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Have Multi-Unit and Multi-Brand Franchisees Set a New Standard for Franchisors?

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I. Introduction

Is it a newer standard, or just an old one getting more attention? Multi-Unit, Multi-Brand – what is it?

A multi-unit franchise is one in which a franchisee owns more than one unit. There are several ways to structure a multi-unit franchise: an area development agreement, an area representative agreement, a master franchise/sub-franchise agreement, or simply multiple units with multiple separate franchise agreements of the same brand. An area development agreement provides franchisees with the right and obligation to develop a certain number of units within a defined territory within a defined time period. An area representative agreement designates one "area developer" for a territory who does not necessarily operate its own units, but helps offer for purchase units to franchisees and, in many instances, trains and monitors the franchisees in this territory. Finally, the master franchise/sub-franchise agreement grants the legal right to both offer and sell franchises based on its own franchise agreement, essentially being delegated the role of the franchisor in a specific territory.

The multi-brand franchise concept can have two meanings: one meaning a planned association of two or more distinct brands owned by the same franchisor (or related parent entity), or the other being a franchisee that owns and operates franchises of different franchised brands that are owned by distinctly different franchisors (for example, a franchisee that owns a McDonald's and a Dunkin' Donuts, two franchises owned by two entirely different franchisors). In some ways, multi-branding can be viewed as a marketing tactic to create associational links between products. Multi-brand franchises are often used as a strategy for franchisors to leverage their resources efficiently across several businesses. They have become a popular form of expansion for many franchise systems and it is increasingly common to find several brands under the same ownership roof or teaming up with each other to take advantage of these efficiencies.

It seems as if the days of franchisees looking to open just one store as a means to obtain employment are gone (in part). Today, franchise ownership, or as a result of franchisors' initiative, is increasingly shifting towards large, multi-unit operators. The popularity of multi-unit franchises is partly based on economies of scale and what may be viewed as the ease of having less franchisees, but the same or more units. Multi-unit operators can share portions of their overhead among units, creating synergies in areas such as advertising, manufacturing, distribution, information, and administrative expenses. Offering multi-unit opportunities to franchisees also benefits franchisors with economics of scale benefits. Also, multi-unit franchisees often tend to have a better track record of success with opening new units and giving franchisors the advantage of not having to spend as much time and money on a single unit owner to expand its unit count. These franchisees can utilize the same successful operating principles for multiple units, thereby maybe reducing the franchisor's risk that a new unit will fail.

Multi-brand franchises are also a growing trend in the industry (for example, the Dwyer Group and its multiple brands or segment for its intra-brand explosion). While this space at one time seemed to be dominated by restaurant operators, other industries including financial, real estate, business coaching, automotive, and hospitality have taken to the multiple brand concept. Advantages of multi-brand franchises include the possibility for higher sales and profits, the ability to share overhead among the brands, and the benefit of increased diversification of a franchisee's portfolio. One significant reason for the growth in multi-brand popularity is the desire to keep pace with, or stay ahead of, the ever-changing tastes of their customers. Modern customers demand convenience, accessibility, and quality and are very loyal to specific brands. Also adding to the growth of multi-brand franchises is the involvement of large corporations, which have the ability to leverage the infrastructure they already have in place to launch several brands.

An issue that could arise under the multi-unit concept is a franchisee (or group of franchisees) that own/operate a significant number of units and become as large as or bigger than the franchisor in terms of economic values can gain significant leverage, and then the franchisor may discover that tail is wagging the dog.

And then there is the combination of multi-unit franchisees with multi-brand concepts. This paper takes a general look at the two concepts.

II. Multi-Brand Franchisees

Multi-branding has a large variety of applications. It has been referred to as "a planned association of two or more distinct and differently branded goods, services, or business concepts." For example, a single restaurant facility might offer both KFC chicken products and Taco Bell Mexican food, be identified by both trademarks, and feature elements of both systems' trade dress.

Like all business models, there are advantages and disadvantages to multi-branding for the franchisor and franchisee. The advantages start with diversification – and being able to have different concepts, brands and categories under one roof and to possibly help leverage one another during down times, or to help increase sales with the ability to offer more choices. Higher sales tend to lead to higher profits which, in turn, lead to a higher return on investment. The disadvantages include a franchisor or franchisee spreading themselves thin across multiple brands and concentrating on only one brand in particular, and being associated with a brand that obtains some negative publicity, which then, by virtue of guilt by association, affects the other brands, assuming that they are, in reality or perception, associated with one another.

Exploring the possibility of cobranding involves the consideration of business, legal, and practical issues. Here are some examples of these types of issues:

