Private Equity in Franchising – A Lesson from Dunkin' Donuts

JOHN SOTOS

Published on May 5, 2015
Posted in: Blog, John Sotos

Until about a decade ago private equity funds kept away from investing in the franchise industry. That is no longer the case.

A lot of private equity firms are now investing in franchise systems and others are aggressively pursuing franchise systems as never before. Even the venerable Warren Buffet's Berkshire Hathaway got a lot of press recently with its investment in car dealerships, although Berkshire has owned Dairy Queen for over 15 years and as such, was a leader in this field.

Despite all the new found interest of private equity in franchising, the impact on this industry sector has not been the subject of universal acclaim. If anything, the results have been mixed. A lot of criticism has been leveled against the propensity of private equity to set very short term investment horizons. Accusations of "strip and flip" strategies have found a wide audience both among regulators and franchisees. Now the Quebec Court of Appeal has weighed in with a stinging decision against Dunkin' Donuts[1] and its treatment of its franchisees in the Quebec market, that has significant implication for private equity investors in the franchise sector.

Although the Dunkin' situation did not involve "strip and flip" strategy, the court found that Dunkin' had in effect abandoned the market to competition by Tim Horton. In the court's view franchisors have ongoing obligations to support the growth and development of the franchise brand and system regardless of the fact that Dunkin' had few positive ongoing contractual obligations. This obligation to support is continuous and extends over the life of the contract. The fact that the contract itself provided for no such express obligations on the part of the franchisor, as is common in the industry, was of no assistance. The obligation to "protect" the brand was implied. As the court noted, "*the franchisee relied on the franchisor assuming this role to justify his or her investment."* In the court's view:

> *"[T]he franchisor had implicitly agreed to undertake reasonable measures to help the franchisees…This includes the duty to assist them is staving off competition in order to promote the prosperity of the network as an inherent feature of the…franchise contract."*

While this decision comes out of the province of Quebec, the principles are not far different from those in the regulated common law provinces. Accordingly, the not infrequent allegations of private equity investors acquiring franchise companies, "stripping" franchisee equity through increased fees and costs that the franchisor controls, so as to grow EBITDA and sell out at significant multiples before the system implodes, are now likely to gain further traction and have adverse consequences for the investors not only in Quebec but other parts of Canada if such allegations are borne out. There is no reason for the same analysis extending to other franchise owners alleged to be stripping equity for a better price on disposition.