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PRIVATE EQUITY CONSOLIDATORS: ARE PE-BACKED FRANCHISEE CONDOLIDATORS CHANGING FRANCHISING?

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I. Introduction

Private equity firms and other institutional investors, like venture capital firms and family offices, have been investing in U.S. companies, including franchisors, for decades. However, some of them have relatively recently begun focusing on franchisees, particularly as franchisee organizations have gotten larger and diversified into multiple concepts. The explosive growth of franchising across industries over the past 20 years has meant that an increasing number of franchisees are now large enough to meet the investment criteria of many smaller, and now even some of the larger and more well-established, private equity firms. This paper provides an overview of the issues that franchisors, franchisees and private equity firms face when private equity and other institutional investors seek to invest in large franchisee organizations.

A. What is "Private Equity"?

Private equity funds are typically limited partnerships managed by a private equity firm that raise capital from institutional investors and high net worth individuals to invest in multiple portfolio companies. Private equity funds look for opportunities to leverage their capital and business expertise to increase the enterprise value of portfolio companies and then profitably exit their investments prior to the expiration of the life of the fund (which is usually 10 years). As such, private equity funds generally make large, relatively short-term investments to take a controlling position in companies that have achieved stable cash flows, often using significant amounts of debt. The management teams of the portfolio companies often remain in place and retain a small equity interest in the business.[1]

B. Paper Framework – Perspectives of the Franchisor and Franchisee/PE Investor

Although the parties need to resolve the same issues in any transaction involving private equity investment in franchisees, they of course can have very different interests and viewpoints when it comes to addressing these issues. This paper analyzes these issues from all perspectives – franchisor, franchisee, and private equity/institutional investor. As with all negotiations, there is no one universal "correct" approach. Each franchisor has a different level of encouragement or tolerance for large institutional investors owning their franchisees. Each franchisee has a unique organizational structure and ownership with their own goals. And each private equity firm has its own investment strategy and risk management approach. This paper attempts to explain many of the varying viewpoints that each stakeholder will have when approaching these issues. Hopefully these explanations will provide insight and ideas for the parties to bridge the

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[1] For a more detailed discussion, see Francesca Turrito, Luciana Bassani, Dominic Hui, David W. Koch and Sajai Singh, *A Marriage Made in Heaven? Private Equity and International Franchising*, International Journal of Franchising Law Vol. 31 Issue 1, 12 (2015) and Joel R. Buckberg, Peter D. Holt and Stephen D. Aronson, *Private Equity Program*; International Franchise Ass'n 2011 Legal Symposium.

gaps and develop creative solutions in negotiating the agreements among the franchisor, the franchisee and the institutional investor.

II. Certain Benefits and Downsides to Private Equity Investment in Franchisees

The increasing size and sophistication of private equity funds and the continued focus of these investment vehicles on businesses within the franchise industry presents numerous opportunities and risks from both the franchisor and franchisee perspectives. The introduction of a sophisticated private equity group into a franchisor's system can, among other things, result in opportunities for the system, including potential unit growth/broader distribution, significant reinvestment in franchised units, benefits from economies of scale (e.g., with respect to franchised unit sourcing), and the implementation of best practices as a result of the private equity group's broader experience. However, private equity investment can also present complex challenges from both the franchisor and franchisee perspectives.

A. Franchisor Perspective

i. Private Equity Funds Can Inject Significant Capital into Franchise Systems and Their Introduction Can Serve as an Exit Path for Franchisees Without a Succession Plan

Private equity investment often brings new capital into franchise systems, which can be used for remodeling existing units, operational improvements, and investing in new development projects. In nearly all franchise systems – but especially in aging systems with a capital-challenged franchisee base – this influx of capital could be crucial for maintaining and enhancing the quality of services and facilities, thereby attracting more customers and increasing revenue.[2] For example, private equity firms often invest in upgrading the physical appearance of franchised locations while simultaneously working to implement new technologies and improve operational efficiencies. These investments and enhancements can lead to increased customer satisfaction and loyalty, boosting the franchisees' profitability.

Additionally, private equity investment can provide an exit strategy for long-standing franchisees who lack a clear succession plan. A partnership with a well-capitalized private equity group that is eager to join a franchise system allows franchisors to ensure continuity and stability within their network by transitioning ownership to financially capable entities.

The legal framework governing these more sophisticated franchise transactions often involves detailed agreements to protect the interests of both franchisors and the private equity franchisees, including specific provisions that address required capital and financial requirements. Moreover, such detailed agreements are generally aimed, from the franchisor's perspective, at ensuring that the private equity capital is used effectively

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[2] John Sotos and Jason Brisebois, "The Impact of Private Equity on the Franchising Industry", online: < The-Impact-Of-Private-Equity-On-The-Franchising-Industry.pdf>.

and that the transition process is smooth. The details regarding these complex agreements are discussed in detail below, but they typically include provisions related to the use of funds (including required investments into operating units), performance metrics, and compliance with franchise system standards.

ii. Private Equity Funds Typically Have Shorter Investment Horizons, Tend to Buy Existing Units and Not Develop New Ones, and May Cut Costs to Boost Short Term Profits

Private equity funds typically have a relatively short investment horizon, with a potential focus on maximizing short-term profits rather than long-term growth and sustainability. For example, although it varies by individual private equity fund, the average investment holding period for most private equity investments is six years, and the typical fund life is approximately ten years.[3] This often leads to a focus on the acquisition of existing portfolios of units rather than the development of new operating units.[4]

To achieve returns more quickly and service debt, some private equity funds may implement cost-cutting measures and seek to increase efficiencies wherever possible[5], even if such actions negatively impact the quality of service and brand reputation. Such efficiency measures might include reducing staff, attempting to reduce marketing expenses, or limiting investments in training and development. For instance, to obtain efficiencies, a private equity firm might elect to reduce the number of employees per franchised location to lower operational costs, which has the potential to negatively impact customer service satisfaction and product quality.

The potential legal implications of such actions can be significant, as franchise agreements almost universally include requirements that franchisees to maintain certain standards and operational practices. A failure to adhere to critical brand standards can lead to disputes and potential legal challenges. Given the incentives for all franchisees (and especially private equity franchisees that have shorter investment time horizons) to potentially cut costs to boost short-term profits, franchisors must carefully monitor private

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[3] Alicia Miller, "Why Most Franchises Might Not Attract Private Equity Investments", *Forbes* (April 4, 2024), online: < https://www.forbes.com/councils/forbesbusinesscouncil/2024/04/04/why-most-franchises-might-not-attract-private-equity-investment/>.

[4] However, note that some private equity firms do take a more growth-oriented mindset, especially when it comes to developing additional operating units or even acquiring complementary businesses. With a strong private equity partner, this can particularly be a benefit to multi-brand franchisors when such private equity partner desires to invest in multiple franchisor brands. Moreover, some private equity franchisees may choose to utilize "tuck-in acquisitions" in complementary business, which may also improve economies of scale. See Alicia Miller, "How Private Equity Operates in the Franchising Sector", *Global Franchise* (July 23, 2024), online: < https://www.global-franchise.com/insight/how-private-equity-operates-in-the-franchising-sector>.

