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TOP OF THE NEWS

BAGEL BRAWLS: BAB Holdings, which owns **Big Apple Bagels**, announced that it will buy privately held **Chesapeake Bagel Bakery**, which would make BAB the second-biggest bagel chain in the U.S. The Chesapeake units will retain their name. Together, the companies will have 268 stores in 31 states. Meanwhile, Eatontown, N.J.'s **Manhattan Bagel Co.** gobbled up 23 Buffalo-based **Bagel Brothers** stores in the Buffalo and Cleveland markets, increasing the number of franchised and company-owned stores to 247, including 17 in western New York and 12 in Ohio. The Buffalo stores will be incorporated into the territory of Manhattan Bagel regional franchisor **Big Apple Development Corp.** These bagel developments follow the purchase of **Bruegger's** in May by **Quality Dining** for more than $180 million in stock. The formerly Burlington, Vt.-based Bruegger's (headquarters were moved to Quality Dining's offices in Mishiwaka, Ind.) has 337 stores and is the nation's largest bagel eatery .... The **Tunica-Biloxi** tribe of Louisiana is the first Native American tribe to own and

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Succession Planning For Franchisors and Franchisees

By Bruce S. Schaeffer

AS THE franchisee population grays, there is no better time than now for franchisees and their professionals to address the need for estate planning.

Franchising as a unique American success story is, of course, about 25 years old. The operators who got into franchising in the early 1970s are generally now successful and wealthy and reaching their fifties, sixties and seventies. Therefore, these ubiquitous assets — franchises — have joined the list of properties with which estate and financial planners

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Supreme Court 2, Montana 0: *Doctor's Assocs. v. Casarotto*

By Charles G. Miller

WITH ANY LUCK settling the score once and for all, the U.S. Supreme Court ruled that a Montana statute requiring that notice of arbitration be placed on the front page of any contract containing an arbitration clause was preempted by the Federal Arbitration Act (FAA). *Doctor's Associates, Inc. v. Casarotto*, __ U.S. __, 116 S. Ct. 1652 (May 20, 1996).

The decision was not unexpected since the Supreme Court had late

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Succession

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must deal.

The first step in estate planning is computing the estimated estate tax. The first step in computing the estate tax is determining the value of the assets, i.e., the franchise(s). Valuation of franchises is no easy task.

A franchise is in many respects a unique asset, and succession planning using techniques developed for other types of assets may not be viable. Ensuring the most efficient "seamless" transfer requires input from the franchisor as well as from the more traditional estate planners, accountants and attorneys. These mature franchise outlets are the franchisor's prime shops: they've been paying steady royalties for more than 20 years in many instances. So, it's in the franchisor's economic interest as well as the franchisee's to see that the store is not damaged by the transfer occasioned by death (or estate planning).

Major Issues

The major issues raised when a practitioner is confronted with succession planning for a franchisee are:

(1) Restrictions on the transfer of the franchise imposed by the franchise agreement; and

(2) Valuation problems with respect to the "franchise," which is a contract right for tax purposes.

The key to any successful solution to these issues, clearly, is to plan in advance. This absolutely requires obtaining the cooperation (to the best extent possible) of the franchisor, because, without the franchisor's consent, the best laid plans will surely go astray.

1) Restrictions on Transfer

Every UFOC must have a section

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Succession

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concerning renewal, termination, repurchase, modification and assignment of the franchise. Typically, the agreements place severe restrictions on the franchisee's right to alienate the franchise freely.

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. Some franchisors have very definite antagonisms toward plural ownership.

Some questions that should be asked, according to the International Franchise Association, include:

- 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 ownership interests or sale of business, transfers to family members or among existing owners)?

Rarely will a franchisor prevent a sale to a qualified outsider but, frequently, franchisors will not allow a devise to a partnership of working siblings. This puts the practitioner in the uncomfortable 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.

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.

TOP OF THE NEWS

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operate a **Burger King Corp.** franchise in the United States. Construction has just begun on the Marksville, La., unit, the decor of which will be unique in its Native American theme. **John R. Blackerby,** Director of Native American Development for BK, helped make the announcement .... To boost the competitiveness of **Malaysia**'s products, the country's **Ministry of Entrepreneur Development** announced that it seeks to produce 1,200 Malaysian franchisors under the five-year Seventh Malaysia Plan.... Two intriguing business approaches: Atlanta-based **Floor Coverings International** uses an "Avon" approach to carpet sales — a truck brings dozens of carpet samples to a consumer's home, and a computer lets the consumer visualize how things will look with new colored carpeting. There are 200 franchisees. Second, Minneapolis-based **LASER QuipT** services laser printers on site, the first such business in America, says the company.... **HFS Inc.** bought **Avis Inc.** for about $500 million in cash and about $300 million in HFS common stock, subject to Avis shareholders' approval. **Avis Rent a Car,** which owns and runs the rental car locations and rental car fleet and related debt, is to be spun off to HFS shareholders, and Avis Inc. is to be a wholly owned subsidiary of HFS and license its name to Avis Rent a Car. Avis adds to HFS' growing stable, which includes **Howard Johnson, Days Inn** and **Century 21.... Taco Bell** is to give away an unusual prize late July — a Taco Bell franchise. The country's third-largest restaurant will waive $450,000 usually required for initial fees, working capital, equipment and training.