Contract Issues

The contract issues run the gamut from franchise disclosure document (FDD) issues to the structuring of the franchise agreement to (assuming the franchisee is dealing with two separate unrelated brands within its same footprint) the relationship between the two, and as to any contract issues dealing with such (possibly even contracts between the two brands concerning the franchisee operations). Starting with the FDD, a franchisor needs to analyze whether or not it will structure its FDD to be a single brand FDD or a multiple brand FDD. A multiple brand FDD may seem like a more efficient FDD model, but in reality, it may cause numerous issues with the prospective franchisee in terms of a complicated-to-read FDD to issues dealing with the various registration states and how such is perceived by the examiners in the review registration states, along with even trying to comply with the various exemptions that might be available, both at the federal and state level.[1] The issues range from having one brand that might meet the exemptions to another that, on its own, may not; and, if such still qualifies for exemptions in a combined FDD, the issue of confusing a franchisee by having brands that don't necessarily have the same operating concepts (and then trying to properly address those issues within the FDD and franchise agreement), providing, assuming the election to do so was made, various Item 19 Financial Performance Representations. All of these issues come into play with as to why there is an FDD in the first place, and that is to provide information to the prospective franchisee in order for him/her/it to make an informed decision based upon the information required to be provided pursuant to the FDD (both on a federal and state level). If there is too much information, or information that is confusing in terms of following what applies to which brand, then is the franchisor, in the long run, providing a disservice to the prospective franchisee; and then potential claims by the franchisee which overshadow any thoughts of a more effective and efficient multi-brand FDD? The benefit of a multi-brand FDD is that it is, if drafted properly, a one-stop shop document as to the comparison of the different brands being offered by the franchisor.

Contract issues are not just related to intra multi-brand concepts, but also as to franchisees that have multi-brand unrelated units. The problem sometimes arises when the units are at the same location within the same building on the same real estate and to which the brands are complementary, and in order for the franchisee to obtain its desired economies of scale by utilizing the same backroom functions and possibly even crossover of employees, these raise additional issues for all of the franchisors. Additional issues may even come into play as to restrictive covenant issues, timing of each respective franchise agreement, and issues dealing with confidentiality among the brands and the training requirements.

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[1] See *Franchise Disclosure Challenges for Large, Sophisticated or Multi-Brand Franchise Companies* (October 15-17, 2014, American Bar Association 37th Annual Forum on Franchising).

There are different options available to license multi-brand outlets. One of these options is a single license agreement for both brands. A single franchisor that owns multiple concepts may grant a license agreement covering the requirement for running each concept. Another option is a separate license agreement for each brand with a bridge license to coordinate the operation of each brand and resolve inconsistencies between the separate licenses.

Coordination

Conflicting or inconsistent contractual terms must be reconciled. Integration requires that each concept with its own trade dress, brand recognition, and contractual/operational requirements be integrated or at least coordinated with the other to ensure a seamless operation from the customer's perspective and minimal administrative issues for the franchisee and franchisor.

Fees

Multi-branding may complicate the calculation and allocation of royalties and advertising fees. Items that the two brands have in common, e.g. soft drinks in a restaurant cobrand, may complicate the determination. One way to allocate common items is to account carefully for sales attributable solely to one brand or the other, then apply that ratio to sales of the common products. Another is simply to split all revenue between the brands in an agreed ratio without going through a rigorous accounting. While the latter approach is easier to administer, it is subject to inaccuracies from one location to another and from one reporting cycle to another. Percentage rates may differ: one brand may cover categories of sales that the other does not, or one may have fixed-dollar minimum payments and the other does not. The franchisors should decide whether to require a single cash register/point-of-sale system for the entire business, or if separate registers are allowed, how to assure accuracy of reports and proper allocation of revenue under the contracts. Once collected, ad fees may be spent in very different ways. A franchisor is obligated to spend ad fees only for marketing the brand that generated them. A single-brand franchisee will not want to pay fees to advertise a multi-brand concept or the cobrand. When a marketing fund seeks to advertise multi-brand outlets in a particular area, coordination between advertising funds or the creation of a single combined fund for multi-brand outlets will be necessary. Franchisors should avoid commingling funds collected from one brand with funds collected from another.

Sites and territories

Brands may need their own site requirements and policies to possibly limit intra-brand competition; or, are they each distinguishable such that they cater to distinctly separate demographic/customers? Do Marriott's 30-some brands compete against one another or do they target different end users? Do the Dwyer Group's 18 different brands complement or compete with one another? Does there need to be territory restrictions, not only among the same brand, but as to the other brands of the franchisor (or its affiliates)? Some might argue that, for example, for a system that has 30-some brands, it is almost indistinguishable among a number of the brands as to what demographics or target customers they are going after; and, is there really a difference between brand #1 and brand #30? This may now take the issues of territorial encroachment to a new level of not only worrying about an identical brand being placed near an existing franchisee of the same brand, but similar competing brands of the same system. Now, franchisees need to be concerned not only about the competition that they could contemplate from others outside the franchise system, but may also have to be concerned with direct competition from their very own franchisor. Accordingly, franchisors, stated in the obvious, need to contemplate not only the results of new brands being implemented as to their bottom line profitability, but how it will affect the existing franchisees in their other related brands; and, do the franchisors then need to be even more pragmatic about developing impact policies to possibly provide some comfort to their own franchisees and, in particular, as to the "other" brands?

If the site requirements for each brand are inconsistent, the requirements must be reconciled. Some franchise agreements limit intra-brand competition with protected territories for franchised outlets. Partnering a brand without that restriction with one that has that restriction may be seen as introducing intra-brand competition or limiting potential development. Another problem arises if a franchisee wants to multi-brand with a brand that competes with another brand owned by the franchisor. A Taco bell franchisee who wanted to multi-brand with a Popeye's would be entering an industry segment (chicken) already offered by Taco Bell's parent, YUM! (with its KFC franchise).

An issue that franchisors need to be careful about is, as is always the case when providing territorial restrictions: what will the future bring and will they box themselves in if they provided not only too large of a territory protection for franchisees, but any territory at all? Obviously, there is no one-size-fits-all and it needs to be evaluated within the type of industry and foreseeable growth plans.

