hefty estate taxes, as in the case of the St. Louis Rams in 2008 and the Miami Dolphins in the mid-90s.

The NFL had “long spurned” the idea, because the assets of a trust are technically owned by the trustee who has not been approved by the league as an owner. But, “escalating franchise values" forced the League to reconsider so that NFL franchise owners could “do the type of planning the very wealthy have done for their businesses for many years.”

In a contemporaneous article detailing the NFL vote, Sports Business Journal used the Oakland Raiders to illustrate the enormous financial benefits a trust can provide. Observing that asset values are now “soaring past $1 billion," the article notes that the late Al Davis purchased the Raiders in 1972 for “just a few million dollars.” When Davis passed in 2011, the team was valued at $761 million, and there was much speculation as to whether Davis' heirs would have to sell to pay what could amount to more than $175 million in estate taxes on the team alone. Ultimately, Davis' heirs – wife Carol and son Mark – were not forced to sell, most likely due in substantial part to the unlimited marital exemption. When Davis' widow passes, however, her heirs will be subject to a 40% federal inheritance tax rate (after an $11.18 million exemption). Establishing an irrevocable family trust for the benefit of her son, Mark Davis, who runs the team, could greatly reduce that tax bill or even eliminate it altogether.

2. Case Study No. 2: Hooters

Although some franchise agreements call for termination upon the death of the franchisee, the wisdom of doing so is questionable from the standpoint of attracting and retaining qualified franchisees, and in some states, like Iowa, it is prohibited. In cases where the franchise agreement does not terminate upon the franchisee’s death, the use of a trust can substantially

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7 Kaplan, supra note 5.

8 Id.

9 Id.


11 Mayoras, supra note 10.

12 Iowa Code § 523H.5 (permitting a franchisor to disapprove a transfer if the proposed transferee does not meet the franchisor’s current financial requirements for franchisees, but providing that transfers to a spouse, child, or partner upon the franchisee’s death or disability are deemed not to be transfers requiring the franchisor’s consent, and that the franchisor may not interfere with such dispositions).
ease the transition and avoid the delays, uncertainty, and publicity that can accompany the probate process.

It is difficult to cite an example in which a franchisee’s death caused problems for the franchise business because such cases rarely if ever make national headlines. But a notorious cautionary tale can be found in the controversy surrounding the estate of Robert H. Brooks, founder of Hooters of America, Inc. Although Brooks’ company was the franchisor, the difficulties plaguing the business following his death would be equally applicable to a franchisee whose estate is challenged.

When Brooks passed away in 2006, his will provided that Brooks’ son and company CEO, Coby, would inherit 30% of the estate. Another 30% was bequeathed to the minor daughter Brooks had with his second wife, Tami. The extent of Tami’s inheritance was $1 million per year for 20 years. Tami opted instead to take her “elective share” under North Carolina law, which entitled her to one-third of the estate. A three-year battle ensued over Tami’s right to an elective share as well as the valuation of the company. Ultimately, Coby Brooks was forced to sell Hooters to a private equity firm to raise money for the settlement with his step-mother and to pay estate taxes. Soon after the sale, Coby left from his position as CEO, whereupon he immediately became a 12-store franchisee of Hooters’ closest competitor, Twin Peaks. It seems that better succession planning, including the possible use of a trust, would have enabled Coby to avoid some of the difficulties and distractions that he encountered in his last three years at the helm of the franchisor.

3. The Trust as a Succession Planning Device: Implications for Franchisors

As illustrated by the case studies discussed above, the death of a business owner can cause major disruptions to the operation of the business. Establishing a trust can help owners avoid those problems. State law sets very high standards of care with respect to a trustee’s fiduciary duty to manage and preserve the assets of the trust. The law prohibits conflicts of interest and risky investments, and allows the trustee to delegate specific responsibilities of

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14 *Id.*

15 *Id.*


17 *See id.*

18 *Daley, supra* note 16.

19 There are two kinds of trusts: revocable and irrevocable. As the name suggests, a revocable trust allows for the person creating the trust, the “grantor” or “settlor,” to make substantive changes to the trust or revoke it altogether. While a revocable trust allows the grantor to avoid probate, it does nothing to avoid estate taxes or claims of creditors. An irrevocable trust, on the other hand, provides all of these benefits: probate avoidance, tax avoidance, and protection from creditors and divorcing spouses.

20 Most states have adopted the Uniform Prudent Management of Institutional Funds Acts (UPMIFA).
investing and managing trust assets to individuals with particular expertise to optimize and grow the trust assets.

Franchisors may be skeptical of the trust as an alternate form of franchise ownership, simply because of their lack of familiarity with this ownership structure. Typically, the franchisor’s chief concern is having the ability to approve any owner or purchaser of the franchise business, to ensure that person has the qualifications deemed necessary for successful operation. The trust form of ownership actually enhances the franchisor’s ability to control this because the franchisor can demand the right to approve the trustee and any franchise operator designated by the trustee. For Franchisors who insist on retaining the owner-operator model, the trust may not be acceptable as an alternate form of ownership, even with the ability to approve the trustee. Such franchisors are in the minority now, however, following a shift over the past decade toward multi-unit franchising.²¹

This provides much more stability, continuity, and control for a franchisor in a state like Iowa where the franchisor cannot interfere with a transfer to the franchisee owner’s spouse or child upon death. If the franchise business is placed into trust, the trust will be operated by a trustee (or by an operator designated by the trustee). Upon the franchisee owner’s death, the trust will continue operating the business for the benefit of the trust beneficiaries, who may be the franchisee’s spouse and/or children; but those beneficiaries will not have the right to own or operate the business by virtue of any inheritance.

Accordingly, a franchisor that is willing to permit trust ownership may have to consider modifications to certain standard franchise agreement provisions, including:

a. Owner/operator: As in the case of the private equity owned franchisee (and the ESOP owned franchisee discussed infra), a franchise agreement that includes the traditional owner/operator requirement will need to be modified. A reasonable alternative would be a provision that grants the franchisor the right to approve the day-to-day operator.

b. Training: Standard franchise agreements typically require the owner to be trained in the franchise business. That provision will need to be modified where the franchised business is placed in trust. To the extent the trustee and some or all of the beneficiaries will not actually be operating the business, it does not make sense to require them to be trained. A practical alternative would be to require the principal operator(s) to be trained.

c. Confidentiality: Because the trustee and beneficiaries will have access to financial information concerning the business, the franchisor should consider extending any confidentiality requirement to them.

d. Guarantees: In most cases, the trustee will likely not be involved in operating the business, and it may very well be an entity such as a bank rather than an individual. Therefore, requiring the trustee to provide a guarantee is not a realistic option, and the franchisor may wish to consider modifying the franchise agreement.

