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SUCCESSION PLANNING FOR FRANCHISE OWNERS

Bruce Schaeffer and Susan Ogulnick

It is estimated that franchising accounts for more than 40 percent of all retail sales in the U.S. with one out of every twelve retail establishments being part of a franchise network. According to a 2004 study done for the International Franchise Association, the 767,483 franchise businesses operating in 2001 employed an estimated 9.7 million workers and produced output of $625 billion. Franchised businesses stimulated additional economic activity of suppliers through their own purchases and those of workers on their payrolls.

With franchising such a ubiquitous force in the economy, sooner or later the wealth management planner can expect to encounter situations involving franchises. It may come up in divorce, in estate and succession planning, in annual valuations for ESOPs or buy/sell agreements, or to set and justify an asking price for potential buyers.

In many respects, a franchise is a unique asset and succession planning using techniques developed for other types of assets may not be viable. Sound planning requires considerable input from the franchisor as well as the more traditional expertise provided by estate planners, accountants and attorneys.

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A hard working franchisee, following the franchisor's methods religiously, can build his or her operation into a very successful business — a valuable asset. However, because of the plethora of restrictions customarily found in a franchise agreement, evolving a sensible estate plan for a franchise owner is often far more difficult than for a sole proprietorship or closely held business.

Usually, when the client is the proprietor of a successful business the succession planner's first concern is gift and estate tax planning. With a franchise, however, the prudent planner must first fix his or her attention on the transfer of the business itself. Often the flexibility available to an estate planner in the privately-held business context is absent. Initially the planner must focus on (1) restrictions on the transfer of the franchise imposed by the franchise agreement; and (2) valuation problems with respect to the "franchise," which is merely a contract right for tax and legal purposes.

The key to any successful solution to these issues requires obtaining the cooperation (to the best extent possible) of the franchisor because without the franchisor's consent, the best laid plans will fail.

WHAT IS A FRANCHISE?

Franchising encompasses a variety of business arrangements that generally fall within two categories: product and trade name franchises and business format franchises. Although it is considered a relatively recent development, franchising has existed in various forms since 1851 when Isaac Singer accepted fees from independent salesmen to acquire territorial rights to sell his sewing machines. Franchising, as a means of distribution, gained broader acceptance with its incorporation into the marketing techniques of General Motors, after 1898, and its eventual use throughout the automobile and gasoline industries, by the 1930s. Elements of franchising were introduced into retail marketing with the development of the Ben Franklin general merchandise stores in 1920 and the emergence of a national network of A & W "walk-up" root beer stands after 1925. Its expansion to the emerging service sector of the economy came with the initiation of national chains of Arthur Murray Dance Studios in 1938, Baskin-Robbins ice cream stores in 1940, and Duraclean carpet cleaning services in 1943.

Product and trade name franchises include arrangements in which franchisees are granted the right to distribute manufacturers' products within a specified territory or at a specific location, generally with the use of the manufacturer's identifying name or trademark. Examples of product/trade name franchises include automobile dealerships, gasoline service stations, soft drink bottlers, and farm equipment dealers. Although product/ trade name franchises account for a large portion of all franchise sales, they now represent a far smaller percentage of all franchise businesses.

The business format franchise is a newer development that generally incorporates trademark licensing with the conveyance of a business format or an entire business system to franchisees. There are basically three elements to a business format franchise: a mark, a business plan and a fee. The franchisee is required to comply with the franchisor's guidelines governing the operation, appearance, and location of the business. The quality of the products or services provided by the franchisees is typically controlled by the franchisor. The most common examples of business format franchises include restaurants, fast-food establishments, hotels, real estate agencies, convenience stores, and automobile service centers. Clearly the fastest growing segment of franchising, business format franchises account for more than 75 percent of all franchise businesses.

RESTRICTIONS ON TRANSFER

Under the Federal Trade Commission rule and most state statutes regulating franchising, a disclosure document in the form of a franchise prospectus must be delivered to a prospective franchisee before purchase; these documents must address renewal, termination, repurchase, modification and assignment of the franchise. Typically, the agreements place severe restrictions on the franchisee's right to freely alienate the franchise. This area of the contracts, denominated Relationship/Termination provisions may be the subject of separate state regulations as well.

The International Franchise Association invites prospective franchisees to consider:

Is the franchisee permitted to transfer interests in the franchise? What conditions or restrictions are placed on transfers of the franchise and of majority or minority ownership interests in the franchise? Does the franchisor have a right of first refusal with respect to proposed transfers, and if so what types of transfers does it apply to (e.g. majority ownerhsip interests or sale of business, transfers to family members or among existing owners)?