The most immediate concern is the threat of cannibalization of sales from an existing trade base to new multi-brand outlets using the same brand as the single-brand franchised business. Franchisees also may fear that the franchisor's management time, attention, and financial resources might be deflected to development of cobranded locations. Some franchisees fear abandonment of the single-brand system in which they are invested in favor of the glamour of the new cobrand network. An existing franchisee seeing his brand paired up with another, unrelated brand may be concerned about ways that the combination might affect the existing business. First, will the existing brand be diluted by customer confusion resulting from the combined presentation of the two brands? Will the cobranding arrangement involve licensing the existing brand in new channels of distribution? Franchisee concerns over fairness and free riding also may arise if cobranded units do not contribute on the same basis as single-brand units into system advertising funds at both the national and local levels.

Confidential Information

The integrity and competitiveness of each brand depend on maintenance of its trade secrets. In order to operate a franchise, a franchisee is exposed to trade secrets and other commercially sensitive information of the franchisor. Knowing the secrets of two brands may not be a problem if a franchisee opens a multi-brand A&W and Pizza Hut, which are affiliates under common ownership, because they focus on different segments. However, if the same A&W-and-Pizza Hut franchisee separately open a

Burger King or Domino's Pizza (assuming they overcome any non-compete restrictive covenant issues), a trade secret problem is more likely because the outside business would be in an overlapping segment outside the scope of the in-term non-compete of the multi-brand licenses.

A potential issue concerning confidential information and trade secrets occurs for those franchisees that entered into a system that did not have other competing brands within the same family, and the franchisor develops a new competitive brand, or the franchisor acquires a competitor and brings it within the family of brands. Now, the franchisees believe that there is a sharing of information from which one of the systems, or both, believe in respect to the other that their particular system is the better of the two and, therefore, now the franchisor is sharing the business practices of their system with the other, and now not only creating competitors, but direct competitors of equal standing. It is one thing if the competitive brands are visibly distinguishable to the customer, but when that line gets blurred, then the franchisees of what was perceived to be the "better" of the two systems become very concerned that they no longer have the competitive edge, not only as to the competition outside of their family, but now, more importantly, within, for which that new system would now have direct access to the confidential information/trade secrets.

Profitability

Before committing to multi-branding, franchisors should establish whether consumer demand truly supports a particular pairing in a target trade area. Evidence of market demand is useful to both franchisees and franchisors to help determine whether anticipated benefits are worth the increased costs and complexities associated with multi-brand outlets. Whether the outlet is feasible and profitable to operate is often a difficult question to answer. Other costs reflect ongoing operations. There will be costs associated with the franchisee learning how to operate the combined unit smoothly. The added complexity and increased transaction volume may require more employees as well as more highly compensated employees. A manager or employee for one brand may not be equally qualified for the other brand. Marketing costs also may increase as the franchisee determines how to target the local area. Typically, sales are recorded by sophisticated point-of-sale systems tailored to one brand. “Different” franchisors may require different systems. It is impractical and costly to operate two independent systems. Inventory management, payroll, and scheduling all may have to be changed or integrated to take each brand into account.

One of the benefits of multi-branding from a franchisee perspective is supposedly the effectiveness and efficiency of two or more brands under one roof. The Sonoco gas station that also operates a Subway, or a combined KFC/Pizza Hut/Taco Bell with the feel of a Hollywood set in the front, with the three distinguishable brand images, and then behind the scenes, one shared back room. In connection with the concept of economies of scale, can there be the sharing of administrative and/or operational matters? And that, too, will depend upon the type of systems involved. For all multi-branded units, there is always a concern of making sure that there is, at some level, a hard separation between the brands. Sometimes, that is difficult to control when one unit is short an employee and calls upon an employee that is currently at brand B to now come over to assist brand C and for guests to change its logoed shirt, hat, apron, or whatever. Now, you have a direct mixing of the brands and one by the true essence of the terms of a franchise agreement is not permitted, and rightfully so. On the other hand, one might argue that, by doing so, especially since they are all together, that it may have been added value marketing by having the employee have on the other branded logo while operating under another brand all within the same facility and, thus, inspire the customers to seek products from the other brand at the same time.

On the other hand, all parties should desire to have the hard line separation, since each comes with its specific branding and marketing and, should there be an issue with one system, it may not then affect the other system. For example, should there be an E-Coli breakout with system A, the effects of such may not trickle to the other brands at the same location, and actually might help the other brands to help overcome the losses of brand A. However, if there is a routine “bleeding” of the brands among one another, then the negative aspect with brand A may then affect brand B and C. All of which leads to an effect on profitability.

Allocation of Growth Opportunities

Single-brand franchisees may perceive cobranding as limiting their own growth opportunities if cobrand sites are developed by others. Existing franchisees will be concerned about the allocation of development opportunities between single-brand and cobrand development channels and the eligibility criteria for franchisee participation. Existing franchisees may wonder whether the development of cobranded sites will limit their own ability to renew or relocate single-brand units.

