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The Franchise Debate –
Does One Size Fit All?

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2011 HOSPITALITY LAW CONFERENCE
AGENDA
THE FRANCHISE DEBATE – DOES ONE SIZE FIT ALL?

The Pros and Cons for Franchisor and Franchisee of Using a Non Traditional Franchise Agreement Strategy for Select Franchise Prospects or How Much to Give to Get Most Out of a Non Traditional Franchise Deal?

February 2011

I. INTRODUCTION AND PROGRAM OVERVIEW

A. Message and Expected Outcomes of Program

B. Traditional Franchisor/Franchisee Relationship Paradigm

1. History

2. Current Contractual/Negotiation Approach

C. Market Trends and Opportunities for Changing the Paradigm for Prospects Who are Attractive Risk Profile Candidates ("ARPC")

1. Definition of an ARPC - Sophisticated Operators/Multi-Unit Developers, Investor Groups and Private Equity Firms

a) Sophisticated Operators/Multi-Unit Developers/Investor Groups – definition and interests

b) Private Equity Firms – definition and interests

i) Cash needs

ii) Exit goals

2. Franchisor/Brands Entering into Agreements with ARPCs

c) Sophisticated Operators/Multi-Unit Developers

i) Because of their contracts with non-traditional venues, management companies such as ARAMARK or Sodexo allow brands to gain entry into different retail environments – from universities to, potentially, off shore oil platforms.[1]

ii) Trends indicate that more parent organizations are seeking management service companies to operate their food services.[2]

iii) U.S. organizations spend over $300 billion to contract out their “non-core” functions to management contract organizations.

iv) In May 2010, Moe’s Southwest Grill entered into an agreement with Sodexo to open Moe’s restaurants in Sodexo-managed locations.[3]

v) In 2009, Einstein Bros. Bagels’ parent corporation Einstein Noah Restaurant Group, Inc. announced its strategy of entering into agreements with companies like ARAMARK, Sodexo, and Compass Group, among others. The company was slated to open 30 to 45 restaurants in 2010.[4]

vi) Wahoo’s Fish Taco opened its first franchised location this year, which is owned and operated by ARAMARK.[5]

d) Investor Groups and Private Equity Firms

i) A global private equity index indicates that deal volume from private equity is rising, but it has yet to reach pre-recession levels.[6]

ii) From 2001 until the first quarter of 2010, global equity investments by private equity firms was $296 billion.[7] The average contribution of private equity firms to U.S. deals was 46% in 2009, an increase from 39% in 2008 and 33% in 2007.[8]

iii) Large restaurant franchisees continue to attract private equity groups.[9]

iv) Private equity groups are no longer investors and acquirers of franchisor brands, but have increasingly become investors in multi-unit franchisees.[10]

v) Bain Capital acquired the Domino’s master franchisor for Japan in January 2010.[11]

vi) Duke & King Holdings LLC’s pending acquisition of 14 Popeye’s.[12]

vii) Argonne Capital Group bought 35 IHOP franchised restaurants.[13]

viii) Franchisor sold 84 Papa John's units to an affiliate of Milestone Capital Management LLC. [14]

ix) An investment fund operated by Prometheus Partners bought 24 IHOP restaurants. [15]

x) Olympus Partners bought 147 Taco Bell, KFC and Golden Corral franchised restaurants.[16]

xi) Halifax Group bought 116 franchised Papa John's restaurants. [17]

xii) Sentinel Capital's acquisition of 123 Pizza Hut franchised restaurants which has since grown to 225 restaurants in the Los Angeles area. The private equity group previously owned and operated Taco Bell and Church's franchisees (who have since sold their holdings to franchisees).[18]

II. ASSESSING RISK PROFILE OF ARPC

A. Advantages of ARPC

1. Asset/Financial Security to Withstand Losses or for the Brand to Access for Damage Recovery.

2. Business and Financial Acumen Resources Exceeding Brand.

3. Experience Doing Deals; Knows Key Arrangements Needed and Other "Deal Paraphernalia" Not Needed.

4. Enhanced Credibility to Brand/Street Smarts.

B. Drawbacks of ARPC

1. ARPC Too Big or Experienced that Brand Believes Relationship Overly Leveraged.

2. Franchisor /Brand Not Confident Enough to Live Without Traditional Safeguards or Too Smart to Live Without Traditional Safeguards?

