The Franchising Future:
Ideas to Increase Revenue and Minimize Risk

September 30, 2014
The Franchising Future Seminar
Valuation Overview
September 30, 2014

Valuation Research Corporation

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Agenda

• Background and Experience of VRC
• Industry Overview
• Valuation Overview
• Valuation Methodologies and Process
• Valuation Risks for Buyers and Sellers
• Questions
Valuation Research Corporation

Established in 1975, VRC is an independent full-service valuation firm that provides business enterprise, capital stock, fairness and solvency value-related opinions in support of corporate transactions and valuations of intellectual property and tangible assets for financial reporting and tax purposes.

VRC has eight domestic offices with approximately 100 employee and eight global affiliates with approximately 650 employees.

VRC maintains relationships with corporations, lenders, accountants, investment banks, private equity firms, and law firms.

VRC was instrumental in forming the Appraisal Issues Task Force (AITF), a valuation industry group that meets quarterly with representatives from the FASB, the SEC, and the PCAOB to discuss valuation issues surrounding financial reporting.

### Retail Fuel and Convenience Industry Experience

<table>
<thead>
<tr>
<th>Company</th>
<th>Experience Summary</th>
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<tbody>
<tr>
<td>ConocoPhillips</td>
<td>We valued tangible and intangible assets of $10 billion in connection with Blackstone's acquisition ofikc.</td>
</tr>
<tr>
<td>Phillips 66</td>
<td>We valued tangible and intangible assets of $9 billion in connection with Energy Transfer’s acquisition of Phillips 66.</td>
</tr>
<tr>
<td>K-Valleymark</td>
<td>We valued $500 million in operating assets in connection with the press acquisition of K-Valleymark.</td>
</tr>
<tr>
<td>K-Mart</td>
<td>We valued $1 billion in operating assets in connection with the acquisition of K-Mart.</td>
</tr>
<tr>
<td>ExxonMobil</td>
<td>We valued $30 billion in operating assets in connection with the divestiture of Mobil Oil.</td>
</tr>
<tr>
<td>White Hen</td>
<td>We valued $50 million in operating assets in connection with the acquisition of White Hen.</td>
</tr>
<tr>
<td>JW Food</td>
<td>We valued $100 million in operating assets in connection with the acquisition of JW Food.</td>
</tr>
<tr>
<td>QFC</td>
<td>We valued $50 million in operating assets in connection with the acquisition of QFC.</td>
</tr>
</tbody>
</table>
Middle Market Transactions*

2013
- Deal volumes were off 11% in 2013 from 2012
- Median EBITDA multiples were up slightly in 2013 (6.5x) from 2012 (6.2x)
- Modest increase in debt/EBITDA multiples (3.5x) in 2013 of about 3%
- Real GDP grew by 1.9%

2014 Outlook
- Deal volumes are expected to continue to grow for remainder of year
- EBITDA Multiples are expected to stabilize
- Volume of deals will be strong due to pent-up demand from private equity

* Less than 250 million in transaction Value
Current M&A Environment – Middle Market

Middle Market M&A Activity

<table>
<thead>
<tr>
<th>Year</th>
<th>Average TEV/EBITDA Multiple</th>
<th># of Deals (&lt;$250 MM)</th>
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<tr>
<td>2007</td>
<td>6.2x</td>
<td>10,462</td>
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<tr>
<td>2008</td>
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<tr>
<td>2009</td>
<td>6.0x</td>
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<tr>
<td>2010</td>
<td>5.9x</td>
<td>8,732</td>
</tr>
<tr>
<td>2011</td>
<td>6.2x</td>
<td>8,782</td>
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<tr>
<td>2012</td>
<td>6.2x</td>
<td>8,792</td>
</tr>
<tr>
<td>2013</td>
<td>6.5x</td>
<td>8,178</td>
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</table>