Brand Protection

Franchisors that cobrand must guard against dilution of their brand and insist upon uniformity across the system, or at least within discrete segments of it. If a franchisee neglects the second brand, the brand may lose some of its equity and confusion or disaffection among consumers will occur. Operating standards, as adjusted to accommodate both brands, may become compromised. Franchisors must guard against the lowest common denominator becoming the norm for operations, facilities, and upgrading. Multi-branding only works if the venture offers two or more product lines the public wants. Preservation of the reputation of both is essential to franchisors and their systems, not just to make multi-branding successful, but also to maintain the success of already existing single-brand outlets

Cross-Default

A typical provision within a franchise agreement is a cross-default provision that allows the franchisor to default the franchisee, in the event that the franchisee is in default under the terms of the franchise agreement, not only as to that particular franchise agreement, but also as to any and all other agreements between the franchisor and the franchisee. In other words, if a franchisee has more than one location, and is in default under an agreement for one of its locations, the franchisor can not only terminate the actual defaulting location, but also all other locations of the franchisee. In the context of a multi-branded franchisee, a franchisor needs to make the analysis, rather than a knee-jerk reaction to implementing a powerful cross-default termination provision, as there could be unexpected adverse effects upon the unit brands that were not in default. In many instances, it is typical for the franchisor (or its lawyers) to, upon insistence, immediately resort to all provisions within the franchise agreement that are tools of termination, without necessarily giving consideration to the long term picture of the effects of such. In particular, the simplicity of stating that a franchise agreement and all others will be terminated on a date certain, may cause the franchisor to actually lose a franchisee that was in good standing and operating profitable locations within the other brands, or it may cause a franchisor to have to scramble to work on the take-over process for multiple locations and have to prepare to run them as “corporate” units. Many franchisors take the position that, if a franchisee is in default of one, then by implication, the franchisee is a “bad” franchisee and must be out of the system, even if they are compliant within the other brands. In turn, a franchisor could be losing locations in multiple brands simply because it believes it has the upper hand vis-à-vis a cross-default provision. The same is also true within the multi-unit franchise concept; in that a franchisee can be in default at one location, but its other locations may be operating in full compliance (and profitable) which, but for the cross-default provision, would not otherwise be subject to termination. A franchisor could, without fully analyzing the situation, be terminating a successful multi-unit franchisee simply because one unit happened to be in default. Obviously, it would depend upon what the default is based upon and, if it is for something related to fraud, then obviously the franchisor would want to eliminate the franchisee from its entire system and brands. However, if it is not related to fraud and it deals with operations or strictly related to the one unit, it would behoove franchisors to fully analyze the situation and not be so quick to invoke the cross-default provision; and maybe use it as a way to resolve the issue, as it is a powerful tool. Further, the franchisor could incur economic issues with its investors, bankers and the like. The bottom line is that a cross-default provision should not be something that is utilized on a willy-nilly basis.

Competition

In developed markets, intra-brand competition may intensify from new points of sale of the cobrand. If an existing nearby Taco Bell loses as much in sales as the Taco

Bell in the new KFC/Taco Bell gains, the franchisor gains nothing and the stand-along Taco Bell loses, and then antagonizes, an existing franchisee with no net gain to anyone.

Multi-branding can be beneficial to both franchisors and franchisees. However, it involves a complex assortment of issues and concerns.

III. Multi-Unit Ownership

In the early years of the evolution of business format franchising as we know it today, the classic model was the sale of unit franchises to a single franchisee. It was rare for franchisees to own more than one unit and rarer still for a franchisor to grant to a single franchisee the right to open several franchised units, in a given territory, over a specified period of time. Today, multi-unit deals are fast eclipsing the sale of "ma and pa" single unit franchises as the expansion model of choice for a growing number of franchisors. Why?

From the franchisor's perspective, multi-unit franchising reduces the cost of marketing their franchises, assisting in the establishment of each unit, managing necessary system changes and head office operational support. Additionally, the franchisor gets a more sophisticated and resourceful franchisee and, arguably, a better quality of product and/or service for their customers. For multi-unit franchisees, they get a greater likely-hood of profitability, with the risks spread over a number of operating units and a greater margin of profit through the sharing of management costs and resources. These benefits, and more, have been proven time and time again; even to the point that there are lots of examples of super successful multi-unit franchisees who have gone public or been the purchase target of private equity funds.

Implementation

Without a doubt, for franchisors, growing the system through a multi-unit franchisee structure is very different than through unit franchise sales. A prospective multi-unit franchisee is most likely better financed, more sophisticated and more demanding in their purchase decisions than a unit franchisee. So, the franchise sales cycle will likely be longer and could be more costly per **deal** than the sale of single units. Of course, the cost of opening **units** would be lower for the franchisor with a multi-unit franchise strategy.

There are a number of ways for someone to become a multi-unit franchisee. The most direct way is for the franchisor and the prospective franchisee to intentionally negotiate a multi-unit franchise agreement providing for many things, including the number of units to be opened, the territory in which the units will be opened, and the timeframe in which they will be opened. Additionally, such an agreement will set out how much the initial franchise fee will be for the development rights and for each unit, which may differ from a single unit agreement. This is so, because the franchisor will not have to train the multi-unit franchisee for each unit opening and other initial costs incurred by the franchisor may be lower for such things as the selection and securing of sites.

