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Private Equity Program

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INTRODUCTION

Private equity investors have poured billions of dollars into franchise companies, including one of the largest private equity transactions ever reported, the $26 billion acquisition of Hilton Hotels by Blackstone Group. Other major private equity investments in franchise companies have included the Dunkin Donuts system acquisition by Bain Capital, The Carlyle Group and Thomas H. Lee Partners for $2.4 billion, and more recently, the acquisition of The Dwyer Group by TZP Group, LLC[2]. As the burdens of "going public" have increased with the advent of the Sarbanes-Oxley legislation and other regulations on publicly traded issuers of securities, private equity opportunities remain an attractive alternative to owners of franchisors seeking to execute on exit strategies.

Private buyers, meaning not a public company, generally fall into two categories – financial buyers and strategic buyers. Financial buyers own the business for the sole purpose of generating returns in the form of dividends, either from operating cash flow, usually enhanced by cost reductions or consolidations, or from leveraging the balance in a recapitalization, and capital gains from sale when value or time reaches the investment horizon. Private equity investors almost always fall into this category. Strategic buyers also seek a financial return, but the acquired business often fits into a portfolio of existing businesses that complement each other in some way. The strategic buyer reduces cost by consolidating operations with existing business units or other means of eliminating duplicate functions, as well as by giving the new business unit access to technology, markets, channels or sales forces of the existing business units, and vice versa. The strategic buyer usually has no fixed investment horizon, but may act on an ad hoc or opportunistic basis to spin off or sell the franchisor business unit when returns no longer meet corporate objectives or valuation growth has slowed.

This paper introduces critical concepts underlying private equity investments in franchise companies and highlights the potential impact of private equity fund owners on a franchisor and its franchise program. Private equity investments should not be confused with venture capital, although in the literal sense, private equity is venture capital. The primary difference is the stage of development of the enterprise. Venture capital is traditionally early stage investment, the first money into the business after founders, friends and family have invested sufficient funds to start the business and develop the initial round of assets to be acquired and prove the concept of the business is workable. Angel investors then fund the start up with the first round of outside investment. When the business is ready for significant expansion or needs future technology development, venture capital investors provide risk capital with the expectation of very high rates of return as the business grows from infancy through its early stages. Venture capital investors understand and tolerate early and middle stage losses while the business develops and refines its technology, market strategy and operational prowess. During this phase of corporate life cycle, the franchisor builds the

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[2] The authors wish to thank Samuel L. Katz, Managing Partner of TZP Group, LLC, for his contributions to this paper.

brand in its region and moves into position for national and international growth. After the business has reached stable cash flow and profitability, with scalable technology and a platform for rapid, sustainable growth, the business is a candidate for private equity.

PE Fund interest awakens when the franchisor hits the level of $5 million to $10 million of earnings before interest, taxes, depreciation and amortization (EBITDA), a surrogate for operating cash flow. Other factors considered in the diligence process are the health of the system, measured in terms of its unit and franchisee turnover, percentage of franchisees with positive cash flow and profitability at the unit level, the percentage of area developers who are on schedule and likely to complete their committed units, the company store population and whether they can be sold to franchisees to harvest capital for debt repayment or working capital, the growth potential in terms of unit expansion and geographic expansion, and whether the company has a strong infrastructure that will serve as a platform for future acquisitions that can lever existing overhead. More PE Funds are looking to keep the selling owners in the management and ownership group with significant stakes so they can benefit from the upside potential of the PE Fund's recapitalization.

This paper intends to guide the reader through the prospect of a PE Fund investment in a franchisor portfolio company.

A. The Private Equity Fund: Formation and Structure

(i) Securing Investors

Before forming a private equity fund (the "PE Fund"), the PE Fund will need investors to commit capital. Organizers of a PE Fund will commonly draft a private placement memorandum (a "PPM") or similar type of disclosure document to detail the purpose and operation of the PE Fund. The United States Securities and Exchange Commission (the "SEC") has promulgated certain regulations that exempt an offering of securities (in this case an investment interest in a partnership) from regulation with SEC.[3] Exempt offerings are commonly referred to as Regulation D Offerings. To qualify for a Regulation D Offering, sale of the ownership interests in the PE Fund are limited to only "accredited investors", which generally includes institutions and pension funds along with certain high net worth individuals.[4] An investment interest in the PE Fund will be highly illiquid and subject to significant restrictions on subsequent sale, transfer or assignment of the investment interest.

PE Fund investors generally fall into two broad categories which may affect the structure of the transaction: tax exempt investors such as public, corporate and union pension funds, endowments of charitable institutions and charitable foundations; and taxable investors such as composite funds of investments made by other funds under a pooled asset management plan, banks and financial institutions, insurance companies, family offices managing family wealth vehicles, high net worth individuals and sovereign wealth funds. In 2009, pension funds accounted for over 27% of private equity investments.[5]

(ii) Basic Structure

A PE Fund is typically formed as a limited partnership. The most common jurisdiction for PE Fund formation is the State of Delaware because Delaware courts generally have taken an expansive view of the "freedom of contract" and permit the limitation (or even elimination) of fiduciary duties.[6] Limited partnerships are "flow-through" entities for tax purposes, i.e., the limited partnership owes no tax on income or gains generated by the partnership and any items of income, gain or loss, whether capital or ordinary gains or losses, flow-through and are reportable to the Internal Revenue Service by the partners.[7] A limited partnership has two classes of partners: limited partners and general partners. As the name implies, losses and liability for limited partners ("LPs")

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[3] 17 C.F.R. § 230.501 et seq.

[4] *Id*.

[5] Dow Jones Private Equity Analyst, April 2010.

[6] Jack S. Levin, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS (2010) § 1001.3.

[7] I.R.C. § 701.

are limited to the capital contributions (the amount invested in the fund by an LP) made by each limited partner to the limited partnership, absent a written agreement to the contrary. The general partner (the "GP") is subject to potentially unlimited losses and liability for the obligations of the partnership and serves as the controlling partner or manager of the limited partnership. Fund assets, *i.e.*, each investment made by the fund, are generally held in special purpose entities.[8]

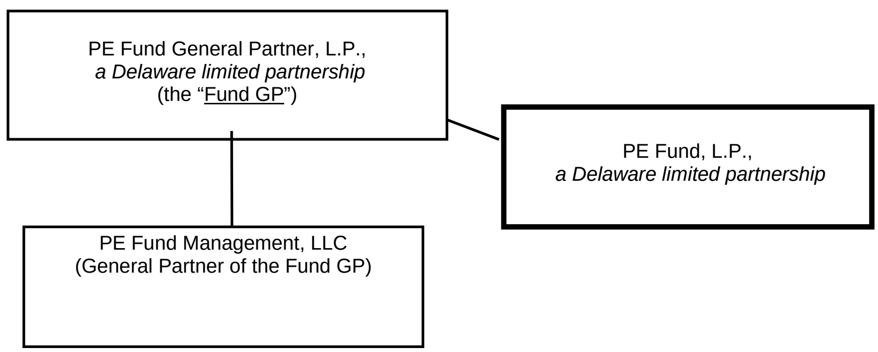
B. The Private Equity Fund: Management

Two structures prevail for the management of a United States based PE Fund: a single manager structure and a dual manager structure. With a single manager structure, the GP of the PE Fund handles all aspects of the PE Fund's management.[9] With a dual manager structure, the PE Fund engages the services of a separate outside manager to handle day-to-day functions of the PE Fund and the GP of the PE Fund is responsible for handling all major decisions of the PE Fund.[10]

(i) Single Manager Structure

Under a single manager structure, the GP is responsible for conducting the day-to-day business of the PE Fund which may include the identification, pursuit and acquisition or disposition of PE Fund assets. The GP also handles administrative and operational functions for the PE Fund. Detailed descriptions of the tasks to be performed by the GP will be set forth in the partnership agreement of the PE Fund. Additionally, the GP holds an investment interest in the PE Fund, commonly committing 1% to 5% of the PE Fund's capital. GP is also commonly a flow-through entity, either another limited partnership or a limited liability company.[11] The GP is also commonly organized in State of Delaware just as the PE Fund. The limited liability of the GP serves as a liability shield for principals of the GP. Figure A provides a diagram of the single manager structure.

Figure A



[8] *See generally*, Levin, STRUCTURING VENTURE CAPITAL § 1001.

[9] *Id*. § 1004.

[10] *Id*. This approach is commonly used for PE Funds based in New York City to avoid being subject to the City's unincorporated business income tax. *Id*.

[11] *Id*.