²¹ Jason Daley, Why Multi-Unit Franchise Ownership is Now the Norm, Entrepreneur, https://www.entrepreneur.com/article/245881 (May 30, 2015) (stating that as of May 2015, 53% of the 450,000 franchise units in the United States, and 76.5% of franchised restaurants, were owned by multi-unit franchisees).
agreement to provide that the franchisee is in breach if it falls below certain balance sheet thresholds.

C. **Not-for-profit Entities as Franchisees**

With an increased emphasis among many businesses on “doing good” and “corporate social responsibility,” more and more franchisors are considering programs geared toward offering franchises to not-for-profit entities.

1. **Should a Not-For-Profit Entity (NPE) Enter Into Franchising?**

An NPE contemplating franchising should take into account several considerations, many of which are based on the sophistication and experience of the NPE and the flexibility and interest of the franchisor. First and foremost, the NPE should determine whether it is financially sound enough to invest in buying a franchise. Even if the franchisor waives or discounts the initial franchise fee (as many have done in this situation), the NPE will likely have to incur expensive start-up and operational costs. NPEs should make sure they have the necessary capital in hand, or that their supporters will provide the necessary funding or financing via donations.\(^{22}\)

Next, an NPE considering franchising should have experience with earning income as opposed to simply fundraising. In addition to the culture shock of earning income via a business operation instead of fundraising, there are accounting and other operational matters that come with owning and operating a franchise for which the NPE will be responsible.\(^{23}\)

The NPE must also make sure it has the necessary internal and external resources to operate the franchise. Having employees or supporters willing to take on the management and operational aspects of the franchise business will be important for a successful venture.\(^{24}\)

2. **What does the Structure of the NPE franchisee look like?**

There is nothing unique about an NPE acting as a franchisee, whether it is a multi-unit franchisee or single unit franchisee. Indeed, the same federal and state franchise laws and rules apply when offering a franchise to an NPE as to a traditional franchisee entity.

Most non-profit organizations that would consider franchise ownership are likely 501(c)(3) tax exempt organizations. And while one may initially assume that a tax exempt organization cannot operate a for-profit franchise as a franchisee, that is not the case. “To be tax-exempt under section 501(c)(3) of the Internal Revenue Code, an organization must be organized and operated exclusively for exempt purposes set forth in section 501(c)(3), and none of its earnings may inure to any private shareholder or individual. In addition, it may not be an action organization, i.e., it may not attempt to influence legislation as a substantial part of its activities and it may not participate in any campaign activity for or against political candidates.”\(^{25}\) Despite the admonition

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\(^{23}\) See id.

\(^{24}\) See id.

above, an NPE is permitted to earn profits. However, the NPE’s activities must be substantially related to its tax-exempt purpose and its profits must be used consistently with that purpose, e.g., the NPE franchisee purchases the franchise to employ or train its members/constituents as described below in connection with the NPE Beaver County Rehabilitation Center and the Candy Bouquet International franchise. Accordingly, if structured properly a 501(c)(3) NPE can own and operate franchises and earn profits from the operation of those franchise units.

To retain its tax-exempt status the NPE may not devote a substantial amount of its time to activities unrelated to the tax-exempt purposes of the NPE. A charitable organization that offers job training can operate franchised ice cream shops and use the ice cream shops to train individuals on how to operate and work in the store. Such activity would likely be deemed related to the tax-exempt status of the charity and would not pose a risk. But if the job-training charity decided to run an auction house and use the auction proceeds as a fundraising activity, the charity will likely put its tax-exempt status at risk. Nonetheless, merely operating an unrelated business such as the auction house will not invalidate the charity’s 501(c)(3) tax-exempt status, provided that the money and time spent operating the auction house is “insubstantial.”

“Insubstantial” has not been specifically defined by the Internal Revenue Service, but an NPE spending no more than 10% of its time and revenue on the for-profit activity will be able to maintain its tax-exempt status. Be advised, however, that the net income earned from the for-profit activity is subject to the prevailing corporate income tax as unrelated business income.26 Once the unrelated business activity becomes substantial, or above the estimated 10% threshold, then the NPE could be at risk of losing its tax-exempt status. At this point, it is advisable for the NPE to form a for-profit subsidiary. The NPE would be the sole owner of the subsidiary and would receive all of its profits in the form of dividends. The NPE must be careful in setting up the structure of the for-profit subsidiary and cannot use charitable assets to benefit the for-profit subsidiary franchise activity.27

The most common structure for spinning off a for-profit activity is a regular (or “C”) corporation. The primary advantage of a C corporation is that for-profit activities are separated from the tax-exempt purposes of the nonprofit, assuming the corporate structure is set up and maintained properly.28 Having the franchise owned by a C corporation will avoid any Unrelated Business Income Tax (UBIT) issues and will not jeopardize the nonprofit’s tax-exempt status, as the activities of the C corporation will not be attributed to the NPE.29

Additionally, dividends paid by the C corporation subsidiary normally will not be taxed as UBIT for the nonprofit. Consequently, there will be only one level of tax on the profits of the subsidiary’s activities, instead of a double tax (once at the corporate level and again at the

26 Cmty. Wealth Ventures, Inc. et al., supra note 22, at 10-11.
27 See id.
29 See id.
shareholder level) that is typically imposed on corporate profits.\textsuperscript{30} However, any interest, rents, or royalties paid from the subsidiary to the NPE may be subject to UBIT.\textsuperscript{31}

Conversely, a NPE may not wish to hold the for-profit franchise in an LLC where the subsidiary will conduct an unrelated business activity. In that situation, the NPE may have to pay UBIT on its net income from the LLC and the revenue-generating activities potentially could jeopardize the NPE’s tax-exempt status, as the LLC’s activities will be attributed to its parent NPE. Id.

3. The Pros and Cons of NPE Franchising

If NPE franchisees are really no different from for-profit franchisees, what are the advantages and/or disadvantages of franchising with NPEs?\textsuperscript{32} The allure of NPE franchising has been identified as follows:

- Franchisors can take advantage of the large size of NPEs and their member and donor lists. The NPE franchisee provides an untapped pool for potential franchisees on a national, regional, or statewide scale.

- NPEs view the franchisee opportunity as a new source of funding and income. And the NPE franchisee can take advantage of the strong franchise brand and associated business with less risk, as well as the available training and expertise the franchisor provides.

- The NPE usually has resources for finding the necessary capital to support their franchises.

