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Win-Win

Four topics often vex relationships, but smart fixes do exist

By Dennis L. Monroe

Four key topics arise again and again in the relationship between franchisors and franchisees, generating frequent and significant discussion, and sometimes controversy. Let's examine each topic and offer some reasonable solutions.

They are: store closures and related consequences; personal guarantees under the franchise agreement; relocation of sites; and defaults under the franchise agreement. (My discussion of these issues was a joint effort with my partners Randy Evans and Ryan Palmer.)

A better approach to closures

Unfortunately, not all locations are successful. Franchisees may encounter any number of obstacles that could dramatically affect the profitability of a location, such as changing demographics, changes to ingress/egress for the location, and other factors beyond their control. When this occurs, it is often in the best interest of both parties to close the location.

While the franchisor has an interest in keeping as many locations open as possible, both from a financial standpoint (royalty income) and a brand standpoint (historical and continuing success of its franchised units), it also has an interest in making sure its franchisees are financially strong.

It is clearly detrimental to the franchisee, and indirectly to the franchisor, to continue to operate a store that is unprofitable and a drain on the overall financial health of the franchisee. Many franchisors are reluctant to allow unprofitable stores to close and often seek to impose termination fees and other penalties on the franchisee. In my view, this is not always the right approach.

Often the better approach is for the franchisee and the franchisor to have open and honest communication about a site that is simply not financially viable, and to explore all available options, including closing the location and mitigating the lease and other associated costs, or moving the store to a better location.

The antiquated guarantee

Personal guarantees are one of the antiquated requirements of many franchise agreements. Assuming the franchisee is adequately capitalized and is not overleveraged, the franchisor and the franchisee should address guarantee requirements in the context of the broader business deal.

The franchisor should require the franchisee remain adequately capitalized through the term of the franchise agreement, and, as part of its agreement to consider a waiver of typical guarantee requirements, should require that the franchisee provide frequent financial statements, both profit and loss statements and balance sheets, for the franchisee and any affiliates or consolidated entities. The franchisor might also structure the guarantee so that it springs into existence automatically following any failure to maintain adequate capitalization.

Even if guarantees are part of the deal, the agreements themselves can be structured to address major concerns of both franchisors and franchisees. For example, the liability under a guarantee can be limited to cover royalties and advertising fund contributions for some defined period of time or to "burn off" at some defined point in the future (for instance, when the franchisee achieves some predetermined level of financial stability).

Another approach is for a franchisor to accept a letter of credit from the franchisee in lieu of personal guarantees from the principals. For example, the franchisor may be willing to substitute a letter of credit from the franchisee in an amount equal to projected royalties and advertising fund contributions for some defined period of time, typically nine to 12 months. This is particularly true where the franchisee is owned by a private equity fund, which is generally not able or willing to provide guarantees.

Another recent approach I have seen is for a franchisor to pursue personal guarantee insurance on behalf of the franchisee and principals. To mitigate risk in this way generally costs between 1 and 2 percent annually of the amount guaranteed.

Relocation of sites

This topic goes hand in hand with the first issue of store closures. Relocation, rather than closure, is often the best solution when a franchisee is faced with an unprofitable or underperforming store but has a significant capital investment in that store that it does not want to walk away from.

There are several things the franchisor should do to facilitate this relocation. The franchisor should not charge a fee and should extend the franchise agreement to give the franchisee the standard term at the new site. For instance, if an underperforming site has been open for seven years and has a 20-year franchise agreement, the new site should be granted a 20-year franchise agreement at no cost. Additionally, the franchisor should provide an appropriate ramp-up period for royalties and advertising.

What to do in defaults?

Franchisors and franchisees frequently clash over the operation of franchised stores and compliance with a franchisor's various brand standards. The franchisor is the owner of the brand. As a result, the franchise agreement will often impose strict standards for the franchisee's operation of its business. While franchisors have a right, and in some cases a duty, to protect their brand, it's possible to take it too far.

One common point of friction between franchisors and franchisees is remodeling and re-imaging standards. Franchisors often require franchisees to update stores to meet new brand standards, and franchisees often claim the franchisor hasn't demonstrated an appropriate return on investment for the required expenditures. Franchisors should use their company stores and willing franchisees to test and refine remodeling programs and make the results part of "selling" the required expenditures to existing franchisees.

Another area of contention is required product purchases. Franchisors have the right to control the products and suppliers used by franchisees in the operation of their businesses. Even so, franchisors should use these controls only when necessary to maintain the standards of the brand or to provide a benefit to the franchisees.

For example, a franchisor might choose to protect a formula or recipe for proprietary products by designating a single-source supplier. A franchisor might also restrict suppliers to help franchisees receive volume purchase discounts not available outside of the franchise system.

These four issues often lead to tensions between franchisors and franchisees, but reasonable solutions can be found.

The goal is to create a win/win situation for the franchisor and franchisee alike, helping them avoid that dreaded litigation that sometimes occurs. FT

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