[5] Sotos and Brisebois, *supra* Note 1, at 9.

equity-backed franchisees to ensure compliance with franchise agreements and brand standards in order to maintain brand integrity.

iii. Private Equity Funds Can Be Consolidators of Fragmented Markets

While there are potential negative impacts to the franchisor's brand that can result from too much of a focus on efficiency or cost-cutting, private equity firms can, however, act as consolidators in fragmented markets, helping to streamline operations and create more efficient business models. By acquiring multiple franchised units within a market (especially multiple units owned by smaller franchisees and acquiring struggling competitor locations), private equity funds can leverage economies of scale, reduce operational redundancies, unlock additional development opportunities and enhance market presence. This consolidation can lead to increased bargaining power with suppliers and improved competitive positioning. For example, to the extent permitted within the applicable franchise system, a private equity firm might negotiate bulk purchasing agreements with suppliers, reducing costs for all franchised units under its control (or potentially even those not under its control).

However, the legal complexities of such consolidations are considerable, involving negotiations on trademark rights, franchise agreements, and regulatory compliance. Ensuring that all legal aspects are addressed is crucial for the success of consolidation efforts. Franchisors must work closely with legal advisors to navigate these complexities and protect their interests.

iv. Private Equity Funds Can Have Riskier (More Highly-Leveraged) Financial Structures

To obtain projected returns for investors, it is not uncommon for private equity funds to employ highly leveraged financial structures in connection with their investments, thereby increasing financial risk. These structures typically include significant amounts of debt, which can strain the financial stability of the franchised units involved. Of course, these types of highly-leveraged financial structure can directly impact the underlying franchised units; however, depending on the size of the private equity fund's portfolio in relation to the overall franchise system, such leverage can also present systemic risks for the franchisor as well.

From the franchisor's perspective, the legal responsibilities and risks associated with these financial arrangements are complex and therefore require diligent and thoughtful oversight. While the private equity franchisee must exercise careful management of debt obligations and adherence to financial covenants, including bank covenants, the considerations for the franchisor are different.

To protect the health of the operating units and the overall franchise system, franchisors will often seek to impose leverage restrictions applicable to the franchised unit portfolio as well as regular, detailed financial reporting from the private equity franchisee. This allows the franchisor to monitor important financial health information in real time.

Such reporting and monitoring mechanisms are designed to give the franchisor advance notice before a private equity-backed franchisee faces challenges in meeting debt repayment schedules which can lead to distressed franchisee scenario, that franchisors, of course, want to avoid.

As noted above, the franchise agreements (and/or more complex framework or similar agreements governing the overall relationship between the franchisor and the private-equity fund) may include provisions that address the financial health of franchisees. Further, while the failure to meet these financial requirements can lead to legal disputes and/or potential termination of the franchise agreements, the goal is to maintain a healthy and growing franchise system. Therefore, franchisors must ensure that private equity-backed franchisees have robust financial management practices in place to mitigate the risks associated with their particular financial structure.

v. Private Equity Funds May Have Less Loyalty to the Brand/Model and May be Less Willing to Support System Changes Absent Short-Term Return on Investment

Private equity funds are often under pressure to deliver near-term financial returns to their investors.[6] Therefore, from a franchisor's perspective such franchisees may exhibit less loyalty to the brand and be less willing to support system-wide changes. This may hinder the franchisor's ability to implement necessary and/or desirable updates and improvements to the franchise system that are designed to drive growth, increase sales, or modernize the system. For example, a private equity franchisee might resist investing in new marketing campaigns, technology upgrades, or new product/service introductions that do not promise immediate financial returns.

Disputes can arise when franchisors and franchisees disagree regarding what is "required" under the terms of the franchise agreement and/or brand standards. Disputes between a franchisor and a private equity-backed franchisee may be particularly costly for various reasons, including the potential size of the franchised portfolio, the ability of a well-capitalized franchisee to continue to resist changes mandated by the franchisor, and the costs associated with distractions arising from disputes over compliance with franchise agreements.

One important way to mitigate such risks is for franchisor and its counsel to confirm, before entering into such relationships, that the franchise agreements (and other applicable ancillary agreements) include unambiguous provisions permitting the franchisor to impose system changes and updates. Further, regular and open communication with the franchise system (and especially private equity-backed franchisees) regarding the benefits of system changes is also critical.

[6] Sotos and Brisebois, *supra* Note 1, at 7.

vi. Private Equity Franchisees Can Become Too Concentrated, Creating Additional Risk and Challenging Negotiating Dynamics Between Franchisee and Franchisor

Large private equity-backed franchisees can create concentration risk to a franchise system (i.e., if a significant portion of the franchise network is controlled by a single entity). This situation can lead to challenging negotiating dynamics between the franchisee and franchisor, as the well-capitalized private equity-backed franchisee will naturally utilize its increased bargaining power to seek concessions from franchisor. For example, a large private equity-backed franchisee might demand more favorable terms in franchise agreements, additional development or other incentives, or simply resist compliance (or attempt to limit the requirements that it comply) with franchisor policies or changes in brand standards.

The legal risks associated with such concentration include potential breaches of franchise agreements, disputes over territorial rights, and challenges to changes in brand standards. Addressing these risks requires careful drafting of franchise agreements and related agreements and proactive management of franchise relationships.

B. Franchisee Perspective

i. Existing Franchisees Looking for PE Investment

Successful franchisees, often formed initially as family businesses or closely-held companies, can reach a certain scale and find that they need assistance to take their business to the next level of growth. This assistance could be, for example, additional capital investment that is necessary to implement new brand initiatives, remodel existing locations, or add new locations, whether through acquisition or new development. It also could be operational assistance. When a franchisee organization grows to a significant number of employees, a different level of operational support is needed to address the myriad new finance, accounting, human resources and other issues that do not exist in most small businesses. Or perhaps the founder(s) of the franchisee organization are looking either for an exit or succession plan, or to monetize part of their investment. Private equity and other types of institutional investors can provide this assistance.

Private equity investors and other similar institutional investors do not manage the day-to-day operations of their investments, but instead often look for a strong management team to stay in place following the investment. So if the founders are looking for an investor who will allow them to remain in their leadership roles, a private equity investor can be a good choice. However, sometimes a private equity investor may have an existing investment with another franchisee in the same brand, or in a similar business, and may be looking to add the franchisee's business into its existing investment. In that case, the private equity investor may be less interested in retaining the founders and senior management.

Even if the franchisee's founders remain in their management roles, however, in most cases they will no longer be in control of the major decisions involving things like

annual budgets, financing, and capital investments. Private equity firms are usually laser-focused on increasing sales and EBITDA in order to meet their criteria for the internal rate of return and planned exit strategy. Existing franchisees looking for private equity investment should recognize that, in most cases, the private equity investor will be the one calling the shots on significant issues impacting the business.

ii. Private Equity Looking for Franchisee Investments

For private equity firms, franchisees can be an attractive investment. Many firms like the predictable returns and cash flows that result from investments in franchisees of larger franchise networks. Also, with the franchisor having developed and tested the franchise operating systems, a franchised business can require a relatively low level of operational oversight from the private equity investor.