- Franchisors are able to co-brand with the NPE and take advantage of being able to “do good” and participate in corporate social responsibility (CSR) by giving back to the community. Indeed, a franchisor’s investment in such CSR activity is becoming more crucial to the success of any franchise brand, especially with millennials. A 2014 study titled “The Nielsen Global Survey of Corporate Social Responsibility”\textsuperscript{33} examined more than 30,000 consumers in 60 countries worldwide to better understand the impact of CSR on behavior. Of the over 30,000 global consumers surveyed:

  - 67% prefer to work for socially responsible companies

\textsuperscript{30} See id.


55% will pay extra for products and services from companies committed to positive social and environmental impact
52% made at least one purchase in the past six months from one or more socially responsible companies
52% check product packaging to ensure sustainable impact, and
49% volunteer and/or donate to organizations engaged in social and environmental programs

As for potential disadvantages, there are a few:

- NPE franchisees may have different motivations for franchising that do not necessarily involve making the highest profit. Instead, many NPE franchisees may be more interested in placing their constituents in jobs, training their constituents, or simply using the franchise operation to help spread the word about their mission. Breaking even might be acceptable to the franchisee as opposed to increasing profits and expanding the franchise business.

- NPE franchisees may lack the required skills to operate the franchise and may need additional franchisor training and supervision to be successful. This could drain a franchisor’s resources and hurt the franchisor’s ability to support its non-NPE franchisees.

- There is some risk that an NPE may get in legal or ethical trouble or align itself politically or socially with positions that are not consistent with or supportive of where the franchisor stands. Franchising and co-branding with an NPE must be carefully calculated and monitored by the franchisor to make sure the NPE activities outside the franchise operation and/or associated therewith do not harm the brand value of the franchise.

4. Considerations for the Franchise Agreement in NPE Franchising

In the case of NPE franchising, there are a number of standard franchise agreement provisions that likely will need to be modified, as follows:

a. Royalties and Fees: Aligning objectives

When working with NPEs as franchisees it is important to try and align objectives in the franchise agreement. For example, franchisors should consider mandating minimum sales or minimum royalties to provide the NPE with the appropriate for-profit objectives. In exchange, the franchisor could waive or reduce the initial franchise fee or defer it if the NPE hits the targets. Royalty rates could also be adjusted more favorably for NPEs.

If the franchisor wants to capitalize on the size and membership of the NPE to expand the franchise, area development agreements are likely a good way to align objectives with the NPE franchisee. And perhaps, a franchisor’s NPE relationship would also benefit from an area representative agreement providing incentives for growth with the NPE.

b. Co-branding and Marketing
Additional provisions for co-branding, marketing, and promotion should be carefully expressed to make sure the franchisor and NPE are going to work together to promote the franchise and CSR relationship. Franchisors should consider setting aside marketing dollars or even donating a percentage of profits to the NPE charity to try and obtain as much recognition for its NPE franchise relationship and its CSR activity as possible. NPE franchisees also benefit from this relationship by gaining recognition, sometimes on a national or even global scale, from its association with a franchise brand. Such recognition not only increases revenue, but could also attract new donors and supporters for the NPE mission.

c. Vetting and Quality Control

Franchisors should carefully vet the NPE and make sure the franchise agreement provides ample ways for the franchisor to retain approval rights over the various decisions the NPE may make regarding site selection, vendors, and (subject to joint employer considerations) managers and other employees.

d. Training

Training should also be a main component of any NPE franchise agreement. The agreement should mandate successful completion of any training before the NPE can start operating any franchise location. Additional and/or mandatory supplemental training should also be considered, including periodic updates about best practices in the operation of the franchise.

e. Waivers

NPEs may also be able to negotiate a waiver of any personal guarantees usually mandated by franchisors.34

f. Exit Strategy and Termination

In connection with joint venture franchising, franchisors who offer/solicit NPE franchisees should carefully provide for an exit strategy if things go wrong with the NPE. The ability to terminate should clearly express the grounds and make sure to note that the grounds for termination are for good cause. For example, if the NPE does not meet the minimum sales targets, or if the NPE is found liable for fraud or misuse of charitable funds, the franchisor should be able to immediately terminate the franchise agreement.

5. NPE Franchisee Examples

Beaver County Rehabilitation Center. The partnership between Beaver County Rehabilitation Center (BCRC) and Candy Bouquet International (CBI), formed in 2001, is a good example of an NPE franchisee-franchisor relationship. BCRC is a non-profit that provides employment opportunities and training to people who are vocationally challenged. CBI is a large franchisor of candy arrangements. While BCRC usually partnered with local businesses to provide training and employment for their clients, BCRC wanted more control. The CBI franchise seemed like a good choice because of its low franchise fee (indeed it was discounted), and the absence of a standard royalty. As a franchisee, BCRC only had to pay an association fee based on population size in a given territory. The CBI franchise operation also matched up well with the

34 Cmty. Wealth Ventures, Inc. et al., supra note 22, at 18.
BCRC employment mission because the work involved was labor intensive and required several operation steps that the BCRC clients could be trained to learn. The CBI candy arrangements also fit well with a BCRC business called Gifts Delivered, and BCRC was able to integrate the CBI franchise operation into its existing business. BCRC operated CBI franchises at least until 2016, but the relationship recently terminated.\(^{35}\)

**True Bethel Baptist Church.** An example of an NPE franchisee operation that is unrelated to the non-profit operation is the opening of a Subway franchise by the True Bethel Baptist Church (TBBC). TBBC saw an opportunity to support the urban community in which it was located, and it felt that a highly recognized brand like Subway could succeed in its community despite the area’s high crime rate. TBBC created a for-profit subsidiary to operate the for-profit franchise and paid Subway the standard franchise fee. Subway, in turn, showed a willingness to work with TBBC to find suitable locations (e.g., right next door to the church) and provide training. Despite minor trouble with employees and management, the franchise was profitable from the start and all initial issues were overcome. While the for-profit operation is important, TBBC uses its Subway franchise operation to support its job training mission for the local community constituents.\(^{36}\)

**Platte River Industries.** The relationship formed between Platte River Industries (PRI) and Auntie Anne’s serves as another example of NPE franchising. PRI’s mission was to create employment opportunities for individuals with disabilities in the community. PRI had already operated a small popcorn store in the Denver Airport, but it was not doing business like the Auntie Anne’s across the way, nor was the popcorn store providing sufficient employment opportunities. PRI and Auntie Anne’s engaged in extensive negotiations for PRI to purchase the existing Auntie Anne’s location in the airport. Other than a reduction in the purchase price, PRI was treated like any other franchisee with regard to royalties and other fees, including area development fees(?). From the initial purchase in 1998 to 2006, PRI operated 5 franchises, earning about $25,000-$30,000 annually, and ensuring that at least 50% of its employees were disabled individuals. Each of the franchisee entities was operated as a separate, wholly-owned for-profit LLC under PRI. Nonetheless, after a review of updated information available on the internet, the authors could not determine whether the PRI locations were still operating.