— Andrew J. Hollander

Once the specifics of the allowable succession have been defined, the practitioner can go forward with the remaining tax problems.

Because of the restrictions and time-restraints on orderly transfer of a franchise, which may be the largest asset of the estate, practitioners should be aware of the use of life insurance both to provide a fund for payment of estate taxes and to provide bequests to those who will not be affiliated with the franchise after the franchisee's death.

2) Valuation

This is the most difficult problem of all. Internal Revenue Code Sec. 2031 generally requires the estate tax to be imposed upon the fair market value of the estate of the deceased at the time of death. Franchises present unique problems in the area of valuation at date of death. The normal methods of discounted cash flow and comparable sales have to be adjusted because of the risk of non-renewal. Simply put, the issue is whether to analogize the franchise to a bond with a principal that produces income or to an annuity that makes distributions for a term-certain consisting of income and principal (a wasting asset).

Statutory Changes. Valuation has become a must because of recent statutory changes and court mandate. Some of the important law changes should be noted. In 1979, New York Business Corporation Law Secs. 1104(a) and 1118 introduced minority shareholders rights.

The Deficit Reduction Act of 1984 (in retrospect a hilarious title) introduced undervaluation penalties

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Casarotto

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last year vacated and remanded an earlier decision by the Montana Supreme Court in the same matter. *Doctor's Associates, Inc. v. Casarotto*, __ U.S.__, 115 S. Ct. 2552 (1995).

The Court relied on its holdings in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), and *Perry v. Thomas*, 482 U.S. 483 (1987), to the effect that the FAA mandates enforcement of arbitration clauses in both federal and state courts, except where grounds exist for revocation of contracts generally, such as fraud, duress or unconscionability. *Id.* at 1655.

Since the Montana statute was directed at arbitration clauses, and thus did not come close to enunciating a state policy regarding "revocation" of contracts in general, it was preempted.

The Montana Supreme Court had relied on language in *Volt Information Sciences v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 109 S.Ct. 1248 (1989), that state regulation

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Planning

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in estate and gift tax matters. I.R.C. § 6660. Then the Tax Reform Act of 1986 legislated that charitable contributions of closely held stock valued at more than $10,000 required qualified appraisals.

Subsequently, the I.R.S. promulgated a stream of Revenue Rulings, Technical Advice Memoranda and Private Letter Rulings. *See, e.g.*, Rev. Rul. 81-253 1981-2 C.B. 187, holding that there would be no minority discounts allowable in family transactions due to family attribution, and Rev. Rul. 83-120 1983-2 C.B. 170, giving instruction on how to value preferred stock. In Rev. Rul. 93-12 1993-1 C.B. 202, the I.R.S. finally acquiesced (after many court losses) to the proposition that family attribution would not prohibit minority interest discounts on transfers among family members.

All of this, coupled with the addition of Chapter 14 to the Internal Revenue Code, §§ 2701-2704 outlining valuation rules on transfers of corporate and partnership interests, transfers of interests in trust, buy/sell agreements and lapsing rights or restrictions, has put business valuations in the spotlight.

Case Law. There has been a dramatic increase in the awareness of valuation issues by both the courts and the Service. Courts certainly appear to have become more proactive and comfortable with making real valuation decisions rather than resorting to the Solomonic practice of splitting the difference. There has been a substantial rejection of valuations based on allegedly "comparable" companies which the courts have found to be not comparable.

The courts have also expressed a recognition of the importance of professional credentials and qualifications of business appraisers while holding that other professionals with credentials in other fields (e.g., accountants) are not necessarily accepted as knowledgeable in business valuations. The IRS itself has increased the trained business appraisers on its staff, including many who are certified by the American Society of Appraisers or the Institute of Business Appraisers, the two major certifying organizations.

Among the many major business valuation court cases in the '80s and '90s the most important was *Estate of Edgar V. Berg*, 61 TCM 2949 (1991), where the court held that a valuation based on a prior case should be rejected. But most importantly, the court assessed an undervaluation penalty under Section 6660 and held that an appraisal by the accountant for the business, who had previously testified as an expert in other court proceedings but was not a certified appraiser, would not be respected.

This chilling holding was overturned on appeal to the 8th Circuit, but the message is clear: an accountant will not be respected as a business appraiser solely on the basis of his expertise as an accountant.

As the cases show, valuations must be supported by the empirical data and professional imprimatur of a certified appraiser to garner the respect of the courts. As has been noted by commentators:

"The message given by the Tax Court is clear: The failure of a taxpayer to make a cogent presentation of empirical data in arguing for discounts will most likely result in a denial of the discounts sought. Taxpayers should take notice of the admonishments of the courts to avoid unfavorable consequences." Hall, Lance S. and Polacek, Timothy C. "Strategies for Obtaining the Largest Valuation Discounts," *Estate Planning*, January/February 1994, 38, at Page 44.

Practical Tips

The three key tips for practitioners when confronted with succession planning for franchisees are as follows:

1) Obtain a valuation from a qualified expert;

2) Review the termination/renewal provisions of the franchise agreement very carefully; and

3) Work *with* the franchisor — obtain its approval for the plan and get it to assist in the valuation.

Otherwise, as the professor said, you will get the right answer to the wrong question. ■