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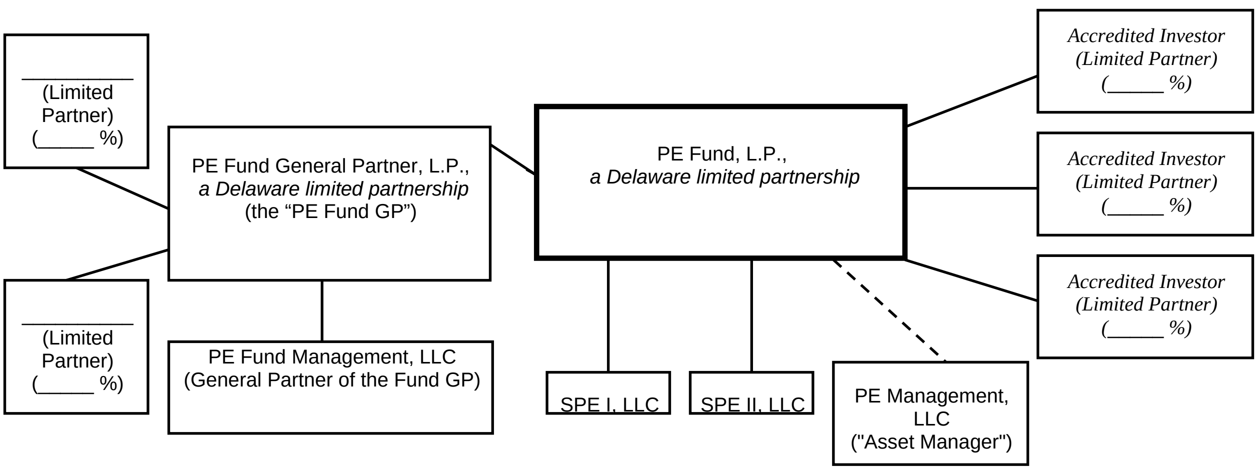
(ii) Dual Manager Structure

Under a dual manager structure, the PE Fund engages the services of an asset manager (the "Asset Manager") by entering into a management agreement.[12] The Asset Manager handles many of the tasks performed by the GP under the single manager structure including, but not limited to, the identification, pursuit and acquisition or disposition of PE Fund assets. The Asset Manager GP under the dual manager structure, however, is not omnipotent as certain major decisions will be subject to review and approval by the GP of the PE Fund. These major decisions would commonly include the acquisition and disposition of PE Fund assets and significant budgetary decisions. Both the GP and the Asset Manager will usually share common ownership, *i.e.*, the principals of the GP will be the same or similar to the principals of the Asset Manager. Figure B provides a detailed diagram of a functioning dual manager structure.

Figure B



C. The Private Equity Fund: Fee Structure

(i) General Fee Structure

Often referred to in industry parlance as the "two and twenty", PE Fund managers generally earn two types of fees for managing PE Fund assets. The first fee, the "two", is a management fee based on a percentage of committed capital.[13] Investors typically enter into binding commitments to contribute cash to fund the PE fund when the GP notifies them that it has found and structured a target the meets the PE Fund criteria. The commitments are time limited, so there is ample incentive for the PE Fund GP to find and complete appropriate transactions in time to obtain fully funded commitments. The most common percentage amount is two percent. The second fee, the "promote"

[12] *Id*.

[13] *Id*. § 1003.1.

or "carried interest", is a management fee derived from the profits of the PE Fund. For example, the PE Fund's partnership may provide that, for every dollar earned by the PE Fund after the LPs capital contributions have been returned, the GP is entitled to $0.20 or twenty percent.[14] The percentages assigned to the management fee and the promote may be higher or lower based upon demand for the PE Fund and the bargaining power of the PE Fund's organizer.

In the case of the dual manager structure, the management fee and the promote are split between the Asset Manager and the GP. The GP, in charge of major decisions for the fund, earns the promote while the Asset Manager earns the management fee for managing the day-to-day operations of the PE Fund.[15]

(ii) Taxation of the Fee

The two forms of management compensation produce varying federal income tax results. The two percent management fee is generally includible in the Asset Manager's gross income when received, and is deductible by the PE fund when paid. [16] The Asset Manager will include the income on the partner's own federal income tax return which is taxable at ordinary income tax rates. The deduction on the other hand flows through to the various partners as a separately stated item of expense and is generally deductible by the partners only to the extent such fee and other miscellaneous itemized deductions exceed two percent of the partner's adjusted gross income.[17]

Under current law, the "twenty" of the "two and twenty" construct is broken into two distinct categories: the "capital interest" and "profits interest."[18] A capital interest is one that gives the holder a calculable share of the proceeds if the PE Fund assets were sold at their fair market value and immediately distributed. The receipt of a capital interest for services provided is taxable as compensation in the same manner as the two percent management fee.[19] A profits interest, on the other hand, is not subject to immediate valuation and therefore, absent an election, is not immediately includible in the Asset Manager's gross income.[20] Because the tax law links the timing of the PE Fund's compensation deduction with the Asset Manager's income inclusion, the profits interest is deductible only when the Asset Manager includes the amount in gross income.[21] As previously referenced, the manager may make an election under Section 83(b) to immediately include the amount of the profits interest in income upon receipt.[22]

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[14] *Id*.
[15] *Id*. § 1004.
[16] I.R.C. §§ 61(a); 162(a).
[17] I. R. C. §§ 212; 702; 67(a).
[18] Rev. Proc. 93-27.
[19] I.R.C. § 83(a); Treas. Reg. § 1.721-1(b)(1). Predictably, the PE Fund would also be entitled to a compensation deduction.
[20] Rev. Proc. 93-27.
[21] I.R.C. § 83(h).
[22] I.R.C. § 83(b).

Such an approach is generally advisable as it permits the interest to be includible at a lower valuation with subsequent appreciation taxed at preferential capital gains rates.

D. Private equity investment vehicle

(i) Target structure

Franchisor systems traditionally operated in a corporate structure that took two basic forms, driven by the answers to the questions of how many audits would be performed and how much risk isolation/protection is necessary to ring-fence the risks associated with a franchise system. A private franchisor would often use a dedicated franchisor subsidiary with audited financial statements, owned by a parent entity that owned the franchise system intellectual property, and that used other subsidiaries to operate company stores, supply franchisees and company stores, and act as a temporary operating entity for recovered franchise stores. Structure decisions were driven by financing requirements, lenders and minority investor needs. If the parent had audited financial statements, it could decide to guarantee the obligations of its franchisor subsidiary and use its audited financial statements in place of the franchisor's statements.

Structure for franchisors became more complex with the July 1, 2008 effective date of the revised Federal Trade Commission ("FTC") Franchise Rule and the changes to Item 21, the financial statement disclosures. The separate audited financial statements of a parent that commits to provide post-sale obligations for the franchisor must now be included, whether or not the parent is a guarantor of the franchisor's obligations.[23] The Compliance Guide highlights the FTC's concern about franchisees making decisions to invest in a franchise system where the parent entity, on whose financial health the business depends, has not disclosed its finances and condition to the prospective franchisee.[24] Vivid demonstrations of this risk were observed in the bankruptcy of the Bennigan's restaurant chain parent, which left its franchisees in operation with the buyer of the chain assets from the secured creditors[25] and the Peaberry Coffee chain in Denver.[26]

The Peaberry case is particularly instructive because the franchisees, judging they would be unable to obtain redress from the defunct parent, also brought a claim against the attorneys who drafted the Uniform Franchise Offering Circular of the subsidiary franchisor, claiming it failed to disclose material information about the poor performance and weak financial condition of the company stores and the parent. The UFOC omitted the parent information because it was not strictly required under the

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[23] 16 CFR §436.5(u)(v)

[24] Federal Trade Commission *Compliance Guide* May 2008, p. 114.

[25] http://www.bizjournals.com/atlanta/stories/2008/10/20/daily45.html.

[26] Colorado Coffee Bean, LLC, et al v. Peaberry Coffee, Inc,, et al., CCH *Business Franchise Guide* ("BFG") ¶14,325 (CO. Ct. App. 2010).

original FTC Rule. The case illustrates how broadly courts may look to disclosure of relevant organizational financial health, particularly in view of the FTC's admonition about the importance of parent financial condition if the franchisor cannot truly stand alone and meet all of its obligations to franchisees. The individual officers of the Peaberry company will face trial on personal liability under Colorado law under common law theory of fraudulent non-disclosure, according to the intermediate appellate court's ruling. At this writing, no further appellate or trial court actions were reported.

Portfolio companies of PE Funds are typically structured as Delaware "C-corporations" under the Internal Revenue Code. The PE Fund acquires common stock and possibly a class of high yield debt or convertible debt to enhance yield. The lender to the acquisition will take on secured debt of the portfolio company, with a security interest in substantially all of the company's assets, or select classes of assets with ready markets for liquidation. The high yield debt may be mezzanine debt held by a third party.[27] Mezzanine lenders expect a higher interest rates and shorter maturity than the senior secured debt. The use of a C-corporation facilitates management equity incentive plans and insulates the PE Fund investor entity from the tax consequences of the portfolio company. The C-corporation is taxed on its net income at corporate rates, so the cash flow must account for the loss of cash to corporate taxes. If the PE Fund is comprised of tax exempt investors who are not concerned about tax consequences of the portfolio company ownership, the franchisor or a parent entity may be structured as a Delaware limited liability company or limited partnership.