A few other notable examples of NPE franchising by a well-known franchise brand are:

**Partnerships.** Ben & Jerry’s started its “PartnerShops” program in 1987 for youth-development and job training nonprofit organizations, and is considered one of the pioneers in offering franchises to non-profit entities. But as of 2018, the Ben & Jerry’s website notes that it is no longer offering any more PartnerShops franchises, but is instead supporting their existing Partnership franchisees.

**Subway.** In 1996, Subway began working with nonprofits opening franchises in school cafeterias and hospitals, some of which are owned by the institutions.

**Nathan’s Famous.** Nathan’s Famous partnered with the YWCA of Greater Pittsburgh in 2010.

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\(^{35}\) See id. at 3-4.

\(^{36}\) Cmty. Wealth Ventures, Inc. et al., supra note 22, at 20-21.
Blimpie. Blimpie granted a franchise to Affordable Homes of South Texas, which constructs homes for low-income families in Texas, in 2013.

D. Publicly-held Franchisees

It is relatively rare for publicly-held entities to consider the development or acquisition of multiple-unit franchisees. It is almost equally rare for existing multiple-unit franchisees to go public. Yet, neither of these are unheard of situations,37 and so we consider below the Franchise Agreement and policy issues associated with selling to publicly-held franchisees and allowing franchisees to go public. While the process of approving a public offering is somewhat different from the initial sale of franchises to a public company, (e.g., the former typically entails the review of public offering documents in order to assure that the franchisor is not making any representations, and that the franchisee is not making any misrepresentations concerning the franchisor), the required Franchise Agreement modifications, and needed policy adjustments, are largely the same.

In general, the most significant concern with having a publicly-held franchisee is that the franchisee will have a much more compelling and significant “master” than the franchisor – the public market itself. That is, the public company will have shareholders who prioritize dividends and capital gains ahead of ongoing success of the franchised businesses. One way to temper this concern is to sell franchises to companies that are public only to a limited extent (e.g., 25 percent public, with the remainder of the stock closely held), but even this scenario presents the “other master” problem, as the value of the closely held shares will depend upon the value of the traded shares.

The general reasons to favor a publicly-held franchisee are similar to the reasons for favoring a private equity owned franchisee. That is, such publicly-held franchisees are typically well-capitalized and have the financial wherewithal to both develop new franchised units and to strengthen the financial performance of existing franchised units. This financial capability also enables them to hire top professional management, and to rationalize and consolidate markets by acquiring other franchisees.

Franchisors that are willing to have publicly-held franchisees often have in their Franchise Agreements provisions that allow for the franchisee to go public, subject to certain conditions. These conditions include a right of approval and a right by the franchisor to review the public offering materials (especially for purposes of determining that they contain no representations (e.g., brand references) that would lead an investor to believe that the franchisor is participating in the offering of securities). The franchisor may also require affirmative references or disclaimers in the materials regarding the non-participation in the offering by the franchisor, as well as reimbursement for the costs of reviewing the materials, and indemnification for any claims arising against the franchisor as a result of the offering.

37 See Pizza Mgmt., Inc. v. Pizza Hut, Inc., 737 F. Supp. 1154, 1178 (D. Kan. 1990) (upholding franchisor’s withholding of consent to franchisee making a public offering of shares because the very nature of public offering made it “veritably impossible” for public purchasers of franchisee’s stock to satisfy conditions in franchise agreement for approval of a transfer). Note also the following publicly-held franchisees: Diversified Restaurant Holdings (NASDAQ: SAUC) (Buffalo Wild Wings franchisee); Carrols Restaurant Group, Inc. (NASDAQ: TAST) (Burger King franchisee); Arcos Dorados Holdings, Inc. (NYSE: ARCO) (McDonald’s Latin America & Caribbean franchisee); Meritage Hospitality Group, Inc. (OTCMKTS: MHGU) (Wendy’s franchisee); and HMS Holdings Corp. (NASDAQ: HMYS) (franchisee of multiple brands, including Smashburger, California Pizza Kitchen, and Starbucks).
In connection with such public offerings, and in connection with the sale of franchises to publicly-held franchisees, the publicly-held franchisee is also going to want certain changes to be made to the Franchise Agreements and to certain policies of the franchisor. These changes are generally the same or similar to those required by private equity firms (and discussed in Sections II.A.1 through 8., above). For example, as a result of the existence of hundreds, if not thousands, of shareholders it will be impossible to require all such “owners” to sign guarantees and to commit to confidentiality and non-compete provisions. Further, such owners cannot be required, as a legal or practical matter, to seek the approval of the franchisor to transfer their shares on a stock exchange, or to obtain approval for the purchase of their shares “on the margin” (even if they are pledging their shares in the multiple-unit franchisee for security). As to franchisor policies, such as Transfer Policy Guidelines set forth in the Operations Manuals, modifications or exceptions may also be requested – and, as a practical matter, be required – by publicly-held franchisees.

E. Employee Stock Ownership Plans as Franchisees

Another alternative franchisee entity is the Employee Stock Ownership Plan (ESOP). There is no means of ascertaining exactly how many ESOPs exist nationwide, but the National Center for Employee Ownership estimates there are nearly 7,000 ESOPs covering more than 14 million employees.38 Of course it is also unknown how many of these 7,000 ESOPs are franchisees, but anecdotally the ESOP seems to be gaining traction as a form of franchise ownership.

A case in point is The Saxton Group Holdings, a highly successful multi-unit franchisee that in 2013 established an ESOP to sell its shares to the company’s employees. At the time, The Saxton Group was the largest McAllister’s Deli franchisee in the United States, operating 50 “fast-casual” restaurants in four states, along with four Pinkberry frozen yogurt stores in the Dallas area.39 In 2013 when founder Kelly Saxton sold 100% of his shares to the ESOP, the company employed 2,000 people and was named as one of Restaurant Franchise Monitor’s Top 100 Restaurant Franchisees.40 The deal was a “leveraged ESOP,” discussed more fully in Section II.E.3. below, and The Saxton Group enlisted private equity firm Long Point Capital to structure and help finance the sale.41

In news reports of the deal, Saxton explained that establishing the ESOP was a way to reward and motivate employees, which he considers “the best part” of a business that is “all about hospitality.”42 For Saxton, learning about and implementing an ESOP was a natural progression


40 Id.

41 Id.

of a fundamental belief in the value of sharing ownership with employees: ten years earlier he sold a pizza franchise company to his senior management team.\(^{43}\)

Some franchisors have also implemented ESOPs in recent years, citing motives similar to those discussed by Saxton. Franchisor i9 Sports is a prime example. In 2016, the Florida-based youth sports league franchise created an ESOP for its approximately 50 employees.\(^{44}\) In addition to motivating employees by “fostering a literal sense of equity,” the company’s founder Frank Fiume viewed it as “the perfect solution” as he looked to become less financially tied to i9 Sports.\(^{45}\) Fiume got a cash infusion allowing him to diversify his portfolio, without having to “exit the business from a participatory standpoint.”\(^{46}\)

1. **What is an Employee Stock Ownership Plan?**

An ESOP is a special form of defined contribution plan designed to invest primarily in qualifying employer securities.\(^{47}\) Essentially, an ESOP is a vehicle that enables the owners of a company to sell all or part of their shares to the company’s employees. Viewed from the employees’ perspective, an ESOP is a qualified, defined contribution employee benefit plan that enables employees to accumulate stock in the company that employs them.

