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One Company or Twenty Companies?

By Dennis Monroe

One of the old debates in the restaurant industry concerns the way to structure the overall company—whether to create a single or multiple companies organized by units, property ownership or geographic region. Here are my thoughts:

A. Basic Legal Structure - Type of entity to be used

1. In today's corporate world we almost uniformly use limited liability companies (LLCs). (There are exceptions, particularly if you are looking to make a public offering.) Once you set up an LLC, it can be converted to a corporation, and certain tax elections can be made so it is treated differently than a partnership. The LLC entity form creates the most flexibility.

2. What state do I form my LLC in? We normally form in the state where the restaurant and corporate office is located, or...

b. The state of Delaware. If the concept is going to grow, lenders, investors and other interested parties like the comfort of having a Delaware entity. Delaware is the universal venue of choice because it has defined corporate laws governing shareholder/members, and this clear understanding of governance gives investors, lenders, and the public (in case of an IPO) a clear understanding of their rights.

B. Number of Entities to Use. Once you've decided the type of entity and state of formation, it's time address how the assets are held in each entity. The old adages "less is more" or "keep it simple" may not necessarily hold true in these circumstances.

1. The first major reason to keep restaurants in their own entity is protection from potential liability, both from employee claims and creditors. Normally the individual restaurants are held in a holding company, so there is still one controlling owner (e.g., the holding company), but the restaurant—or, in some cases, several restaurants—are owned in separate entities. The protection entails multiple issues. For instance, if there's a major employment lawsuit in one entity, the liability does not impinge upon the other entities. Of course lawyers try to bring all of the entities together, but if proper corporate formalities are maintained, the other entities are not held liable for the issues affecting the one unit entity.

2. If for an individual unit entity there are no personal guaranties, no cross guaranties by other entities or outside liability for the lease, then the individual entity creates an insulation from liability. For example, if the site is substandard, and you cannot negotiate out of the lease or possibly the debt for that store, you can then close the store or at least threaten to close it because the entity is normally insolvent. This approach creates a buffer as it relates to the lease obligation and the other debt held by the remaining entities. The creditor or lessor can always go after the assets of the individual entity (which may be the furniture, fixtures, equipment, leaseholds and maybe some cash). But that's it.

3. Separate entities also offer flexibility in a sale. You could sell one unit, and rather than using an asset sale, if it is an LLC, you could opt for a membership sale, and the buyer would receive the same tax advantages as in an asset sale, thus simplifying the transaction.

4. By having a separate entity for each site, you can reward a single well-performing store by providing incentives for individual store employees rather than employees in all stores (particularly if these incentives are non-qualified benefits, such as certain deferred compensation or appreciation rights, etc.).

C. Multi-store entities. You don't have to use a separate entity for each store. Sometimes you can group stores together. For instance, if you are planning to do an IPO or seeking a PE investment in certain aspects of the holding company, you can group stores in different entities and also look for different types of financing by entity vs. overall company.

1. Favorite Structure—the one that starts with a holding company. It often has three subsidiaries or brother/sister entities:

a. Management Company. The overall store management team is employed by this entity and charges a management fee to the individual stores.

b. Intellectual Property (IP) Entity. The IP is owned by a separate entity, so if there is any major liability issue, the intellectual property can be protected. Further, the IP entity can license the IP to the individual stores and third parties and create value in the entity.

c. Individual Stores. Again, we like to group stores in individual entities or to group stores together to provide protection for all of the stores. Sometimes these aren't individual stores but individual regions, such as the Twin City entity that has four stores and then a Wisconsin entity for development and so on.

d. Real Estate Holding Company. This is normally a brother/sister entity where the real estate you may own is held outside of the operating entity.

2. Badco. If you have a number of stores in one entity, you can drop down the stores not doing well to a newly created entity we call a "badco." The good stores are held in separate entities, which is usually a subsidiary holding company. This process gives bargaining power for dealing with bad apples.

D. Tax and Accounting. If an entity is wholly owned by another entity, then the subsidiary is disregarded for tax purposes. For example, if you have a holding company that owns 15 restaurants, a management company and IP company, only federal tax return will be filed (sometimes they may need to file multiple state returns).

E. Accounting. Each entity and store has individual P&Ls and balance sheets for internal manager purposes. If all entities are held under a holding company, the GAAP financial statements can be consolidated so a lender/investor/franchisor or any third party can see the true picture of the overall business.

I believe it's better to have multiple entities for liability, financial and business protection. The tax compliance and upfront legal costs for creating entites are minimal since you are normally using the same boilerplate documents. In making your plans, consider the structure discussed here to determine whether there are good reasons to opt for multiple entities.

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