Alternatively, a franchisor may have a policy of allowing franchisees to acquire more than one unit over time. This could be done through the sale by the franchisor of new units to an existing franchisee or by an existing franchisee buying existing units from other franchisees in the system. Sometimes, franchisors (often new franchisors eager to grow) will grant rights of first refusal for additional units to close a deal. This is very tempting for the neophyte franchisor and is looked at as a low cost concession. However, the characteristics of a good multi-unit franchisee may not be evident at the beginning of the franchisor/franchisee relationship and the franchisee's ability to acquire more units will be based solely upon the desire of someone else to join the franchise system. This in not the best way to implement a multi-unit franchise strategy.

The Multi-Unit Franchisee

As mentioned above, multi-unit franchisees differ from unit franchisees in many ways. A multi-unit franchisee has to be able to create and guide a strong management team at the unit level for several units, not just run a single unit. A multi-unit franchisee will need access to more capital than a unit franchisee. And a multi-unit franchisee will have to contend with system, market, legal, environmental, product offering and many other changes over a much greater territory and workforce than a unit franchisee. If a franchisor is embarking upon a deliberate multi-unit franchisee strategy, more units can be opened sooner and the cost of assisting with openings and ongoing support of units would likely be lower than with a single unit franchise program. However, the franchisor will have to choose candidates without knowing for certain how well they will function within the particular system. If the multi-unit strategy is to grant additional unit franchises to existing unit franchisees, then the pace of growth may be slower, but the quality of multi-unit franchisee may be better. The challenge, however, is that quality multi-unit franchisees may not have the patience to start as a single unit franchisee.

Not all unit franchisees, by a long shot, are capable of becoming competent multi-unit franchisees. So, depending upon the multi-unit strategy chosen by the franchisor, a system may have a variety of multi-unit and single unit franchisees. There is nothing inherently wrong with that, but the franchisor has to be able to support both classes of franchisees and allow for their different needs and abilities. Therein lies the challenge and the risks for any number of issues, i.e. changes to products and services, employee recruitment and retention, technology changes, marketing initiatives, etc.

Another consideration is how many units should one multi-unit franchisee be allowed to own. The easiest answer is to allow one multi-unit franchisee to own as many units as they can run profitably. But that may be too facile an answer. Some other considerations are the risk in dealing with a far to powerful and influential franchisee when problems arise, will the multi-unit franchisee maximize sales (from which most franchisors earn their core revenue) and not just maximize profits and, if the multi-unit franchisee runs into financial or other difficulties, will the impact on the system be too great.

IV. <u>The Agreement</u>

Agreements that provide for one franchisee owning a number of units are often referred to as Area Development or Territorial Agreements. The agreements that support such arrangements need to be carefully constructed. The following are some of the key provisions and considerations in drafting or reviewing/negotiating such agreements. It should be kept in mind that, if the franchisee is being allowed to acquire additional units simply on an *ad hoc* basis, consideration should be given to documenting some of the party's understandings and arrangements found in a traditional multi-unit agreement.

The Parties

It is most common for the multi-unit franchise agreement to provide that a separate unit franchise agreement will be executed for each unit franchise. Should the multi-unit franchisee be allowed/required to hold unit franchise agreements all in one corporation or in a number of related corporations? For the franchisee, having a separate corporation hold each unit franchise agreement protects the successful units from the failure of any other units. For the franchisor, it probably does not matter, as long as there are cross guarantee and cross default provisions, in favor of the franchisor, among the various unit franchise agreements.

The Territory

Most multi-unit franchise agreements provide that the rights are granted, often on an exclusive basis, for a specific territory. Multi-unit franchisees frequently attempt to negotiate the broadest possible territorial rights, which is understandable. However, one of the most common mistakes made by franchisors is to grant exclusive rights to territories which are far too large, with the consequences that the territory remains underdeveloped and/or the franchisor realizes much less from the territory than would have been the case had the one large territory been broken up into smaller territories. Sometimes this occurs because of the lack of knowledge, on the part of the franchisor, of the potential of the system in the territory and sometimes it occurs because the franchisor feels it would be easier and more cost effective to deal with just one multi-unit franchisee in a larger area. While there is some validity to these latter considerations, the franchisor will most often have a stronger, and arguably a more profitable system ultimately, if territories can be kept as small as possible.

By having more multi-unit franchisees, rather than less in a particular region, the franchisor has some manoeuvring room, if a multi-unit franchisee fails or fails to perform adequately. One of the other multi-unit franchisees in the region can, either temporarily or permanently, move in to fill a void left by the failed multi-unit franchisee. It is also less likely that a particular multi-unit franchisee, "bites off more than he/she can chew". The franchisor is also able to exert more control or influence over the performance and conduct of a number of less powerful multi-unit franchisees than would be the case with one very powerful multi-unit franchisee.

The Term

Similarly, it is a common mistake on the part of franchisors to grant terms that are too long. With a shorter initial term and more frequent and shorter renewal terms, the franchisor can more easily control the actions of the multi-unit franchisee and the quality of development in the territory. At the very least, there should be very clear performance criteria and thresholds which the multi-unit franchisee must meet for a variety of things, including the right to renew, the maintenance of exclusivity, the extent of the territorial rights, and the degree of independence of the multi-unit franchisee in directing the system in the territory.