From a technical standpoint, an ESOP is an ERISA plan similar to a 401(k) in that the employer contributes a defined amount to the plan on behalf of employees, with no guaranteed return on the investment. In the case of an ESOP, however, the plan invests primarily in the stock of the employer rather than in bonds, mutual funds, other equities, and the like.

2. **Why is an ESOP Attractive to Franchisees?**

ESOPs are attractive for many reasons. One of the primary benefits is motivating employees and aligning their interests with management by giving them equity in the company in a “shared capitalism” model.\(^{48}\) Results of annual economic performance surveys conducted by the Employee Ownership Foundation bear this out. In 2014, for example, the Foundation released results from the 23\(^{rd}\) Annual Economic Performance Survey (EPS) of ESOP companies.\(^{49}\) Since the survey’s inception 23 years earlier, 93% of survey respondents consistently agreed that establishing an ESOP was “a good business decision that has helped the company.”\(^{50}\) More

\(^{43}\) Id.


\(^{45}\) Id.

\(^{46}\) Id.

\(^{47}\) See ERISA §§ 406(a)(2) and 407(a)(1)-(2), 29 U.S.C. §§ 1106(a)(2), 1107(a)(1)-(2) (1994); I.R.C. §§ 409(l)(1)-(2), 414(i), 4975(e)(7)-(8).


\(^{50}\) Id.
than three-quarters of respondents reported that the ESOP positively affected overall productivity.\textsuperscript{51} 70\% of respondents reported increases in revenue, and 64\% reported increased profitability.\textsuperscript{52} Fully 80\% of respondents reported that the company’s stock value increased as determined by outside independent valuations.\textsuperscript{53}

In addition to motivating employees, ESOPs provide for certain tax advantages.\textsuperscript{54} For S-corporations that have an ESOP, no federal income tax is due on the portion of stock owned by the ESOP.\textsuperscript{55} If the ESOP owns all the stock, then the company pays no federal income tax.\textsuperscript{56} Companies can use the substantial tax savings to expand operations and even acquire other businesses. An ESOP may also have significant tax benefits to the owner/seller of the business. For example, by using a “Section 1042 rollover,” a C-corporation can defer all capital gains taxes by selling at least 30\% of the company’s shares to an ESOP.\textsuperscript{57} To qualify, the seller must use the proceeds to purchase securities of other United States companies.\textsuperscript{58} If the seller then bequeathes those securities to his/her heirs, the heirs receive a stepped up cost basis as of the date of death, thereby avoiding capital gains entirely.\textsuperscript{59}

ESOPs can also play a significant role in corporate finance strategy. Other qualified retirement plans may acquire and hold employer securities, but the ESOP is the only type of plan that can borrow funds for that purpose.\textsuperscript{60} The “leveraged ESOP” is particularly attractive to selling shareholders because it allows them to cash out more equity up front rather than over time as employee contributions to the plan are made. Alternatively, the ESOP can be a tool for corporate finance, whereby the employer uses borrowed funds to pay for equipment purchases, business expansion, capital improvements, and the like.\textsuperscript{61}

In some cases, another advantage is that an ESOP may allow the seller to obtain going concern value rather than book value. This is particularly true where there are fewer potential buyers for a franchise business, such as in rural or remote areas. The ESOP can also be used as a means of business succession, whereby the owner can retain management control and play

\begin{itemize}
  \item \textsuperscript{51} Id.
  \item \textsuperscript{52} Id.
  \item \textsuperscript{53} Id.
  \item \textsuperscript{56} Id.
  \item \textsuperscript{57} 26 U.S. Code § 1042.
  \item \textsuperscript{58} Id.
  \item \textsuperscript{59} Case, supra note 54.
  \item \textsuperscript{60} See I.R.C. § 4975(d)(3).
\end{itemize}
an active part in continuing to run the business while exiting ownership and taking equity out of the company.

3. **How is an ESOP Structured?**

When a company forms an ESOP, it sets up a trust fund for its employees and transfers shares of the company to plan participants by (1) contributing cash with which to purchase company stock, (2) contributing shares directly to the plan, or (3) having the plan borrow money to buy shares. In the third option, known as a “leveraged ESOP,” the company makes contributions to the plan over time to enable the plan to repay the loan.

The company sponsoring the ESOP, the selling shareholder(s), and the plan participants receive certain tax benefits – hence the term “qualified employee benefit plan.” Contributions to the plan are tax-deductible, and employees do not pay tax on the contributions until they retire or otherwise leave the company, at which time they sell their shares back to the company or on the open market.

Because an ESOP is a trust, the company’s board of directors must appoint a trustee to be the shareholder of record for the company stock held by the ESOP. In addition, a plan administrator is named to perform certain administrative functions concerning the ESOP, all in accordance with ERISA.

The chief duty of the trustee, as a fiduciary, is to protect the trust assets for the benefit of the plan participants. The trustee typically negotiates the ESOP’s corporate stock purchase and, in furtherance of this task, conducts an annual appraisal of the corporate stock through an independent appraiser. The trustee could be an outside institution, such as a bank, or it could be someone inside the company, such as an officer or director.

The function of the plan administrator is to do exactly what the name implies: administer the plan. Plan administrators often engage an outside consulting company to provide administrative and accounting services associated with tasks such as managing plan distributions, determining employees’ eligibility to participate, tracking vesting periods, and providing updated reports to the company and plan beneficiaries. The plan administrator does not necessarily have to be an individual. Rather, that role can be performed by a committee or by the company itself.

4. **Who Manages and Controls an ESOP-owned Company?**

In most closely held companies and sole proprietorships, the same individuals who own the company also manage the business. When corporate ownership is vested in multiple or potentially numerous employees, the question becomes “who’s running the company?”

In the case of an ESOP, corporate decision-making may differ from a closely-held company in some, but not all, respects. At first blush, it may seem like the establishment of an ESOP results in a multiplicity of new owners, without any guidance as to who is responsible for managing the business. That is not really the case.

