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Avoiding Pitfalls for Private Equity Investors in Franchisors: Structure Counts

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Private equity-owned franchise systems are flourishing. Private equity firms are attracted to a franchisor's continuous royalty stream; an organizational structure where the franchisees' drive to succeed aligns substantially with the franchisor owner's goals to drive value; an asset-light structure; and outlet growth without capital investment, relying instead on capital and credit supplied by the franchisees for the development and updating of their own outlets. All of these attributes of the franchise model mean that private equity firms can spend their time, talent, financial resources and intellectual capital on making the company run more effectively, which will attract more franchisees. As a result, private equity investors in successful retail businesses and networks enjoy predictable cash flow and the opportunity to leverage intellectual property assets, with the added benefit of rapid expansion on scalable business platforms. However, when the businesses are franchises in the United States, regulatory concerns and issues could derail financial engineering of the investment and some finance plans, and potentially reduce or delay returns on investment. But with modest efforts at smart planning, these potential distractions are avoidable.

Background

In the U.S., franchising loosely follows the model of securities regulation with important variances. The Federal Trade Commission (FTC) promulgated its Franchise Rule effective in 1978, amended it in 2007 and will likely amend it again in the near future. There is no federal agency registration or pre-sale review, just a voluntary compliance framework, featuring a franchise disclosure document, called the "FDD"; a timing regime requiring a 14-day waiting period after disclosure before any contract is signed or fees paid; and the threat of FTC action for violations. Some guidance has been issued through a Compliance Guide and FAQs, but issuers are largely dependent on their counsel to create a compliant FDD and sales program. There are some exemptions and exclusions available for large investment franchises and seasoned franchisees, but nothing akin to what is available under securities laws for exempt securities, transactions and issuers.

The FTC left the door open for states interested in this market to enact and enforce additional regulatory programs. Only 11 states ("Review States") have an agency review and approve the FDD before offers and sales commence. Five more states ask for annual notice filing registration, and four states use a single notice filing registration good for the entire existence of the franchisor. The Review States each have their own, somewhat similar rules, both published and unpublished, and there are exemptions for seasoned franchisors. To be seasoned, the franchisor generally must have 25 franchises in operation for at least five years, and an audited net worth at or above a certain level, or the parent entity owning at least 80 percent of the franchisor must have an audited net worth at or above the specified level, and agree to guaranty the obligations of the subsidiary franchisor to franchisees. The subsidiary franchisor must have an audited net worth of more than $1 million. The exemptions are like golden tickets and should be utilized, if possible, to avoid the unpredictable outcomes and impediments to franchise sales and growth affecting non-exempt franchisors that undergo Review State registration.

Balance Sheets

Private equity operators make an unforced error in structuring the balance sheets of the franchisor to reduce its GAAP net worth to be less than the minimum necessary for qualifying for these exemptions. There are three

levels – $15 million, $10 million and $5 million. At the $15 million level, in New York, Illinois and Virginia, the fast route to those key markets is preserved, with an annual notice filing only in Virginia. At the $10 million level, annual notice filings are needed in North Dakota, Rhode Island and South Dakota. At the $5 million level, annual notice filings must be made in California, Illinois, Indiana, Maryland, New York and Washington. These notice filings are simple and are generally not subject to regulatory discretion. If the opportunity for the regulatory exemption is lost through balance sheet design, the franchisor will be unable to offer and sell franchises in these major market states for months each year while its application for renewal is processed and reviewed by the Review State authorities.

Even worse than the loss of an exemption is a balance sheet design that produces a franchisor with a low or negative net worth. This can easily happen with intangible amortization, debt financing and certain allocations of debt and liabilities. Should that approach be taken, the Review States may impose "financial assurance" requirements. The regulators will not trust the franchisor to have sufficient working capital to meet its pre-opening obligations to franchisees, and security must be provided in the form of a surety bond, a parent or affiliate guaranty, an escrow arrangement for initial fees or deferral of the fees until the franchise opens and all pre-opening services have been performed by the franchisor. In addition to the negative signal this requirement sends to the highly competitive marketplace for franchisees, the administrative burdens, credit issues, contingent liability disclosures and Risk Factor disclosures that must be made in the FDD to address a financial assurances requirement could diminish or delay the franchisor's prospects for success. In effect, a seasoned franchisor is recycled to startup status, and must prove itself to the marketplace once again, losing a substantial portion of its perceived value.

Governance

One area of structural concern is the governance of the franchisor when there is a desired investor presence in the governance architecture of the enterprise. Under the FTC and Review State rules for the FDD, certain disclosures must be included in the FDD for the people who function as the executive decision makers and board of directors of the franchisor. These disclosures include all positions held currently and for the five years preceding, plus disclosures regarding litigation and bankruptcy in which the person is a defendant or a debtor, or an entity in which they are an officer, director or partner is the defendant or debtor. Partners or employees of private equity funds who hold positions as portfolio company officers or directors may need to disclose information about other portfolio company cases unrelated to the franchisor. The failure to do so could lead to a right of rescission for each franchisee in a Review State, so non-disclosure is a high risk option with expensive, negative consequences. In addition, an overlay structure – where the franchisor is a member-managed LLC and the parent is a board managed entity that controls the franchisor as its sole member – causes all members of the parent board to be subject to disclosure. The preferred route is to use a manager-managed LLC as a franchisor with the parent member having the right to select and replace the manager at its discretion. In that case, only the franchisor's management are subject to disclosure.

Private equity investment in franchising enterprises has been rewarding to private equity funds. However, attention to a few details of structuring the balance sheet and governance can make that investment more rewarding more quickly.

If you have questions about private equity investment in franchise systems, please Joel Buckberg or any of Baker Donelson's Private Equity lawyers.