

Legal and Financial Thoughts for The Top 200

By Dennis Monroe

As you can see from the Monitor's annual Top 200 ranking of the largest franchisees, a significant share are multi-concept operators. Multiple concepts seem to be the trend and a way for the large multi-unit operators to grow. They usually start out with a core concept such as Applebee's, Burger King, or, in general, QSR or casual, and then expand. Normally mature concepts do not offer as much expansion and development opportunity as newer start-ups or earlier-stage franchise concepts. Enticing as this prospect may be, it is important to look at how you structure multiple concepts for purposes of legal protection, exit, tax and a number of other key issues.

Let's look more closely at several of these matters:

1. Franchise Requirements. Many franchise documents require the concept be held in a separate entity and that its bylaws provide the only purpose of the entity is to hold the interest in the concept. The common structure is to put the concept in separate entities but then gathering all of the different entities in one holding company. For financial purposes, they will have consolidated financial statements. For legal purposes, these entities are separate, but for tax purposes they can file one federal tax return.

2. Legal Protection. Since you need to have a separate entity, in most cases it is good to use an LLC, which gives all of the legal protection of the corporation and more flexibility. It is also prudent to create separate entities if you have a concept whose performance is uncertain, and where you may be dealing with landlords, creditors and the franchisor. Normally these entities are modestly funded to the extent the franchisor requires, and the assets have minimal value. This approach creates nice liability protection and gives the operator some comfort in trying out new concepts. Unfortunately, this does not mean we lawyers are not going to try to bring everything together, particularly if there is a bankruptcy by one entity (which has become more and more common). Nonetheless, this is still the way to structure for separate franchise concepts.

3. Sharing Ownership. The use of separate entities creates some unique opportunities for employees. In many cases the employees of an earlier-stage concept (vs. a mature concept) are interested in some kind of upside in the concept. That being said, separate entities allow for either ownership, phantom ownership or deferred compensation only at the entity level, not the holding-company level, all creating greater incentive, particularly if the concept needs to grow and be worked vigorously.

4. Financing. It is becoming more popular to do blanket financing over all the various concepts. I still think there is big advantage to financing on a concept-by-concept basis. It certainly provides the operator with greater flexibility, particularly when it comes to tapping equity in existing concepts. Rather than tying up assets needlessly because the bank or lender wants to wrap its hands around the whole company, I recommend to keep things separate, thus allowing for different financial covenants complying only at the entity level.

5. Exit Strategy. The exit strategy is a real key. If there is a sale, having separate entities gives you the opportunity to stage either an asset sale or membership (stock) sale and not have to spin the business or assets off. S corporations and C corporations are somewhat problematic for stock or membership sales. When selling a membership interest, LLCs are unique in that the buyer can get a step up in basis for the assets that are being purchased, thus allowing for significantly more depreciation. The ability to conduct a stock/membership sale definitely makes the transaction easier and normally generates the maximum amount of capital gains for the seller.

6. Tax Shifting. From a tax standpoint, particularly if these entities from the various concepts are not consolidated, the operator has an ability to move some common expenses and intercompany transactions so as to maximize tax losses or minimize taxable income, including state tax. Also, separate entities give the owner the assurance that there is enough equity or debt basis to be able to take losses. This can be done through a number of different techniques, all of which require the use of separate entities. State tax is a real issue for large, multi-concept operators. Creative use of management fees, subleases and asset rental may be techniques to shift income or at least create loss net income from higher-tax-rate states to ones with lower rates.

7. Liability. I cannot emphasize enough the importance of the liability protection. I was involved with a large holding company that had various concepts and entities. They had a bad lease they wanted to get out of. It was held in a separate entity and therefore there were no outside guaranties. The entity had operated for quite a while and then took a downturn. The resulting lease negotiations with the national landlord were tenuous and problematic, particularly because the landlord looked at the overall size of the holding company and assumed the holding company would be liable.

Fortunately, having a separate entity with minimal assets, except for the low-value restaurant FF&E, helped transform the outcome of the negotiations from what should have been a multi-million dollar settlement when the restaurant was closed to a more reasonable low six-figure settlement.

8. Franchise Rights. The multi-concept operator needs to vigorously negotiate its franchise agreements, because issues like non-competes and overall corporate and personal guaranties become more problematic if the franchisee has other successful franchise concepts and wants to grow. Some franchisors do not like the use of a management company or private equity. These are roadblocks to growth, and the Monitor list of the top 200 certainly seem to want to grow.

In general, multi-unit concepts owned by multi-unit operators are here to stay. It is the way of the future to take advantage of many of the really great established and emerging concepts. Remember to be careful in your structure, plan for problematic situations and negotiate in such way as to ensure protection and growth.

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