PERSPECTIVES ON NON-TRADITIONAL FRANCHISE OWNERSHIP STRUCTURES

Marc Lieberstein, Kilpatrick Townsend & Stockton LLP (New York, NY)
Bret Lowell, DLA Piper LLP (Reston, VA)
Susan Metcalfe, Potomac Law Group, PLLC (Philadelphia, PA)
AGENDA

I. INTRO

II. DISCUSSION
   A. PRIVATE EQUITY (BRET)
   B. TRUSTS (SUSAN)
   C. NOT-FOR-PROFITS (MARC)
   D. PUBLICLY-HELD (BRET)
   E. ESOPs (SUSAN)
   F. JVS (MARC)

III. CONCLUSION
Why Should You Consider a Non-Traditional Franchise?

• Six different types – each with own plusses and minuses

• On balance, all six can be a “good thing”
  – Enlarge the pool of prospective franchisees [Susan]
  – Lead to better finances [Bret]
  – Make franchise system more robust and dynamic [Marc]
A.
PRIVATE EQUITY OWNED FRANCHISEES
(BRET LOWELL)
1. **PE Goals**
   - Originally – Franchisor
   - Currently – Franchisor and Franchisee

2. **Acquisition Requirements**
   - Franchisor approval
   - Franchise Agreement – execution or assumption
   - Guarantee
   - Owner commitments (confidentiality / non-competition)
3. Hurdles (and bases for denial) to PE Ownership

- Newco has no track record
- Newco has no financial statements
- Newco is highly leveraged
- Equity stake of manager is too low
- PE owners need to attend training
- PE owners need to sign guarantees
- PE owners need to sign confidentiality
- PE owners need to sign non-competes
4. Legal Impediments to Denial of Consent

- Breach of Contract
- Restraint on alienation
- Good faith and fair dealing
- Tortious interference (seller and buyer)
5. Practical Perspectives – “Foolhardy” to Deny

• Loss of extensive capital infusion
  – Renovation of existing units
  – Construction of new units
  – Higher resale values (system wide)
• Financial knowledge and capabilities = greater success
  – PE units
  – Brand enhancement
  – Greater system revenues / royalties
6. Practical Perspectives – Sensible to Deny

• PE has short-term / limited (7 year) perspective
• PE driven by financial returns only
  – Closure of marginal units
    ▪ w/o regard to brand
    ▪ w/o regard to development obligations
    ▪ w/o regard to breach
  – Opening of new units (via negotiations and w/o regard to rights)
7. Compromise Position – Proceed “Subject To”

- Agreement Modifications
- Policy Modifications

8. Typical Modifications

- Owner/Operator
- Training
- Confidentiality
- Financing
- Non-competition
- Transfer
- Guarantees
- Other (cross-defaults)
B.

TRUST OWNERSHIP OF FRANCHISE BUSINESS
(SUSAN METCALFE)
1. Benefits of the Trust – Estate and Succession Planning

• Reduce or avoid taxes
• Avoid probate
• Ensure smooth transition between generations
2. Implications for the Franchise Agreement

- Owner/Operator
- Training
- Confidentiality
- Guarantees
C. NOT-FOR-PROFIT ENTITIES AS FRANCHISEES (MARC LIEBERSTEIN)
1. Advantages of Non-Profit Entity (NPE) Franchise Relationships

- NPE’s offer a large prospective franchisee pool size
- New source of funding and income for NPE’s; less risk
- NPE capital resources can support their franchises
- Franchisors / NPEs take advantage “doing good”
  - 67% of consumers prefer to work for socially responsible companies
  - 55% will pay extra for products and services from companies committed to positive social and environmental impact*

* 2014 Nielsen Global Survey of Corporate Social Responsibility (30,000 people/60 countries)
2. Disadvantages of NPE Franchise Relationship

- NPE franchisees may have different motivations
- NPE franchisees may lack the required skills; need additional training and supervision
- Risk of inconsistent brand positions, or unaligned political or social positions
3. NPE Franchisee Structure

• Nothing unique – an NPE is like any other franchisee; BUT
  – The franchisee entity is different – usually a 501(c)(3) tax exempt entity – permitted to operate a for-profit franchise
  – NPE’s activity must (a) be substantially related to its tax-exempt purpose and (b) have its profits used for that purpose

• IMPORTANT - NET INCOME EARNED IS SUBJECT TO PREVAILING CORPORATE INCOME TAX AS “UNRELATED BUSINESS INCOME”
4. Agreement Considerations for the NPE Franchise Relationship

