

# **Negotiations with Individual Franchisees**

## **The Franchisor's Perspective**

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## **Scope of This Paper**

This paper explores a number of the considerations, both practical and legal, involved in negotiations between a Franchisor and its individual Franchisees, either in the pre-award phase of the relationship or after the franchise has been awarded. The paper generally is from the perspective of the Franchisor, although it also discusses some of the factors which are important to Franchisees as they request, or enter into, negotiations. In particular, it seeks to explain some of the issues which Franchisors see when negotiations are requested and how they handle such requests.

Scenarios explored include those relating to the initial franchise award, awards of additional territories or units, assignment or renewal, as well as notes on some pre-litigation considerations.

This paper does not include a discussion of negotiations in the context of actual litigation nor scenarios involving system-wide negotiations, such as Franchisor proposals to change all or most of the outstanding franchise agreements for operational, marketing or legal reasons, such as the introduction of a mandatory marketing fund, or in response to proposals by a Franchisee association.

## **Executive Summary**

- Changes to the Franchise Agreement made to close a sale are usually made by new Franchisors eager to book a sale and take in revenue, are usually a bad idea, weaken system uniformity, often compromise the elements of good franchise system design and are generally later regretted by the Franchisor.
- Some changes made in connection with the initial sale may make sense, even with mature Franchisors, when either a truly unique situation exists with a particular prospect (particularly an institutional Franchisee) or the prospect makes a suggestion which results in improvements to the documents and which can be implemented on a system-wide basis.
- Franchisors are more likely to make economic (or, more rarely, other) concessions in connection with awards of additional units or territories.
- In assignment situations, Franchisors may make some concessions to the Buyer or Seller, but will almost always require a release.
- Negotiation of terms is less likely in renewal situations, unless the Franchisee is in a particularly strong position, and the Franchisor will nearly always require a release.

- Franchisees in financial distress, and who have been “team players,” may be given work-out plans and other relief, where the prospects of a turn-around are realistic. Again, a release will almost always be required.

## **The Initial Franchise Award**

### **The New Franchisor**

One of the most common situations in which a Franchisor may be willing to negotiate with a Franchisee (or, more typically, a prospective Franchisee) is where the Franchisor is eager (or desperate) to make a sale, either for cash flow reasons, to recruit a particularly desirable Franchisee or to enter a new market, perhaps just in front of the competition.

This desire to “close the sale”, while certainly understandable, generally results in concessions that are later regretted by the Franchisor.

Perhaps the most common of these scenarios is what is called “selling the Ponderosa”, a term referring to awarding a large exclusive territory which the Franchisee never adequately develops.

This approach often results in the Franchisee soon reaching a level of gross sales and income which may be entirely adequate for his or her needs and in which he or she has little incentive to make further capital commitments, or take additional risks, to open more units or further develop the territory. That lack of further development then allows competitors to open units, secure favorable locations and take market share away from the franchise system that made this mistake.

For example, consider a “desperate housewife” Franchisor, eager to make a sale (perhaps to meet this month’s payroll?) and who grants a prospective Franchisee exclusive rights to the Las Vegas market in 1998, and only requires the opening of 5 units. Seven years later, the Las Vegas market has expanded significantly, and can reasonably support additional units under the same brand, but the Franchisee has met his or her development schedule, has a healthy income from those five units and now has different priorities (entering other businesses, going fishing, etc.) Seeing the market opportunity, competitors secure rights to most of the remaining available Class A locations, open 11 other company-owned or franchised units in the area, and become the dominant players in the market, relegating the first brand to a permanently subordinate position.

The result? Diminished market share, reduced top-of-mind-awareness among potential customers, lessened funds available for system-wide marketing, etc., all

because a Franchisor was willing to “do whatever it takes to make the sale” early in its development and ignored long-term consequences in favor of accommodating requests of an individual Franchisee.

It’s scenarios like this that result in nearly all Franchisors who have made such concessions early in their development later regretting them. Whatever one’s philosophical orientation, interviews of mature Franchisors generally reveal regrets over most of the concessions they made early in their development process.

In addition, other issues are related to individual negotiations, and may explain the reluctance most Franchisors have to engage in them:

#### UFOC Disclosure Issues

A pattern of awarding franchises on terms other than those disclosed in the UFOC can lead to later claims that the UFOC contained misrepresentations, in purporting to offer franchises on terms materially different from those actually utilized in a significant number of real-life awards. After all, if the UFOC says that no exclusive territories are awarded, and the Franchisor then begins a practice of doing so in, say, 30% of its awards, is the UFOC a misrepresentation? Franchisees who received less favorable deals may have claims based on the fact that they were led to believe that the franchise was only available on one set of terms, when the Franchisor was actually closing deals on different terms, which were more favorable.