Source: Mergerstat, GF Data Resources

Industry Overview – Franchises

Market Activity

- Franchise demand for has grown performance has improved since the recession
- New franchise unit transactions have passed existing unit transactions as large recession-based backlogs have declined
- In 2014, demand for new franchise units is projected to increase by 20.2% to 49,800
- Franchised business service units are projected to grow the fastest at 2.8%
- The slowest growing franchise business line is retail food, projected at 0.8% through 2014
- Overall, 73,800 unit transactions are projected for 2014, a 12.4% increase since 2013

Source: International Franchise Associations, FRANdata

1: Business services include printing, business transportation, warehousing and storage, data-processing services, insurance agencies and brokerages, office administrative services, employment services, investigation and security services, tax-preparation and payroll services, and heavy equipment leasing. Retail food includes food and beverage stores, convenience stores, caterers, bakeries, liquor stores, and gas stations with convenience stores.
Representative Franchise Deals

- Buyers are getting bigger
  - RMH Franchise Holdings acquired 138 Applebee’s restaurants
  - RMH committed to buy 26 more - $125 million
  - Wendy’s sold 350 stores in a refranchising program
  - Buffalo Wild Wings invested in the equity of PizzaRev
  - Darden Restaurants purchase of Yard House USA

- Private equity – looking in franchise space as potential investment
  - Estimated to have $1.1 trillion ready to invest
Trends in Capital Markets regarding Franchises

- Debt financing
  - Significant senior debt available to large and regional buyers
- Valuation and multiples
  - Multiples are becoming elevated for both public franchises and those being acquired
  - Many between 10x to 14x of EBITDA

What is a Valuation?

- It is the value of your business at a specific point in time, which presumes a hypothetical transaction – between a willing buyer and seller, each knowledgeable
- It is a function of capital markets and economic cycles
- It focuses on the growth, risk and profitability of the business and the industry
- It is both an art and science
Valuation Overview

Uses for Valuations

- Obtaining financing
- Pre-acquisition due diligence
- Accounting requirements (ASC 805 - Purchase Price Allocation)
- Estate & Gift Planning

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Valuation Overview

<table>
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<tr>
<th>Levels of Value</th>
<th>Strategic Company Value</th>
<th>Control Company Value</th>
<th>Public Company Value</th>
<th>Restricted Public Company Value</th>
<th>Private Company Value</th>
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<td>Synergy Premium ~15%</td>
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<tr>
<td>Control Premium ~25%</td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>Minority Discount ~20%</td>
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</tr>
<tr>
<td>Marketability Discount ~15%</td>
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<td></td>
</tr>
<tr>
<td>Marketability Discount ~25%</td>
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</tr>
</tbody>
</table>

NOTE: Discounts and premiums percentages shown above are for illustrative purposes only, and may vary depending on specific characteristics of subject company and/or security.
Valuation Methodologies

- **Income Approach**
  - Discounted Cash Flow Analysis

- **Market Approaches**
  - Public Market Analysis
  - Private Transaction Analysis

- **Cost Approach**
  - Adjusted Balance Sheet Analysis

Valuation Process

A typical valuation consists of the following steps:

- Collect company data (financial and non-financial including franchise documentation)
- Conduct meetings with management
- Industry analysis
- Financial statement analysis
- Market valuation analysis
- Issue draft valuation report
- Discuss with ownership group and representatives
- Issue final valuation report
### Valuation Process

#### Typical Information Requested for a Valuation

- Franchise agreement
- Shareholder, partnership or operating agreement
- Most recent five years of annual and interim financial statements (balance, income and cash flow statements)
- Budgets and forecasts
- Ownership and officers’ compensation for the same periods as financial statements
- Nonrecurring and extraordinary items
- Ownership structure
- Marketing materials
- Top ten and top fifty customers

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### Valuation Process

#### Top Down Valuation Approach

- Economic analysis
- Industry analysis
- Company research and discussion
- Financial statement analysis
- Market valuation analysis
Valuation Process

