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Franchisee/Franchisor Litigation—What Are We Going To Do About It?

By Dennis Monroe

As reflected in a recent Franchise Times article, there is no shortage of litigation between franchisors and franchisees. Our firm recently looked at the specific types of litigation that are the most common. These aren't necessarily reflective of overall disputes, but rather cases that have gone to court and are publicly recorded. Much of the litigation centers around the breakdown in the franchisee relationship, which often results in non-payment of royalties. Other disputes concerned capital investments, particularly when the franchisor mandates investments for remodels or technology. The other major area of litigation centers around development rights, as well as post-termination non-competes and continued use of intellectual property.

I believe the majority of the disputes could have been avoided if there had been open communication between the franchisor and franchisees, using a partnership approach rather than fostering the idea that the franchisor is there to protect its brand and see its royalties grow.

For his take, I talked to an expert in these dispute areas, Ron Gardner of Dady & Gardner, P.A., in Minneapolis. His expertise is franchisee advisory councils (FAC), from existing ones with disputes to ones just being formed. I also looked at FACs as a litmus test as to how a franchise works in terms of cooperation. Gardner said a good FAC has a safe environment for the franchisor and the franchisees to discuss tough issues and air out perceived differences. The expectation is that once FACs are in that space, they can come to a resolution and present a united approach to the franchisee community.

With that as background, let's look at disputes and how they could be handled. First, many disputes evolve when a franchise system has a weak performance and the franchisor's solution is to come up with new products and revenue sources that, in many cases, require capital improvements and new technology, all necessitating additional funding out of the franchisees' own pocket or from their lenders and investors.

Before any capital investments are mandated, franchisees need to be convinced that the capital investment is appropriate and there is a clear understanding of return on investment and revenue potential. If the changes involve an increase in labor costs, which is a big deal in the franchise community, they need to know this upfront. The franchisor should test capital investment in their company-owned stores, then select franchisees to test it, Gardner advised. Once it's determined there is a return on investment and available financing, then it can be rolled out.

Another type of dispute is when a franchisee is financially distressed and stops paying royalties. Franchisors tend to overreact to nonpayment and send a default notice, escalating into an adversarial situation. The driver of these disputes are when franchisees are disappointed in unit performance. Expectations exceed reality, which in turn, leads to conflict. A solution is for franchisors to provide a clear understanding of the unit economics, but also for franchisees to approach the franchisor early on with any financial problems. When I have represented a franchisee, I've heard numerous times from the franchisor that my client is a bad operator or has a bad manager. How much more productive would it be for them to recognize that there is financial distress and help find a solution rather than blame the franchisee?

Another point of contention is the initial franchise negotiation. Gardner suggests that when franchisees initially negotiate their franchise documents, franchisors should provide more information and flexibility in the franchise documents, rather than insist they cannot change anything. He points out that every year when the franchisor does their annual filing, they are likely to make changes in the agreements and certainly the FDD. Their needs to be a reasonable approach to reasonable changes in the initial franchise documents.

Development rights can be another major source of disputes. Too often development agreements provide for an overly aggressive development schedule and severe penalties for not meeting the schedule. Flexibility in timing is a must and solutions that keep the franchisee as part of the system at a reduced number of stores, if the development schedule cannot be met.

Finally, there are times that it is best to part ways in a decivilized manner with an underperforming franchisee. The franchisee can hopefully resell their identified site with a reasonable and not overly restrictive post-termination non-compete, so some value can be recovered.

In summary, the key to a healthy relationship is to not think of it as a zero sum game, where there has to be a winner and a loser. The key is to create a franchise culture of partnership and mutually agreed to solutions for difficult situations.

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