- Royalties and Fees: Aligning objectives
- Co-branding and Marketing
- Vetting and Quality Control
- Training
- Exit strategy and Termination
5. NPE Franchise Relationships

• Ben & Jerry’s PartnerShop® Program
• Nathan’s Famous - YWCA of Greater Pittsburgh
• Blimpie - Affordable Homes of South Texas, which constructs homes for low-income families
• Subway - True Bethel Baptist Church
D.
PUBLICLY-HELD FRANCHISEES
(BRET LOWELL)
1. Uncommon – but occasionally publicly-held franchisees:
   - Buffalo Wild Wings (Diversified Restaurants) (NASDAQ: SAUC)
   - Burger King (Carrols Restaurants) (NASDAQ: TAST)
   - Marriott (Host Hotels) (NYSE: HOST)
   - McDonald’s (Arco Dorados - Uruguay) (NYSE: ARCO)
   - Wendy’s (Meritage) (OTC: MGHU)

2. Two typical scenarios
   - Franchisee “going public”
   - Franchise sale to an existing public entity
3. Disadvantages

- Public market is the “master” – not the franchisor
- Dividends and capital gains of greater importance than franchisor, brand, quality, and other system requirements.

4. Advantages

- Well-capitalized
- Able to readily build, renovate, and consolidate
- Can afford top professional management
5. “Going Public” Conditions

• Right of approval

• Right to review offering materials
  – No representations of franchisor participation
  – Disclaimer re franchisor participation
  – No misrepresentation of franchisee rights

• Right to reimbursement

• Right to indemnification
6. Typical Modifications (for New Sales and IPOs)
   • Background – 100’s or 1000’s of shareholders
   • Unrealistic to require owners / shareholders to:
     – Obtain approved to transfer shares
     – Obtain approved to finance and pledge shares
     – Get trained, regardless ownership percentage
     – Sign guarantees, covenants, or non-competes
   • Required agreement and policy modifications resemble those for “PE”
E.

EMPLOYEE STOCK OWNERSHIP PLANS AS FRANCHISEES
(SUSAN METCALFE)
1. What is an ESOP?

- ERISA
  - Defined employee contribution plan
- Similar to 401(k)
  - Plan invests mostly in company stock
2. Benefits of an ESOP

- “Shared capitalism”
- Tax advantages
- Corporate finance strategies
  - Leveraged ESOP
- Financial exit strategy for owner(s) / seller(s)
3. ESOP Mechanics

- Company establishes trust fund
  - Transfers shares to employees/plan participants
- Company appoints
  - Trustee/shareholder of record
  - Plan administrator
- Board and officers typically remain in place
4. ESOP Fast Facts

- ~7,000 ESOPs in U.S. covering 11m employees
- 22% of ESOPs in manufacturing sector
- At least 75% of ESOPs are leveraged
- Total assets owned by U.S. ESOPs in 2011: $940 billion
5. Employee Ownership Foundation: Annual Economic Survey

- 85-93% agreed ESOPs help the company
- 76% believed ESOPs improve productivity
- 70% reported increased revenue
- 64% reported increased profitability
- 80% reported increased stock value per independent valuations
6. ESOP Implications for the Franchise Agreement

- Owner/operator
- Training
- Confidentiality
- Non-competition
- Transfer
- Personal guaranty
F.
JOINT VENTURES AS FRANCHISEES
(MARC LIEBERSTEIN)
1. The Joint Venture Franchisee Structure

- A JV is a cooperative business entity where two or more businesses join forces.
- JV franchisor and JV franchisee each contribute money, assets, or valuable know-how / materials.
- Joint Venture Agreement
2. The Joint Venture Franchisee Structure – An Example
3. Joint Venture Franchising: Advantages

• Lower initial investment
• Experienced local partner
• “Ownership” incentives = more local franchisee involvement
• Exiting or selling the JV franchise may be easier
4. Joint Venture Franchising: Disadvantages

- Sharing risk of loss
- Disagreements over management and operational matters
- Negotiating and agreeing upon terms: corporate structure, initial ownership and distribution percentages, voting rights
- Local political risks and laws can affect exit / termination, compliance, division of assets (IP)
5. Franchise / JV Agreement Considerations

- Intellectual Property and Assets
- Management and Control
- Termination
- Dispute Resolution
- Transfer and Exit
- Non-Compete
CONCLUSION & FINAL QUESTIONS