Market Valuation Analysis

- Business Enterprise Valuation
  - Operational value
  - Nonoperational value
- Less: Debt valuation
  Market Value adjustments
- Equals: Total equity valuation conclusion
- Discounts:
  - Marketability
  - Minority interest

The Discounted Cash Flow Analysis Considers:

- Sales forecast
- Costs and expenses, including franchise fees, royalties, advertising fees
- Synergy impacts
- Capital expenditures and operating working capital requirements
- Discount rate or weighted average cost of capital
- Residual growth rate
Valuation Process

Market Comparable and Transaction Analyses

- Database search
- Review business descriptions and financial performance
- Compute multiples and financial ratios for the selected comparables
- Adjust multiples for differences
  - Size
  - Financial leverage
  - Profitability
  - Growth

Valuation Risks
for Buyers and Sellers
### Franchise Risks

#### Brand
- Brand value is the primary reason for purchasing a franchise
- Brand publicity can have a positive or negative affect on the business and can be outside of franchisee’s control
- Brand value can be different depending on where the business is located
- Many times brand marketing is completely under the control of the franchisor

#### Marketability
- External forces outside the franchisee’s control can affect exit opportunities
- State of the economy may affect marketability
- Access to capital has improved recently but remains short of demand
- Established franchises are generally more marketable than unproven units

### Franchise Risks

#### Franchise Agreement
- Represents a legal binding contract between a franchisor and franchisee
- Franchisor exercises significant control over franchisee’s operations
- Franchise agreement duration, support and fee are key components for consideration
- Special attention should be paid to renewal rights and franchise termination/cancellation policies (buyback or first refusal clauses)
  - Right of first refusal can drive potential buyers from the market

#### Other Risks
- Geographic location - the most recent winter had a major affect on many different franchisees throughout the U.S.
- Employee related risks such as compensation and productivity are present but more controllable by the franchisee
Value Drivers –
How to Increase the Value of Your Business

Qualitative Value Drivers
- Market position and perception of company/franchise
- Strong experienced management
- Diversified customer base, products, and services
- Absolute size
- Strong moat – Increased barriers to entry
## Value Drivers

### Quantitative Value Drivers
- Consistent, repeatable and growing revenue and profitability
- Improving profit margins
- Efficient use of working capital
- Proper use of financial leverage
- Efficient asset utilization

## Questions

Questions?
<table>
<thead>
<tr>
<th>Location</th>
<th>Address</th>
<th>Phone</th>
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<tbody>
<tr>
<td>Boston</td>
<td>260 Franklin Street, Suite 530, Boston, MA 02110</td>
<td>617.330.1610</td>
</tr>
<tr>
<td>Chicago</td>
<td>200 West Madison Street, Suite 2110, Chicago, IL 60606</td>
<td>312.957.7500</td>
</tr>
<tr>
<td>Cincinnati</td>
<td>312 Walnut Street, Suite 1700, Cincinnati, OH 45202</td>
<td>513.579.9100</td>
</tr>
<tr>
<td>Milwaukee</td>
<td>330 East Kilbourn Avenue, Suite 1425, Milwaukee, WI 53202</td>
<td>414.271.8662</td>
</tr>
<tr>
<td>New York</td>
<td>500 Fifth Avenue, 39th Floor, New York, NY 10110</td>
<td>212.983.3370</td>
</tr>
<tr>
<td>Princeton</td>
<td>200 Princeton South Corporate Center, Suite 200, Ewing, NJ 08628</td>
<td>609.243.7000</td>
</tr>
<tr>
<td>San Francisco</td>
<td>50 California Street, Suite 1300, San Francisco, CA 94111</td>
<td>415.277.1800</td>
</tr>
<tr>
<td>Tampa</td>
<td>777 South Harbour Island Boulevard, Suite 980, Tampa, FL 33602</td>
<td>813.463.8510</td>
</tr>
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</table>
ABOUT HAYS COMPANIES

- Hays Companies was founded in 1994 and is a privately held organization, owned by its leaders and managers.
- Number of employees: 700+
- Firm revenues 2013: $160,000,000
FRANCHISOR GOALS

- Profit opportunity that can increase value of franchisor.
- High franchisee participation to create volume discount.
- Low touch for franchisor staff.
- Allow franchisees to focus on building business.
- Protection of assets, including brand.
- Uniform coverage.
- Loss control and safety specialists.