(ii) Tax considerations for acquisition targets

Certain targets will be more attractive than others from a tax perspective. Either through the PE Fund's organizational documents or as a result of the managers' fiduciary obligations to the investors, the PE Fund may be limited in its ability to invest in flow through entities such as limited liability companies and partnerships. Focusing only on domestic investors, tax exempt entities generally prefer that operating targets be organized as C-corporations to avoid unrelated business taxable income ("UBTI") which is not exempt from tax. A target engaged in a U.S. trade or business will produce UBTI if the target is operating as a flow through entity.[28] Unlike Section 512(c)(1), which applies look-through principles to a tax exempt investor's ownership of a flow through vehicle, income generated by a target operating as a C-corporation will not flow through to its owners for tax purposes. Instead, the target corporation will be taxed at its own level with dividends and any gain on a subsequent equity disposition being exempt from UBTI.[29] Due to the negative tax consequences from a PE Fund investing in a flow through entity when it has a tax exempt investor, the fund will generally set up a “blocker corporation” to hold the investment in the flow through entity. The blocker corporation will be taxed at its own level, and will distribute income up to the parent PE

[27] Larry Jordan Rowe, "Private Equity: United States", November 1, 2010, *Practical Law.*com, pp. 13-14.

[28] I.R.C. § 512(a)(1).

[29] I.R.C. §§ 512(b)(1), 512(b)(5).

Fund through dividend distributions. Although this subjects the PE Fund to the negative double tax regime under Subchapter C, it avoids putting the entity's tax exempt status at risk by shielding it from the active trade or business income of its portfolio investments and also allows for the attraction of larger, institutional investors who may be unwilling to invest otherwise.

If the PE Fund has only taxable investors and the PE Fund manager anticipates the target making consistent distributions, it likely makes the most sense for the target to be a flow through entity. Doing so subjects the income of the target to only one level of tax at the investor level and avoids subjecting any distributions to a secondary dividend level tax. This contrasts with a C-corporation target, where the income is taxed at the corporate level and then again when the net income is distributed to the shareholders as dividends.[30] If the PE Fund manager does not anticipate consistent distributions being made by the target and the only investment objective is capitalizing on future appreciation in the target's equity value, the target may be organized as a C-corporation. This approach not only gives the PE Fund access to the tax free reorganization principles under Subchapter C, it avoids any issues pertaining to "phantom[31]" income recognition by the PE Fund investors when the target operates as a flow through. Yet another option is to purchase the target as a flow through entity and allow it to continue operating as such until a potential disposition arises. At that time, the entity would either check the box to be taxed as a C-corporation or form a new wholly-owned C-corporation to be the sole owner of the flow through target. This approach would give the PE Fund access to the tax free reorganization principles under subchapter C and also allow the target to be sold in a public offering.

Another tax consideration for a PE Fund from a target entity structure perspective is whether the PE Fund is able to obtain a stepped up basis in the targets assets upon acquisition. If the target is currently operating as an LLC or partnership, the PE Fund will want to ensure a Section 754 election is in place to avoid paying tax on any built-in gain resulting from any premium paid at acquisition (purchase price in excess of book value of tangible assets). If the target is currently operating as a corporation, a step up in the basis of the assets is generally unavailable because the fund will likely not be a "corporate purchaser."[32]

(iii)Leverage & securitization

Rarely, if ever, do PE Funds invest on an unlevered basis in a target company. The norm is to lever acquisition financing to the point of marginal safety for debt service coverage ratios required by lenders and rating agencies. Often this financing takes the

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[30] See I.R.C. § 301(c)(1). It is assumed for the purposes of this paper that the target has sufficient earnings and profits such that any distribution will be treated as a dividend.

[31] Phantom income is income recognized as constructively received by the taxpayer for tax purposes without receipt of any cash associated with the income.

[32] I.R.C. § 338.

form of tranches of debt, including secured debt issued directly to lenders or through securitization of pledged assets such as unit mortgages, franchise agreements and related receivables, and equipment financing, and mezzanine debt that is either unsecured or junior to the senior debt in a cash flow "waterfall" that allows investors in higher risk debt to obtain higher returns. The target owner benefits because the overall interest cost is less than the rate that would be paid if all lenders were *pari passu* in risk. We discuss securitizations and their effect on structure below. Leverage allows the equity investors an overall higher rate of return than an all-equity investment, particularly with borrowing costs as low as have been observed since 2008. Savings can be as great as 200 basis points compared with conventional financing. For a $500 million financing, that amounts to $10 million of benefit before application of additional administrative costs.[33]

Complex financing for PE Fund franchisor acquisitions drives complex corporate structures. The complexity increases dramatically when lender's counsel push a structure intended to make significant assets such as the brand's intellectual property "bankruptcy remote" and thus safe for lender foreclosure if the parent or franchisor fail. A number of the large franchise system acquisitions mentioned above utilize this financing and complex structure. The complexity of the Dunkin Donuts system caused one judge in the Southern District of Florida to dismiss a case on procedural grounds because he did not understand the relationship among the Dunkin corporate family members.[34] Other Dunkin termination enforcement cases, where the judges have been more accepting of the structure, recognize the bifurcation of ownership between the franchisor, a limited liability company that operates the franchise system and owns the franchise agreements, and the owner of the intellectual property, which owns the marks and the system that it licenses to the franchisor. The post-termination Lanham Act claims against a holdover franchisee are brought in a joint action by the franchisor and IP holder against the franchisee.[35]

A typical leveraged financing creates the following entities:

- A special purpose master entity that issues notes to investors in exchange for the cash to purchase the collateral pool of franchise agreements from the existing franchisor.

- A special purpose entity subsidiary of the master entity that will be the owner of the existing franchise agreements for their duration until the notes are paid.

[33] David Kaufman, David Oppenheim, and Jordan Yarett, "Franchise Securitization Financings," 27 *Fran. L. Journal* No. 4 (Spring 2008) pp. 1. (hereinafter, *Kaufman et. al*)

[34] Dunkin Donuts Franchising, LLC et al v. Komal International, LLC, BFG ¶14,008 (S.D. FL 2008).

[35] See, e.g., Dunkin Donuts Franchising LLC et. al v. Kev Enterprises. Inc., BFG ¶14, 151 (M.D. FL. 2009).

- A servicer that will provide the administrative services necessary to manage the portfolio of franchise agreements as the administrative resources of the issuer are limited by design. The servicer performs the obligations of the franchisor under the franchise agreements in the collateral pool, so the agreements must allow for delegation of the responsibilities of the franchisor.

- A back up servicer that will assume the servicer's duties if it should no longer be eligible to perform based on disqualification criteria such as the servicer's bankruptcy. The back-up servicer is not affiliated with any of the franchisor or its owners.

- A newly created special purpose entity that will be franchisor of new franchise agreements, usually a subsidiary of the issuer, with the ability to satisfy the disclosure and audited financial statement requirements of a FDD.

- A separate entity, usually a trust, that will own the intellectual property portfolio and license the system as needed to the other parties that require such rights to perform under their commitments to franchisees.

To assure bankruptcy remote treatment for the collateral pool, the franchisor creates a special purpose issuer entity ("Issuer") that will own the revenue generating collateral such as the franchise agreements. The transaction must be a true sale and not one intended as security to avoid the pull of priority creditors under the bankruptcy code and Article 9 of the Uniform Commercial Code. The transferor must retain no indicia of ownership or control over the franchise agreements. The Issuer is newly created with no creditors, employees or business activities. Its charter limits its activity and ability to issue additional debt or equity. The assets transferred are not subject to any liens, claims or encumbrances. Structural devices are employed to prevent a voluntary bankruptcy filing and inhibit, to the extent possible, an involuntary bankruptcy.