However, private equity firms investing in franchisees also need to understand the inherent limitations on their control and autonomy that result from the franchise relationship. Sometimes a firm may have a "playbook" that it has used with other investments to increase cash flow and improve the business. This might involve, for example, shutting down underperforming locations, expanding into new product lines, and acquiring other businesses. These steps will almost certainly either require the franchisor's approval or be prohibited by the franchise agreement. Private equity firms need to understand the realities of the franchisor-franchisee relationship and the limitations that they place on the firm's ability to change the franchised business.

III. Are you Ready for Private Equity Investment?

Private equity firms investing in franchisees tend to be most interested in large, profitable, well-run franchise platforms in a successful franchise system or smaller, financially attractive add-on acquisitions.[7] Franchisees can prepare for private equity by building a financially successful business, assembling a strong, experienced management team willing to take direction from new leadership, identifying opportunities for continued growth and developing organization systems to accommodate a professional diligence process. From the franchisor's perspective, there should already be many profitable units and many profitable franchisees in the system, so that private equity is interested in investing and won't dominate the system when it enters. The system also shouldn't be fully mature, so that there is still plenty of room for unit and enterprise value growth. The franchisor should have an experienced management team

[7] Typically, private equity firms make an initial investment in a large, successful multi-unit franchisee within a successful franchised system and then make follow-on acquisitions of other (often smaller) franchisees in the system. Sean Craig, *All in the franchise: Why private equity loves the business model*, The Daily Upside (2025), https://www.thedailyupside.com/finance/ma/all-in-the-franchise-why-private-equity-loves-the-business-model/ (last visited Mar 31, 2025). The initial acquisition tends to be at a higher-earnings multiple, while follow-on acquisitions tend to trade a bit lower and have more relaxed criteria for a franchisee target. *How private equity operates in the franchising sector*, Global Franchise (2024), https://www.global-franchise.com/insight/how-private-equity-operates-in-the-franchising-sector#:~:text=Private%20equity%20firms%20also%20love,discussed%20extensively%20in%20the%20book. (last visited Mar 31, 2025).

and a robust set of contractual protections and policies in place with respect to franchisee acquisition, growth, financial stability and brand standards so that it can harness the benefits of private equity while curbing its risks.

A. Franchisee Perspective

i. Unit Economics

In order to obtain private equity funding, a franchisee must have strong unit economics.[8] As private equity firms tend to have relatively short investment horizons, the franchisee's units should already be profitable at the time of the investment. The franchisee may be able to get credit for the future profitability of recently-opened locations, especially if the franchisee and the system more broadly have a strong track record of locations becoming profitable after the initial ramp period. The private equity firm will also be looking at the unit economics of the system as whole.[9] Private equity firms tend to focus on franchise systems with strong unit level economics first and then look at the economics of franchisees in that system.[10] Profitable franchisees in generally unprofitable franchise systems may struggle to attract private equity investment.

ii. Management Platform

Franchisees should have a strong management platform that will continue to efficiently and effectively operate franchised locations after the private equity investment is made.[11] The management team should have deep institutional knowledge of the franchise system and strong relationships with the franchisor.[12] The private equity firm is generally not looking to get involved in the day-to-day operations of the franchised business or bring in a new management team. If the private equity firm has to set up a new management team, it may affect the valuation of the transaction. The management platform should be robust enough to support the private equity firm's growth ambitions.

iii. Opportunities for Growth

Private equity firms are typically looking to grow their footprint within a system, sometimes through developing new units and sometimes through acquiring existing units from other franchisees. In a successful and growing system, newly-developed units can be sold for multiples of the cost to build them and acquired units can be purchased at lower multiples and then sold at higher multiples as a part of a large, integrated franchise

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[8] Greenwich Capital Group, *The Evolving Landscape of Private Equity Investments in Franchising*, at 3 (2024).
[9] *See How private equity operates*, supra note 2.
[10] *Id*.
[11] Francesca Turrito, Luciana Bassani, Dominic Hui, David W. Koch and Sajai Singh, *A Marriage Made in Heaven? Private Equity and International Franchising*, International Journal of Franchising Law Vol. 31 Issue 1, 12 (2015); *The Evolving Landscape* at 4.
[12] *The Evolving Landscape* at 4.

platform.[13] As such, contractual development rights to open additional units and a strong development pipeline are typically attractive to private equity firms. Some franchisees attempt to upsize their development rights from the franchisor right before they go to market for this reason. Development rights also protect franchisee from competition and encroachment within the system.[14] Private equity investors may be interested in pre-baked add-on acquisitions, strong relationships with potential sellers and being a large player in a fragmented market.

iv. Adequate Scale

Franchisees must be operating at sufficient scale to attract an initial private equity investment.[15] The minimum number of units will vary by system and by private equity firm, but most private equity firms are looking to be a significant player in the franchise system upon entry, deploy substantial capital with their initial investment, and to acquire a large enough platform to support future growth.[16] Once the private equity firm makes this initial investment, scale becomes much less important for follow-on acquisitions, as even single-unit franchisees may be attractive add-on targets if they have strong unit economics and are geographically contiguous.

v. Willingness to Cede Control

Many franchisees are led by independent entrepreneurs who have built successful businesses and have developed a great deal of experience and expertise in operating within a particular franchise system. Accepting private equity funds results in a loss of control, especially with respect to big picture decisions. Franchisees may be asked to change practices that have been effective for years, make personnel changes, or change their approach to operations and development by their new private equity sponsor. The franchisee should be ready to take strategic direction from their private equity sponsor and follow a new reporting structure.[17]

vi. Records in Order

Private equity firms are looking to conduct a professional diligence process in connection with an acquisition.[18] Before soliciting private equity investment, a franchisee should make sure that all of its financial records and legal documents are in order so that

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[13] Harris Chernow, Edward Levitt, and Tom Wells, *Have Multi-Unit and Multi-Brand Franchisees Set a New Standard for Franchisors?*, International Franchise Association 51st Annual Legal Symposium, at 12 (2018).
[14] *The Evolving Landscape* at 4.
[15] Helen Bond, *Partners in PE? Private equity, meet multi-unit franchisees!*, Mult-unit Franchisee Mag: Issue 2, (2022), https://www. franchising.com/articles/partners_in_pe_private_equity_meet_multiunit_franchisees.html
[16] *How private equity operates*, supra note 2.
[17] *How private equity operates*, supra note 2.
[18] *Id*.

it can promptly stand up a well-organized data room and put its best foot forward in the sale process.