Initial Franchise Fee

One of the most difficult numbers to ascertain in all of franchising is the amount that should be charged for the front-end franchise fee or territorial rights fee for the grant of multi-unit franchise rights or other rights. This number will be influenced by many factors, including the length of the term of the grant, the history of success of the franchise system, the amount of training and initial support to be provided by the franchisor and the level of additional investment required of the multi-unit franchisee. From the franchisor's point of view, the most common mistake made in this area is to set the fee too low. One way to alleviate this problem is to set a minimum amount and calculate the final fee based upon the performance of the master franchisee, either by number of units opened or percentage of sales or some other basis that increases the front-end fee as the system is expanded within the territory. On the other hand, multi-unit franchisees often pay too much for such fees upfront, which can drain the master franchisee of much needed capital during the critical early stages of development of the territory. For the multi-unit franchisee, the best approach is to fix the amount of the front-fee, but have its payment dependent upon the number of franchises opened over an extended period of time.

Selection of Locations

Two of the principal motivations for the franchisor choosing to expand through multi-unit franchising is to benefit from the Multi-unit franchisees local knowledge and to pass on to the multi-unit franchisee the responsibility for finding quality locations within that market. However, it is a common mistake for the franchisor to abdicate the responsibility for final approval of locations, before the multi-unit franchisee has proven itself capable in this crucial areas. The end result being that, if the multi-unit franchise arrangements fail, which happens most often in the early stages of the relationship, the franchisor may be saddled with inadequate or second rate locations. It is advisable then, that the franchisor contractually retain the right of final approval for location selection, and exercise it in the early years, even if this right is later passed on to the multi-unit franchisee.

The Development Schedule

Establishing a fair and achievable unit development schedule is often, at the same time, difficult and critically important. Agreeing to realistic targets and timelines avoids having to deal with the failure of an otherwise capable multi-unit franchisee or the need to renegotiate the arrangements to accommodate a revised schedule.

The parties may want to specify stages of development, including for the opening of an initial unit and subsequent units. The development schedule often sets out a specific number of franchised units the multi-unit franchisee must open and may include the number of units that must remain in operation at any point in time.

The agreement should also address what will happen if the multi-unit franchisee's obligations and targets are not met. While the development schedule is crucial to ensuring the franchisor's business plan and standards are adhered to, flexibility is necessary in order to be able to cope with the inevitable contingencies inherent in a complex and expanding franchise system. At a minimum, the franchisor will want to include the right to extend time limits in order to avoid terminating an agreement over reasonable delays. Beyond timing, the parties will also want flexibility in terms of location, size and other characteristics of each unit to enable the franchisee to adjust the business plan based on local tastes and preferences that the franchisor may not have knowledge of or experience with. When drafting these provisions, the parties may agree to include a right of the franchisor to reduce the exclusive territory of the multi-unit franchisee if the development schedule is not achieved, rather than terminating the entire agreement for a breach of the schedule. A variation on this is a provision that allows the franchisor to simply terminate the franchisee's further rights of development under the agreement. The remainder of the territory could then be available to the franchisor to grant to another franchisee, or develop itself.

Suppliers

A supply network is frequently integral to a successful franchise system. Larger multi-unit franchisees may have the resources to establish their own supply network within their territory and may need to negotiate the right to purchase from local suppliers in order to manage costs efficiently. In some instances, this may require negotiating modifications to the system standards to accommodate local supply (such as serving Canadian steaks rather than USDA prime, or using local building materials rather than importing southern yellow pine). Nonetheless, the franchisor will very likely want control with respect to goods and materials sold or consumed in its franchises. This may be as strict as providing for authorized suppliers, or may rather entail relying on standards and specifications that must be met by the vendors and service providers used by the franchisee. While franchisees may push back against restrictions on their ability to seek out supply agreements that are economically and practically favourable to their operation, productive negotiation should include a discussion of the pricing options of authorized suppliers or standards. Control over the supply chain will also impact entitlement to collect rebates from suppliers. Additionally, potential supply chain challenges, such as the accessibility of specified materials in the given territory, should be considered at the outset, before concluding the multi-unit franchise agreement.

Default and Termination

Terminating a franchisee for default is always fraught with disappoint and challenges, but there are additional complexities and issues when the franchisee is a multi-unit franchisee. For example:

- Will the multi-unit agreement itself be terminated?
- Will all of the signed unit agreements be terminated?
- Will the franchisor have an option to purchase operating units?
- If the franchisee is keeping some operating units, will the franchisee be allowed to modify its obligations that were based upon a certain number of operating units, i.e. royalty rates, inventory and supply sources and pricing, number and length of renewal terms, etc.?

These and many other issues need to be considered by the parties and addressed in the multi-unit franchise agreement, with appropriate adjustments in the pro-forma unit franchise agreement, before a deal is concluded.

V. Strategic Growth

When exploring growth of any franchise business, one of the options that inevitably comes up is private equity or venture capital as a fundraising option. As with any financing source, there are pros and cons to utilizing any sort of financing, especially when selling equity is involved or the prospect of losing full autonomy. Over the last ten years, private equity firms have increasingly been attracted to the multi-unit franchise space due to perceived stability of revenues within large brands and their scalability. Private equity investors are drawn to industries that are fragmented with many businesses that lack relatively sophisticated tools and management teams. This fragmentation allows private equity investors to employ tried and true tactics to increase efficiency across a large base of locations where there once may have been none, or at least, less efficient versions of the tactics employed by the investors. This tactical arbitrage combined with the ability to scale quickly via acquisitions of proven operating businesses with history draws in these private equity investors with the potential for high returns.