III. USING CORE LEGAL AND BUSINESS VALUES IN GETTING TO A NEW RELATIONSHIP PARADIGM

A. What is a "Core Value?"

B. Brand /ARPC's Values in Negotiation

IV. AGREEMENT FORM AND PROVISIONS – WHAT MAKES SENSE TO CONSIDER IN ASSESSING RISK PROFILE OF PROSPECT AND DEAL VALUE

A. Termination and Exit Strategy

1. In-term option to terminate without cause / termination payment

2. Cross defaults

B. Materiality Condition

C. Reasonableness Standard

V. TRANSFERS

A. Selling units and approval criteria

B. Succession planning

C. ROFR/ Right of First Offer

VI. NON-COMPETE COVENANTS:

A. Types of products/concept and geographic scope

B. In-term vs. post-term covenants

C. Co-branding

D. Acquisitions

E. Grandfather for pre-existing deals

VII. STANDARDS CONSIDERATIONS

A. Deference to Facility's Requirements, if applicable

B. Departing from Franchisor's Standards

1. Modified menu offering

2. Modified training requirements

3. Modified personnel requirements

4. Ability to use alternative suppliers

C. Financial Considerations

1. Imposition /Negotiation of personal/ corporate guaranty/ letter of credit

2. Limit on potential damages recovery

3. Sole Remedy

VIII. FRANCHISEE EXPANSION

A. Lack of or Limited Development Schedule Restrictions

B. Option to Develop Additional Units within the Specific Geographic Area/ Facilities

C. Right of First Offer

IX. CONCLUSION – REALITY CHECK

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[1] John Lofstock, *Cornering the Non-Traditional Market*, May 1, 2010, http://www.csdecisions.com/article 9654/cornering-the-nontraditional-market.htm.

[2] Robert A. Brymer, Hospitality & Tourism (11th Ed. 2004 Kendall/Hunt Publishing Co.).

[3] http://moessouthwestgrill.wordpress.com/2010/05/17/moe%E2%80%99s-southwest-grill-signs-nationwide-agreement-with-sodexo/

[4] *Convenience spurs record growth for Einstein Bros. Bagels*, Fastcasual.com, November 23, 2009, http://www.fastcasual.com/article/96911/Convenience-spurs-record-growth-for-Einstein-Bros-Bagels.

[5] *Wahoo's Excited For Newest College Location*, QSR Magazine, February 3, 2010, http://www.qsrmagazine.com/news/wahoos-excited-newest-college-location.

[6] Phil Berlowitz, *Global private equity index up but below pre-recession,* Thompson Reuters, October 21, 2010.

[7]Private Equity Growth Capital Council, http://www.pegcc.org/pe-by-the-numbers_2008/.

[8] Id.

[9] Barry Kurtz, *Franchise system's size, structure dictate private-equity payout*, Nation's Restaurant News, September 23, 2007.

[10] Jan Gilbert, Jack Wixted, and Mark Friedman, *A Shifting Sales Paradigm – Private Equity Firms and Large Multi-Unit Developers as Franchisees,* IFA Legal Symposium, May 16-18, 2010 (citing Julie Bennett, Take advantage of private equity while the ardor is high, Franchise Times Mag., Sept. 2006, viewed at http://www.franchisetimes.com/content/story.php?article=00322).

[11] Id.

[12] Id.

[13] Id.

[14] Id.

[15] Id.

[16] Id.
[17] Id.

[18] Id., *See also* http://www.sentinelpartners.com/secondary/company/secondary/a-SouthernCA%20Pizza.htm