Another Look Under the Hood: *Is Your Ownership Structure Right for You?*

Almost a decade ago, I prepared an article for Geared Up that addressed this very same topic. Since then, there have been hundreds of millions of dollars from private equity injected into PF® franchisee businesses. Since that time, many "founder" PF franchisees have ventured into other brands outside of the Planet Fitness® system. So, I thought it was worth revisiting: Is your ownership structure right for you – especially as it relates to ownership outside of the PF system?

As you expand your network of franchised brands, it is critical to establish the appropriate legal ownership structure. Your structure should be designed to provide the best potential benefits for your business operations and position you to attain your business goals and objectives. If structured properly, your ownership and corporate framework will serve to maximize asset protection and tax efficiencies, accommodate your succession, estate planning and exit strategies, allow for portfolio diversification (for example, investments in real estate and/or holdings in other non-competitive brands) and provide flexible, streamlined management capabilities.

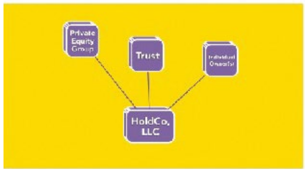
The legal structure for sophisticated multi-unit operators is typically comprised of a network of legal entities with a holding company at the top of the chain and a series of subsidiary entities beneath it. The holding company/subsidiary structure, which is explained in more detail below, yields structural leverage opportunities, allows for pooling of assets and the ability to transfer wealth in a more efficient way, and can provide significant tax advantages.

What is a Holding Company?

A holding company is a special type of entity, typically a limited liability company or corporation that primarily serves to "hold" investments as opposed to providing goods or services. In the context of multi-unit franchise developers, the holding company owns all or a majority of the membership interests or shares of each of the subsidiary entities. It does not own, operate or manage clubs and should have no business activities other than serving as an owner of the subsidiary entities (in whole or in part). The subsidiary entities are the legal entities that own and operate the individual franchised locations or territories.

by Justin Klein

Generally, it is at the holding company level that you find the breakdown of the individual owners and investor groups. The owners of the holding company may include individual investors, trusts, legal entities and private equity firms. Issuing ownership interests in one holding company, including to trusts formed for estate planning purposes or to family members, as compared to interests in various club entities, simplifies the process, is more efficient, and may provide certain tax advantages.

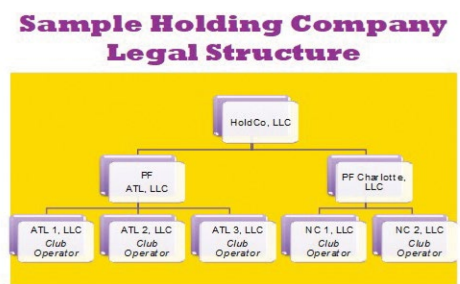


It is of significance to note that the operating agreement or shareholders agreement for the holding company is, in several respects, the most critical tool in managing relations between owners and should be carefully crafted to address the unique and particular needs of each mix of ownership groups, as well as issues triggered under the franchise agreement and area development agreement

(ADA). It should spell out specific procedures for dealing with disputes and other issues that may arise over the course of the relationship. Deficiencies at this level can spell disaster when relationships between individual owners or ownership groups are tested or break down.

Area developers with two or more ADAs may consider implementing a more sophisticated structure involving one or more intermediate holding companies under the ultimate parent holding company to effectively create "silos" for each area development territory (each an ADA territory). Organizing the structure in this fashion neatly compartmentalizes each ADA territory, the applicable ADA, as well as the underlying operating clubs and their respective franchise agreements. This structure, among other benefits, simplifies the ability to transfer an entire ADA territory and its underlying clubs without affecting the overall ownership structure, or the remaining territories and operations. This structure also allows flexibility to include investments in real estate or other brands under the same holding company umbrella.

Below is a sample of the holding company subsidiary structure:



Pictured is a sample of the holding company subsidiary structure.

To illustrate the potential asset protection benefits provided under the holding-company model, assume the structure at left is in place. ATL 2, LLC generates substantial profits in excess of a reasonable reserve. The excess profits are transferred from ATL 2, LLC up to HoldCo, LLC, the parent holding company. A class action lawsuit is filed against club ATL 2, LLC due to a data security breach involving club members and a substantial judgment in excess of insurance coverage is awarded. ATL 2, LLC is forced into bankruptcy. The legal ownership structure contained the damage to ATL 2, LLC, leaving the rest of the network intact and undisturbed.

Advantages of Using a Management Company

As the number of operational clubs in your portfolio increases, so does the need to streamline management and the administration of certain employment functions. The formation of a separate management company, often in the form of a sub-chapter S corporation or a limited liability company, serves to address these issues.

The management company allows for flexibility and creativity in compensating managers and owners, and may also provide significant tax advantages, including allowing for the recognition of losses that may otherwise be suspended if left at the club level. Structuring the management company as the employer for certain management and other personnel, if done properly, may also serve as a measure of asset protection at the club entity level, as it may isolate the club entity against potential liability for employment-related matters.

Factors to Consider

Of course, with this sophisticated ownership structure comes added costs, the need to establish separate accounts and records, and the drafting and implementation of legal agreements between the entities. Respecting the distinction between the various legal entities, maintaining separate bank accounts and obtaining and maintaining appropriate insurance coverage are all measures that should be carefully addressed. These added costs and burdens, however, are often significantly outweighed by the substantial benefits afforded by the holding company structure.

Of course, selecting the appropriate corporate structure is ideally positioned at the commencement of your operations. However, this is not always the case. Be mindful that there may be restrictions on unilateral changes to your ownership structure under your franchise and/or area development agreements and generally must be approved, in advance, by your franchisor. Likewise, there may be tax implications that should also be carefully considered.

Put Together a Team of Professionals

There is no "one size fits all" approach, as each ownership group has its own set of concerns, goals and needs. Putting together the right team of professionals consisting of experienced attorneys, accountants and business advisors to advise you and guide you through this process is crucial. It is never too early – or too late – to address your legal structure.

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