#### California-Specific Issues

For Franchisors offering franchises in California, awards on terms different than those disclosed in the UFOC registered with the state can be illegal unless there is compliance with specific state requirements, analysis and compliance of which always involves legal costs and possible delays.

#### “Political” Issues

Even if no legal requirements have been violated, few Franchisors will look forward to explaining, in public and at their next convention, why Mr. Jones got a substantially more favorable deal than Ms. Smith, each of whom bought at about the same time. Given that few secrets in a franchise system remain secret for long, this type of embarrassing scenario is reasonably likely to come about.

#### Administrative Issues

The merits of any particular negotiation aside, few Franchisors are willing to administer, for example, a system of 106 units with 23 different form of franchise agreements and embodying different business deals and legal rights and obligations.

## **The Mature Franchisor**

Mature Franchisors are even less likely to make changes in the terms of their franchise awards or agreements, with the exception of the unusual situations noted below.

### **Creating Better Documents for the System**

Both new and mature Franchisors are (or should be) willing to explain the reasons behind Franchise Agreement provisions, whether or not they are willing to change them. When explained, Franchisees generally understand that the provisions have a rationale, are not arbitrary and are usually designed to protect the joint investment of the Franchisor and the Franchisees in the system.

In unusual (but not unheard of) situations, prospective Franchisees have suggested changes to franchise agreement provisions which make them more understandable or practical in their application. When that happens, Franchisors should adopt such changes, not merely for the Franchisee suggesting the change, but probably also on a system-wide basis. After all, if something can be said more clearly, or there's an unanticipated aspect of a problem that should be addressed, the entire system should benefit from the solution.

### **Issues Unique to a Particular Franchisee**

Certain issues are truly unique to a particular Franchisee and even a mature Franchisor should be willing to address those issues if a negotiated change does not threaten the integrity of the system.

For example, consider a Franchisor offering franchises for a children's tutoring center, which includes in its standard Franchise Agreement a clause prohibiting the Franchisee and his/her spouse from being involved in any similar or related activity. A Franchisee's spouse, who teaches in the local school system but not on her own time or for separate compensation, might technically be in violation of the clause, but the Franchisor may be willing to sign an amendment or side letter allowing her to continue her public school activities under clearly defined and understood conditions.

Similarly, some QSR (quick serve restaurant) franchise systems may allow a Franchisee to operate other food service businesses (perhaps even in the QSR category, so long as they are not part of competitive systems or have similar primary menu items.

### **Prospective Franchisees with Market Power or Unique Situations**

Finally, exceptional Franchisees may receive exceptional agreements, which can be the result of negotiations.

For example, a large publicly owned Franchisee operating multiple brands (e. g. Host Marriott) will typically attempt to negotiate changes (and may succeed) in the Franchise Agreement relating to assignment, competitive activities, and even in some of the dispute avoidance and resolution clauses. Similarly, non-standard venues (casinos, military bases, universities, malls, Indian reservations, etc.) may require separately negotiated provisions which take into account the unique nature of the facility or the Franchisee.

### **Awards of Additional Franchises, Units or Territories**

Many of the considerations discussed above will apply when an existing Franchisee (or a new entrant to the system) asks for additional franchises, units or territories, or an expanded territory. Those considerations include, for the Franchisor, a desire to not compromise core principles on which the franchise system was founded, avoidance of “political” problems based on charges of favoritism and potential legal requirements flowing from awards of franchises on terms different than the standard arrangement discussed in the UFOC.

However, unusual business situations may overcome these objections, and each situation is different. For example, a Franchisor offering only unit franchises may, for an exceptionally qualified candidate, be willing to consider award of an area development or other multi-store arrangement, if the appropriate market and other factors exist.

Multi-store deals may also result in adjustments to the initial franchise fee charged (for example, to reflect lowered training costs), but almost never to royalty fees or required marketing fund contributions.

### **Assignment (Selling Franchisee to Purchasing Franchisee)**

As franchise systems mature, instances of one Franchisee selling out to another Franchisee become more common. Note that the buyer can either be an existing Franchisee, generally a “neighbor,” or a new entrant to the system. In any of these situations, the seller and/or the buyer may ask for exceptions to the Franchisor’s policies regarding assignments or to the assignment provisions in any existing documents covering the franchise to be sold.

Below we discuss a few of the potential areas where negotiations may occur; many others are “deal-specific” and are, therefore, not discussed below due to the wide range in variations.

### Concessions Requested by the Seller.

Most Franchise Agreements contain a clause requiring the Seller to remain liable for all current and future obligations under the Franchise Agreement being assigned, or any replacement agreement. For example, if the buyer fails to timely pay royalties or other amounts to be owed during the term of the franchise, the seller will be obligated to pay them. Obviously, sellers would prefer not to have this liability, while Franchisors would prefer to have an additional “deep pocket” to look to if they’re not paid.

