Guiding You Through the Legal Maze.℠

IS YOUR FRANCHISE A 20-YEAR "RENT A BUSINESS?"

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THE PROBLEM

The typical franchise agreement is usually for an initial term of 5 to 10 years with a right to renew for an additional term. This means that at some point in time the franchise relationship may end if the franchisee does not exercise a right to renew or where the franchisee has no additional right to renew and the franchisor refuses to renew. In representing prospective franchisees, I have had numerous occasions to ask the franchisor: "What happens after 20 years when the renewal term ends?" Surprised at the question, the candid response by the franchisor was "I don't know, we haven't been operating that long."

My reply was that according to the literal terms of the franchise agreement, there is no legal obligation for the franchisor to renew the franchise agreement again even if the franchisee wants to. The post expiration provisions apply including possibly giving the franchisor the right to buy your franchised business at a low price, the franchisor having the right to take over your lease, telephone number and listings, your customer list, and, to put salt in your wounds, you must comply with the covenant not to compete and cease operating the business for 2 years.

The effect of all of this is that you did not really buy a franchise in which you build up equity to sell or to give to your kids; you "rented" a franchise business for 20 years. It makes it virtually impossible for you to resell the franchised business if there are only a few years left. At the end, like any lease, there is no equity accumulated. The business cannot be sold or inherited after the end of the renewal term - it disappears. Most franchisees really do not understand this; otherwise they may never have signed the franchise agreement in the first place.

COMMON RENEWAL TERMS

Evergreen Renewal Rights

You are buying a franchise as a long-term investment where equity is accumulated for you to sell and retire, or pass down to your children. You need to negotiate unlimited ("evergreen") rights to renew, whereby the franchise agreement is automatically renewed at your option, provided you are not in default under the franchise agreement and other reasonable conditions are met, such as the payment of a minimal renewal fee, signing the franchisor's then-current form of franchise agreement but without material changes in material business terms including not increasing royalties or other payments, not reducing the size of the protected territory and not expanding the non-competition covenants and without the execution of a general release. This way as long as the business makes economic sense you have the right to renew the franchise agreement.

Notice to Renew

Most franchise agreements require that you give written notice to the franchisor of your intention to renew the franchise agreement during a specified period of time, for example, within 360 to 270 days before the end of then term. If you fail to give timely written notice, the franchise may have the right not to renew you. Since the franchisor has staff monitoring the franchises and maintaining franchisee compliance files, it is not unreasonable to require that the franchisor give first notice to you of the end of the term and your right to renew to prevent inadvertent oversight and loss of franchise.

Renewal Franchise Agreement

Most franchise agreements provide that, as a condition to the franchisor's consent to renew, you agree to sign the "then current form of franchise agreement." Basically, you agree to sign whatever from of franchise agreement the franchisor shoves in front of you 10 years from now at the time of renewal without any opportunity to discuss and negotiate any material changes that the franchisor has unilaterally made to the agreement.

The renewal franchise agreement is likely to be materially different from the one you signed years before, such as higher fees, larger and/or longer covenant not to compete, smaller or no protected territory, greater obligations on the franchisee and/or fewer obligations by the franchisor. This is because franchisors have a habit of revising (tightening) the franchise agreement after a court decision in favor of franchisees or a desire to increase the amount of income the franchisor receives from its franchisees.

You are between a rock and a hard place. If you do not sign the renewal franchise agreement you may be forced to get out of the business for 2 years due to the covenant not to compete. Accordingly, from your perspective, the renewal franchise agreement should not be materially different from the existing franchise agreement unless collectively negotiated with the franchisees and approved by a majority of the franchisees.

Renewal (No Default)

Many franchise agreements provide as a condition to the franchisor's consent to renew that you "shall have substantially complied with all the terms and provisions of the franchise agreement, any amendment or successor franchise agreement, and all other agreements between the franchise and the franchisor, its subsidiaries, affiliates or divisions relating to the franchise business." Technically, with this type of language, if you have ever been in default during the term (even if timely and properly cured!), you could lose your right to renew. The unfairness of this provision is obvious. You should only have to be not in default at the time of renewal. Therefore, this provision needs to be deleted.

General Release on Renewal

Most franchise agreements have provisions which say, as a condition to the franchisor agreeing to the renewal of a franchise, that you sign and give to the franchisor a general release releasing all claims that you may have, known or unknown, against the franchisor. What if you have a valid claim and/or are in litigation with the franchisor at the time of renewal? I've seen it happen! Try to eliminate this provision or have it state that the franchisor has to give you a general release as well and further provide that the release will not include known claims and pending or threatened litigation. There are several states where this release is not enforceable. See if there is a state-specific addendum to the franchise agreement deleting this requirement. Check with your franchise attorney.

Qualifications at Renewal

Some franchise agreements provide that, as a condition to the franchisor consenting to a renewal of the franchise agreement, the franchisee must comply with the then current training and qualification requirements imposed by the franchisor on new franchisees. If you qualified for the last 10 years, why have unilateral, unknown, and possibly arbitrary, new qualifications apply? Try to have this provision eliminated.