These are the same questions a succession planner must consider. A sample provision from a franchise agreement requiring approval of any transfer reads as follows:

Neither Franchisee's interest in the Franchise Agreement nor any of his rights or privileges thereunder, nor the franchised business or any interest therein, may be assigned, transferred, shared or divided, voluntarily or involuntarily, directly or indirectly, by operation of law or otherwise, in any manner, without first... obtaining Franchisor's approval.

This standard type of restriction enables franchisors to enforce their high quality standards and to ensure uniformity within their system. Failure to comply with these restrictions becomes cause for termination of the agreement. Thus, a franchisee with a succession plan that goes against the franchisor's demands may well end up with no franchise at all.

More than that, succession planners must review the other specifics of the Franchise Agreement; some of the terms may be very restrictive and must be considered before trying to formulate an estate plan.

Here are some other typical terms:

This Agreement and the Licensee's rights and interest hereunder shall not be subject to sale, assignment, lease or sublease, transfer or encumbrance, conveyance, consolidation, merger, (all of which are hereinafter included within the term "transfer") in whole or in part in any manner whatsoever, without the prior written consent of the Company.

The proposed transferee shall be interviewed at the Company's headquarters office and shall be responsible for paying all related and incidental expenses of attending such interview.

The proposed transferee or transferee's Manager shall have personally attended and satisfactorily completed the Company's initial Training Course. The transferee or transferee's Manager is responsible for paying all related and incidental expenses of attending the Training Course including, but not limited to, the cost of travel, meals, and lodging.

So, one must ask if there are hidden expenses incidental to the transfer of a franchise. But far more important in estate/succession planning are potential drop dead details. For example,

Notwithstanding anything herein contained to the contrary, in the event of the death or legal incapacity of the Franchisee...the rights and obligations of the franchisee hereunder shall inure to the benefit of such of the executors, administrators, heirs, conservators or legatees of the franchisee (collectively the "Legatee") and if the Legatee be determined by the Company, in its sole reasonable discretion, to be able to perform such duties and obligations.

Then comes the kicker, which the practitioner preparing the succession plan should be aware of:

In the event the Company determines that the Legatee is not capable of performing all of the duties and obligations required to be performed by the franchisee under this Agreement, the Legateee shall have 12 months from the date notice of such determination is given to transfer this Agreement to a bona fide purchaser in accordance with and subject to all of the provisions of this section. (emphasis added).

Obviously, to complete a transfer of a very substantial asset (or possibly several franchised units), within one year of death, in a situation which by definition is bereft of the most knowledgeable player, the decedent, is very difficult. Often, it can only be done at a substantial discount. This is particularly germane to the situation of the franchisee where the franchise(s) make up almost all of the estate.

Working With the Franchisor

After conducting a first meeting with the client and reviewing the relevant franchise documents, a practitioner would be well advised to contact the franchisor's legal department before going forward and devising an estate or succession plan. Otherwise, the plan may appear to do wonders for the franchisee but be unacceptable to the franchisor. For example, some franchisors have very definite antagonisms toward plural ownership.

Franchisors develop such restrictions not because they are cruel, belligerent blockheads; rather, they are successful business operators who learn from their mistakes. A franchisor that found that a substantial number of its operations which were owned by partners ended up in litigation between the partners causing the franchise operation to suffer (thus diminishing their royalty receipts), could easily decide to prohibit any form of plural ownership. Indeed, several franchisors have concluded that more than one owner will be allowed only in the husband-and-wife context-no brothers and sisters and no unrelated partners. Of course, this is not always the case. Many franchisors do allow plural ownership of at least a minority interest.

Rarely will a franchisor prevent a sale to a qualified outsider, but often franchisors will not allow a devise to a partnership of siblings. This puts the practitioner in the position of sometimes having to recommend a pre-death sale (with none of the income tax benefits of a stepped-up basis) over a normal devise to the children.

Most franchisors will work with the representatives of the estate of a franchisee to arrange an orderly and profitable sale if an appropriate heir is not available to be a qualified owner-operator. However, the input of the franchisor should be solicited early on in the planning stage. Only after consulting the franchisor will the practitioner know what can and cannot be done. This need for consultation with the franchisor cannot be emphasized too strongly. Once the specifics of the allowable succession have been defined, the practitioner can go forward with addressing the remaining problems.