FRANCHISEE GOALS

- Easy to manage program.
- Allow franchisees to focus on higher impact activities.
- Uniform, franchisor-approved coverage.
- Competitively priced.
- Easy claim reporting process.
- Easy to generate certificates of insurance.
HAYS COMPANIES & PROGRAM CAPABILITIES

HAYS PROCESS

- Information gathering
- Development of Proprietary Web Based Communication Platforms
- Development of Insurance Coverage and Rating Parameters
- Apply Best Practices for insurance coverage for franchises
- Captive feasibility study
- Customized Billing
- Claims and Q&A Support

Distinguishing Features

- Experienced franchise customer service and support from an organization with extensive program expertise.
- Marketing expertise and data-mining capabilities to effectively target markets and meet customer needs.
- Products that provide high value because they are competitively priced.
- Sophisticated technology and automation, to support the ease of sale.
- Loss Control Services available to provide information and hands on instruction to improve safety.
- Claim Advocates to make sure clients are treated fairly.
- Currently administering over forty specialty programs.
INSURANCE PROGRAM GOALS

PROTECT BRAND

➢ Franchisees have adequate coverage to insulate Franchisor against a loss.
➢ Require coverages to cover liability for specific, hard to place exposures of a group.
  • Cyber, employment practices, excess limits
➢ Use insurance program as a selling point to potential franchisees.
➢ Make sure you are an additional insured on members’ policies.

INSURANCE PROGRAM GOALS

IMPORTANT FOR MEMBERS TO HAVE ADEQUATE COVERAGE

➢ Franchisees should have a minimum amount of coverage that is adequate to protect against exposures.
➢ Collect certificates from those that are not in sponsored program.
➢ Leverage buying power with a large group to reduce cost of insurance.
➢ Add insurance requirements into franchise documents.
  o Can make sure Franchisees are adequately covered
  o Drive members into program
INSURANCE PROGRAM GOALS

OPTIONS

- Coverages for group below market.
- Master policy with common renewal date.
- Consolidate loss and premium information.
- Add enhancements to program easily.
- Drive traffic to your franchise portal.
- Build business plan for a captive.
- Coverage options included in captive:
  - Property, Crime, General Liability, Professional usually included; and
  - May included Workers' Compensation, Excess Liability, Cyber Liability
- Looking for predictability of losses, ability to control losses and how much potential exposure is in captive.
HAYS COMPANIES TECHNOLOGY

CLAIMS

Asset Protection Plan
Project your business with our comprehensive property and liability insurance plan, designed specifically for Soup Fitness & Kinoa.

Claims Information

Workers’ Compensation Claims  All Other Claims

HAYS COMPANIES TECHNOLOGY

CLAIMS

Asset Protection Plan
Protect your business with our comprehensive property and liability insurance plan, designed specifically for Soup Fitness & Kinoa.

CLAIM INSTRUCTIONS

- Notify 3rd party claim administrator
- Include name and phone number of any witnesses
- Include date and time of incident and other relevant information
- Notify 3rd party claim administrator immediately

HAYS COMPANIES | 13

HAYS COMPANIES TECHNOLOGY

CLAIMS

Asset Protection Plan

What to do in the event of a claim

- Notify 3rd party claim administrator
- Include name and phone number of any witnesses
- Include date and time of incident and other relevant information
- Notify 3rd party claim administrator immediately

HAYS COMPANIES | 14
## Asset Protection Plan

Protect your business with our comprehensive property and liability insurance plan, designed specifically for Snap Fitness & Kusama.