Of critical importance to avoiding substantive consolidation[36] under bankruptcy law is an Issuer existence and corporate governance structure that is entirely separate from the sponsoring franchisor, including its own agents running the business, separate funds and bank accounts, its own accounting books and records (which may be consolidated with the sponsor for financial statement purposes), business communications distinct from the sponsor, direct payment of its own liabilities, rigid

[36] Substantive consolidation allows a debtor or trustee to associate non-debtor affiliates with a debtor if necessary to reorganize the debtor into an economically viable entity, provided that prior to the bankruptcy the affiliates were operated as interconnected or as a unified business. Substantive consolidation is a judicially created doctrine rooted in the equitable powers of the bankruptcy court under §105 of the Bankruptcy Code. See Federal Deposit Insurance Corporation v. Colonial Realty Company, CCH *Bankruptcy Law Reports* ¶74,645, (2nd Cir. 1992). As the Fifth Circuit noted more recently, this extreme remedy is to used sparingly. Any bankruptcy judge applying the doctrine will be subject to heightened scrutiny for abuse of discretion in its application. Wells Fargo Bank Of Texas v. Ronald J. Sommers, Trustee, CCH *Bankruptcy Law Reports*, ¶80,474, (5th Cir. 2006).

abhorrence of incurring additional indebtedness, a reasonable overhead allocation from the sponsor and strict observance of corporate formalities.[37]

Unlike fixed asset collateral pools for other securitization, where the underlying assets have fixed payments into the revenue stream, franchise securitizations have predictably variable revenue streams based on royalties paid by franchisees. Because franchise agreements terminate with some frequency, existing franchise agreements in a collateral pool may need to drop out and be replaced by a new franchise agreement. The job of servicing the portfolio and providing the back office work necessary to administer the revenue stream and effect payments to the note holders falls to the servicer. The replacement franchise agreement is also vetted and selected by the servicer when an existing franchise agreement no longer qualifies for the collateral pool. New franchise agreements must satisfy criteria set by the Issuer before a substitution can occur, as we discuss below. The backup servicer may act as a monitor for the servicer's decisions on new and substitute franchise agreements, with appropriate reporting to all interested parties.

Because the new franchisor will be a start-up entity, albeit well capitalized, it will need to register to offer and sell franchises, have all of its franchise advertising approved where required, and undergo the uncertainties of *de novo* franchisor registration. The experience of the former franchisor will be lost for the purpose of qualifying for the large and seasoned franchisor exemptions. So the transaction timing will be somewhat dependent on the whims of major registration state registration authorities, even where the franchisor offering terms and franchisor management team disclosed in Item 2 of the FDD remain substantially the same as the former franchisor.

While substantive consolidation issues are discussed extensively in the excellent article by Kaufman, Oppenheim and Yarett, the principles could be applied in non-securitization financings if sufficient interest savings are to be realized, or lenders demand a more bankruptcy remote structure to protect their collateral security in conventional financing.

The most persuasive analysis among the Circuit Courts of Appeal opinions on substantive consolidation is the Second Circuit opinion in the matter of *In Re Augie/Restivo Baking Co., Ltd.,* 860 F.2d 515 (2nd Cir. 1988), which distilled the multiple factor analysis used by other courts focused on the actions, behavior and inactions of the debtors[38] into a two part test focused on how creditors treated the debtors:

> (i) Whether creditors dealt with the entities as a single economic unit and did not rely on their separate identity in extending credit; or (ii) whether the affairs of the

[37] Kaufman et al., p.4.

[38] See, e.g., In Re Vecco Construction Industries, 4 B.R. 407, 410 (Bankr. E.D. Va. 1980); In Re Eagle-Picher Industries, Inc., 192 B.R. 903 (Bankr. S.D. Ohio 1996); In re Auto Train Corp., Inc., 810 F.2d 270 (D.C. Cir. 1987).

debtors are so entangled that consolidation will benefit all creditors. 860 F.2d 515, 518.

The second prong of the test tests the level of entanglement of the debtors' books and records, and the level of effort necessary to unscramble the affairs so creditors can pursue their claims against the individual debtors. Where no accurate identification and allocation of assets is readily ascertainable, or the costs to do so would consume the available assets, then substantive consolidation benefits all creditors and the test is met. Other courts have meted out more precise judicial balancing factors borrowed from principles of "piercing the veil" and fraudulent transfers designed to hinder creditors, as yardsticks of debtor conduct intended to measure whether there is really one enterprise or several.

The use of a Delaware business trust[39] for holding the intellectual property seems unusual at first, but its genius shines in reflection. The entity is usually not a taxpayer and any taxable income or loss flows through to its beneficiaries. The trustees must act for the benefit of its beneficiaries, which are set to match the ownership of the franchisor's interest in the franchise system. The trust licenses the intellectual property assets to the entities operating the franchise system and sublicensing the usage rights to franchisees. Most securitizations differentiate between pools of existing franchises that form the collateral for the notes issued by the issuer, and new franchises that are granted post-transaction. In either case, the franchisor entity must own the present right to sublicense the franchise system intellectual property to the franchisee. Since the new franchise agreements may substitute into the securitization collateral pool on termination of an existing franchise, the sublicense rights must be portable on the grantor side. The servicing rights may also shift as a result of default by the franchisor-sponsor, or resort to the collateral and sale under Article 9 of the Uniform Commercial Code. The beauty of the trust is the ability to allow for beneficiary changes and substitutions without the need for any conveyance of beneficial interests similar to equity interest transfers. The trust indenture or agreement does not need to provide for beneficiary votes or consents to effect such interest conveyances. The trust provides a more stable and flexible platform than a limited liability company for such purposes.

The difficulty in franchise systems following the securitization model is the dichotomy between the consumer-facing elements of the brand, where the single, all-encompassing brand monolith seeks its destiny in the marketplace, and the franchisee-facing enterprise with its carefully defined roles of the limited separate entities, each serving a distinct and separate function in the overall conduct of the enterprise, connected through the servicer. Whether a franchise system can be sufficiently disconnected by these structural elements to fight off an attempt to consolidate the case of a bankrupt franchisor with its non-debtor affiliates is a multi-billion dollar question waiting to be answered, again.

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[39] Title 12 of the Delaware Code, Chapter 38. *See* Folk on Delaware General Corporation Law, Welch, Turezyn, and Saunders, STATUTORY TRUST ACT (TITLE 12, CHAPTER 38, DELAWARE CODE).

(iv)   Governance & management participation

The portfolio company, whether a C-corporation or a board-managed limited liability company, will witness the PE Fund's governance participation through its nominees holding a majority or all of the Board seats, and approving all matters of significance and as reserved in the entity's bylaws. PE Fund GP's and Asset Managers take varying approaches to monitor the performance of fund investments. Strategic investors may participate significantly in management and cause the target to operate as a subsidiary of the parent, with due regard to any minority interest ownership. At the other end of the spectrum is a passive investor GP watching quarterly financial statements and annual reports, content to allow target management to manage the business, as long as financial objectives, annual budgets and growth targets are met. Most PE Fund GP's and Asset Managers fall in between these poles, taking an active role on the portfolio company board of directors, approving C-level hiring and firing decisions, and monitoring financial performance monthly. The success of many PE Funds depends on the GP acting as a resource and facilitator for target management, assisting with obtaining operational advantage through the affiliation with the PE Fund sponsor.

(v) Management integration

PE Fund acquisitions usually follow ownership and management equity sales, often in turn followed by retirements, new venture formation or other forms of "life after" the transaction. A new management team sweeps into place, often recommended or commanded by the PE Fund to put new blood and different talent into key roles. Very often, this change of leadership is what the founder wanted to accomplish but was unwilling to displace friends and loyal employees responsible for the founder's good fortune. Entrepreneurial mindset and leadership fades when confronted with the daunting management tasks of high velocity, large scale growth, and planning for operating as a larger, more bureaucratic institution and absentee ownership.

Toward this end PE Funds are typically careful about disrupting the chemistry of a successful team. During the diligence process, the Asset Managers and selected senior management of the target will make a candid assessment of who continues, who is needed and who needs to be reassigned with a view toward saving costs, matching people with slots on an organizational chart, and assuring business continuity. Some targets are great concepts in need of better management; others are great managers in need of more resources to achieve the potential of the brand. The PE Fund will communicate its thoughts about which category best fits the target in the later stages of diligence and contract negotiation. The acquisition agreement may condition the transaction on the signing of employment agreements by key managers, and conversely, will require the termination at closing of certain managers, perhaps with severance packages that assure a smooth transition and no competition during the post-closing period.

(vi)   Reporting

For senior managers of a franchisor, particularly former owner-operators, accustomed to running the business with no oversight, the reporting structure of a PE Fund investor may be among the biggest changes in the working environment. Understanding the expectations of the PE Fund GP for reporting is a key element of management diligence and acquirer pre-closing communication.

Every franchisor should have its own internal metrics for tracking its own performance, besides its monthly or quarterly profit and loss statements. The best run businesses tend to focus on a small number of key metric measures management has the ability to control and influence by management action. The PE Fund GP will watch those metrics more closely as they may offer advance warning of circumstances that require management action before financial performance is affected. Reports are often combinations of financial, market, transactional and sales data.

An important area of focus will be data derived from franchisees and other point of sale information. A franchisor knows what it learns from franchisees and its own company stores. PE Fund GP's will have varying degrees of raw or point of sale data interest. A GP may use a style that analyzes its own store-level data, or wants franchisor management to demonstrate its own ability to collect and analyze relevant data. In that case, the franchisor and its franchisees should expect enhanced oversight, robust data collection and reporting, and more focus on analytics in managing the business. Franchise systems accustomed to more intuitive and interactive management styles will face a cultural change.