To qualify as an ESOP under ERISA, the plan’s investments must consist primarily of the employer’s publicly traded stock, or, in the case of a stock that is not publicly traded, stock with
voting power equal to or greater than all other classes of stock. As the shareholder of record for the shares held in the ESOP, the ESOP trustee votes with respect to any action requiring shareholder approval. However, the trustee is required to solicit instructions from plan participants with regard to certain votes, such as mergers, dissolutions, and liquidations.

As the shareholder of record, the ESOP trustee votes with other corporate shareholders to elect board members. Of course, the ESOP trustee will have been appointed by the company’s board of directors in the first place, so their interests are typically aligned – particularly because they both have a fiduciary duty to act in the best interest of the company and its shareholders. It is conceivable that the trustee’s views of what’s in the company’s best interest could diverge from those of the other shareholders, but in most cases the composition of the board of directors, as well as the company’s roster of officers, will remain the same following the establishment of an ESOP. This is particularly true if the management team is comprised of the selling shareholders, and they are simply looking to cash out without exiting management. Thus, the establishment of an ESOP, in most cases, will not change the management and operation of the franchised business.

As in the case of other alternative entities discussed supra, such as private equity and not-for-profit entities, the franchisor may require modifications to the franchise agreement, including:

a. **Owner/Operator:** As in the case of the private equity owned franchisee, the franchisor should consider eliminating the owner/operator requirement and replacing it with a provision that grants the franchisor the right to approve the day-to-day operator and the percentage of equity interest that individual will maintain in the business.

b. **Training:** Not all of the shareholders will require training in every facet of the franchise business, and therefore any standard provision requiring all owners to be trained should be modified to require the principal operator(s) to be trained

c. **Confidentiality and Non-Competition:** Because shareholders will have the right to certain financial information of the business, the franchisor should consider extending any confidentiality requirement to any and all shareholders. Careful consideration should be given in consultation with counsel as to which of the shareholders should execute non-competition covenants. A non-competition agreement executed by a lower level employee with a small fraction of ownership in the company may not be enforceable, and requiring it may not be advisable depending upon the circumstances and applicable state law.

d. **Transfer:** Franchisors that normally insist on approving any transfers may need to reconsider this requirement in connection with an ESOP to account for departing employees who sell their shares back to the company.

e. **Guarantees:** As in the case of private equity ownership, it would be impossible, or at least highly impracticable, to require all shareholders to give personal guarantees. Such requirement could be limited to principal owners and/or operators, or the franchisor may be satisfied with a letter of credit or strong balance sheet and history.

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62 I.R.C. § 4975(e)(7)-(8), 409(I)(1)-(3).

63 See I.R.C. § 409(e) (relating to “pass-through voting”).
5. **Can (and Should) Franchisors Work with ESOPs?**

As the concept of the ESOP as an alternative franchisee entity is still relatively uncommon, franchisors may be skeptical of the proposition. Franchisors should not reject the idea out of hand, however. The ESOP may be an attractive option for franchisees for the many reasons discussed above, and the franchisor’s willingness to work with an ESOP would undoubtedly help foster good relations with franchisees who are considering it. Moreover, the improved customer service, productivity and profitability that often accompanies an ESOP clearly benefits the franchisor as well as the franchisee, as does the implementation of a well-formulated succession plan for franchisees approaching retirement.

Traditionally, sole proprietorships and closely held companies are the preferred forms of franchise ownership because franchisors typically want to ensure that the business is operated by the particular individual they have approved, based on that individual’s training, experience and other personal qualifications. As discussed in Section II.E.4., above, the management of a company establishing an ESOP need not change.

To ensure individual accountability, the franchisor could propose modifications to the franchise agreement whereby (i) the franchisor has the right to approve or reject proposed board members and/or officers of the company, (ii) the principal operator of the franchise business must hold a certain minimum percentage of equity in the company (iii) and the operator and other key personnel must execute confidentiality and non-compete provisions. Consideration should also be given to what happens if and when the ESOP is unwound. Each year, three to four percent of all ESOPs are terminated and an unknown number of additional ESOPs are frozen. Franchisors (and of course, the franchisees proposing this entity structure) should be prepared to address this and any other transfer or succession concerns.

F. **Joint Ventures as Franchisees**

In the course of gathering information about using the JV structure for franchising, it became apparent that use of this concept is not widespread in the US. Even so, both US and non-US franchisors may want to consider using the JV structure, especially when expanding their franchises outside of the franchisor’s home country, as the JV structure potentially provides for more franchisor control over the franchise and its franchisees.

1. **Joint Venture (JV) Franchisees: The Structure**

A JV is a cooperative business entity where two or more businesses decide to join forces for a specific business activity, i.e., franchise ownership. In a JV the business entities will contribute money, assets, or other valuable know-how or materials to the JV. JVs can take different forms and operate as a separate business entity, e.g., private corporation, limited liability company, or partnership. Taxes and individual state tax codes usually drive the decision on which form the JV will take. The parties can also form the JV via a joint venture agreement, whereby the franchisor and franchisee maintain their individual corporate statuses, but they operate under the JV agreement which governs their respective obligations, e.g., managing the JV and franchise operation, profits, losses, payment of taxes, etc. But in light of many international franchise

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64 Kaiser, supra note 44 (noting that unwinding an ESOP can be a challenging process).

65 For a general discussion on unwinding ESOPs, see Freezing or Terminating an ESOP, National Center for Employee Ownership, [https://www.nceo.org/articles/freezing-terminating-esop](https://www.nceo.org/articles/freezing-terminating-esop) (last visited July 25, 2018).
regulations that mandate a franchisor own and operate company-owned units before franchising, the JV will likely need to take the form of a corporation, partnership, or LLC.\footnote{See Theodore P. Pearce et al., Structuring Joint Ventures in Franchising, 14 INT’L J. FRANCHISING L. 23, 31 (2016).}

In a nutshell, the way a JV would likely be set up is with the franchisor having a franchise agreement with the new JV entity, and the JV entity would be owned jointly by the franchisee and franchisor. The franchisor could also create a new company to partner with the franchisee in the JV.\footnote{See Eric Parker, Are Joint Ventures the Best of Both Worlds?, FRANCHISING PLUS (Oct. 18, 2016), http://www.franchisingplus.co.za/news-articles/233-are-joint-ventures-the-best-of-both-worlds.} Regardless of who the actual JV parties are, the parties would have a joint venture agreement which governs their relationship, obligations, taxes, etc. The JV could serve as a franchisee, master franchisee, or area developer. The franchisor could also form multiple JV entities with different franchisees to expand the franchise business.