### My Club Listing

<table>
<thead>
<tr>
<th>Club Number</th>
<th>Program</th>
<th>Club Location</th>
<th>Club City</th>
<th>Enrollment Form Completed</th>
<th>Request Additional Coverage</th>
<th>Date Forms Completed</th>
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<tbody>
<tr>
<td>100004</td>
<td>kusama</td>
<td>2100 NW 100 St Suite 2000</td>
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<tr>
<td>100005</td>
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<td>100010</td>
<td>kusama</td>
<td>4725 EP True Play Suite 104</td>
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<td>24th Ave NW</td>
<td>Lamers</td>
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</tbody>
</table>

***Select your club and choose the appropriate insurance option above***
HAYS COMPANIES TECHNOLOGY

Asset Protection Plan
Protect your business with our comprehensive property and liability insurance plan, designed specifically for Snap Fitness & Aiosana.

My Club Details

<table>
<thead>
<tr>
<th>Club Number</th>
<th>Program</th>
<th>Club Name</th>
<th>Grand Opening</th>
<th>Club Locations</th>
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<td>85th &amp; 9th Ave SW 85th &amp; 9th Ave SW</td>
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UPDATE MY INFORMATION

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<tr>
<th>Owner/Location Information</th>
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<th>Club Information</th>
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<td>123 Main St</td>
<td>River Falls, WI</td>
<td>WI</td>
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<td>5</td>
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Who's The Boss? 
Joint Employer Issues in the 
Franchise World 

By Terry Potter

JOINT EMPLOYER DOCTRINE

- Two entities controlling employees’ working conditions
- Matter of degree
- Where to draw the line
- Multiple tests
NLRB & McDONALDS

- Result of Fast Food Forward movement
- $15 an hour demands
- Lay-offs of participants
- 181 ULP cases filed since November 2013
- 43 found meritorious
- Division of Advice guidance

NLRB TEST
TLI, Inc. 27/NLRB 798 (1984)

- Two separate entities share or codetermine those matters governing the essential terms and conditions of employment
- The employer must meaningfully affect matters relating to the employment relationship, such as hiring, firing, discipline, supervision and direction
NLRB TEST

- No one factor controls
- Written agreements relevant but not controlling
- Actual practice will control

ISSUES

- Deep pockets – McDonalds, USA
- Limited to this franchise group and the NLRB
- Background
  1) NLRB joint employer analysis – invitation to file briefs – what is the standard?
  2) Lawsuits in state and federal courts for wage violations under Joint Employer Doctrine
  3) Missouri Supreme Court – Starwood Hotels case
Questions?
Nexus, or “What do you mean I am doing business in Pocatello?”

Presented by
Eric Stutz, Partner
EKS&H, LLLP

and

Operational Audits: Think Differently

Presented by
Sandy Shoemaker, Partner
EKS&H, LLLP

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Nexus Defined

Nexus is the link or connection between a political jurisdiction and a taxpayer before that jurisdiction can impose a filing requirement for either sales or income tax.
Nexus: Constitutional Limitations

• Applying the due process and commerce clause hurdles:

The Debate Since Quill

• How much physical presence is needed for physical presence
  – Deliveries
  – Occasional visits
  – Trade shows, printers, and warehouses
  – Internet

• Can you have physical presence through agency, affiliation, and attribution

• Is physical presence necessary for income tax nexus?
**Nexus - agency, affiliation, attribution**


  
  – If someone is your agent they will create nexus

**Nexus -- agency, affiliation, attribution**


- *SFA v. Tracy*, 65a2 N.E.2d 693 (Ohio 1995)


- Then see what happened:


Nexus – the “Amazon” wars

• Amazon.com, LLC v. New York State Department of Taxation and Finance, 20 N.Y.3d 586 (N.Y. 2013)
  – The New York Court of Appeals upheld the New York Amazon Law as facially constitutional.
  – The Court found that although physical presence is generally necessary for sales tax nexus, it need not be substantial, and can be met if economic activities are performed in the state by a seller on behalf of the taxpayer.
  – The bottom line is that if a vendor is paying New York residents to actively solicit business in this State, there is no reason why that vendor should not shoulder the appropriate tax burden.”
  – The United States Supreme Court denied certiorari on December 2, 2013.