In addition, experienced Franchisors may have been “burned” in the past in situations in which a strong Franchisee sold out to a financially weak buyer and then was not liable when the buyer failed to make royalty payments. Franchisors may believe that requiring the Seller to remain liable may make the Seller more selective as to the buyer chosen.

However, in some situations, the Franchisor may be willing to terminate the Seller’s liability for non-performance by the buyer after a specified period of time in which the buyer has performed all obligations.

In addition, sellers sometimes request a reduction in the assignment fee to be paid, particularly if they are unable to persuade the buyer to pay it or make it part of the purchase price. Franchisors may allow a reduction, particularly if they are on friendly relations with the seller and the buyer does not need training or there are other opportunities for cost savings at the Franchisor’s level.

### Concessions Requested by the Buyer.

Buyers may also request concessions from a Franchisor’s normal policies. One example relates to the clause in most Franchise Agreements that the Buyer can (and usually, as a matter of practice, is) required to sign the then-current form of the Franchise Agreement, which generally contains more Franchisor-friendly clauses than earlier versions, sometimes even including requirements for higher royalty or marketing fund payments. Franchisors rarely allow exceptions to this requirement, for obvious reasons.

On the other hand, buyers will sometimes ask for options, or at least rights-of-first-refusal, on additional territories and/or units, and if the Franchisor is convinced that the buyer is qualified to operate additional units, and is likely to remain so, those requests may be granted.

In all of these situations (and in the renewal, and financially distressed Franchisee, situations discussed below), the Franchise will almost always insist on a release of all known and unknown claims from the Franchisee and any related persons/companies. To grant concessions, and then later be sued by the same

person who received those concessions, for anything occurring prior to the assignment, renewal, etc., is viewed as an unacceptable risk by nearly all Franchisors.

### **Renewal**

Renewals will also present situations similar to those in assignments, such as requests for non-signing of the then-current form of Franchise Agreement (again, rarely agreed to) and/or reduction of the renewal fee, also rarely agreed to. Franchisors are understandably reluctant to waive those provisions, unless an exceptional business situation is present or the Franchisee has unusual bargaining power.

### **The Financially Distressed Franchisee**

Any mature franchise system will eventually encounter a situation in which a Franchisee is in a position of financial difficulty, wants to remain in business and part of the franchise system, but needs some financial concessions to do so. With bankruptcy being the alternative, something that rarely benefits either the Franchisee or the Franchisor, a payment plan or other “workout” may be preferable to Franchisor and Franchisee alike.

Depending on a number of factors, the Franchisor may be agreeable to a deferred payment plan or other adjustments. The factors typically considered by Franchisors, in making the decision as to whether or not enter into some plan include the following:

- Has the Franchisee been a “team player” with respect to system compliance and payment history, at least up until his/her recent difficulties?
- Are the problems that led to the financial difficulties temporary in nature or systemic (possibly even self-inflicted) and unlikely to be resolved by temporary adjustments? Hurricane Andrew is one situation; a Franchisee’s untreated cocaine habit is an entirely different one.

If the Franchisor can be convinced that the Franchisee’s problems can be fixed and that the “day of reckoning” is not merely being put off, then a payment plan or other adjustment may be structured, but the Franchisor will almost always require a release, possibly signing of the then-current Franchise Agreement, security covering the Franchisee’s past and future obligations, etc.

### **Pre-Litigation Disputes**

In disputes in which potential litigation is a factor, almost anything can be on the table and the possibility of a resolution through negotiation will be significantly influenced by the following factors.

The strength on one party's (or the other's) underlying legal claim will be, of course, central to any possibility of a concession by the Franchisor. If the Franchisee has something close to an assured winner in litigation, and the resources to take the dispute to a decision, he/she are almost assured of being able to receive substantial concessions in their favor. This will be enhanced if the Franchisee has done sufficient "homework" (which can involve a substantial investment) to be sure that the threat of litigation is realistic and will be perceived as such by the other side. Mere threats, without evidence of the possibility of a successful lawsuit, are rarely effective.

Franchisees should be aware that in a pre-litigation scenario, their negotiating position may be strongest before they file a lawsuit. At that point, the threat of placing the Franchisor in a situation where it will have to disclose the litigation in its UFOC may result in some negotiating leverage; once the suit is filed, that leverage has gone largely away, since the Franchisor will usually be obligated to disclose the lawsuit even if it is eventually settled.

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*This material is presented for training and discussion purposes only. It should **not** be used or relied on without first consulting an attorney who is an experienced franchise law specialist, and discussing with him/her your particular facts and business situation, as well as, all applicable laws. Proceeding without the benefit of experienced, franchise-specific legal advice directly related to your fact situation, documents, business model, etc. is **not** recommended.*

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