Because of the restrictions and time restraints on orderly transfer of a franchise (which is often the largest asset of a franchisee's estate), practitioners should consider the use of revocable or living trusts to own the franchises (if allowed by the franchisor) to avoid the time delays of probate. Also, they must consider the use of life insurance both to provide a fund for payment of estate taxes and to provide bequests to those who may be denied ownership of the franchise after the franchisee's death.

Franchise Valutions Are Not the Same

Some scholarly analyses of how franchises differ on an economic basis from other businesses may be found in the following:

- Nevin Sanli and Barry Kurtz, "Appraisal of Franchises Requires the Use of Unique Valuation Procedures," Franchise Law Journal, Vol. 26, Number 2, Fall 2006, p.67; and
- E. Hachemi Aliouche and Udo Schlentrich, "Does Franchising Create Value? An Analysis of the Financial Performance of US Public Restaurant Firms," from the William Rosenburg International Center of Franchising at the University of New Hampshire.

However, there is precious little information available about the valuation of franchise businesses. For example, the vast databases of organizations like the National Association of Certified Valuation Analysts (NACVA) and the Institute of Business Appraisers (IBA) have no franchise specific valuations and CCH's massive "Business Valuation Guide" does not even have the word "franchise" in its index. Because valuing a franchise business can be very different from valuing other businesses, succession planners need to be aware of the following:

(1) Contract Right, not Outright Ownership – First and foremost, ownership of a franchise is not the same as outright ownership. The full bundle of rights attributable to owning something outright is absent in a franchise agreement and all rights to own and/or alienate the property are determined by the franchise agreement. The asset is merely a contract right; whatever the benefits or burdens of ownership, they are to be found in the franchise agreement – not in the common law. That is not the case with a regular closely-held business or family farm.

(2) Management Analysis – Although any sensible valuation of a business takes into account the strengths and weaknesses of management, in the franchise context this is a two-tiered analysis. The valuation must focus on the management skills of both the franchisor and the franchisee. Again, that is not generally the case with a business owned outright.

(3) Franchisor/Franchisee Relationship – In no other business context is the value of the enterprise so dependent on one relationship; the franchisor usually owns the trademark, creates and controls the marketing strategy, designs store layouts and fixtures, creates and owns operating manuals, and may even own the real estate on which the store is built. Normally such complete dependency upon one other entity would be considered an inordinate business risk, like a dependency on a single customer. But in the franchise situation it is more often a strength than a weakness.

(4) Regulation – There is a new Federal Trade Commission rule which became effective in July, 2008 governing the disclosures that franchisors are required to make to prospective franchisees. Plus, there are 14 states that require the registration of franchise offerings. No other type of business (other than the securities industry) is as highly regulated in as many areas and separate jurisdictions as franchising. This alone makes it vastly different from other forms of business.

(5) System-wide Goodwill – All operators in a franchise system are closely bound. In no other type of business would a tainted hamburger or scallion sold in an eatery in Washington or New Jersey so heavily impact or affect other businesses in states across the country (as was the case in recent years with Jack in the Box and Taco Bell).

Additionally, and uniquely, in practically every franchise agreement there is a specific clause which provides that all goodwill from the operation of the unit inures to the franchisor – not the franchisee that is operating the unit. Thus, the most valuable intangible asset usually owned by any business is specifically disclaimed in the franchise context.

(6) Restrictions on Transferability – As discussed above, generally a franchise is not freely alienable. Customarily there are conditions in franchise agreements which impact the valuation such as i) the risk of non-renewal, ii) the risk of non-approval of a proposed transferee, and iii) the presence of rights of first refusal (ROFRs) in the franchisor. The U.S. Tax Court has characterized ROFRs as difficult to value but probably causing a 10-15 percent discount from the total enterprise value.

(7) Divorce – valuation of a franchise in a divorce context may be completely outside the ambit of the traditional legal definition of "fair market value". In the divorce context the discounts that generally apply, such as for lack of marketability or minority interest may not be recognized because some divorce courts refuse to apply the concept of a hypothetical sale; rather, they determine the value of franchises strictly on a discounted cash flow basis assuming they will be held, rather than sold.

Conclusion

A successful franchisee operating multiple units may have up to 90 percent of his or her personal wealth tied up in their franchise units. A financial planner might be appalled at the lack of diversity of such an investment portfolio. Thus, wealth management planners have to recognize that franchise owners present unique succession planning situations and it is incumbent on them to solicit the input of franchisors early on to assure a smooth and effective plan is adopted and implemented.

Bruce S. Schaeffer is founder and president and Susan Ogulnick is vice president of research and operations of New York-based Franchise Valuations, Ltd.