Nexus – the “Amazon” wars

  – “In short, performance marketing over the Internet provides the basis for imposing a use tax collection obligation on an out-of-state retailer . . . However, national, or international, performance marketing by an out-of-state retailer which appears in print or on over-the-air broadcasting in Illinois . . . will not trigger an Illinois use tax collection obligation.

  – “The Act therefore imposes a discriminatory tax on electronic commerce within the meaning of the ITFA.”
Sales Tax Summary

- Sales tax—Physical presence is still the bright-line test but we don’t know how much physical presence or to the extent nexus can be acquired through affiliation or attribution.

- But what about income tax nexus?

Income Tax Nexus: Public Law 86-272

- “No state…shall have the power to impose (an) income tax…if the only business activities within such state (are) the solicitation of orders…for sales of tangible personal property, which…are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from outside the State…”
P.L. 86-272: Key Elements

- Solicitation of orders
- For sales of tangible personal property
- Sent outside the state for approval or rejection
- Filled by shipment or delivery from outside the state

P.L. 86-272 does not extend to:

- Sales of services
- Sales or leases of realty
- Sales or licensing of intangibles
- Or to the following taxes
  - Michigan “business tax”
  - Ohio Commercial Activity Tax (CAT)
  - Texas Margin Tax (TMT)
  - Washington “business and occupation tax”
  - Franchise taxes on capital or net worth (e.g., PA)
**Income Tax Nexus: Key Questions**

- Does the physical presence test apply to both sales tax and income tax nexus?

- Should economic presence be the test for income tax nexus?

**Economic Presence and Income Tax**

  - “…by licensing intangibles for use in this state and deriving income from their use here, Geoffrey has a ‘substantial nexus’ with South Carolina [for purposes of the state’s income tax].”

  - An out-of-state bank that issued credit cards to West Virginia customers had income tax nexus based on its “significant economic presence” in the state.
Economic Presence and Income Tax

  – Marketing credit cards in the state does create income tax nexus.

  – Licensing trademarks to franchisees in the state alone triggered income tax nexus.

Economic Presence and Income Tax

• Multistate Tax Commission Proposal
  – (the “factor presence” standard)

• Any company whose activity in a state exceeds
  – (1) owning $50,000 of property; or
  – (2) $50,000 of payroll; or
  – (3) $500,000 of sales
  has nexus for both income and sales tax.

  – Under the proposal, a remote seller whose only contacts with the state is through either Internet or catalogue sales would have nexus in the state if those sales exceeded $500,000. Thus, the proposal would remove the physical presence standard established in *Quill.*
**Marketplace Fairness Act (MFA) of 2013**


- This bill provides a state two options for gaining the Congressional authorization to require remote sellers to collect sales tax:
  - SSUTA member states have to provide 90 days notice that they will exercise authority under the Act;
  - Non-SSUTA members may exercise authority by complying with the minimum simplification requirements under the Act by enacting legislation that (1) specifies the taxes to which the authority applies; and (2) identifies products and services that will be excluded from the authority.
  - The MFA only applies to remote sales and remote sellers.

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**Operational audits – how to build strong relationships**

- Running a thriving business requires variety of skills, including the ability to assess both the longer-term big picture and the specific issues confronting you today

- Franchisee relationships are the heart of your business
  - If they succeed you succeed – or if you are a successful system – they will succeed

There are no secrets to success. It is the result of preparation, hard work, and learning from failure.  
Colin Powell
Why do we need to do audits?