Renewal (or Option) Fee

A renewal fee (sometimes called an option fee) is a fee charged by the franchisor in connection with the renewal of the franchise or the option to obtain a successor franchise agreement. The fee can range from zero to a whole new then-initial franchise fee of tens of thousands of dollars. Since there are little out-of-pocket costs incurred by the franchisor in renewing your franchise (no advertising expenses, brokerage commissions, costs to find a location, costs to train, etc. that the franchisor initially incurs), negotiate to eliminate any fee or make the fee reasonable and not let it be a profit center for the franchisor.

Remodeling Upon Renewal

Some franchise agreements require as a condition to the franchisor's consent to renew that you remodel the premises to conform to the franchisor's then current trade dress. This could cost you tens of thousands of dollars. You should not have to remodel again if you recently remodeled. Remodeling should be subject to a capital expenditure limitation.

Conversion of Renewal

Some franchisors that have more than one concept they franchise reserve the option to require you to change to another of the franchisor's concepts upon renewal. This really makes no business sense for you unless the original concept is dated and no longer profitable. Try to delete this provision so you have the option but not the obligation.

YOUR OBLIGATIONS UPON EXPIRATION AND NON-RENEWAL

Upon the expiration and non-renewal of the franchise agreement, you may have a number of obligations to the franchisor. Many of these post-expiration obligations are penal in nature. Maybe they are appropriate if you default. Are they appropriate if you decide not to renew and want to operate independently? They certainly do not appear to be appropriate if you terminate the franchise agreement due to the franchisor's default! Try to negotiate that these provisions only apply on termination due to your default including:

Cease Operations

Many franchise agreements provide that, upon the expiration of the franchise agreement, you agree to cease operating the business. You should be able to operate independently at the same location as long as you de-identify.

Franchisor's Option to Purchase the Franchisee's Business

The franchise agreement usually provides that the franchisor has the option (not just a right of first refusal) to purchase the franchisee's business on some set formula upon the expiration of the franchise agreement. The purchase price should be based on the business's fair market value on an ongoing business basis and not upon some other formula that gives the franchisor a windfall such a book value. You should receive all cash and not take a note. If you do take a note, make sure it is secured by a purchase money security interest in the assets sold so that, if the note is not paid, you can go back in and take over the business.

Franchisor's Option to Purchase Certain Assets

Upon expiration of the franchise agreement, you are precluded from using the franchisor's proprietary marks including items bearing the proprietary marks such as signage, paper goods, etc. These items may still have value, but the only person who can use them is the franchisor and perhaps other franchisees. Many franchise agreements give the franchisor, upon expiration or termination of the franchise agreement, the option, but not the obligation, to purchase these assets, usually at cost or fair market value whichever is less. This provision should be changed to a "put," meaning that the franchisor must buy back these items from you since you cannot continue to use them. The purchase price should be fair market value.

Assignment of Telephone Number

Many franchise agreements provide that upon the expiration of the franchise agreement, the franchisor has the right to take over your telephone numbers and directory listings. This has the effect of diverting your business. Upon expiration and non-renewal, you should be able to go independent and keep the telephone number but change the name in the next printing of the listings to eliminate the franchisor's trade name.

Assignment of Lease upon Expiration

If you lease from a third party, your franchise agreement may require you and your landlord to agree to allow the franchisor to take over the lease and the premises if the franchise agreement expires and is not renewed. You then can be evicted from the premises. Try to negotiate that you can stay, de-identify and operate a similar business under a different name if you desire. In any event, provide that if the franchisor takes over your lease, that the landlord releases you from all future obligations under the lease. Otherwise, you continue to be liable.

Covenants Not to Compete

A covenant not to compete is a promise by you to the franchisor that you will not operate a business similar (competitive) to the franchise business. The covenant applies while you are a franchisee (that is, "in-term") and for a period of time (usually 2 years) after the franchise agreement expires or is terminated (that is, "post-term"). With respect to the post-term covenant, try to provide that it does not apply if: the franchise agreement expires and is not renewed; the franchise agreement is transferred to a franchisor-approved buyer (but your buyer may want one); or the franchise agreement terminates due to default by the franchisor. One state, California, refuses to enforce any post-term covenant not to compete.

Covenant Not to Solicit

Many franchise agreements provide that during the term and for a period of time thereafter you agree not to solicit the employees of fellow franchisees or of the franchisor. As long as similar covenants apply to your fellow franchisees and the franchisor so that your employees cannot be raised, it is not an unreasonable provision.

De-Identification of Premises

If you stay at the premises, the franchise agreement will likely require you to "de-identify" the premises, that is, make changes in signage, color, layout, etc. so that the public doesn't know it was once part of a franchise chain. Know, before signing the franchise agreement, what the franchisor expects of you in this regard and the likely cost.

CONCLUSION

If you are already a franchisee, pull out your franchise agreement and see what your renewal rights are. What happens under your franchise agreement when it expires and is not renewed? If you do not like the answers you may want to try to negotiate a better deal when you get a chance, recognizing there is no legal obligation on the franchisor to change the terms of the deal.

If you are thinking of buying a franchise, these issue needs to be addressed by you and with the help of a competent franchise attorney he or she can advise you on the your renewal rights and attempt to negotiate for you a better deal.

You want to own your franchised business for as long as it makes money - not lease the franchised business for 10-20 years and end up with zilch.

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