When contemplating a private equity or venture capital, it's important for a multi-unit franchisee to consider:

- What are my goals for growth and total unit counts prior to exit? Investors will be focused on driving growth and operational efficiency. This means a focus on rapidly growing unit count through acquisition and new development. Private equity firms will focus on ensuring operations are efficiently run with limited excess spend – this can mean a tightening of spending for founder run businesses. It is also worth considering the experience and connections private equity investors bring to the table. For most, it is not their first rodeo. Private equity investors in the franchise space typically have experience spanning multiple brands and a vast network of professionals known to them. This experience and network can be invaluable to an entrepreneur at many cross roads, especially when rapidly growing unit count.

- When is a full or large exit contemplated? Private equity and venture capital firms generally have set investment horizons before they expect to sell equity. Here it is important to know the actual time horizon of the investment group you go with. Not all private equity firms are created equal. Some private equity investors will have a non-negotiable 5-year target horizon due to the structure of the vehicles they raise capital through. While others could have no such limitation and, in effect, an indefinite time horizon. Knowing this detail ahead of time is necessary, especially if you prefer to stay fully or partially involved with the business.

- What business restrictions will you tolerate? Private equity and venture capital firms will place tight restrictions on a business, including but not limited to having a say over capital investments, related party transactions, executive salaries, strategy, and exits and future financings. This goes back to the decision to give up full autonomy. How much autonomy are you willing to give up? How much will your business gain through added standards or professionalism? It is important that both parties fully understand the implications of the authority you provide to an investment group before choosing to go with one or the other. Understanding this will make life easier down the road and cultivate a better relationship with your company and the investor.

- What do I want my role to be? Some entrepreneurs would prefer to take a step back from the business while also maintaining significant ownership, in other words, hit the golf course. Others may wish to simply take an equity investment and tell investors to bugger off. It is important that you investigate the private equity group in detail to study how they have invested in the past and how they may behave moving forward. This is to ensure they match your lifestyle and business goals, and to minimize friction moving forward. Good places to start would be to reference check with past entrepreneurs, ask for introductions to present and past operating teams of the investor, read press releases of past investments and look at their tangible results. Most importantly discuss your honest goals with the investor and gauge for yourself if they are a good match.

From a franchisor perspective, it is important for to consider:

- Does the private equity or venture capital firm investing in the multi-unit franchisee share the same vision of the franchisor? For investment firms experienced in the space, looking at a track record with other brands is an indicator of how they will operate within the system. Some firms are comfortable following the system entirely, while others are more activist in nature pushing the franchisor for changes to the system. Franchisors should ensure the multi-unit investor will meet and exceed their obligations as a franchisee and promote the direction of the franchisor. Large franchisees can be a problem in the wrong context or an enormous boon in the correct.

- Is there a financial benefit to having a well-capitalized private equity group in the system? Many multi-unit private equity groups have established relationships at the major banks through multi-year relationships. These relationships can incentivize a bank or series of banks, which typically wouldn't lend within the given franchise system, to underwrite loans within the franchise. That is, in some cases, a franchisor and its existing franchisees can benefit from the reputation of a private equity group through increasing the pool of lenders willing to lend to the system. Benefits here are not limited to better interest rates, longer loan periods, looser covenants and greater access to general financing. In addition, having a private equity group purchasing franchisees within a system provides an active market for franchisees wishing to sell and pushes the value of owning a franchise within the system higher. As seen in many brands recently, having multiple private equity buyers in a brand can noticeably increase the resale value of a franchise location. How large do you want the private equity backed multi-unit franchise to become in your system? At a certain scale, a multi-unit franchisee may become overly influential within a franchise system. It's important to understand the goals of a private equity back franchisee to ensure alignment around potential size of the franchisee. As mentioned earlier, large franchisees can be a problem in the wrong context or an enormous boon in the correct. If you were to have a misaligned activist franchisee, who was also your largest or 2nd largest franchisee, problems could follow. Conversely a well-capitalized large franchisee backed by a private equity group could be pivotal to the growth of a brand and a boon to the development pipeline. It is important to understand the private equity group before signing on the dotted line.

A Single Brand or Many Brands

One decision for operators is if to take on one or multiple brands. For operators, this is driven by a desire to diversify their holdings to multiple brands or due to lack of opportunity within their existing geographic footprint. For instance, in many instances a brand may be fully developed in their market and bringing a new brand to the portfolio allows the core team to continue to grow within their existing footprint. This move could also be motivated by economies of scale. It is possible an operator could spread their existing team across multiple brands, leveraging their existing infrastructure and best practices under one umbrella.

Investment firms have differing attitudes on this, but up until recently (the last couple of years), private equity firms preferred to invest in single brand platforms with the goal of either acquiring additional locations in different markets or developing new locations within that brand. However, in recent years, private equity firms have determined that it is possible to leverage existing management and operational teams to take on additional brands within their footprint.