- The success of any franchised business system depends on the ability of the franchisor and the franchisees to meet interdependent responsibilities in a collaborative and consistent manner.
  - Franchise agreement
  - Setting standards – operations manuals
  - Protect the brand
  - Setting expectations
  - Send a message to a specific unit
  - Send a message to the system as a whole
  - Assist with changes (change management)
  - Not just a royalty audit

Coming together is a beginning. Keeping together is progress. Working together is success.” --Henry Ford

How do you currently address these issues:

- Use of Regional managers
- Internal resources
- Outsourcing
- Royalty audits
- Put your head in the sand……
Start with …..

- Outline your goals for the program
  - Consider involvement of your FAC
- Bring together key players –
  - Implementation team (front-end)
  - Support team
  - Regional managers
  - Finance
  - Others?

Phase 1: Get the Background

Gather & Analyze Information
- Obtain and review the Franchise Disclosure Document (“FDD”) and a sample franchise agreement to understand expectations and requirements of a franchisee.
- Obtain and review the operations manual.
- Interview key management personnel to further understand the specific areas of concern for all franchise locations and for “problem” locations.
- Obtain and review any relevant documentation of previously known compliance issues with “problem locations”.

11
Phase 2: Develop Franchisee Audit Program

• Prepare an audit program tailored to the specific needs of the system.

• Establish the scope and duration of the procedures.
  – This is where you set the focus – limited procedures or expansive
  – Could be modified by situation – “good guys” vs. “problem children”

• Design a draft report template.
  – Development of a deliverable both for the franchisor and franchisee is key to building
    the relationship

Phase 3 - Validate Program & Test Objectives

• Review the audit program and report template with management, legal
  counsel and other Company stakeholders as deemed necessary to ensure
  that:
  – all areas of concern have been adequately addressed, and
  – the level of detail reflects the desired cost-benefit analysis of the
    consequences of franchisee non-compliance and the level of cost and effort
    required to perform the procedures.

• Visit an “ideal location” franchise and perform cursory procedures to
  ensure that the designed program will result in expected results and
  identify alternate procedures for use where records may not be available
  or full-cooperation of franchisee is not received.

• Finalize the audit program and report template.
Phase 4 – Implement the program

- Client identifies location(s) and dates on which to perform procedures.
- Perform procedures as determined in the audit program.
- Prepare draft report and review with management and legal counsel.
- Make follow-up inquires or additional testing procedures as necessary.
- Issue final report.
- Review audit results with the Franchisor and discuss areas where the franchisor or franchisees can improve operations.

- Determine how to communicate results to franchisee
Questions and Discussion
Anatomy of the Target Data Breach, and Lessons Learned

Peter Sloan
Deborah Juhnke, IGP, CRM

Husch Blackwell

Hacktivism

Financial

Cyber-espionage

Husch Blackwell
World's Biggest Data Breaches
Selected losses greater than 30,000 records

http://www.informationisbeautiful.net/visualizations/worlds-biggest-data-breaches-hacks/

Target Timeline

- Malware Installed
  - Nov 27
- Krebs Breaks Story
  - Dec 11
- 40 Class Action Lawsuits
  - Dec 13
- Target Announces 40M Cards Stolen
  - Dec 19
- Target Announces 70M More Affected Accounts
  - Jan 8
- Target Share Prices Plunge
  - Jan 10
- CEO Resigns
  - Mar 5
- CIO Resigns
  - May 5

30 Days

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The Kill Chain

Reconnaissance

- Public information – Internet searches
- Target vendors
- Supplier portal
  - Stored files
  - Metadata scans
  - User names/format
  - Windows domain - print
Phishing and Vendor Access

