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Managing Relationship Issues When Franchisees Operate Multiple Brands With Different Franchisors

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Franchising continues to grow as a part of the national and global economy. As this trend continues, we anticipate that an increased number of franchisees will operate more than one brand. This trend will present many interesting and challenging legal and business issues that both franchisors and franchisees will need to address to optimize their business relationships. Some of these issues may be addressed contractually, although many will be able to be resolved only by full and frank communications of the concerns and expectations of both parties, the hallmarks of franchise relationship management.

At first blush, as is often the case in franchising, the interests of the franchisor and the franchisee, may appear to be at odds in connection with franchisees operating multiple brands. If, however, one assumes that both parties have the shared goal of optimizing the financial and intangible benefits from their business relationship, the interests of the parties begin to merge. This paper will discuss at a high-level some of the significant business issues that parties might expect to confront when the franchisee operates more than one brand and manages ongoing business relationships with different franchisors. Any one of these topics could be the subject of a separate discussion and presentation, and there are issues in some systems that we may not even address or appreciate. The fundamental premise, though, is that both franchisors and franchisees need to confront early and directly the relationship management issues and dynamics that necessarily will exist when a franchisee operates more than one brand as a franchisee of more than one franchisor.

Introduction

This discussion will focus primarily on the dynamics involved when a franchisee is "serving more than one master." That presents different issues from a situation where the franchisee operates more than one brand franchised by the same franchisor or affiliated franchisors, although some of the issues discussed here may arise in that scenario as well. There is always the possibility, moreover, that the issues will eventually present themselves if affiliated brands are sold or split into separate companies. In a two-day span in January 2011, for example, Yum! Brands, Inc. announced that it was putting its LONG JOHN SILVER'S® and A&W® restaurant chains up for sale,[1] and Wendy's/Arby's Group, Inc. announced that it was exploring

[1] Press Release, Yum! Brands, Inc., *Yum! Brands Places Long John Silver's and A&W All–American Restaurants for Sale* (Business Wire, Jan. 18, 2011), available at http://www.yum.com/company/pressreleases/011811.asp

strategic alternatives for its ARBY'S® brand.[2] In either case, franchisees operating more than one of those affiliated brands may find themselves operating competitive brands overnight.

The scope and relevance of this topic is evident in the fact that 46 of the largest 100 restaurant franchisees identified in a recent survey operate multiple concepts with different franchisors. That includes 16 of the largest 25 of those franchisees. Another 17 of the largest 100 franchisees operate different brands with affiliated franchisors.[3] To prove a previous point, of those 17, several operate either A&W or LONG JOHN SILVER'S restaurants together with other Yum! Brands that may become competitors if the brands are spin off. The dynamic could be more complicated if the two brands are sold to different new owners. A franchisee may, with a few pen strokes, find itself operating three competing brands.

Still, despite the known pitfalls, franchise systems increasingly will find that the most fertile source for franchisees is other franchise systems. While this will be especially true for new franchise systems, the attractiveness of experienced multi-unit operators will not be limited to nascent concepts. In a recent article, for example, executives of Checkers Drive-In Restaurants, Inc. discussed the advantages of expanding into new geographies with experienced operators of non-competitive brands.[4] There is a consensus, if not a conventional wisdom, that a given level of sophistication comes with any successful operator of a multi-unit business, and adding that person to a franchise system by definition eliminates some of the risk that exists in every new franchisee.

It should be noted that franchisees operating multiple brands, and potentially competing brands, are quite common in international markets. As franchisors delve into previously uncharted territories internationally, it is much more common to engage with multi-unit operators with previous experience operating American brands. The comfort of dealing with a known quantity, or at least an entity with an observable track record, outweighs the concerns surrounding competitive offerings by the same franchisee. Domestically, the larger pool of franchisee prospects seems to shift the cost/benefit balancing more against having franchisees operate competing concepts.

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[2] Press Release, Wendy's/Arby's Group, Inc., *Wendy's/Arby's Group Exploring Strategic Alternatives for Arby's* (Business Wire, Jan. 20, 2011), available at http://ir.wendysarbys.com/phoenix.zhtml?c=67548&p=irol-newsArticle&ID=1517886&highlight=

[3] *The Restaurant Franchise Monitor's Top 200 Restaurant Franchisees*, FRANCHISE TIMES, August 2009, at 41.

