How To Help Your Franchising Clients Survive The Recession

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One way that a struggling franchisee can get some wiggle room is by negotiating a reduction in advertising and royalty fees paid to the franchisor.

FRANCHISORS AND FRANCHISEES have a better chance at weathering the current economic turmoil than plenty of other entrepreneurs, given the organizing principle of the franchising industry—namely that in war as in commerce, there is strength in numbers.

But they aren't immune to trouble, and if you count franchisors or franchisees among your clients, they may soon come to you for help in surviving the ongoing downturn in the economy. The good news is that the legal ties that bind franchisors and franchisees—along with the ties that bind franchisees to landlords, lenders, and vendors—contain enough wiggle room to give all of these parties a chance to come away from hard times still doing business with one another. This is true even though franchising agreements typically give the upper hand to the franchisor, just as leases and loan documents typically give the upper hand to landlords and lenders.

The bad news is that, for franchisors, making use of that wiggle room is the last thing they want to do, since it involves violating the sanctity of two items at the heart of franchising—royalties and fees for advertising and marketing. Specifically, it means taking a cut in these revenue streams, either by reducing them temporarily or by deferring payments for a struggling franchisee.

Royalties and ad fees commonly vary with the franchisee's revenues, and in any economic downturn they can constitute a substantial drag on the working capital of a struggling franchisee. In a worst-case scenario, they can threaten the franchisee's enterprise, not to mention the franchisor's. Franchisors, however, do not readily agree to accommodate struggling franchisees with reductions in these revenue sources even in hard times, in part because royalties and ad fees are the lifeblood of their own enterprises, and in part because, if a particular franchisee gets a cut in royalties or ad fees, others will want the same. Clearly, for the franchisor, taking a cut in royalties or ad fees is a last resort, to be undertaken only under extraordinary circumstances—and only for as long as it takes to get things back to normal. The lawyer who negotiates such an accommodation thus faces no easy task.

INSPECT THE AGREEMENT • The first step is to inspect the franchise or other agreements covering royalties and fees for advertising and marketing, looking for wiggle room around which to build an argument that these sources of revenue are powerful tools in the hands of a franchisor determined to survive the current economic downturn with as many franchisees in tow as possible. The worst that can befall a franchisor is to lose good franchisees, whether in good times or bad, and the cost of a temporary cut in royalties or ad fees may well pencil out as less painful than the cost of recruiting new franchisees in a recession like the current one, marked as it is by a massive loss of personal wealth—usually the source of a franchisee's initial investment and startup costs—plus a severe contraction in the credit markets.

Getting Reductions In Ad Fees And Royalties

The lawyer may find more wiggle room in fees for advertising and marketing than in royalties. Only the shortsighted entrepreneur eliminates advertising and marketing when times get tough. On the other hand, only the foolish franchisor continues to support a particular advertising and marketing program if deteriorating economic conditions make it ineffective. The better idea is to funnel money into advertising and marketing strategies best suited to such circumstances, eliminating those showing poor results and possibly putting the savings into the hands of good franchisees to fashion advertising and marketing campaigns reflecting conditions in their own areas.

As an alternative, the franchisor could offer a temporary reduction in ad fees in an amount reflecting the franchisor's position, the product or service, the franchisee's marketplace, and possibly dozens of other factors. The franchisor who takes two percent of gross sales for advertising and marketing fees, for example, might consider a reduction of .5 percent. But an analysis of the franchisor's advertising and marketing programs shows that the old 80-20 rule applies; 20 percent of the money this franchisor spends on advertising and marketing brings in 80 percent of revenues. Hence it might be possible for this franchisor to reduce ad fees by as much as 1.5 percent.

A third alternative is to allow a struggling franchisee to defer payment on royalties and ad fees, in part or in whole, for a specified period in the expectation that the franchisee will use the savings to get back on track. This alternative is often the choice for franchisees that have already fallen behind on royalty and ad fee payments, and in exchange for the concession, franchisors typically insist that the franchisee keep up with current payments so as not to fall farther behind.

THE WORKOUT AGREEMENT • Whatever the concessions, the workout agreement should emphasize that the goal is to get through hard times, not to institute permanent changes in the financial relationship between franchisor and franchisee. No franchisor can be expected to countenance a permanent reduction in royalties or ad fees, in other words. This means franchisees must come to the negotiating table armed with detailed plans showing how they plan to use the savings as working capital to get their businesses back to normal. They should also be prepared to file regular (preferably quarterly) reports on their progress toward normal operations, and to sign promissory notes for any royalties or ad fees in default.