- Social engineering
- Fazio Mechanical
- Billing, project management & contracts portal
- Keystroke logging malware
- Password collection
- Free software w/o real-time protection, consumer oriented

Alert System Worked…

- SOC – Security Operations Center
- Rare for retailers
- FireEye software, used by Pentagon & CIA
- Malware auto-delete disabled—can halt e-mail for business users
- Generic name: “malware.binary”
- Likely receive hundreds a day

But security personnel did not respond
Command and Control

- Access for over a month
- Toward low end: most take months or years to detect
- Could have analyzed credential use or filtered C&C ports

Exfiltration

- Plain text to FTP servers
- Located in Russia
- Could have “white-listed” approved FTP servers

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The Aftermath

- Over 100 civil suits – consolidated
- Derivative shareholder suits
- Bank suit
- CIO & CEO gone
- Earnings down
- Credibility damaged

Recent Developments

- Target announced it expects to pay $148M for breach-related costs
- Target is attempting to delay discovery in multidistrict litigation
- Financial institution plaintiffs’ consolidated complaint was filed August 1
- Consumer plaintiffs’ consolidated complaint filed August 25
Lessons Learned

1. It may not be matter of “if,” but rather “when”
2. No industry is immune
3. Small ≠ safe

Recent Breaches of Franchises

- Hotel: • White Lodging
- Retail: • Home Depot
- Grocery: • Supervalu
- Charity: • Goodwill
Why Small ≠ Safe

Often:
- Decentralized
- Lack dedicated IT staff
- Lack clear response plan
- Misperceive risk

Applying the Kill Chain
**Identify: What To Protect**

- **Regulated Information**
  - PHI
  - GLB
  - PII
  - PCI-DSS

- **Private Information**
  - Privacy Policies
  - Privacy Expectations

- **Business Information**
  - Trade Secrets
  - Business Confidential

---

**Assess: How To Assess Risk**

1. **Identify**
   - Locations of Data
   - Policies
   - Workflows
   - Threats
   - Vulnerabilities

2. **Assess**
   - Metrics
   - Controls
   - Security
   - Probabilities
   - Impacts

3. **Act**
   - Prioritize Risks
   - Assign Responsibility
   - Document

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Establish: How To Establish a Program

- Planning & Preparation
- Security Controls
- Vendor Management
- Training & Awareness
- Response Planning

Planning & Preparation

- Don’t make it easy!
  - Portals, files
  - Risk assessment
- Develop a comprehensive information security plan
  - Policies
  - Controls
    - Administrative
    - Physical
    - Technical
  - Breach Detection/Response
Technology Controls

- Adhere to standards
- Invest in appropriate tools
- Keep systems patched
- Know where your data is
- Pay particular attention to mobile data
- Understand the implications of the “Internet of Things”

What Do These Have in Common?

- Traffic lights
- Security cameras
- Home heating systems
- Glucose meters
- Hotel wine coolers
- Baby monitors
- Particle-accelerator
- Garage doors
- Refrigerators
- Webcams
- Fetal heart monitors
- Hydroelectric plants

They can all be detected on-line through “Shodan” search
Vendor Management

- Verify levels of access
- Monitor access
- Eliminate single log-ons
- Require authentication
- Require security training
Training & Awareness

- First line of defense
- Passwords!
- Phishing awareness
- Human interpretation

Detect & Respond: Response Planning

- First 24 Hours
- Notification Obligations
  - Affected Individuals
  - Government Agencies
  - Consumer Reporting Agencies
  - Media Outlets
  - Business Partners
  - Insurance Carriers
  - IT Solutions Vendor
- Standardize Process
  - Document your analyses
  - Timely report confirmed breaches to all required individuals and agencies
  - Report only confirmed breaches

Update: Policies & Controls
We all are…. The Weakest Link!
Contact Us

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  peter.sloan@huschblackwell.com

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  (816) 983-8803
  deborah.juhnke@huschblackwell.com