As franchise sales growth is a key success factor for any PE Fund investment, franchisors should expect the PE Fund to track franchise sales lead generation, prospect management, closing rates and pre-opening drop out rates closely. Economic models for the business will depend on a steady flow of new stores and retention of the best performing existing stores. Metrics to monitor growth are likely to follow.

(vii) Capital Investment and Cash Flow Allocation

As a provider of capital, the PE Fund expects a return on its invested capital commensurate with its risk and market for such investments. The more capital invested, the more return investors require. Franchisees fear the transition from a modestly levered, privately owned business where the owners earned a comfortable return but were not beholden to third party investors or fiduciaries, which characterizes many sellers of franchisors who reach the end of their investment horizon and management interest, to investors looking for above market returns. Coupled with acquisition debt, the fear for franchisees is that the franchisor will be cash poor, with substantial cash flow from the business devoted to dividends and cash distributions to investor owners. An alternative view of reality is that the PE Fund is a fount of accessible capital, when the franchisor's capital well has run dry, to provide fuel for growth and reach the next level of franchisor performance, sophistication and stability.

For most portfolio company investments, the truth of their capital and cash flow likely lies somewhere in between these poles. The PE Fund GP will impose a capital investment discipline and analysis that the predecessor may not have observed previously, which more often will require higher returns on investment because of the higher cost of capital of the portfolio company. Traditional financial analysis relies on a decision rule drilled into the minds of financial analysts – a capital project merits pursuit if the net present value of its cash flow is positive at the company's cost of capital. The cost of capital takes into account debt interest rates, and mandated returns on equity set by investors in the company's equity, In a PE Fund portfolio company, the prior owner's need for after tax cash flow to sustain lifestyle goals are replaced by pure financial returns and capital appreciation. Whether this means more or less cash for the business is a math exercise. If the acquisition debt and mezzanine debt does not impose a severe burden and the need for dividends to PE Fund investors is subordinated to the desire to accrete value to the enterprise, there is a reasonable possibility that more cash will be available for the franchisor's capital needs.

(viii) Management equity participation

A major incentive for key management in a PE Fund portfolio company is their participation in ownership and equity appreciation. Indeed, unless the company has an irreplaceable asset with its own intrinsic value (which is possible with a franchise company), management continuity is a significant factor in the valuation of the business. Executive change is expensive for owners. The selling managers and owners may retain a continuing equity interest, either directly through share or interest ownership of the portfolio company, or an earn-out of the purchase price. Some PE Fund buyers may require either a rollover of existing ownership or reinvestment of some or all of the cash proceeds from the sale. These rollover interests may be redeemed or purchased if the portfolio company reaches certain financial benchmarks.

PE Fund managers typically set aside 10-15% of portfolio company equity for management to receive or earn to incentivize performance and retain talented management. The equity is usually subject to vesting over time or as the portfolio meets the performance goals set by the PE Fund.[40]

The common forms of management incentives include direct equity, indirect equity and synthetic equity. Direct equity includes shares of stock, stock bonus plans and restricted stock, where the shares are subject to divestment if the employee leaves the company or the goals for the company are not reached. Indirect equity includes stock options and restricted stock units, which allow the owner to purchase stock at a fixed or formula price. Synthetic equity includes phantom stock, stock appreciation rights and performance units, where the employee is compensated for appreciation in equity value as if the employee was the economic owner of the equity, but does not own the interest. The use of a C-corporation facilitates more flexibility in management incentive structures without immediate tax consequences to either the portfolio company or the managers.

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[40] See Larry Jordan Rowe, "Private Equity: United States," *Practical Law Company*, Nov., 1, 2010, p. 21.

The goal of the incentives is to reward management for performance of the portfolio company consistent with the accretion in value of the PE Fund's equity, which may involve more than simple bottom line net income or earnings before interest, taxes, depreciation and amortization.

(ix) Tax considerations of management equity incentives

In general, if the manager is compensated for his existing ownership interest in the target with new unrestricted equity, this will generally be a capital transaction subject to only capital gains tax. However, restrictions placed on the new equity issued in the transaction will generally be taxed under Section 83 as a transfer of property for services. As previously mentioned, issuance of restricted equity is common in this arena to align managements interest with that of the incoming fund investor. For tax consequences, so long as the restrictions exist on the manager's equity, the value of the equity is not includable in the manager's taxable income.[41] However, if the stock or membership interest in an LLC substantially increases in value while the restrictions are in place at the time it is no longer subject to a substantial right of forfeiture, a greater amount of income will be included on the manager's personal return. Consequently, it likely makes sense for the managers to immediately make an election under Section 83(b) to have the value of the equity included in their income at the time of the transfer.[42] If the manager's existing equity is exchanged for restricted stock, it makes even more sense to immediately make the election because it will be deemed that the existing interest is transferred for its fair market value which will further reduce the taxable income currently includable by the manager.[43] Managers may resist having all their equity restricted. In that situation it may be prudent to include a buy back provision either in the target's organizational documents or as a part of the acquisition documentation such that the manager's equity is required to be purchased by the company upon the manager’s departure but at a discounted price. This balances the parties' respective interests by giving the manager the freedom to leave without sacrificing the entire value of its equity, but doing so at a reduced price. If restrictions are simply added to the manager's existing equity interest rather than to new equity issued by the PE Fund, the manager will not be required to recognize taxable income.[44] However, it still may be prudent to make the Section 83(b) election because the stakes can be fairly high and it is often hard to tell whether an exchange has occurred.

E. Operating in a private equity environment

(i) Impact on franchise program

[41] I.R.C. § 83(a).

[42] I.R.C. § 83(b).

[43] I.R.C. § 83(b) (the “amount paid” on the exchange of non-vested shares is the fair market value on the exchange date when the election is made.)

[44] Rev. Rul. 2007 – 49.

Private equity investment should be viewed as validation of the franchisor's business model and future prospects for growth and system success. The PE Fund employs rigorous investment criteria and careful diligence efforts, usually taking into account the interests, mood and attitude of the franchisees toward the franchisor. New equity is usually infused, as a company for sale rarely invests in the business beyond the minimum necessary to sustain the business at the then-current level. As we note elsewhere, new ownership usually includes new management, often with the skills necessary to manage the anticipated growth in the franchise system and cover gaps in the selling group's skill set or experience.

But a PE Fund not familiar with franchise systems may have a learning curve with a steep angle. Unlike conventional investments where management operates the entire vertical enterprise, the vertical severance of roles in a franchise business, where franchisees are responsible for consumer-level pricing and service delivery, demands more in-depth knowledge of the business, and more tolerance of the independent decision makers in the business model. The diligence process should have revealed to the PE Fund managers exactly what elements of the vertical the franchisor can control, how that control is asserted, and the limitations on the control possible under the existing franchise agreements.

Traditionally, PE Fund takeovers produce significant efforts to reduce costs by program and position elimination. Some cutting will be overdue, as selling owners rarely make cuts before the sale. The first negotiation between continuing management and the PE Fund is usually what gets cut and consolidated, to enhance cash flow. The extra cash will be needed to provide returns to the PE Fund investors, and pay the debt service on the acquisition debt. The law and lore of the franchise system come into play, as the portfolio franchisor management must educate the PE Fund cost cutters on the legal obligations to provide services to franchisees and the non-contractual support traditionally provided by the franchisor to the system. One shock feared by franchisees is rapid cutback or cutoff on services and assistance on which they have come to rely in operating their businesses. The issue for managers is the impact on the brand culture and relationships that any wholesale or even incremental changes could have as a result of changes in management style or philosophy. Franchisee relationships with the new owner will surely commence and progress in the wrong direction if change viewed as negative by franchisees is drastic, dramatic and autocratically imposed without consultation or discussion. To be sure, a troubled system with the need for significant change may benefit from such an approach, but those are not usually the target of private equity.

As mentioned above, the PE Fund investment will achieve its capital gains if the portfolio company substantially increases in value over the investment horizon of the PE Fund. Franchise system growth is almost always a key part of the value increase. For example, when Bain Capital, together with the Carlyle Group and Thomas H. Lee Partners, bought Dunkin Donuts, the Dunkin store map was largely bi-coastal, with a heavy skew toward the Northeast United States. The attraction, and the high valuation for the selling owner, was the opportunity to fill in the map and achieve manifest destiny with the brand. That exponential growth is what PE Fund investors seek.

To accomplish that goal, one of the fastest growth methods is to sell more franchises to existing franchisees. An early strategy change for the franchisor may well be a revised offering to existing franchisees with more attractive terms such as reduced initial fees or royalties, incentives for more store openings, and financing packages. To be sure, conventional bank lenders have more interest in financing growth of successful operators into multi-unit owners than in financing new entrants for de novo single units. Another growth option is conversion franchising of existing businesses in the same marketplace, which is not available for all genres of business. Sometimes called "roll-up" franchising, the franchisor and PE Fund may establish a capital allocation for buying existing independent operators and converting them, then selling the converted operations as franchised operations. This tactic has been successfully executed in real estate brokerage, hotels, and tax preparation businesses.