[4] *Crown Me: Checkers starts making its move into New England*, FRANCHISE TIMES, April 2011, at 61.

Much like individual investors, franchisees will likely be increasingly drawn to "diversification," and franchisees that are successful operating under one franchise model may seek to manage their portfolio risk by operating different franchise concepts. This might be manifested in diversification within industries, e.g., different segments within the restaurant space, or across industries.

In addition, the seismic changes in the capital markets over the last several years have made it truer than ever that "the only person who can get a loan is one who doesn't need the money."[5] In franchising, that has been reflected in a reduced ability for new franchisees to finance a business and for many existing franchisees to expand their existing businesses. This makes larger, well-established franchisees more attractive both to their existing franchisors and to other concepts. Assuming access to capital will not loosen appreciably in the next several years, it can reasonably be assumed that more franchisees will begin to operate different brands, and more franchisors will have to address the business and legal issues involved when franchisees operate brands franchised by different franchisors.

Given that standard franchise agreement terms are often twenty years and nearly always at least ten years, the market conditions over the life of a franchise agreement will change significantly, and it will be important to draft agreements and manage relationships in light of that reality. The notion of franchisees operating different brands may also present interesting cultural challenges for some franchisors. While multi-brand operators may be part of the fabric of some franchise systems, many of the iconic franchise systems operated for many years in a world where it was a rare case for a franchisee to operate other concepts. Franchisees of McDONALDS®, WENDY'S®, and BURGER KING® were just that, franchisees of those concepts, and neither the franchisor nor the franchisee seriously contemplated anything different. As a result, many older franchise agreements did not even address issues potentially arising when franchisees operated other concepts.

We will address several key issues that franchisors and franchisees will need to consider, and preferably address appropriately, when a franchisee diversifies it holdings to include other franchise concepts. While these areas are by no means all-inclusive, they present issues that are common and significant enough to warrant consideration. There are few legal answers to the questions presented; instead, the best resolutions will flow from a functional franchise relationship

Key Issue #1: Capital Structure

Franchisors have a legitimate interest in understanding, approving, and, as practical, regulating the capital structure of its franchisees. A fundamental concern for a franchisor is whether its franchisees have capital structures and capital sources adequate to meet the needs of the operating business and any requirements or

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[5] A paraphrasing of a notable quote from aerospace industry executive Norman Ralph Augustine, who said, "It's easy to get a loan unless you need it."

commitments to grow the brand. Most franchisors are resourced and capable of managing those issues when a franchisee operates only in one system. The dynamics are significantly different, and much more complex, when the franchisee operates multiple brands under multiple affiliated operating entities.[6]

It is unacceptable to a franchisor for the franchisee's business to be put at risk of failure by the franchisee's other brands. This is particularly true, at least from the franchisor's perspective, if the franchisor is the most established, mature or credit-worthy brand in the franchisee's portfolio. A franchisor wants to insure that its franchised units are not at risk of failure based upon the lack of success of another brand operated by the franchisee. The franchisor (of a successful brand) will always be concerned, and rightfully so, with putting protections in place that limit, to the extent possible, the franchisee's ability to take capital or other resources from the healthy brand to subsidize an unhealthy brand.

There likely will be limits, however, on the franchisor's ability to prohibit all types of capital transfer. After all, if the obligations to the operating business and the franchisor are met, the profit of the business belongs to the franchisee. It may be challenging for one franchisor to exert much control over the franchisee's deployment of its own capital, simply because it is generated in the form of profits from operating the franchisee's brand. Instead, a franchisor might consider whether it can negotiate covenants with the franchisee to establish some capital reserve, or equity level, requirements to ensure that the franchisee is retaining enough of the profits to meet future needs of the specific business. Needless to say, this might be a contentious negotiation between the parties, particularly if the franchise agreement does not in the first instance preclude the franchisee from operating the other concept, or require the franchisor consent to do so.

While franchisees acknowledge and even appreciate this concern of franchisors, it may sometimes be at odds with the realities of the capital markets. The starting point for a lender is to maximize its collateral and repayment sources. So, if the franchisee insists on keeping its established business completely separate from the new venture, as the first franchisor would prefer, lenders almost surely will view the loan request as a startup venture, giving the franchisee no credit, literally or figuratively, for its long and successful business history. Thus, an established and successful hamburger restaurant franchisee will be on a par with a startup business if it insists that its new entity operating a frozen yogurt concept be capitalized separately from the existing business.