Any workout agreement must put clear time limits on the new arrangement. It should also contain a general release of claims in favor of the franchisor covering all matters arising before the date of the workout agreement. Such clauses may be a hard pill for franchisees to swallow, but they commonly agree because they have no choice.

The workout agreement should specify that, should the franchisee default, the franchisor may terminate the agreement with notice, usually five to 30 days. Last but not least, the workout agreement should contain a cross-default clause specifying that any default by the franchisee on any of the terms of the agreement constitutes a default on the original franchise agreement.

NEGOTIATION IDEAS • It should go without saying that franchisors should waste no time offering to negotiate workout agreements with troubled franchisees whose operations have proven profitable in the past, resulting in regular payments of royalties and ad fees. It should also go without saying that no workout agreement should put the franchisee under such pressure as to make failure a certainty. Indeed, the agreement should enable the franchisee, given a reduction in royalties or ad fees, to generate enough new cash flow to meet current obligations and eliminate any arrears in a reasonable period of time.

On the other hand, with franchisees already in shaky condition, the better idea may be to let them fail.

Lawyers who represent franchisees play the negotiating game with fewer cards in their hands and more people to negotiate with—not just franchisors but also landlords, lenders, vendors, and possibly others. But they are not without options. Job one for this lawyer, as for the lawyer representing franchisors, is to find wiggle room in the franchise agreement and in any agreements between the franchisee and landlords, lenders, vendors, and others.

Start Early

The franchisee's lawyer must also persuade the client to waste no time in approaching these stakeholder parties when trouble arises—and the good news here is that landlords, lenders, and vendors have an interest in keeping the franchisee's doors open, just as franchisors do. Given the rise in vacancy rates in commercial real estate nationwide, landlords are already showing themselves willing to make concessions on rent and other terms to good tenants—usually minor concessions, to be sure, but concessions nonetheless. Similarly, although banks have greatly tightened lending standards for new borrowers, and many are lowering, sometimes even eliminating, existing lines of credit for business and personal borrowers alike, they hesitate to cut off good customers altogether. As for vendors, if they must choose between closing the door on a known customer and finding a new, unknown one, the choice is usually clear.

Be Prepared

To take advantage of these factors, the franchisee's lawyer must come to the negotiating table well armed with financial statements and evidence showing that the franchisee has made good efforts to do business in the face of troubles beyond the control of any individual.

Paint A Bright Future

Overall, the goal is to maintain the viability of the franchisee's business no matter what happens to the economy. This means negotiating for concessions that will put the franchisee in position to generate new business. Above all, it means insisting on reasonable terms that will enable the franchisee to discharge any new obligations to the stakeholders, and the sooner the better.

CONCLUSION • In short, the lawyer should put the franchisee client in a position to under-promise and over-perform. Given the pressures exerted on all business enterprises by the ongoing economic downturn, the lawyer who represents such a client must keep in mind that all of the stakeholders in a franchisee's business venture need one another—and that each must give a little that all may find satisfaction in the end.

PRACTICE CHECKLIST
The Workout Agreement

An effective workout agreement must contain detailed language describing the default and the terms under which the franchisee will correct it. In addition, the franchisor should obtain a promissory note setting out the debt owed, interest rate, payment schedule, payment method, and consequences of any default on the part of the franchisee.

The following are the important terms of the workout agreement itself:

- A brief history of the relationship between franchisor and franchisee specifying the date and purpose of any franchising, licensing, or other agreements signed by both parties;
- An outline of the financial obligations, including royalties, fees, and other charges payable by the franchisee to the franchisor;
- A recitation of defaults detailing the sums in arrears payable by the franchisee to the franchisor;
- An assertion of the franchisor's right to terminate the franchise, license or other agreement because of franchisee's default;
- A statement that the parties desire to enter into a workout agreement;
- A statement detailing how the franchisee is to repay the monies owed to franchisee, including terms, interest, and frequency of payments;
- Cross-default language specifying that any default by the franchisee on any of the terms of the workout agreement constitutes a default on the original franchise, license, or other agreement;
- Language giving the franchisor a security interest in assets held by the franchisee—for example, leaseholds, machinery, furnishings and equipment, vehicles, inventory, and the like;
- A statement that the franchisor retains the right to declare the entire debt due and payable should the franchisee default;
- A general release of claims against the franchisor covering all matters arising before the date of the workout agreement.