(ii) Impact on operational flexibility

Operational flexibility is impacted by new owners, new board members and new business objectives. The PE Fund is likely to introduce or impose a comprehensive budgeting and planning system for the franchisor's financial planning, or adjust the existing system to meet the reporting and information needs of the PE Fund. When actual results vary from projections, and do so for several reporting periods, PE Fund managers may get nervous and will want more information. The volatility of costs and revenues on the macro and micro levels may not have factored into the budgetary calculus, so an education and experience process must occur.

If the PE Fund is injecting capital for the franchisor, greater operational flexibility may be the by-product of a stronger franchisor. When the franchisor is capital starved and needs additional capital for expansion or updating, the PE Fund injection will enhance the brand and benefit the franchisees. The franchisor management and the PE Fund board must reach a shared understanding of the challenges facing the system and the most effective solution. The process of reaching the understanding may take more time, resources and evidence than the effort and process to which the franchisor's management had become accustomed before the transaction.

Other limits on flexibility may be imposed by financing, particularly securitization. Franchisee selection criteria can be affected, and the drive for expansion by taking risks on marginal candidates may overtake the deliberate approach of finding the right person for the right location. Management may be more constrained to say yes than to say no to new applications. Management may also have more restrictive rules on financial concessions, workouts and other consideration given franchisees with challenges.

(iii)Tax considerations to operating the target

As previously mentioned, if the target is held in a flow through entity, any income generated by that target will be considered unrelated business taxable income ("UBTI") to a tax exempt investor and will be considered income effectively connected with the conduct of a U.S. trade or business for a foreign investor.[45] Both of these negative tax consequences can be avoided if the equity of the target investment is held in a "blocker" corporation.[46] If the PE Fund has only domestic taxable investors, the tax consequences of the target will flow through to the investors which will attribute UBTI to the tax exempt investor.[47] In contrast, if the equity in the target is held by a blocker corporation below the fund level, or if the target is currently operating as a corporation, the target will be responsible for paying tax on its own income thereby avoiding the attribution of the UBTI concepts to the tax exempt investor. This benefit is offset to some degree by the fact that any distributions made by the corporate target to the PE Fund will be subject to another level tax as a dividend.[48] Any distributions made by a target held as an LLC or partnership will not be subject to another level of tax.[49]

(iv) Typical covenants

The financing of the franchisor acquisition will impose operating covenants and financial covenants so the senior lenders and mezzanine lenders can monitor the financial and operational health of the business while their debt is outstanding. If company store and support assets are pledged, real estate lending covenants will be added. The goal of the covenants is to prevent cash drain of the business and diminution of the capability to sustain performance and value as a going concern. The failure to meet certain targets may require more frequent reporting, like shifting from quarterly to monthly reports, and may require a cash flow waterfall arrangement where the royalties are deposited in a lockbox and cumulated by the senior lender until the month's debt service cash need is met. Franchisor management can expect to see the following covenants:

<u>Financial</u> – the franchisor or the portfolio company parent must meet these covenants or face remedial measures:

- Debt Service Coverage Ratio – a multiple of 1.x times annual debt service, perhaps separate for the senior lender and the mezzanine lender, to assure
- Working Capital – positive working capital (current assets must exceed current liabilities) at a particular level to monitor short term financial condition

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[45] §§ 512(a)(1), 871(b)(1).

[46] §§ 512(c), 871(a).

[47] I.R.C. § 702(a).

[48] I.R.C. § 301(c)(1). Again, assuming the target has sufficient earnings and profits.

[49] I.R.C. § 731(a).

- Net Worth – set at a certain threshold to assure sufficient long term capital for sustaining the business; this measure may allow debt to the PE Fund subordinated to third party lender debt to count as capital

- Average Days Receivables – depending on royalty payment frequency, lenders may watch for longer payment cycles as a mirror to the financial health of franchisees

- Default Ratio – percentage of franchisee accounts past due more than 60 days to serve as an early warning of more serious system issues

- Return on Equity – dividends plus increase in retained earnings or a deemed market capitalization based on comparable companies to assess whether the PE Fund is achieving its financial objectives

Reporting – the franchisor or portfolio company parent will likely produce some or all of these reports:

- Unaudited balance sheet, income statement, cash flow statement and owners' equity statement at least quarterly

- Audited annual financial statements

- Annual operating budget with forecast revenues and expenses related to revenue or other variables; then monthly comparisons of actual to budget and forecasts, with reforecasts as needed when externalities or internal decisions affect forecasts

- A monthly dashboard of key operating metrics that are leading indicators of future performance or components of current performance that can be affected by management decisions

- Franchise development reports showing leads, franchise applications, franchise approval committee action, signed franchise agreements, development cycle information, and store openings

- Franchise compliance reports showing franchisees with performance issues, supply chain non-conformance, defaults, transfers, workouts, terminations and reinstatements

- Financing reports on the status of franchisee loans and accounts receivable

- Supply chain reports on vendor activity, supply flow, advance purchases, price level changes

- Advertising schedules, media buy costs and market research data

- Consumer and franchisee feedback reports on satisfaction with franchisee and franchisor performance and service

- Litigation reports on material litigation and exposures likely to impact franchisor financial performance, subject to privilege issues

Affirmative/Negative Covenants – The portfolio company, franchisor or both will likely have the following covenants to observe, codifying good corporate practice, but perhaps acting as yardsticks to measure management attention to the details of operations which if not faithfully executed, may result in higher levels of routine oversight and scrutiny:

- No incurrence of indebtedness above the threshold necessary for seasonal working capital lines and authorized debt, and no pledge or encumbrance of assets

- No issuance of new equity or rights to obtain equity except approved management and employee equity plans

- No loans of managers, employees, franchisees or third parties except relocation programs and extensions of credit in conjunction with accounts receivable workout plans or approved financing disclosed in Item 10 of the FDD

- No purchases of franchisee units or other businesses

- Offer, sell, renew, terminate and extend franchises in compliance with applicable law

- Maintain entity good standing in all applicable jurisdictions

- Comply with all other applicable laws and pay or contest when due all taxes

- Pay or bond any judgments before executable

- Maintain required insurance and monitor insurance required to be maintained by franchisees

- Obtain and maintain all required licenses, permits and governmental authorizations

- Engage in no "insider" transactions with managers, employees or their affiliates unless standard, disclosed terms and conditions apply

- Protect intellectual property with registration, confidentiality and non-disclosure agreements, and other steps necessary, including actions to stop infringement and quiet ownership rights

- Observe environmental and occupational safety laws and regulations

(v) FDD disclosure and agreement impact

Depending on the structure of the franchise organization, the PE Fund transaction may have no impact, or a major impact on the Franchise Disclosure Document ("FDD"). At the very minimum, the history of the franchisor disclosed in Item 1 will be revised to disclose the ownership change and affiliation of the franchisor target with the PE Fund. The instruction for Item 1(a) references "any parents[50]." How far up the chain of ownership does this disclosure extend? The Federal Trade Commission clarified this potentially undefined term in the May 2008 Compliance Guide to extend to all parent entities in the chain of ownership, not just the immediate parent entity of the franchisor or the ultimate parent entity, and all entities in between the franchisor and the ultimate parent. While the disclosure opens for viewing by prospective franchisees the entire chain of ownership, the information disclosed is limited to the name of the entity and the principal business address.[51] Still, the FTC Statement of Basis and Purpose refers to franchisee concern about potentially competing company store outlets, owned by the ultimate parent of the franchise system.[52]

Because the historical and market context of the franchise system remains an important disclosure component, Item 1 also presents the prospective franchisee with information about the predecessors and affiliates of the current franchisor. A corporate history of turnover and ownership changes is a matter of public record as part of the FDD. Affiliate disclosure includes those selling franchises in any line of business, and those that provide products and services to the franchisees[53]. The affiliate definition captures any entity that is controlled by, controls or is under common control with another entity.[54] The conservative reading of this definition extends disclosure of affiliates to any entity controlled by the common parent. So PE Fund GP parent investments in other franchise companies, even through other PE Funds, could be considered affiliates. Certainly, vertical integration with suppliers to a franchise system will produce a robust disclosure of the corporate family and interlocking ownership in all of the FDD's of the PE Fund's investments.

A portfolio company acquisition financed with leverage secured by franchise system assets, whether the transaction is characterized as a sale or financing, will need disclosure of the sale or assignment and whether the franchisor remains obligated to provide all or part of the financed goods or services, and that the franchisee may lose all

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[50] 16 CFR §436.5(a)(1).

[51] Federal Trade Commission, May 2008 *Compliance Guide*, pp. 29-30.

[52] 72 FR No. 61, p. 15474 (March 30, 2007).

[53] 16 CFR §436.5(a)(1).