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[6] Most well-drafted franchise agreements require that the franchisee operate the franchised business through single-purpose entities such that one entity should never operated multiple concepts. Of course, at some level the ownership interests converge in a common holding company or the individual principal. Franchisors must be vigilant, however, in enforcing this requirement in the franchise agreement as franchisees, for reasons of expedience or necessity, sometimes do not adhere to the contractual requirements for separateness of entities.

Of course, the prior business success of the franchisee may give the individuals behind the business more financial strength than most start up entrepreneurs, and that personal wealth will almost certainly be required to be offered up in the form of personal guarantees for the new business debt. That reality itself undermines to a degree any efforts by franchisors to insulate its brand from all financial risk posed by expansion into other brands. There have many instances in recent years in which a healthy franchise business was put at risk, or even lost, because the principal became personally overextended. Creditors of the individual may proceed against the individuals interest in the franchisee entity, forcing either bankruptcy or a sale, with risk to both the franchisee and the franchisor.

In addition, if one of the franchisors is a relatively new concept, that franchisor may encourage, or even expect, the franchisee to look to the profits from its existing business to fund the growth of the new brand. The new franchisor might even be willing to approve what might otherwise be an undercapitalized franchise entity knowing that the principal will be able to access the profits of the existing business to fund operation or growth of the new venture.

The relationship issues become increasingly complex if there is a development obligation, or even expectation, with both brands. A franchisee may, for example, have been approved by one brand for significant development opportunities based on a certain demonstrated net worth and liquidity, derived largely from the existing business with the franchisor. In such a case, the franchisor will have a heightened comfort level with the franchisee's financial prospects, and also the franchisor will view the transaction in light of the benefits it will derive from growth by the franchisee. There may also be a willingness to forgo strict compliance with a development commitment if the franchisee is proceeding in good faith and any missed target is a function of specific brand performance issues or other reasons the franchisor understands or views as unavoidable. If the franchisee signs on with another brand, however, and undertakes a separate development commitment to its new franchisor, the dynamic with the first brand very well may change. If the first franchisor believes that liquidity is flowing out of its franchisee, specifically to fund development of the new brand, the franchisor may feel that the assumptions underlying its decision to grant development rights to the franchisee have been changed by the franchisee. Certainly, a franchisor will be less keen to accept as an excuse for non-performance under a development agreement the explanation that the franchisee had too many resources tied up with developing a different brand.

If the parties fail to address these types of issues early and collaboratively, either by contract or through developing some shared understanding of expectations, there is a significant chance that disputes will arise that will threaten the relationship. The parties may resort to legal action, which is inimical to an optimized franchise relationship. After all, as the previously-quoted Norman Ralph Augustine observed, "People do not win people fights. Lawyers do."

Key Issue #2: Organizational Structure and Efficiencies

Issues invariably will exist related to the franchisee's organizational structure when a franchisee operates multiple brands. Questions of training, confidentiality and the skill and "full time best efforts" of operations personnel are all impacted when the franchisee operates different brands. These areas are rife with potential pitfalls.

A franchisee that diversifies into other brands (like one who expands under one brand) will always look for operational and organizational efficiencies that result in increased profitability. For example, a franchisee operating 20 ice cream/frozen yogurt units may have a chief financial officer or some equivalent, with a finance organization supporting her. The cost of the finance function might be $300,000, or $15,000 per unit. That franchisee will be able to grow to 40 units without adding a new CFO or even appreciably increasing the size of the finance function. Perhaps, at 40 units, two additional financial managers will be added, and the cost of the finance function will increase to $440,000, or $11,000 per unit. Assuming some congruence of sales of the new units with the old, there is some cost efficiency in that simplified example.