Additional structure considerations include:

- Will the JV parties be equal shareholders or will either entity take a larger percentage ownership stake?
- Will the parties allow for different classes of ownership shares, perhaps providing for the franchisor entity to own shares that provide it with stronger voting rights?
- Distribution of profits?
- Voting rights? Who makes the deciding vote in a deadlock situation?
- Will the parties appoint directors? Who controls this appointment?
- Termination or exit rights.\footnote{Pearce et al., supra note 66, at 35.}

2. **The Pros and Cons of Joint Venture Franchising**

There are several benefits to using the JV model for multi-unit franchising expansion:

- Depending on the situation, the JV franchisee partner has a lower initial investment because the franchisor is a partner in the JV franchisee entity. For example, there may be existing franchisor employees who simply do not have the financial backing for a franchise unit. Using the JV structure may enable the existing employee to obtain a franchise without the higher initial investment. Of course, this likely means that the JV will be set up, at least initially, to favor the franchisor JV partner who will likely receive a higher percentage of the profits to recoup its investment. In this way it seems both the franchisee and franchisor JV parties can benefit from the JV structure.

- The franchisor benefits from the JV structure because it can result in finding more suitable and experienced franchisee partners in the local jurisdiction. Experienced franchisee partners will want the “ownership” title provided by the JV franchise structure, which may also allow them to have more control of the local operation of the franchise. In this way
the JV structure, unlike the NPE structure, is likely to attract more qualified and skilled franchisees, as they will have “skin in the game” by contributing their assets to the JV in exchange for the additional control they are seeking over the local franchise operation.

- Alternatively, the franchisor could set up the JV franchise in a manner providing the franchisor with more control over the operation. In some situations where the franchisor is starting up, this increased level of control could help the franchisee succeed in less time, and incentives could be provided to reward the franchisee with additional ownership stake or control upon reaching certain targets.⁶⁹

- If the franchisor contributes 51% of the start-up capital, it maintains control over the JV franchisee, but the JV franchisee partner still has to contribute 49% and should be very motivated to succeed. And in this scenario, the franchisor could receive 51% of the profits, in addition to, or in some situations instead of, receiving royalty fees and other franchise fees.

- For the JV franchisor, exiting or selling the JV franchise could be much easier. The JV agreement could have provisions which enable the JV franchisor party to sell its equity stake without interference from the JV franchisee, and/or sell the entire franchise entity to a new entity. In such instances, the JV franchisee could be given a right of first refusal or first negotiation to buy out the JV franchisor or the franchise entity in its entirety. These multiple exit options are usually attractive to JV franchisors.

- The JV franchisee partner feels confident in the franchise because the franchisor has made an investment in the JV franchisee entity.

- The JV franchisee usually has less to lose because its investment in the new business is less than it otherwise would have been, but for the JV franchisor’s investment.

- The JV franchisee feels confident that if it ever wanted to exit, the franchisor would likely be in a position to purchase the franchise at a profit multiple (assuming the franchise is doing well).

- Both parties benefit from the JV franchisee because it enables them to test the concept before entering into a full-blown franchise operation.⁷⁰

The potential disadvantages are:

- While sharing the risk of loss and profits, such sharing may not be ideal from the JV franchisor perspective, especially if the initial investments were not equal.

- If the JV franchisee partner is ineffective with management, and disagreements arise over operational matters, the decision-making process becomes labored and tedious.


⁷⁰ Pearce et al., supra note 66, at 24.
• Negotiating and agreeing upon the corporate structure, initial ownership and distribution percentages, and voting rights could be a very difficult process.

• Political risks abound if the government changes and decides to nationalize JV entities in the jurisdiction, or to pass laws mandating higher tax payments on JV entities.

• While one significant benefit to a JV is that the local JV franchisee partner has expertise and should be able to operate successfully and expand, issues may arise if the local JV franchisee partner is not meeting targets or decides to make operational or supply chain changes that are inconsistent with the JV franchisor standards. Achieving compliance may be difficult if the local JV franchisee partner is a 50/50 owner in the JV because the JV franchisor may not be able to exert the desired control over the local JV franchisee.

• The JV franchisor partner could become bound to the local laws and regulations that govern the company, including local employment and labor laws.

• Exit strategies may be impacted by local laws and regulations, including whether it is even possible to shut down the JV operation, how to divide up assets, intellectual property, and know-how, including improvements.71

3. Considerations for the Joint Venture Agreement and Franchise Agreement in Joint Venture Franchising

In light of the advantages and disadvantages of JV franchising, there are several modifications and accommodations the parties can address in the franchise agreement and/or the joint venture agreement to diminish and maybe even avoid major issues during the joint venture franchise relationship.

a. Intellectual Property/Assets

With regard to assets including know-how, improvements, and intellectual property, the JV parties must really assess their respective positions before entering into any agreement.72 It is more likely than not that each party to the JV is going to have certain assets in their possession before they enter into the JV relationship, and neither should have to relinquish their ownership to such assets if the JV relationship terminates. For example, if the JV franchisor entity owns the trademarks that the JV franchisee will be licensed to use them during the JV relationship, the franchise agreement and/or the joint venture agreement should provide that under no circumstances should the JV franchisor lose ownership of its trademarks or any control of their use in the jurisdiction where the JV franchisee is operating. Similarly, the either the joint venture or franchise agreement could provide that if the JV franchisee has local experience with specific supply chain entities, or perhaps brings its local POS system to the JV operation, it should not lose ownership of those assets. And if those JV franchisee assets become crucial to the franchise operation, it should be anticipated in the joint venture agreement that in the event of a breakup the JV franchisor will need to pay the former JV franchisee for its assets. Payment could be in the form of a royalty on purchases from the superior supply chain entities, or perhaps on sales resulting from use of the POS system.