B. Franchisor Perspective

i. Unit Economics

The franchise system must, as a whole, have strong unit economics.[19] Private equity firms are looking for a successful franchise system where most units are profitable and there are a number of successful franchisees that are attractive targets for investment.[20]

ii. System Growth

Private equity firms are most interested in growing systems, where there are rich opportunities to develop and acquire.[21] From the franchisor's perspective, there should be adequate headroom for private-equity-fueled expansion. If not, this growth can cannibalize the profitability of existing units, which can cause problems for both the private equity firm and the system more generally. Starbucks, for example, recently experienced a slowdown in growth due to this issue, which led to a number of store closures.[22]

iii. Sufficient Size and Maturity

The franchise system should be big enough that a private equity firm can make a significant investment without dominating the system. Having a single franchisee with an outsized voice can distort system policies and create uncomfortable dynamics between the franchisor and the franchisees.[23] Similarly, the brand should be sufficiently mature such that it is not being shaped by the requests of a private equity-backed franchisee operating on a relatively short time horizon.

iv. An Experienced Management Team

Franchisors will want an experienced management team who is comfortable working with a private equity partner.[24] The franchisor's management should be both

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[19] Mark Gartner, *Franchisors vs. Franchisees: Why Private Equity Likes Both,* ClearLight Partners (2020), https://www.clearlightpartners.com/franchisors-vs-franchisees-why-private-equity-likes-both/ (last visited Mar 31, 2025).
[20] Alicia Miller, *Why Most Franchises Might Not Attract Private Equity Investment*, Forbes (2024), https://www.forbes.com/councils/forbesbusinesscouncil/2024/04/04/why-most-franchises-might-not-attract-private-equity-investment/ (last visited Mar 31, 2025).
[21] *Id*.
[22] *The Evolving Landscape* at 6.
[23] See David Ramsey and Michelle Murray-Bertrand, *Issues in Growth by Multi-Unit Franchising*. Franchise Law Journal Vol. 38. No 3., 369, 372 (2019); See also Stuti Muraka, Stephanie Russ and Alexander Tuneski, *A Paradigm Shift in the Making: Transfers Involving Private Equity And Other Complex Arrangements and Circumstances*, Am. Bar Ass'n 43rd Ann. Forum on Franchising W–17 at 12 (2021).
[24] *How private equity operates*, supra note 2.

receptive to opportunities to evolving the system in partnership with a private equity partner (and its other franchisees) and drawing a firm line on potential changes or requests for one-off exceptions when necessary to protect the brand and the long-term health of the system.

v. Contractual Protections, Standards and Policies

The franchisor should have robust contractual protections, standards and policies in place concerning acquisitions, financial structure, development and brand standards before private equity enters the system.[25] This allows the franchisor to protect the long-term health of the system if the interests of the franchisor diverge from those of a private equity-backed franchisee.

A. Financial structure

Franchisors should have contractual protections and disclosed and consistently enforced written standards governing the financial qualifications of a prospective buyer. This puts the franchisor in a stronger legal and business position when riskier capital structures are proposed.[26] Under certain state franchise relationship laws and under many brands' form franchise agreements, franchisors have an obligation to the seller not to unreasonably deny a proposed transfer. Prospects also have limited rights under certain state anti-discrimination statutes. From a business perspective, it can be difficult to say "no" when a rich private equity firm comes knocking and a franchisee sees a huge payday ahead.

In its form franchise agreement and development agreement, the franchisor should consider going beyond a generic statement that a prospective buyer must be financially qualified and include references to specific financial concepts such as projected cash flows and obligations, liquidity, indebtedness as a ratio of EBITDA (leverage), and business fluctuations.[27] Some franchisors have imposed maximum contractual leverage limits.[28] Burger King, for example, lists debt in excess of a certain multiple of EBITDA as a specific event of default in its development agreement.[29] The franchisor should also ensure that it has contractual approval rights over refinancings.

The franchisor should share specific written financial standards regarding financial qualifications for acquisitions and refinancings with its franchisees. These specific standards can live in an operations manual or other document so that they can evolve over time. At a minimum, franchisees should be required to carefully model out their contractually-committed capital expenses, typical operational expenses and reasonably expected cash flows, account for some reasonable level of negative shocks and ensure that the numbers all work. If maximum leverage ratios (or at least guidelines) are not

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[25] Wiley Rein LLP, *Franchise-Related Considerations in Preparing Your Franchise Company for a Strategic Buyer*, at 2 (2019).
[26] *A Paradigm Shift*, 5-8.
[27] *A Paradigm Shift*, 21-22.
[28] *A Paradigm Shift* at 3.
[29] Burger King Company LLC, *Franchise Disclosure Document*, at 72 (2024).

specified in their contractual transfer provisions, franchisors can do so in these more flexible written standards.

While it may seem tempting to rely on lenders to set boundaries on how heavily a franchisee can borrow and to accept verbal indications from a private equity fund that they will just kick-in more equity if needed, franchisors are well-advised to set their own standards.[30] If the private equity-backed franchisee runs into financial difficulty, the franchisor will typically find itself in a workout situation, where it is pushed to make substantial concessions to prevent the franchisee's financial collapse and the private equity firm is not eager to invest additional capital in a struggling business.[31] Financial standards are also important when the private equity-backed franchisee is looking to exit. In a successful system, the free market can push deal multiples increasingly higher, which typically results in higher levels of leverage to fund escalating purchase prices.[32] At some point one or more of these increasingly unstable financial structures falters, resulting in an abrupt correction in the M&A market and damage to the franchise system.[33]

The franchisor should also consider adding a financial covenant into the development agreement that allows the franchisor to take action (or at least begin workout discussions) before a developer's financial issues result in missed development obligations and operational failures.[34] This covenant can be a specific leverage ratio, a liquidity test, a cross default with financial covenants in a franchisee's credit facility or another financial metric that is meaningful within the franchise system, but it should be well before the bankruptcy or insolvency.[35]

Financial criteria, especially restrictions on leverage, can affect exit value. As such, it can be particularly helpful to establish clear financial criteria before private equity enters the system. Otherwise, franchisors can expect vehement opposition to establishing these criteria from private equity firms in the system, as well as other existing franchisees cognizant of the deal multiples of prior private equity transactions in the system.

B. Franchisee Size

Franchisors should consider establishing limits on the maximum number of units or percentage of the system's units owned by a single franchisee. Private equity firms are looking to make a big initial investment and continue to grow.[36] If a single franchisee gets too large, that franchisee may create concentration risk, creating a potential "too big

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[30] *A Paradigm Shift*, 15-16.
[31] FTC ISSUE SPOTLIGHT, *Risks to Small Business Success in Franchising*, at 16 (2024).
[32] *How private equity operates*, supra note 2.
[33] *A Paradigm Shift* at 13.
[34] *A Paradigm Shift* at 21.
[35] *Id*.
[36] *How private equity operates*, supra note 2.

to fail" situation, and may exert disproportionate bargaining power in the system.[37] Very large franchisees may also have fewer qualified buyers when they are looking to exit.[38]

A few franchisors have explicit requirements in their franchise agreements with respect to maximum size. Little Caesars, for example, prohibits transfers to franchisees owning more than 100 restaurants in its form franchise agreement.[39] Growth limits can also live in more fluid operations manual-level policies. A key prerequisite to establishing such a policy, of course, is the franchisor's willingness to apply it consistently. Just like with establishing financial criteria, a franchisor has a smoother path to establishing size limits before private equity enters the system.

C. Development

Particularly towards the end of a private equity firm's investment in a franchise system, it may have a financial incentive to grow by acquisition rather than organic development, as it may have the ability to acquire units and flip them at a higher multiple in connection with the sale of a larger platform. At a minimum, franchisors should establish policies that provide that the franchisor may deny a transfer if the prospective buyer is an existing franchisee that is not in compliance with all of their current development obligations.[40]

The franchisor should also consider its position more generally on consolidation and flipping, even if it doesn't have a negative effect on the buyer's development elsewhere. In some cases, consolidation can be quite helpful for a system, by unlocking additional development opportunities and taking underperforming operators out of the system. In other cases, it can just saddle the eventual owner of these units (the buyer of the private equity-backed platform) with additional debt.