Of course, no franchisor will publicly speak out against allowing its franchisee to operate as efficiently as possible. In fact, many tout their willingness and abilities to assist franchisees in finding and mining operational and organizational efficiencies. But that willingness to indulge the franchisee's organizational sleekness has limits. If the proposed "efficiency" comes from consolidating functions supporting two separate brands, rather than a larger single brand, franchisors must assess whether the franchisee has the organizational depth, in operations, training and in executive functions such as finance and human resources, to support separate businesses that can deliver the required level of operations for both brands. That may be the determinative factor in terms of the resources the franchisee can share between brands and those it cannot share. In many cases, however, the resolution may depend upon whether any franchisor perceives that resource sharing comes at the expense its brand or the franchisee's compliance with its franchise agreement.

Following on the example above, let's assume the successful 20 unit ice cream/frozen yogurt franchisee decides to expand into a new submarine sandwich franchise concept. Will the ice cream franchisor feel that the sandwich franchisor is benefitting disproportionately from the "efficiencies" created by the now-shared resources? After all, the ice cream franchisor may have spent 10 years working with its franchisee and its key employees, training them and sharing best practices on how to run a better and more profitable franchise business. In that franchisor's view, the "investment" in the franchisee and its organization should pay dividends to the franchisor, through higher sales and unit growth for the franchisor's brand. Now, the game has changed, and the additional 20 units will be eight ice cream locations and 12 sub shops. Is the ice cream franchisor justified in feeling that its knowledge is being transferred to another business, which is getting of a free ride? Justified or not, it is likely that the sentiment will be expressed at some level of the ice cream franchisor's organization.

The franchisor's concern is likely to be highest in connection with unit operations functions. A franchisor will naturally be more protective about its operational training, innovations and technologies, than about some shared accounting functions. While it may be acceptable for a back office financial manager to work on both brands, a franchisor will have more concerns if a unit-level manager moves between brands. In the franchisor's view, there are too many competitive or proprietary issues involved in a franchise operating system to allow a free flow of employees across concepts. Most franchisors will, therefore, draw a line at any sharing or unit-level employees, requiring at least that manager-level employees work only on their brand.[7]

The franchisor and franchisee may have divergent views on above-unit operations employees, such as area supervisors or trainers. The franchisor will, of course, want dedicated employees trained in its brand standards, while the franchisee may see overlap that can be shared across brands. A franchisee may argue credibly that a "customer service trainer" has skills applicable to both ice cream stores and sub shops, and the franchisee may want to leverage those skills across its multiple brands. This may in turn raise the issue of how that specific trainer is herself trained and continuously educated. If one franchisor feels that its training resources are being used to benefit the other brand, there may be a tendency to insist on brand-specific employees. In addition, if one concept puts more focus on and resources toward training or operations, it may guard more jealously the specifics of its programs and methods.

A franchisee would also be well-advised to ensure the franchisor that needed resources will never be diverted from its brand. A franchisor may be concerned that, unless it draws a bright-line prohibition against shared operations resources, operations at its branded units will be compromised by diversion of those resources. For example, if our franchisee operates a sub shop and a nearby ice cream store, and some employees work in both locations, a franchisor will want to know that its staffing requirements will be met, and the franchisee will not move a crew member from the ice cream store to the sub shop (or vice versa) because the other location was short-staffed. This concern will be exacerbated if one franchisor believes that the other franchisor is too lax on its staffing requirements or enforcement, thereby inviting short-staffed locations, which get filled by dipping into the first franchisor's crew. Thus, if a franchisee wants to leverage any potential efficiencies, it needs to demonstrate to the franchisors that it can and will be done without compromising any brand standards.

This type of issue presents challenges for both parties, and their lawyers, in drafting agreements or addenda addressing these issues, and monitoring and enforcement of whatever agreement, formal or informal, that is in place. In addition, as the franchisee's overall business grows and changes, and the business models of the

[7] The franchisor may be less concerned with non-management employees who do not receive extensive training directly from the franchisor. There may be some benefit from having a responsible employee work in both brands if the franchisee's model does not allow for the employee to work on a full-time basis in one brand.

different concepts evolve over time, the parties almost certainly will need to revisit the issues, and probably more than once.

Key Issue # 3: Confidentiality/Non-Competition

In all of the above examples of shared operational and organizational resources, confidentiality and non-competition are significant underlying concerns. Franchisors guard zealously their brand-specific training and operational innovations, and marketing plans and strategies, which they rightfully consider (in most cases) to be confidential and proprietary or, at a minimum, business intelligence that benefits the system. These concerns will surely be heightened to the extent the franchisee operates brands that are viewed in any way as competitive with each other. A franchisee operating PIZZA HUT® restaurants and MIDAS® muffler shops may not raise the same level of concern as a franchisee operating WENDY'S restaurants and SUBWAY® sandwich shops.