[54] 16 CFR §436.1(b).

of its defenses against the lender or buyer as a result of the transaction.[55] As the waiver of defenses against assignees is a key feature of finance covenants, this disclosure becomes highly relevant. Such a practice also means the finance transaction must leave sufficient resources and rights resident in the assignor to answer claims that are not assumed by the assignee. The rules governing fraudulent transfers under Section 548(a) require a transfer of assets to be for reasonably equivalent value and to leave the entity with sufficient capital to meet its known obligations.[56]

The other disclosure areas where the PE Fund ownership may be particularly relevant are Items 8 and 12. The relationship between PE Fund portfolio companies may produce supply chain cooperation that would be disclosed in Item 8[57]. The disclosure must include any supplier in which an officer of the franchisor has an ownership interest[58]. The sensitivity of franchisees on this issue cannot be overstated, as the 2008 revision to the FTC Rule Item 8 substantially enhanced disclosure of interlocks and relationships between franchisors and suppliers. The most significant disclosure in Item 8 may well be the amount of revenue derived and other benefits realized by the franchisor and its affiliates from required purchases of goods and services by franchisees and the precise basis by which it is derived[59]. The information includes the total revenue, revenue from required purchases and the percentage of total revenue such required purchases represent. Any PE Fund considering a vertical integration strategy must understand that this disclosure informs the franchisees about the total load extracted by the franchisor and its affiliates. The "precise basis"

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[55] 16 CFR § 436.5 (j)(3).

[56] 11 USC § 548 (a) reads as follows:

(1) The trustee may avoid any transfer (including any transfer to or for the benefit of an insider under an employment contract) of an interest of the debtor in property, or any obligation (including any obligation to or for the benefit of an insider under an employment contract) incurred by the debtor, that was made or incurred on or within 2 years before the date of the filing of the petition, if the debtor voluntarily or involuntarily— **(A)** made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or **(B) (i)** received less than a reasonably equivalent value in exchange for such transfer or obligation; and **(ii) (I)** was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; **(II)** was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; **(III)** intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; or **(IV)** made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

[57] 16 CFR §436.5(h)(2).

[58] 16 CFR §436.5(h)(3).

[59] 16 CFR §436.5(h)(6)

disclosure reveals what would otherwise be competitively sensitive information about margins and rebates arrangements.

The proliferation of franchise holding companies and brand families led to the enhanced disclosure of interconnected brands in Item 12 of the FDD.

The Franchise Agreement used by a franchisor with a PE Fund owner will be reconstructed from the prior iterations with a few key changes:

- The franchisor will retain the unlimited right to assign the franchise agreement on an outright basis and for collateral purposes. The language will also contain a claims waiver so that any assignee will assume the agreement free and clear of any claims against the assignor. The franchisee will agree to assert any claims it may have only against the assignor. Without such a waiver, the successors in interest will assume the claims of the predecessors in interest.[60] The franchisor will also reserve the right to delegate any or all of its responsibilities to third parties, retaining overall responsibility for performance of the obligations. The franchisee will acknowledge that its consent and prior notice to it of any of the foregoing is not required or a condition to the effectiveness of any transfers described in the clause.

- The franchisor and the marks owner will reserve the right to assign the marks on an outright basis or as security, to an affiliate or third party, so long as it retains a license necessary to support its obligations under the franchise agreement. The franchisor will also reserve the right to change the system and assert full control over the designation and specification of the marks, including a possible rebranding with new and different marks. The reservation of rights will include unfettered discretion to license the marks and commercialize the goodwill of the brand in any venture that will generate cash flow for the intellectual property portfolio.

- The franchisor will reserve the right to divide ownership of the franchise agreements in the chain into two or more ownership entities that may own existing franchise agreements, future franchise agreements or a combination thereof.

- The franchisor will reserve the right to have common ownership with competitors, or be owned by a competitor, or own a competitor, and to share services, personnel, operating methods, computer systems, software, marketing, operational platforms, training programs, operating systems and other infrastructure, resources and support facilities. Note this impacts disclosure in Item 12 of the FDD.

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60 See American Top English, Inc. v. Golden Gate Capital, L.P., CCH *Business Franchise Guide* ¶12,770, (N.D. Ill. 2004) (private equity firm succeeded to claims against predecessor owners of a business under certain licensing and distribution agreements brought by licensee-retailers).

- The franchise agreement will carry a tight definition of the "System" and narrow the scope of any exclusivity clause in a territorial covenant so that any restrictions are applied solely to units bearing the same marks and brand. Loose language like, "Franchisor and its affiliates will not own, operate, lease, license, franchise or manage another Unit within the Territory" will be eschewed unless the franchised business (the "Unit") is narrowly and precisely defined as "a business substantially the same as the franchised business operating under the same Marks and brand category that is authorized to offer substantially the same goods and services." The franchisor will reserve the right to own, operate, lease, franchise, license or finance any other business within the "Territory" assigned in the franchise agreement, including any business similar to the franchised business offering similar goods and services operating under different marks or in a different brand category, and any other business under the marks and in the same brand category outside the Territory.

- The franchisor will reserve the right to market products and services similar to the goods and services offered by the franchise system in other channels that may compete with the franchised business within or outside the Territory under different marks and brands.

- The franchisor will reserve the right to assign and pledge royalties and other revenue streams separately from the franchise agreement, to facilitate financing. This reservation will include the right to direct payments to a particular location, such as a lock box, and with respect to non-domestic franchises, the right to specify currencies for payment other than U.S. Dollars. Many franchisors will include a tax "gross-up" provision to assure the net royalty available to sustain financing will not be diminished by state and local taxes directed at these revenues.

(vi) Source of expansion capital

The PE Fund commitment to the franchisor often includes access to capital to meet approved expansion plans. The access may take the form of additional equity or arranged mezzanine financing through lenders disposed to follow the PE Fund into its portfolio companies. For example, the use of mezzanine financing to develop new stores in key markets that are to be sold to franchisees when seasoned matches the short term nature of mezzanine lending. The franchisor can borrow wholesale to sell retail assets and realize a net return, with the benefit of continuing revenues from franchise royalties. PE Fund equity often displaces short term and intermediate term borrowing that characterizes a fast growing franchisor, which ultimately raises the cost of capital for the enterprise but reduces its needs to generate short term cash flow to satisfy lenders.

PE Funds generally invest to achieve long term capital gains through direct investment in businesses that will benefit from improved management and operations. The PE Fund typically has a ten year life, with the sponsor having an option to extend the term for an additional period. Investors may be called upon for additional capital investment, after the initial investment for a portfolio company, to sustain the need for additional equity.[61] While some might consider such capital calls to be "good money after bad," the prospect is made clear to PE Fund investors at the time of their commitment to the PE Fund.

(vii) Fund affiliate integration and cross cooperation/selling

Unlike a multi-brand, single genre franchisor like Yum! Brands or Choice Hotels, the realities of multiple franchisor portfolio companies owned by a single PE Fund produce very few synergies or areas of cross–pollination. Each portfolio company stands independently of the others, and the PE Fund must preserve the exit strategy for each one separately. Introductions for commercial purposes can be facilitated as can, perhaps, group purchasing for franchisor infrastructure procurement, but such cooperation is not likely to extend to franchise system activities. The interlocks would be commercial contracts negotiated on an arms'-length basis. While the PE Fund makes introductions and may encourage temporary group or pooled buying of commonly used goods and services (like advertising, for example), such pools must be very flexible to allow entry and exit of the portfolio companies at the discretion of the PE Fund, with no lagging obligations that may adversely affect the value of the portfolio company at sale.

For the same reasons, the PE Fund is unlikely to push down group buying cooperatives among its franchise system franchisees except on an ad hoc basis. Disclosure of this possibility is required in Item 8 of the FDD[62] although its addition to the franchise system support function would likely not bring any repercussions. Franchisees are usually leery of interlinked arrangements among franchise systems unless initiated on their own and under their control. One avenue of potential benefit, however, is a national accounts program at competitive pricing, among PE Fund portfolio companies, if the program is commercially viable and not crammed down the throats of participating entities for the sake of building "the story" of the portfolio.

(viii) Supply chain issues

In the wake of the large settlement awarded franchisees of Quizno's in 2010 and other cases involving allegations of supply chain abuse, the notion that a PE Fund will change the franchisor's supply chain management to extract more revenue from suppliers is more perilous than previously thought.[63] Any notion of adding franchisor revenue from simply imposing higher supply chain costs to fuel a rebate to the

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[61] Rowe, *Ibid.*, p. 13.

[62] 16 CFR § 436.5(h)(9).

[63] See Siemer, et al., individually and on behalf of all others similarly situated, plaintiffs, v. The Quizno's Franchise Company LLC f/k/aThe Quizno's Corporation, et al., defendants., CCH *Business Franchise Guide*, ¶14,440, (N.D. Ill. 2010); Tubby's #14, Ltd., et al. v. Tubby's Sub Shops, Inc., et al., CCH *Business Franchise Guide* ¶13,460, (E.D. Mi. 2006).

franchisor will be met with resistance if that prospect is not part of the franchise system's disclosed possibilities and history.