Relatedly, private equity-backed franchisees may have an incentive to acquire additional development rights (either from the franchisor or another franchisee) and flip, rather than develop, them. This can be a problem if the private equity-backed franchisee doesn't invest in building a development pipeline for these units and the franchisor ultimately has to reset (and delay) the development schedules upon a transfer. A franchisor may consider adding an "anti-flipping" restriction to its development agreement. Planet Fitness, for example, prohibits the sale of development rights and any locations in the development area for the greater of two years from entering the system or one year from the addition of new units or the signing of a new area development agreement.[41]

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[37] *A Paradigm Shift* at 12.
[38] Dean Zuccarello, *When is Big Too Big?: Re-Evaluating Unlimited Multi-Unit Growth*, Franchising.com (2016), https://www.franchising.com/articles/when_is_big_too_big_reevaluating_unlimited_multiunit_growth.html (last visited Mar 31, 2025).
[39] Little Caesar Enterprises, Inc., *Franchise Disclosure Document*, 57-58 (2024).
[40] *Issues in Growth*, 366-67.
[41] Planet Fitness Franchising LLC, *Franchise Disclosure Document*, 54-56 (2024).

D. Brand Standards

The franchisor should have a process in place for uniformly enforcing brand standards. There can be an incentive for private equity firms to look for opportunities to cut costs, particularly towards the end of their investment horizon in a brand. As such, processes to ensure that franchisees are spending adequately on local marketing, completing their remodels up to brand standards and otherwise maintaining and operating their locations can help promote the long-term health of the brand.[42] Intermediate sanctions short of termination (including financial consequences and restrictions on acquisitions) are also important, so the franchisor has palatable options when faced with operational deficiencies.[43] Franchisors can also consider tying incremental development rights to specific operations and remodel metrics.[44]

vi. A Collaborative Approach to Optimizing the Model

The franchisor should have a structure in place to collaborate with its franchisees to optimize the franchise model. Private equity firms enter a system with a keen eye on unit economics.[45] They are likely to be quite interested in opportunities to reduce costs and boost short-term revenue.[46] An existing enterprise value optimization committee structure can channel these inclinations in a productive way and in collaboration with the franchisor and other franchisees. This also helps reduce one-off requests for special exceptions to brand standards and discourages the private equity-backed franchisee from charting its own course and cutting corners.

IV. Franchisor Negotiation Tactics

The involvement of private equity in franchised businesses brings a unique set of challenges and opportunities for both franchisors and franchisees. Negotiation tactics used by franchisors when dealing with private equity investors are critical in ensuring the stability and growth of the franchise system. From managing financial risks and legal responsibilities to addressing negotiation dynamics and necessary modifications to franchise agreements, franchisors must be vigilant and proactive. The following sections explore various negotiation approaches that franchisors can employ to navigate the challenges and opportunities brought about by private equity investment in franchisees.

A. The Need for Modifications to the Franchise Agreement Opens the Door for New Asks

The ownership and operational structures utilized by private equity investors typically necessitate a number of changes to the form of franchise agreement used by the franchisor. These modifications can create an opportunity for the private equity investor

[42] *Issues in Growth*, 370-371.
[43] See *A Paradigm Shift* at 12; See also *Issues in Growth* at 370.
[44] *Id*.
[45] *How private equity operates*, supra note 2.
[46] *Id*.

to request further franchisee-friendly changes to the franchise agreement, because the franchisor has a harder time making the usual argument that the franchise agreement is a "standard form" that cannot be significantly modified. This dynamic underscores the necessity for franchisors negotiate/retain terms that safeguard their interests while reasonably accommodating private equity investors.

B. Positions Depend on How Welcoming the Franchisor is to Private Equity investments

Franchisors may adjust their "going-out" positions depending on how welcoming they wish to be to private equity investment. However, the provisions of the franchise agreements related to transfer approval can significantly impact the franchisor's negotiating leverage. If the standard under the franchise agreement and/or an applicable state franchise relationship law is that the franchisor's consent may "not be unreasonably withheld", the threat of a claim based on a franchisor's failure to reasonably evaluate a private equity buyer can force the franchisor to be reasonable in its negotiations. If the franchisor has more discretion in rejecting proposed buyers, the franchisor is more free to take a harder line and impose stronger terms against private equity investors.

C. Non-Compete Provisions

In most franchise systems, non-competition provisions are a common tool used to protect the franchisor's interests by preventing current and former franchisees from starting competing businesses. Private equity investors, however, typically invest in many different industries and are very wary of any restrictions on their investments. At a minimum, private equity investors will demand to carve out any existing investments and activities and exclude limited partners from being covered by the restrictions.

The scope of the non-compete is often highly negotiated, as private equity investors will want to limit the restrictions to be as narrow as possible, both in terms of the types of business activities that are covered and the entities restricted. Franchisors will push for the non-compete to cover all funds owned or controlled by the private equity investor, plus all of the portfolio companies owned by those funds, while the private equity investors will fight to exclude affiliated funds and portfolio companies from the restrictions. This delicate balance requires careful consideration and negotiation to ensure both parties' interests are adequately protected.

D. Confidentiality Provisions

Confidentiality provisions are crucial in safeguarding sensitive information about the franchise system and often need to be updated to work with a private equity model. Because private equity investors often have large funds with many different portfolio companies, the risk of confidentiality breaches is heightened. Private equity owners are also often unwilling to personally sign the confidentiality agreements that franchisors often require of owners. Finally, because private equity executives often oversee multiple portfolio companies, the confidentiality obligations may need to be tailored to allow for such oversight.

E. Guarantees and Letters of Credit

Financial protections are a key concern for franchisors when dealing with private equity-backed franchisees, and these are often highly contentious and heavily negotiated. Private equity firm owners are unlikely to be willing to sign personal guarantees, the favored protection of franchisors. Corporate guarantees given by the fund are often the franchisor's second preference, but these are also fraught with issues for private equity investors because of the potential risk to other investments created by the guaranty. These risks are sometimes addressed by negotiating caps or sunsets on the guarantor's obligations.

In lieu of (or in addition to) guarantees, franchisors sometimes require letters of credit to be provided by the franchisee that can be drawn upon in the event of a default by the franchisee. Letters of credit can be challenging for private equity investors to agree to because of the capital cost incurred by franchisees to obtain and maintain a letter of credit (which ties up capital that could otherwise be used for growth or to improve the business).

F. Transfer Provisions

Transfer provisions are often one of the most difficult areas to negotiate with private equity investors. Private equity investors are typically hyper-focused on being able to exit their investments within a certain time frame, so the restrictions on the sale of their franchised units are often heavily negotiated, with a focus on the conditions that the franchisor can impose and the standard under which franchisor can approve the buyer. Ultimately, finding a balance that safeguards the franchisor's interests while allowing flexibility for private equity investors is essential for a successful partnership.

Private equity investors also often negotiate for flexibility to make minority transfers without the franchisor's approval. Restrictions on minority transfers are problematic for private equity firms that like to make transfers of stock to new executives, allow transfers between current investors, and bring in new limited partners. Provisions that require franchisor approval of heirs and representatives upon the death or disability of owners are also problematic for many private equity firms.