The standard twenty year term, or minimum ten year term, of most franchise agreements, and the rapid pace at which the market place is changing, complicate the issue of competition between different brands operated by a single franchisee. Nowadays, the definition of who and what is the competition may change quickly and dramatically. Many examples of concepts not thought of as "competitive brands" just five or ten years ago are viewed that way now. As little as seven years ago, frozen yogurt concepts were not necessarily in the "smoothie" business. Still, it might not have been too much of a stretch to think that a frozen yogurt shop and a smoothie seller could become more competitive. But it certainly was not so obvious that McDONALD'S restaurants, BURGER KING restaurants, and DUNKIN' DONUTS® locations might be competing with SMOOTHIE KING® outlets or TCBY® shops for "share of stomach."[8]

It goes without saying now that most fast-food brands have increased their offerings of traditional dessert items and products such as smoothies. At the same time, more concepts are expanding into day-parts they never competed for previously. SUBWAY and STEAK N SHAKE® are now offering breakfast, JAMBA JUICE® is expanding its offerings beyond the meal-replacement smoothie, and more changes are certainly on the horizon in most businesses.

In the recent past, many in-term non-compete provisions of different franchise agreements may not have seemed to be in conflict and, in fact, were not considered to be problematic by franchisors. Over time, however, as business models evolve, concepts never considered to be competitors may find themselves fighting for the same customers more often than either ever contemplated. In that context, allowing a franchisee to share resources becomes a riskier proposition if a franchisor perceives it to be giving aid and comfort to the enemy.

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[8] The origin of the term "share of stomach" is not settled. It was popularized after being used in the 1980s by Roberto Goizueta, CEO of The Coca-Cola Company, to communicate his view that the company does not simply compete against its arch-rival Pepsi Cola Company.

This concern involves multiple facets of confidentiality and competitive information, and even the potential for a breach of confidentiality can drive decision-making. A franchisor may be reluctant to have a franchisee that operates competitive concepts serve as a member of a marketing advisory council, because members of the council are privy to confidential information in advance of other franchisees. There could even be a concern that one franchisor asks the franchisee to play a leadership role in its system for the purpose of making the other franchisor more cautious in its dealings with the franchisee. That, in turn, may tilt the franchisee toward the "friendlier" franchisor when the next decision is made as to what concept to build next. Those issues complicate even further the concerns related to confidentiality and competition when one franchisee operates multiple brands. Beyond confidentiality, however, the issues go to the core of the relationship between the franchisee and the different franchisors.

Consider our ice cream and sub shop franchisee. What if the sub shop franchisee is testing a smoothie product, or is negotiating a license to offer ice cream products as a dessert offering across its system? Can it share that information with the franchisee, knowing that the franchisee sits on the new product development counsel of the ice cream franchise system? What if its franchise agreement provides that all new product line extensions must be approved by franchisees or a franchisee association? What steps can it take to ensure that the confidentiality surrounding its strategy, its negotiations, or the terms of its license agreements with a third-party are kept confidential?

It would take little effort to hypothesize dozens of flash points that might arise in similar situations. Surely, there will be franchise agreement provisions that may be invoked, which may or may not provide guidance or a satisfactory resolution. It will become increasingly important for both franchisors and franchisees to understand what their franchise agreements state in this regard. And both sides must remember that other franchisees will be watching developments closely. If a franchisor reaches some understanding with the multi-brand franchisee about access to confidential information, will other franchisees, which operate only the one brand, assert that the franchisor is not taking adequate precautions to protect the trademark and proprietary information essential to the system's success? From a relationship management perspective, the franchisor should consider whether the other franchisees feel that way even if they don't raise the issue directly.

Although these and other potential conflicts abound, it is unlikely that they will stem the flow of franchisees to different brands, so the parties on both sides need to consider the issues that might arise and establish some framework for addressing them. It is a fair assumption that addressing the issues in a business concept is much preferred to addressing them in a legal setting. It remains to be seen, however, where those resolutions will be found.

