A Protective Structure

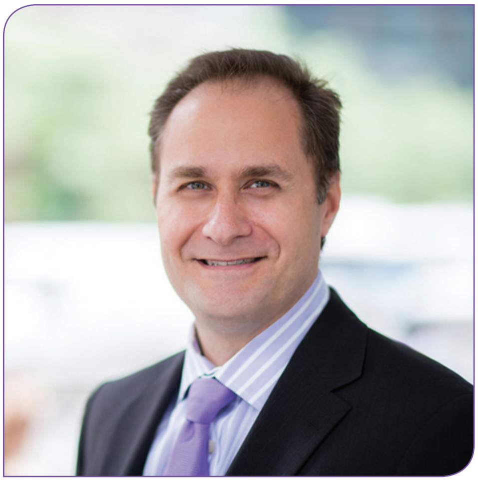
Jordan Fisch Addresses the Value of Holding Companies as a Risk Management Strategy for Multiunit Operators

If you and your partners are planning to grow your business by adding additional restaurant ventures, you might want to talk to your attorney and accountant about creating a holding company to insulate each unit from the liabilities of the others.

By Barry Shuster

Jordan A. Fisch is a member of the law firm Cole Schotz P.C., which has offices in New Jersey, New York, Delaware, Maryland and Texas. Fisch's practice includes, but is not limited to, counseling closely held and family-owned businesses, providing those businesses with general corporate advice. In addition, Jordan has developed a niche practice representing restaurateurs and restaurant groups in connection with structuring and organizational matters, and the acquisition, financing and wind-down of restaurants.

In this installment of "Fast Five," Fisch addresses the value of holding companies in structuring new restaurant business groups, and other formation issues new operators might want to discuss with their lawyers when contemplating their growth strategy.



Jordan Fisch has developed a niche legal practice representing restaurateurs and restaurant groups in connection with structuring and organizational matters. Fisch believes a holding company can be a good risk management structure when the same group of investors own more than one restaurant business. If growing from one to two (or more) restaurants or franchising your brand is part of your plans, you might want to discuss this structure with your legal and tax advisers.

_RS&G_: Jordan, in your practice, you counsel operators on how to structure restaurant "groups," which I interpret as two or more individual units with common ownership. Let's start with the simplest example possible, and one that is relevant to a large percentage of _RS&G_ readers.

Let's say I own Restaurant A LLC, and I am planning to expand my holdings with the creation of Restaurant B, perhaps funded by different investors, and perhaps operating as different concepts and under different trade names. Are there particular benefits or downsides for this relatively small restaurant "group" to creating a third entity as a holding company, and what are they? How might this change as I add unit 3, 4, 5 and so on?

JF: A holding company works best when the same investors are involved in each restaurant venture. A typical structure in that scenario is a holding company with separate wholly owned subsidiaries for each restaurant establishment — whether of the same restaurant concept or otherwise.

This structure insulates each restaurant from the liabilities of each other restaurant and is most protective. If there are different investors in each restaurant, a holding company would work only for those investors that are common to all restaurant ventures. In that instance, each restaurant would be owned by the investors investing in that restaurant venture and the holding company of the other investor group.

RS&G: Would you change your approach if I am replicating my concept with additional identical units with the hope of franchising, rather than operating a series of different concepts?

JF: If you replicate your concept and you have commonality of investors, yes, a holding company structure works well. For franchising, you may want to consider a wholly owned subsidiary of the holding company that would be used for franchising only. In that instance, that company would serve as the franchisor for all future franchises.

RS&G: Certainly if I hope to franchise, I need to protect my trademark. That's good business for any company, of course. If I understand correctly, you promote creating a separate entity as a holding company for the group's intellectual property, as a general principle for restaurant groups. Since intellectual property is just another, albeit critical, asset of the business, why does it need to be insulated in a separate entity?

JF: Trademark and other intellectual property rights of a restaurant venture are very valuable assets. It is critical to safeguard those against the claims of restaurant creditors (landlords, vendors, contractors, patrons, etc.). The most protective way to accomplish that is to set up a separate entity to hold and license the trademark and intellectual property to each restaurant for its use.

RS&G: Particularly as a restaurant group expands, it can attract more outside investors. Have you found any common legal pitfalls in which entrepreneurs find themselves in the expansion phase, particularly when they go beyond friends and family for capital? What advice can you provide to avoid such problems, both in regard to securities law and investor dispute (of course, in addition to hiring a good business lawyer)?

JF: Engaging a savvy business lawyer is always a good idea. When raising capital or admitting investors other than friends and family, a restaurateur has to be careful to protect his ability to manage and operate the restaurant with the least amount of input from outside investors. For example, a common point of contention is at what point, if ever, has an investor approval right over the business and affairs of the company. Oftentimes a select list of issues that require the approval of an outside investor are agreed upon in advance.

These issues cover such actions as financing, sale, admission of additional investors/dilution, and capital expenditures that exceed budget or are over an agreed-upon sum. These issues are best negotiated and handled by an experienced business lawyer. In addition, when raising capital — whether from friends and family or outside investors — a restaurateur needs to be cognizant of, and comply with both federal and state securities laws. Although there exist many exemptions to the requirement of the registration of securities, compliance is critical and a business lawyer experienced with navigating federal and state securities laws is of particular value.

RS&G: Entrepreneurial operators in the growth phase might become interested in expanding their business holdings with the purchase of existing restaurants, particularly if they could become more valuable with better management. For tax reasons, we found, buyers tend to prefer asset purchases, and creating a new entity going forward. Can you provide any additional insights for restaurant groups on pros and cons of asset versus entity purchases, and sales, if the group wants to unload a concept?

JF: Purchasing the assets of a business is nearly always preferable to purchasing the equity because under an asset purchase structure a buyer can isolate which, if not all, assets it is willing to purchase, and which, if not all, liabilities it is willing to assume.

Further, of significant concern in an equity purchase is unknown or undisclosed liabilities. I typically advise my clients that when purchasing the assets of a business you have discretion over what you want to purchase, which contracts or leases you want to assume, and which liabilities you are undertaking going forward, and when purchasing the equity of a business you are getting the entire business, the good, the bad and the unknown. **RS&G**