G. Development Obligations and Limitations on Acquisitions

Franchisors often try to leverage the capital available to private equity-backed franchisees by including specific requirements for development of new stores on an agreed schedule. Typically, these are paired with economic incentives and/or territorial exclusivity within a geographic area as long as the development schedule is complied with.

On the flip side, franchisors are often wary of the risk that private equity-backed franchisees will grow portfolios to a large scale through acquisitions of other franchised unit portfolios. Having franchisees with very large portfolios is often seen as a risk because of the threat that the whole portfolio could be lost if financial or other issues arise, such as when Pizza Hut's largest franchisee, constituting nearly 20% of its stores in the

United States, entered bankruptcy in 2021[47]. Franchisors may attempt to address the risk of franchisees acquiring large portfolios by placing conditions, limitations, or caps on the acquisition of additional franchised units.

H. Additional Operational Requirements

Distressed portfolios are often a target of private equity investment, so in those circumstances, private equity-backed franchised units may start out operationally challenged. Private equity investors in a franchise system may also be new to the particular industry. Therefore, it is common for franchisors to impose additional operational requirements on private equity-backed franchisees. These requirements can cover areas such as additional training, heightened quality assurance standards, required equity or profit interest grants to the managerial team, requirements to employ certain managerial and operational positions, and franchisor approval with respect to the replacement of key leaders.

I. Additional Financial Requirements

As mentioned above, the highly leveraged financial structures typically used by private equity investors create an increased financial risk for the franchisee. Franchisors often address this added risk by imposing additional financial requirements on private equity-backed franchisees. These additional requirements can include minimum capital investment, enhanced financial reporting obligations, restrictions on dividends, restrictions on leverage, restrictions on growth, required divestitures, and other unique conditions. The aim of these requirements to ensure that the franchisee has the financial resources to operate successfully, is not drained of capital or resources by the private equity investor, and that the franchisor is made aware of any financial issues early on.

V. Franchisee Negotiation Tactics

A. Overview

Most franchise agreements contain requirements that typical private equity and other institutional investors cannot, or will not, satisfy. Many of those provisions are described in this Section. For example, franchise agreements typically provide that any issuance or transfer of a direct or indirect ownership interest in the franchisee entity, whether in that entity directly or indirectly through a transfer of the ownership interests in an upstream parent company, is subject to the franchisor's approval. Taken literally, that would mean that the franchisor would have approval rights over every investment into the private equity fund itself and transfers of those investment interests. That would be an unworkable arrangement for the franchisee and unnecessary for the franchisor.

Because of these types of provisions, private equity and other institutional investors typically find themselves in the position of needing concessions from the franchisor in order to close the transaction. These concessions go beyond the simple

[47] Pizza Hut's largest U.S. franchisee files for Chapter 11 bankruptcy, CNBC (online), <https://www.cnbc.com/2020/07/01/pizza-huts-largest-us-franchisee-files-for-chapter-11-bankruptcy.html>

consent of the franchisor or other counterparty to a contract. The investor needs changes to the form franchise agreement that can impact what the franchisor may view as its critical protections. So the firm's first step is often to "sell" its investment to the franchisor.

For private equity and other institutional investors who are new to franchise investments, they must understand the different nature of the franchise relationship. Many of the strengths, positive attributes and "selling points" of a private equity firm's investment strategy may actually be viewed negatively by the franchisor who has approval rights over the investment. For example, in order to attract investments and be seen as a good "partner" with founders and other business owners, these firms often tout their success in previous investments in cutting costs, buying other similar or competing businesses as bolt-on acquisitions, improving processes through sharing best practices across portfolio companies, and improving supply chain efficiencies. These factors could be great selling points to an existing company looking for a private equity investor, but viewed from the franchisor's perspective, they can be extremely problematic.

While franchisors certainly want their franchisees to be profitable, they sometimes view a franchisee's hyper-focus on "cutting costs" as a means to cut corners, reduce quality standards, and potentially diminish the customer experience, all of which can damage the brand image. Franchisors can benefit from a large, well-capitalized, and well-run franchisee group acquiring other franchisees in the brand, particularly if those other franchisees are poor operators. However, franchisors almost always prefer franchisees to grow through new development, rather than acquisitions which do not result in net unit growth. And of course franchisors are likely to be concerned if the private equity buyer acquires complementary and/or competitive businesses.

Sharing best practices across portfolio companies has long been a calling card for strong private equity investors. Franchisors, however, and in particular franchisors of mature brands (which are the ones that often attract private equity investment), are typically not looking to franchisees to improve their standards and practices. They are looking for franchisees who follow their established standards and practices. Finally, franchisors are interested in supply chain efficiencies, but often need to balance a number of factors, including the ability to supply the entire franchised network, shipping costs, and sometimes generating rebate revenue, when establishing supply standards.

When a private equity or other institutional investor approaches a franchisor for the initial conversations about approving the transfer and other necessary franchise agreement changes, they should keep in mind what the franchisor wants to hear. Traditional private equity selling points may not resonate with franchisors, but factors like a strong history of successful investments in well-run companies, experience with other franchised brands (as a franchisee – not as a franchisor), and a pro forma balance sheet showing a well-capitalized franchisee post-closing typically will resonate with franchisors.

In addition, private equity investments in particular are well known for their relatively short (by franchisor standards) time horizons. Franchisors sometimes worry that a shorter time horizon for the investment may lead the franchisee to prioritize short-

term profits by deferring necessary maintenance, remodels and investment in the existing businesses, which franchisors view as necessary to protect the brand. So private equity and institutional investors should be prepared to explain their anticipated exit strategy to the franchisor and highlight their understanding that enhancing the long-term viability and value of the franchisee are integral both to a successful franchise relationship and a successful and profitable exit from the investment.

B. Transfer Provisions

Most franchise agreements' transfer provisions were designed to apply to one or a small group of individuals who decide to form a corporation or limited liability company to hold their franchised business. These agreements typically provide that any transfer or issuance of a direct or indirect ownership interest in the franchisee is subject to the franchisor's approval. This structure will not work for a number of larger franchisees with complicated capital structures, including private equity and other institutional investors. It is simply impractical for franchisors to retain approval rights over passive investors who are purchasing and selling interests in private equity funds and similar types of large investment pools.

Sometimes a private equity investor can convince the franchisor that their organization should be viewed like a public company. If the franchisee is owned by a public company, then the franchisor will have very little say over the franchisee's ownership and who buys and sells the publicly-traded shares. If the private equity firm has a long history of diverse ownership groups in its funds and successful operations, and the franchisor owns a less-established brand (and therefore might be more willing to compromise to obtain the growth that a well-capitalized franchisee group could deliver), then maybe the franchisor can be convinced. It is relatively rare for the franchisor to accept this approach, however. Larger, established funds often look to invest in larger, established brands, and those brands, while still eager to obtain franchisee growth, are more sophisticated in their understanding of public versus private companies and more reluctant to cede their approval rights over ownership changes.