Key Issue #4: Real Estate Issues

The one area that poses the most potential for serious conflict is real estate.[9] This is unsurprising given that the availability and price of real estate, and the competition for it, has been a key driver of franchise system growth for several years. Franchisors will be wary of sharing operational plans and tactics, and even more concerned about the confidentiality of marketing plans and potential new products. However, they will be almost maniacal in their protection of access to real estate strategies and tactics. The potential for conflict can arise in different ways, and both parties must be mindful of the issue at all times.

Allocation and preference in real estate decision making will be a point of contention in a system where the franchisee is primarily responsible for locating and developing real estate. The franchisor will have a vested interest in how real estate opportunities are allocated between the franchisee's different brands. Each franchisor will want the best sites to go to its brand, while the franchisee may want some flexibility to allocate opportunities as it sees fit consistent with any development obligations. After all, the franchisee is managing m In this area, there will be significant and difficult drafting issues even if there is some alignment on the business agreement.ore than one franchisor and needs to keep each happy.

The issue is not a simple one. What happens, for instance, when the franchisee in good faith believes that that location is sufficient for one brand but not the other? Perhaps the franchisee believes that the location works for a sub shop, but not an ice cream store. While the footprint might be similar, the franchisee might believe that traffic patterns make it an "A" site for a sub shop but only a "B" site for the ice cream store. And the franchisee might stick to its guns and pass on the location, then make the point that if he doesn't develop a sub shop there, a direct competitor of the ice cream concept might. Regardless of who turns out to be right on the property's attributes, the franchisee will point out that handing the common enemy a location serve neither franchisor nor franchisee well. A good amount of energy can be expended hashing out those issues, as the potential of a specific real estate location is often quite subjective and even speculative. Those discussions, moreover, can test the franchise relationship, and both sides need to recognize that reality.

There are even more potential hazards when the franchisor is actively involved in the site location and development process. A franchisor will not countenance a franchisee (or any other party) usurping real estate opportunities presented by the franchisor. In the eyes of the franchisor, it would be felonious if a franchisee passed on a potential location, and after the franchisee abandoned discussions with the owner, the franchisee develops the site with a different brand. There may be valid reasons for the

[9] The authors did an informal survey of select in-house counsel to poll the types of issues that concern them when franchisees operate multiple concepts. Real estate was the most mentioned, by a significant margin.

franchisee's decision, as discussed briefly above. That will, however, likely be an ineffective balm for the franchisor's wound.

The rights and perceptions of other franchisees may be relevant here as well. If the multi-brand franchisee passes on a site as an ice cream store in favor of developing a sub shop, nearby ice cream concept franchisees may question why the franchisor didn't help one of them develop it as an ice cream location. It may matter little in such situations that the franchisor was not actually in control of the real estate decision. Optically, the franchisor seems to have failed to protect the brand.

This is an area, therefore, that should be the subject of clear and mutually understood contractual guidelines. A franchisor is not likely to share any real estate development information with a franchisee absent some agreement that the franchisee will either develop the franchisor's brand or not do anything at all. It serves neither party, however, for the franchisee to disengage with the franchisor for fear of running afoul of some unstated expectation or requirement related to development and real estate issues.

Conclusion

The current trend toward more franchisees operating multiple brands from different franchisors is not likely to reverse in the near future. The reduced availability of capital will further the trend and the increased investment necessary to launch a franchised business will continue to create opportunities for existing franchisees to grow with different brands. Franchisors and franchisees have the opportunity now to write the rules, and set the standards, for managing franchise relationships in this particular context. Franchisees that do it will almost certain maximize their opportunities to invest and grow across concepts. Franchisors that adapt will make themselves more interesting and attractive to the types of franchisees that have the greatest growth potential and that offer a level of franchisee sophistication that mitigates the franchisor's business risks in many respects.

The key to success, we submit, will not be found in the language of existing franchise agreements, or even in most future agreements. This paradigm, with a slight shift in the bargaining power of the parties, must be managed carefully, proactively and professionally. Those systems that are able to work through the issues presented will have a competitive advantage over those that don't. The relationships between franchisor and franchisee can become a business tool to support a franchise system's long-term success. Companies that invest the time and resources in managing those relationships will realize a return on that investment that may help determine how far and how fast they move their brands forward in the coming years.