If the franchisor is in a position to provide a valuable service at competitive prices, or raises below market prices to market levels, franchisee complaints convert to grousing without substance. In either event, any change seen to benefit the franchisor without a corresponding improvement is service, price, availability or technology will raise the enmity level between the franchisor and the franchisees, and diminish the good will sought by the PE Fund with the portfolio company's most significant customers.

F. Exit strategies

The PE Fund investors expect an end game with high returns through capital appreciation. PE Fund investments in portfolio companies are bought to be sold and liquidated when the PE Fund's investment criteria are met. The Asset Manager and PE Fund GP have some discretion based on market conditions, although liquidity needs of the PE Fund investors may produce some pressure to deliver proceeds. The acquisition financing used by the PE Fund may also trigger the need to sell when refinancing is necessary because of debt maturity, covenant issues or lender assessment of risk. The liquidity events mean some distraction for portfolio company management and resource diversion until diligence completes and the transaction closes. But such ownership changes also bring the opportunity for new capital, new strategic directions and new covenants that represent current market conditions, so strategic reset of the brand is the inevitable aftermath.

(i) Sale to another fund

The sale of the PE Fund equity to another PE Fund is called a secondary buyout.[64] Because PE Fund buyers approach investments with different appetites for risk, size and leverage, the new owner may be more suitable for the growth or stability stage reached by the portfolio company than the seller. The availability of better financing terms and higher leverage may present the opportunity for a gain in value that the seller could not realize by refinancing. Another aspect of PE Fund investment is the need for PE Fund sponsors to commit capital before the expiration of their investor funding commitments. Called "dry powder," investors will not extend the commitments to the fund to contribute capital. On the flip side, current PE Fund investments not liquidated because of the lack of financing produce a compulsion to sell by current owners even if the portfolio company timing is not as ripe as would likely be found in the future.

Whether the portfolio company is held as an LLC or as a corporation, disposition of the company will generally result in capital gain treatment for federal income tax

[64] Eva Davis and Hamed Meshki, "Trends in Private Equity Exits," *Practical Law Journal*, September 2010, p. 86.

purposes.[65] If the portfolio company is held as a flow through entity, however, certain items will be taxed as ordinary income.[66] Essentially, any gain attributable to unrealized receivables or inventory items will result in the recognition of ordinary income.[67] Both the sale of a corporation and a partnership will generally be eligible for installment sale treatment where gain is recognized only when consideration is received from the purchaser.[68]

Another emerging trend is the consortium or club deal where a group of PE Funds team with each other or a strategic investor to purchase a portfolio company.[69] Similar to bank loan syndication, the group buying power is larger than any single participant could muster so a larger target can be acquired. The similarities end there, as the group forms for the acquisition negotiations, but at closing, each PE Fund becomes an independent equity investor with the rights and responsibilities negotiated with the other members in the group and embodied in the investor rights agreement. The decision making framework established in the consortium period may carry over into the investment period in lieu of more traditional investor protections such as supermajorities on some voting issues.

(ii) Public offering

A private portfolio company registering its stock and going public is another method of liquidating the investment of the PE Fund. The offering typically produces cash proceeds to refinance debt, or reduce leverage to allow refinancing, and includes a secondary offering to produce cash for the PE Fund. Rarely does the PE Fund liquidate completely in the IPO. The practice does allow a phased and orderly liquidation after an initial stabilization period. There are numerous practical, market and securities law limitations on PE Fund liquidation through an IPO, so it remains a less attractive avenue under current market conditions. Some portfolio companies are dual tracked, with the PE Fund owner pursuing a parallel process of sale or IPO. The resource drain from such a strategy is substantial and the distractions for management enormous, so the tactic is employed only where public and private sale multiples are relatively close and fluid, and where the threat of creating a powerful public company competitor compels a strategic buyer to act preemptively, assuming any antitrust hurdles can be overcome.

The disposition of a portfolio company in a public offering has similar tax consequences to the sale to a third party purchaser. One noteworthy distinction, however, is that because only corporations have the ability to offer shares to the public,

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[65] §§ 741, 1221; Revenue Ruling 99-5.

[66] I.R.C. § 751(a).

[67] *Id*.

[68] I.R.C. § 453(a).

[69] Sean Rodgers and Christopher May, "Interim Consortium Agreements in Private Equity Buyouts," *Practical Law Journal*, December 2010, pp. 48-56.

an LLC first must be converted to a corporation.[70] Generally, this conversion can occur in two ways. First, the PE Fund could create a new Delaware C-corporation and transfer the portfolio company into that C-corporation. This however will trigger ordinary income gain recognition on all unrealized receivables and inventory similar to a sale context.[71] Alternatively, the PE Fund could simply check the box to have the portfolio company taxed as a corporation. Because in this situation the fund is considered the direct owner of the portfolio company it would be the "transferor" under Section 351. As such, no gain or loss would be recognized and the portfolio company's assets would receive a carry-over basis.[72] If the public offering is conducted contemporaneously with the creation of the C-corporation or the checking of the box, the public purchasers in the offering will likely also be considered transferors and will thus not jeopardize the tax free status of the transaction. On the other hand, if the transactions are separated or deemed to be separate by the IRS, the subsequent sale of the shares to the public will result in capital gain income which may be considered short term and thus taxable at a higher rate.

(iii) Management buy out

A traditional form of investor exit is the management buyout, where existing management funds or finds an equity investor to assist in funding the buyout. Such a strategy usually brings second mortgages and other forms of additional collateral, to assure lenders that the managers are committed to the success of the venture. This arrangement suits franchising particularly well, as franchisees who have gained a level of comfort with the existing managers are rewarded with continuity and predictability. That status compares favorably with the uncertain transition to new owners and managers. However, the personal stakes raised by the management buyout and pledge of personal assets may well inhibit managers from demonstrating the same flexibility as when they operated the business with other people's money.

(iv) Refinancing for exit

As credit markets restore to less cautioned lending, a financing technique call leverage dividend recapitalization may return to popularity, particularly for portfolio companies with strong cash flow or balance sheets that reflect paid-off acquisition debt. In this technique, the portfolio company borrows up to the amount it can sustain without (or with little) risk of a fraudulent conveyance challenge under bankruptcy or state law.[73] The portfolio company pays out the proceeds of the financing as a special dividend, creating a return of initial capital or a return on investment that produces significant yield to the PE Fund investors. The financing offers lenders a senior position in the capital

[70] Treas. Reg. § 301.7704.

[71] I.R.C. § 751(a).

[72] I.R.C. § 351(a).

[73] A fraudulent conveyance claim can be raised in bankruptcy under § 548(a). See Note 53, infra.

structure that may balance the increased risk from higher leverage of the portfolio company.[74]

For franchisor portfolio companies, the leverage recapitalization transaction that reduces owner's equity may produce a loss of large franchisor exemptions if the $15 million or $5 million net worth levels are not maintained.[75] Such a loss means that the franchisor will need to register in the merit review states and suffer the potential dark period for franchise sales while registration occurs. If the recapitalization depends on uninterrupted cash flow for the franchisor, the dark periods for registration in these merit review states must be factored into the cash flow projections and debt service coverage ratios.

(v) Foreclosure/Lender take over

If the PE Fund investment is over-leveraged or under-performs its cash flow projections, then secured creditors or junior debt holders may end up owning the business. This unhappy outcome usually results in a sale of the business as a whole to a third party, either through an asset sale in bankruptcy under Section 363 of the Bankruptcy Code, or through a privately arranged sale if the other creditors are to be paid in full. A number of these transactions have turned out successfully for the franchisees, as their role in the bankruptcy or sale process becomes more important than a traditional private sale.

With advent of more complex financing structures and the supervision of troubled asset portfolios by special servicers, who are theoretically responsible to debt holders but in reality are motivated by the fees they collect while servicing the portfolio, the outcome of these transactions is less certain, takes more time, and often twists in more unusual directions. The best examples of this phenomenon are the bankruptcies and bailouts of two large franchisors, General Motors and Chrysler. The Federal government became the ultimate special servicer and crammed down a political resolution that favored the union work forces of the two entities over their debt holders and dealers. As long as the core business is sound, unit economics are positive and the brand competitive, financing and management decisions that turn out to be unsound will not be the death knell. A genre of private equity funds invests in exactly such turnaround situations.

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[74] Davis & Meshki, *Ibid.*, pp. 90-91.

[75] The large franchisor exemptions under New York (Gen. Bus. L. § 684), Illinois (Rev. Stat. § 705/8) and Virginia (VAC § 5-110-75) establish a de facto floor for franchisor net worth in recapitalizations of larger entities. If the entity is smaller, the next threshold for exemptions is $5 million under California (Corp. Code. § 31101) and other merit review state registration exemptions.

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