Assuming that the franchisor will not forego all approval rights over transfers, then, as a starting point, a private equity or other institutional investor should explain to the franchisor the type of ownership and control structure that it envisions for the franchisee group it is looking to acquire. Given the complex web of corporations, partnerships and limited liability companies that these investment structures often utilize, and the varying degree of management and control rights and obligations that these entities can employ, franchisors are often understandably confused about who would really own and control its franchisee. Which entity or entities will have the ultimate say over the voting rights in the shares or ownership interests of the franchisee and its parent companies? Are there one or more groups of minority investors who will have veto rights over major decisions? If so, what are those "major decisions"? Will there be a functioning board of directors, board of managers or similar group of individuals who will be responsible for the management, direction and oversight of the franchised business? How will this group be structured and what decision-making authority will it have?

Larger institutional investors sometimes like to keep this information secret, thinking that their internal structuring information is confidential and relevant only to the investors and management personnel at the franchisee. However, if the private equity investor provides information to the franchisor about the investment and control structure, the investor may be able to convince the franchisor to modify its typical transfer provisions to cover what it really important to the franchisor – who is the majority owner of, and controls, the franchisee group.

After explaining the ownership and governance structure to the franchisor, the private equity firm can then attempt to identify types of non-control transfers where the franchisor's approval and other rights can be significantly diminished or even eliminated without any serious negative consequences to the franchisor. For example, large franchisee organizations often need to undertake restructurings, like adding new parent companies or shifting subsidiaries into different groups, for tax and other reasons. Many times these restructurings simply add or remove intervening parent companies and do not change any of the ultimate beneficial ownership or control of the organization. Another example involves employee incentive ownership, where larger organizations allow employees to participate in the ownership, whether by purchasing shares or through stock options or similar vehicles. There typically is only a small percentage of the company that is subject to these ownership vehicles, and franchisors often have no need or desire to get involved in what are, in a sense, employee compensation decisions.

If the investors can convince the franchisor to limit or eliminate approval and other rights over non-control transfers, that leaves control transfers. Most franchisors are very reluctant to give up approval and other rights over control transfers. However, there are some concessions that franchisors might be willing to provide for control transfers. For example, the transfer fee applicable to control transfers is ordinarily calculated on a franchise agreement-by-franchise agreement basis, so that the transfer fees that apply to franchisee groups with a large number of franchised businesses can be significant. While the franchisor is entitled to cover its costs associated with evaluating and processing the transfer, franchisees can sometimes convince the franchisor to reduce or cap the transfer fees that might otherwise result in a windfall to the franchisor. Also, if the franchisee group is large enough that an initial public offering is a realistic exit strategy, then sometimes the franchisor's pre-consent to that offering can be incorporated into the franchise agreement.

There are a number of very challenging issues associated with a potential public offering of a franchisee's stock, including the types of information shared with analysts and prospective investors, the scope of the control given to the publicly-traded shares, and other factors concerning the post-offering governance. It can take some time to sort through these issues, especially when the precise structure of the public offering may not be determined until long in the future.

Yet another concession may be including some kind of a reasonable negotiation obligation with respect to the next buyer. As discussed above, private equity firms typically have limited investment time horizons, and in many cases the most likely buyer

of the firm's current investment is another private equity firm. That buyer will likely face the same types of challenges with the franchise agreement that the current investor faces. While the modifications to the franchise agreement that the investor needs for this transaction likely will not meet the needs of the next buyer, whose capital and governance structure will be different, the current investor might at least want a provision in the franchise agreement requiring the franchisor to negotiate in good faith with the next buyer.

C. Right of First Refusal

Many franchise agreements' transfer provisions also contain a right of first refusal for the franchisor. This right allows the franchisor to step into the shoes of a potential buyer and acquire the interest in the franchised business, or the ownership interest in the franchisee, on the terms that were negotiated by the franchisee and potential buyer. While these rights of first refusal may not materially impact smaller transactions, they can have a chilling effect on larger transactions. Potential buyers can spend significant amounts of time and money on evaluating and negotiating an investment or transaction, and some of these buyers may be less willing to make that investment if they know that the franchisor can simply exercise the right of first refusal and take their place as the buyer. Selling franchisees worry that this chilling effect could reduce the price that buyers are willing to pay.

The franchisee or investor can ask the franchisor to eliminate the right of first refusal for their business. Franchisors may be unwilling to do so, however. They may want to retain the flexibility to acquire the business or even assign the right of first refusal to a preferred buyer. But if the franchisee organization operates a number of different franchise concepts, the organization may not realistically be able to provide a right of first refusal on the same transaction to two or more franchisors under their different franchise agreements. In other words, if the affiliated group of companies operates three different franchise brands under different entities that are owned by a common parent company, and a private equity firm wants to acquire a controlling interest in that parent company, then the franchisee organization could be required to provide three different franchisors a right of first refusal on that transaction – even though the franchise agreement would only provide a right of first refusal as to that particular brand's business. As a practical matter, this could involve somehow splitting the deal into separate, brand-specific transactions, which would be incredibly challenging given the likely inter-dependence of the three brands' businesses within the franchisee organization. Franchisees may be able to use these challenges to convince the franchisor to drop the right of first refusal, particularly for those brands that comprise a relatively small portion of the organization's overall business.

Some larger investors and franchisees have been successful in getting franchisors to switch from a right of first refusal to a right of first offer/opportunity framework. That switch involves an arrangement where the franchisee proposes a price for the franchised business and offers the franchisor the right to acquire the business for that price. If the franchisor isn't interested, then the franchisee can sell the business for any price at or above that offered to the franchisor without providing another right of first

offer/opportunity. The franchisor would retain its approval and other rights upon the transfer. This approach can be a way to provide the franchisee with more flexibility in structuring its deal and more certainty for prospective buyers, while still providing the franchisor some aspects of its right of first refusal.

D. Guarantees

Franchisors are rightfully concerned that their entity franchisees have sufficient net worth, liquidity and financial backing to invest in their franchised businesses, weather any unprofitable periods, and comply with their franchise agreements. For smaller, closely-held franchisee entities, this typically means that the franchisor requires all direct and indirect owners of the franchisee to sign personal guarantees of the franchisee's obligations. Franchisors also prefer individual owner guarantees because they can limit the incentive for a franchisee simply to shut down the franchised business. Even if the franchisee has no remaining assets to satisfy liabilities (for example, damages for breach of the franchise agreement due to an unauthorized closure), the individual owners would.

Of course, if the franchisee entity is owned by private equity, then it is impossible for all direct and indirect owners to sign personal guarantees. Investors in private equity funds cannot be expected to provide personal guarantees for their investments. So private equity-backed franchisees need to find an alternative way to satisfy the franchisor's concerns while not exposing the organization and its principals to excessive liabilities.

First, the investors could provide the franchisor details on the equity and debt financing that will be in place, and if it is sufficient, they could argue that no guarantee is required. After all, if the franchisee entity itself has adequate financial backing, then a franchisor would have no need to reach beyond the franchisee to a guarantor. However, franchisors are often reluctant to accept a franchisee entity without any guarantee, particularly when many larger franchisee organizations prefer to limit their exposure to third party liabilities by operating their franchised businesses through separate entities.