71 See id. at 26-27.

72 Pearce et al., supra note 66, at 28-29.
b. **Management and Control**

Another issue to address is management and control of the JV franchise operation. The joint venture agreement should specifically address the parties' voting rights, deadlock decision making rights, and ownership percentages. Presumably, in the franchise agreement there could be provisions that provide for significant deference given to the local JV franchisee expertise in many areas like supply chain, employment, and local marketing. On the other hand, in the franchise agreement the JV franchisor may want to exert strict approval rights over the local JV franchisee’s decisions and use of its trademarks; as well as reserving the right to compel the franchisee to modify its practices.\(^{73}\)

c. **Termination**

Termination rights are another important issue for the franchise agreement and the joint venture agreement, which should address these issues in the same manner. The grounds for termination should be clear, and likely both the JV franchisee partner and JV franchisor partner should have the ability to terminate the JV partnership. Most important to address is the issue of good cause for termination; the franchise agreement should expressly state that the specific grounds for termination, if they exist, serve as good cause for termination. The joint venture agreement should also expressly provide grounds for termination that may fall outside of the franchise agreement obligations, e.g., failure to abide by voting rights, or violations of criminal conduct or abuse of power provisions. This is important in several states where the law usually requires a franchisor to show that termination of the franchise is based on a (a) factual predicate; and (b) not subject to waiver, laches/estoppel, wrongful termination, frustration of purpose, or unconscionability. Indeed, some state laws expressly protect franchisees by requiring strict notice and cure periods in addition to good cause. For example, California requires good cause and sixty days’ notice, except in nine specific situations (relating to crime, bankruptcy, and other egregious circumstances).\(^ {74}\) In other states, the common law protects the franchisee in the absence of franchise agreement provisions. For example, Pennsylvania allows termination if the breach goes to the “essence” of the contract and without termination there would be irreparable damage.\(^ {75}\) Connecticut and Delaware have statutes that mandate good faith for termination, which is usually determined by examining the franchisor’s conduct toward the franchisee.\(^ {76}\) And at least Hawaii and Washington have general good faith franchise laws that may make it more difficult for a franchisor to terminate the franchise in a JV situation. This is because the franchisor is a partner in the JV franchise and, if its actions caused the alleged breach of the franchise agreement, the termination could be a breach of the franchisor’s good faith obligation.\(^ {77}\) In New Jersey there is no statute, but the courts considering the issue continuously assess injury to the franchisee vs. franchisor, so there is no certainty there either. At least one Third Circuit case recently rejected the franchisee’s assertion that the franchisor’s “motivation” (racism) should undermine the franchisor’s right to terminate.\(^ {78}\) On the international level, similar “good cause” for termination laws exist as well.

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\(^{73}\) See id. at 31-32.

\(^{74}\) Cal. Bus. & Prof. Code § 20020.

\(^{75}\) See LHL Transp., Inc. v. Pilot Air Freight Corp., 599 Pa. 546, 549 (Penn. 2009).

\(^{76}\) Conn. Franchise Act, Conn. Gen. Stat. §42-133v (a), (c); Delaware Franchise Security Law, 6 Del. C. § 2552 (a), (g).

\(^{77}\) Hawaii Franchise Investment Law, HRS § 482E-6(1); Washington Franchise Investment Protection Act, Rev. Code. Wash. §19.100.180 (1).

d. Dispute Resolution

For consistency, the JV parties may wish to make sure that their dispute resolution provisions are the same in both the joint venture agreement and the franchise agreement. Whether you are operating your JV franchise in the US or internationally, the parties may want to make a serious push for arbitration to govern any and all disputes. If the arbitration provision is drafted well and addresses timing, number of arbitrators, applicable law, location, and arbitrator authority, the use of arbitration to resolve disputes and/or compel termination could result in an expeditious and cost efficient way to reach a resolution and obtain the necessary relief sought. And even though there is an extra step to enforce any issued arbitration award in a local court forum—because most countries where franchisors do business are members of the UN Convention of the Enforcement of Foreign Arbitral Awards—the JV parties have a better chance of getting their arbitration award enforced than they would if they obtained a local court judgment. And while this is a preferred strategy for business outside of the US, parties to a JV franchise operation in the US should consider this option for resolving disputes. While many doing business in the US will opt to use the local US courts, as they are generally efficient and fair, and they have the most power to execute on any judgment, the expense and length of time associated with litigating in US courts may be something the parties wish to avoid.

Another possible dispute resolution method is to use mediation before going to court or arbitration. Mediation can be a fast and inexpensive way to resolve disputes and avoid expensive litigation fees associated with court or arbitration proceedings.

e. Exit

Exit and transfer rights are another matter to address. The ability for a JV franchisor to get out of the JV, or for the JV franchisee to sell the franchise back to the JV franchisor, are important benefits to the JV structure. The JV agreement should carefully delineate the specific circumstances that allow for the JV franchisor to exit the JV, and perhaps also address the JV franchisee’s rights. For example, the agreement might allow the JV franchisee a right of first refusal and/or right of first offer so it has a chance to take over the franchise operation. Similarly, in the franchise agreement or the joint venture agreement, if the JV franchisee wants out, there should be a specified procedure for assessing the present market value for the franchise business if the parties cannot agree, such as utilizing third party valuation. As noted earlier, the JV franchisee should not be able to impede the JV franchisor’s flexibility to exit, especially if the JV franchisor is the large stakeholder in the franchise entity.

f. Non-Compete

Non-compete, including non-disclosure and non-solicitation, provisions are also critical to any JV franchise agreement. And in this situation the local laws governing the parties’ relationship are important to assess. For example, certain states in the US are very critical of, and in some cases, like California78, prohibit, non-compete provisions for employees, although allow some limited reasonable non-compete provisions when a party sells or transfers their business ownership interests, or to restrict the franchisee/employee from using any trade secrets owned

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79 Cal. Bus. & Prof. Code § 16600 provides that, “[e]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade or business of any kind is to that extent void.”
by the franchisor. Such states could protect a franchisee’s, or its employees’, rights to continue working in the business they were trained to work in. In these jurisdictions, de-identification and other provisions related to the post-termination distribution of assets are likely a crucial component of any franchise agreement or joint venture agreement. If the JV franchisor cannot stop the former JV franchisee from competing, the JV franchisor must make sure they compete without using the JV franchisor’s intellectual property and other proprietary information and know how.

4. **Example of JV Franchising in the US**

In the US it appears that JV franchising is rare. One apparently successful example was the JV between United Franchise Group (UFG) and Transworld Business Brokerage (TBB). Ray Titus, CEO of UFG, wrote about how he and TBB created a JV to bring the TBB franchise into the UFG family of franchised businesses. Back in 2011, less than a year after they formed their JV, they were approaching 50 franchisees.

It is not entirely clear why more franchisors do not employ the JV model, although it could be the initial and substantial investment of time and money the franchisor partner would need to make in the JV scenario. And while this initial and substantial investment could be contractually limited, one suspects that if a franchisor is considering this option it may just be better off opening a company-owned operation and not having a JV partner.

III. **CONCLUSION**

As yet, there are no definitive patterns established for the myriad alternative forms of franchise ownership discussed here, and many options exist for addressing specific concerns franchisors and franchisees may have regarding each. One thing is clear, however: in order to continue attracting and retaining top quality franchisees, franchisors should at least be open to proposals for alternative ownership and be flexible in implementing revisions to the traditional form franchise agreement to address unique issues presented by a particular entity form. Many of the benefits inherent in these alternative ownership entities redound to the franchisor as well as the franchisee.
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