A single brand multi-unit franchisee provides the following positives:

- Deep knowledge of a specific system and all resources / attention focused on that brand
- Ability to scale across multiple geographies over time
- Limited overhead needed as additional locations are developed / acquired

A multiple brand multi-unit franchisee provides the following positives:

- Ability to utilize expertise of the management team across multiple brands
- Shared corporate overhead can increase profitability within a system
- Offers employees more growth opportunities across brands
- Can allow entity to keep growing within a geography when one brand is saturated in a specific market
- Allows the franchisee to leverage knowledge gained in one brand to the others

Positives of a Private Equity Partner

Private equity brings a disciplined focus to multi-unit franchisee entities, which can have many positives for a system. Founder led multi-unit franchisees may have a variety of goals, such as ensuring generational transition, maintaining a certain founder lifestyle at the expense of growth, or less disciplined operations. In other words, founder led franchisees personal goals can, at times, be at odds with what is best for the brand. Private equity led multi-unit franchisees are laser focused on driving returns for their investors. This motivation is shared by all private equity investors as they are compensated based on returns provided to their investors. This leads them towards running efficient stores, investing in the business when it drives a strong return, and focusing on growing the unit count of a brand.

In addition, private equity firms bring resources and expertise that includes more sophisticated tracking of metrics, operating partners with deep industry experience, and knowledge of best practices from across brands. Professionalism is a strong attribute private equity investor bring to the table. Private equity investors also force accountability from operators within a system, which usually comes in the form of ensuring strong cash flow is generated by the multi-unit franchisee. Further, as mentioned earlier, private equity firms can also bring a formidable reputation and network with them. These are investors who have an extensive career working across brands within the franchise world in all aspects of their business. This reputation and network can positively manifest itself in the form of experienced operators, experience brand professionals (marketing firms, suppliers, PR firms, etc.) and media coverage.

Private equity firms have multi-year relationships with lenders that are comfortable working with them. These lenders generally do not require personal guarantees as private equity firms are not set up to provide such guarantees. This can benefit operators not only from new banking relationship but also by potentially loosening restrictions set by lenders (such as personal guarantees). In addition, private equity firms are also able to drive some of the best borrowing terms given they borrow frequently and know best terms. This can benefit the entire system. However, it is worth noting that private equity firms typically use leverage when purchasing / investing in a multi-unit entity, meaning that the multi-unit franchisee will have leverage from the start which requires the entity to use cash flow to pay down debt.

Risks for Multi-Unit Franchisees

There are several risks when private equity firms invest in a multi-unit franchise group. Typically, firms are reliant on using debt when purchasing or growing these multi-unit platforms. When using debt, franchisees are restricted with covenants under the bank that can restrict use of capital and ability for the franchise company to pay dividends or remodel and otherwise improve locations. In addition, in a soft economic environment that includes declining sales, the franchise company can end up in a situation where it cannot pay its debt responsibilities and end up declaring bankruptcy. Leverage undoubtedly increases risk. However, this is less of a concern if existing single franchises already use a comparable amount of leverage overall. In a declining economic environment, a larger base of locations may be better able to bear lack luster results than single franchisees.

Private equity and venture firms invest to drive growth or improve operations, meaning that any multi-unit franchise that receives investment will see changes in how the business is run. Considering the points made here will undoubtedly help in the decision-making process and in negotiations with this type of franchisee.

VI. Conclusion

Notwithstanding the many challenges and issues, it would seem that multi-unit and multi-brand franchisees have set a new standard for franchisors. Franchisors have discovered that there is a growing appetite among prospective franchisees for such arrangements and that, if handled well, the franchise system can grow faster and be more profitable than a single unit growth strategy. And franchisees have discovered that their bottom line can be greater and their chances of success are improved by operating multiple units or across multiple brands or both. Private equity and lending institutions are riding this wave as well, as they end up with a more sophisticated borrow/partner and much reduced risk.

Having said all of this, from all perspectives, multi-unit and multi-brand franchising requires a higher degree of planning, more problem solving mechanisms and a greater attention to details than is the case with traditional unit franchising. For those who are up for the challenges, the rewards can be considerable.

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Tom Wells is a Managing Partner and Co-Founder of 10 Point Capital, an Atlanta based private equity firm focused on investing in franchise and multi-unit branded concepts. Tom brings over 10 years of private equity experience investing in a variety of industries and branded businesses. He firmly believes that building a strong brand that resonates with customers is critical to the long-term success of a company. Tom currently serves on the Board of Directors for franchise brands: Phenix Salon Suites, Tropical Smoothie Café and Tin Drum Asian Kitchen. In addition, he supports the franchise investments of BIP Capital. Previously, Tom was part of the investment team at Century Park Capital Partners, a Los Angeles based private equity group focused on the lower middle market. Additionally, he previously worked in the San Francisco office of Harris Williams & Co, a leading middle market investment bank. Tom received an undergraduate degree from Boston College and MBA from the University of Chicago Booth School of Business.

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Harris is a member of the International Franchise Association ("IFA") and has been a speaker on various occasions, along with a turn on the International Franchise Association's Legal Symposium Task Force. He has also served on the American Bar Association Forum on Franchising ("Forum") Governing Committee and served as its Finance Officer. He has also served on the Forum's Publications Committee, was chair of its Litigation and Alternative Dispute Resolution ("LADR") Division and served on the Forum's Nominating Committee for the Board of Governors of the Forum. He is a frequent author for the Forum and elsewhere. He serves as Chair of the Philadelphia Franchise Law Committee, Co-Chair of the Montgomery County Franchise Law Committee and is a frequent speaker and an active member of the New Jersey Bar Association's Franchise Law Committee, among others.

He also serves as an officer and board member of the Temple University Alumni Association and on the Board of Directors of the Temple University Owl Club (Athletic Department), among other civic associations. He enjoys spending time with his family traveling and skiing.

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