If the franchisor is receptive to moving forward without a guarantee, the franchisee could propose some financial thresholds to provide the franchisor comfort that the franchisee will retain its financial backing. For example, the franchisee organization's credit agreement might require the franchisee to maintain certain levels of net worth and liquidity and to satisfy various financial ratios and covenants. The franchise agreement could utilize some of these provisions to provide the franchisor some assurance that the franchisee entity will remain in good financial health. If there is a breach of these provisions, then perhaps a cure for that breach could involve a guarantee by one of the owners.

If the franchisor will not permit the private equity-backed franchisee to operate without some financial security, then the franchisee can offer some alternatives to a guarantee. For example, some franchisees have been successful in convincing their franchisors to accept letters of credit instead of a guarantee. The letters of credit do have

some cost to the franchisee, but many larger credit agreements have mechanisms that allow franchisees to obtain letters of credit for reasonable fees.

If the franchisor insists on a guarantee, then larger franchisee organizations typically push for a guarantee by an entity, like a parent company, instead of one or more individuals. If the parent company has sufficient financial backing, this is often accepted. Some franchisors, however, still insist on personal guarantees from individuals, such as the private equity firm's managing director, and occasionally guarantees from the fund itself. These positions can be controversial for the private equity organization. So when contemplating the investment into a franchisee, it is important for the private equity fund to understand the franchisor's views on guarantees.

E. Confidentiality and Non-Compete Covenants

Franchisors need to protect their intellectual property. A primary means of addressing this concern involves restrictive covenants in the franchise agreement. While the precise scope of these restrictive covenants vary, they usually include requirements both to protect and maintain the confidentiality of confidential information and to refrain from owning or operating a competing business. In many agreements, these covenants apply both to the franchisee entity itself and to its direct and indirect owners and affiliates. This can cause problems for larger private equity-backed franchisees, where, depending on the structure, the fund investors can be deemed indirect owners and all other portfolio companies – even portfolio companies of a private equity firm's other funds – can be deemed affiliates of the franchisee.

Franchise agreement guarantees also can be related to these restrictive covenants. These guarantees often cover two separate but related concepts. First, a guarantee makes the guarantor responsible for the franchisee's financial defaults and amounts owed to the franchisor. Second, a guarantee can also bind the guarantor to the non-monetary obligations of the franchisee, such as the confidentiality and non-competition provisions. It is important for private equity-backed franchisees to recognize this distinction. As discussed above, franchisors will typically understand that not all direct and indirect owners of large franchisees can or will be liable for the franchisee's monetary obligations, but franchisors also are concerned about the non-monetary obligations. They often want the principals of the franchisee bound to the confidentiality and non-compete covenants.

When negotiating the scope of the restrictive covenants, large franchisee groups should seek to understand the importance that the franchisor places on the non-compete. To some franchisors, the non-compete is sacrosanct and they will never allow anyone associated with their brand to have any association with any related business. So while even these franchisors understand that fund investors cannot be bound by a non-compete, they might still insist, for example, that all of the various funds that the private equity firm manages, and all of the portfolio companies in those funds, are bound by the non-compete. This might be acceptable to some smaller institutional investors, but is likely a non-starter for the largest and most well-established private equity firms.

Other franchisors are more flexible with their non-competes. They understand that larger franchisee groups like to diversify their investments with multiple brands, and that providing some movement on the non-compete can be a way to attract these groups to their brand. These more flexible franchisors also understand a critical investment tenant: if a large franchisee group has the capital to grow the business, it will not deploy that capital with the franchisor's brand simply because that franchisor maintains a broad non-compete; it will deploy that capital wherever it believes it will generate the largest return. A broad non-compete is not the best way to convince the institutional investor-backed franchisee to grow with that brand.

If the franchisor has some flexibility on the non-compete, larger franchisees are sometimes successful convincing the franchisor to tie the non-compete and confidentiality clauses together. A franchisor has a legitimate interest in ensuring that its confidential and proprietary information is not used to benefit its competitors. In this case, the confidential and proprietary information is not limited to the information in the operations manual concerning the actual business operations. It also includes sensitive information about the brand and its future, such as areas of focus for growth, planned initiatives and new technologies, new product and service development, and new equipment, all of which are designed to provide the brand a competitive edge. A franchisor does not want to see this information used to benefit its competitors.

Recognizing this, a private equity investor can argue that the non-compete should extend only to those companies/affiliates and individuals who possess this confidential and proprietary information. For example, the franchisee group may itself operate multiple brands through various subsidiaries, all of which are controlled by a common parent company, with the private equity and other institutional investors having their investments in that parent company. In many cases that parent company also has a functioning board of directors, board of managers or similar governing body overseeing the businesses. The franchisee group might suggest that the parent company, and all of its subsidiaries, would be bound by the non-compete but not any investors in that parent company. After all, the parent company (and the individuals on its board of directors) have access to the brand's confidential and proprietary information, but typically the investors do not. They receive information about their investment – the financial results and projections concerning the franchisee group. So the investors may be able to convince the franchisor that they should not be covered by the non-compete. Similarly, because they have no access to confidential or proprietary information, they would not need to be subject to any confidentiality restrictions.

In terms of individuals who are bound by the confidentiality and non-compete restrictions, again franchisors have an interest in preventing individuals with access to the brand's confidential and proprietary information from using that information in a competitive business. So the franchisee can try to limit the individual restrictive covenants to only those individuals who have access to this information. This could cause problems, however, depending on the private equity firm's structure. These firms often designate one or more managing directors or other employees as the principal contacts with the portfolio companies. They might be members of the board of directors or similar

governing body of the franchisee or its parent company, and in that capacity might have access to the brand's confidential and proprietary information. The problem arises because these managing directors or employees also oversee other portfolio company investments, some of which may be competitive businesses. It will be a negotiation with the franchisor to determine the individuals covered by the restrictive covenants.

Another way that the franchisee group can limit the scope of the restrictive covenants is to narrow the definition of competing business and confidential information. Many franchise agreements define these terms quite broadly. A large institutional investor needs to know whether another investment would or would not breach a non-compete. Clarity is critical. This can sometimes be addressed through more precise definitions. For example, a sandwich shop franchise agreement might define competitive business as any business offering sandwiches. This technically could cover a fine dining restaurant with one sandwich on its lunch menu. Modifying the definition to cover only businesses that derive (or can reasonably expect to derive) more than a certain percentage of their revenue from competing products can bridge the gap and help provide the clarity. Another approach is to list out the brands that the franchisor currently considers to be competitive. These approaches can provide both protection for the franchisor and clarity for the franchisee and its investors about which future investments would be prohibited.

F. Cross-Defaults

Many franchise agreements have cross-default or cross-termination provisions, where a default under, or termination of, one franchise agreement can cause a default under all of that franchisee's (or its affiliate's) other franchise agreements. While these provisions might make sense for franchisee groups with two or three franchised businesses, they can be draconian for franchisee groups with 50, 100, or even more franchised businesses. An operational failure at one location of these larger groups does not necessarily indicate a failure of the entire organization. Larger franchisee groups should be on the lookout for these provisions and attempt to limit their scope.

VI. Conclusion

As franchisees continue to increase in both size and the number of brands that they operate, more and more private equity and other institutional investors will be interested in investing in those franchisees. While there are risks on all sides from these investments, careful planning can lead to a relationship that is beneficial for the franchisor and the franchise system, and lucrative for the franchisee and its private equity investors.