

Know Thyself

The direction in which franchisors should be driving franchisees



By Dennis Monroe

In today's fluid and volatile franchise world, it is imperative that a franchise system knows itself and

where it's going. As I have discovered in my representation of many franchisors and franchisees, it is rare a franchisor that has a good understanding of its franchisees' financial positions. It may be that the franchisor understands an individual franchisee or multi-unit operator's profit and loss positions and clearly understands whether the franchisee is current on royalties and advertising payments. This is only a small part of the picture. Franchisees are always concerned about franchise rights, so the first thing to be paid after normal operating expenses is usually the franchisor. Thus, it is very unusual for the franchisor to have an indication of the franchisee's financial problems based solely on royalty and advertising payments. If the franchisor does have franchisees that are in default or falling behind in payments to the franchisor, it is probably late in the troubled company's financial scenario.

What further exacerbates this understanding in a potentially troubled franchisee's situation is distrust between the franchisor and franchisee. Too often, franchisees think that if the franchisor knows too much about their financial position, the franchisor may initiate undue constraints on the franchisee. Often, the theory that knowledge is power and less knowledge is

better clouds many franchisees' minds.

Given this backdrop, what can franchise systems do to help the system move forward and protect the franchisee business model? Please consider the following ideas:

1. Balance sheet:

The biggest problem in the franchise community today is poor balance sheets. Franchise systems should be emphasizing open sharing by the franchisee of their



financial information, particularly their balance sheets. In addition to financial information, the franchisee should provide a list of lenders, liquidity position and, in general, a description of any key financial problems.

2. Franchisee questionnaire:

We have been developing various questionnaires that the franchisor can use to

obtain a good understanding of the franchisees' financial position. The questionnaire is not intended to be a heavy-handed approach, but a way for the franchisees to provide basic information. Here is a sampling of the information requested in a good questionnaire:

- A. Name(s) of the lender(s) and type of loan (this does not have to be terribly detailed)
- B. Franchisee's thoughts about development, where they are with the development process and how the franchisor can help
- C. A list of personal guaranties
- D. A summary of working capital/liquidity needs (e.g., accounts payable aging)
- E. A list of outside investors and issues with these investors
- F. Recent injections of capital

The answers to these questions will provide both franchisee and franchisor with a clear understanding of the franchisee's financial position.

3. Corporate structure:

It is important for the franchisor to understand the overall corporate structure of its franchisees. What types of entities are being used? Have there been Sub-chapter S elections? Have there been conversions to LLCs? What are the buy/sell provisions? What type of insurance is in place?

4. Lenders:

Information obtained from the franchisee regarding lender issues can provide the franchisor with the opportunity to proactively meet with the lenders, and to provide intercreditor rights and some breathing room for the franchisee. Further, many franchisors have retained outside workout firms to help with problematic lender situations and even to assist in the economic cost of these professionals.

5. Landlord positions:

Probably the most important element for franchisors to understand is where its franchisees are at with their landlords. Are there current defaults? Are there potential defaults? Are the rent rates above current market and do they need to be renegotiated? Do the leases have various acceleration rights that may create a problem if there is a default? (Note that assignments of leases and remarketing agreements with lenders can help calm concerned landlords.) Again, many franchisors have retained outside professionals to assist franchisees in renegotiating non-market leases.

6. Supplier and current accounts payables:

Where are the franchisees at with payments to their suppliers? Are they behind? Is there a liquidity crunch? Are there unpaid sales or payroll taxes? I believe if the franchisor is aware of these issues, the franchisor can be of assistance to its franchisees. Franchisor involvement may not be in direct monetary payments but can help provide ways to keep the stores open. An example would be an assurance by the franchisor of the potential payment to a system wide supplier.

Because of the legal nature of the franchise documents, an adversarial relationship can develop between the franchisor and its franchisees. In today's tight economic situation, there really is no room for this approach. Instead, everyone needs to look at the various options and work together in a spirit of trust and cooperation. ^[FT]

Dennis L. Monroe is a partner and chairman of Krass Monroe, P.A., a law firm specializing in multi-unit franchise finance, mergers and acquisitions, and taxation based in Minneapolis.