

THE FRANCHISE HANDBOOK

Winter 1999

Robert Zarco, Esq., Principal and Founding Partner, and Robert M. Einhorn, Managing Partner, Zarco & Pardo, P.A.

The issue of growth—from the franchisor's perspective—or encroachment—from the franchisee's perspective—will continue to be an increasingly important problem for franchising in the new millennium.

It has long been understood that by their very nature franchise systems must continue to grow to

Small franchisees may suffer as a result of a changing growth paradigm.

be successful. It was also long understood by franchisors that the best franchisees were small mom-and-pop type operators who ran only one or at most two or three units and were personally involved in day-to-day operations.

However, as some of the large franchise systems reach maturity and full saturation of their potential markets, industry observers are noticing a fundamental shift among franchisors as to the characteristics of the ideal franchisee. This shifting paradigm threatens to make small mom-and-pop franchisees extinct in the larger franchise systems.

The problems that large, mature franchisors have experienced with growth, or encroachment,

have prompted this change in thinking by franchisors as to the characteristics of the ideal franchisee. The problem, of course, is that in a mature franchise system, each time a franchisor opens a new unit it increasingly cannibalizes sales from existing units. This results in increasingly unhappy franchisees, often corresponding to increased problems for the franchisor.

Through careful drafting of franchise agreements eliminating any territorial rights for franchisees, franchisors have, for the most part, been able to take away the keys to the courthouse for franchisees who seek to assert encroachment claims in court.

However, franchisors cannot expect to have happy, productive or successful franchisees by directly competing against them and cannibalizing their sales by opening new units increasingly closer to existing franchisees. Stated another way, the reality of the situation is that even if some franchisors may have made themselves immune to encroachment claims by franchisees in court, having unhappy, unproductive and unsuccessful franchisees is not the recipe for a successful franchise system.

In order to combat this continuing encroachment problem, large franchisors now prefer to grow their systems with multi-unit or institutional type franchisees. They control particular geographic areas and function, in essence, as sub-franchisors. They are

more willing and financially capable of absorbing the inevitable loss of sales at their units that results from encroachment.

NEW ISSUES

This preference by large franchisors to grow with multi-unit operators is itself creating new issues and problems. For example, single-unit franchisees operating in the shadow of these multi-unit operators are often subtly (or not so subtly) "encouraged" to sell their franchises to the multi-unit operator. In some cases they are involuntarily forced from the franchise system.

The loss of single-unit operators presents further problems for the

It's a matter of time before franchise turf battles spread into cyberspace.

franchisor. More and more frequently, franchisees who desire to sell their franchises are being advised that they are only permitted to sell to the multi-unit operators in the area, since other potential buyers will not be "approved" by the franchisor.

That stifles any competition for the franchise purchase and results in situations where franchisees cannot obtain a competitive price for the franchise, since the local multi-unit operator is the

only potential "approved" buyer and is free to name its price.

Thus, franchisors have discovered a way to reward multi-unit operators for tolerating growth and encroachment by creating a situation that allows them to purchase franchises at favorable, below-market prices.

In short, it appears that franchisors are increasingly reaching the conclusion that the best way to grow their systems without creating adversarial relationships with existing franchisees is to grow only with large, multi-unit, institutional-type operators.

Unfortunately, it appears that small franchisees will suffer as a result of this changing paradigm. They are increasingly being denied expansion opportunities and, in some cases, are being driven to sell their franchises at below-market prices.

Other problems may also arise from this shifting way of thinking by franchisors. For example, it is questionable whether large, institutional operators will be able to deliver the same level of service as the mom-and-pop franchisee. If they are unable to do so, the large franchise systems may suffer both operationally and financially.

Another issue that may arise is a change in the level of bargain-

ing power between franchisors and franchisees. It has long been understood that as a result of their size and financial resources franchisors have had the upper hand in negotiations with individual franchisees. However, many

Franchisees need to be vigilant in the legal protection of their rights.

of the multi-unit, institutional-type operators with whom franchisors now seek to grow are themselves often large companies with significant financial resources.

Time will tell whether franchisors, by preferring to grow with such companies, may unknowingly be ceding some control of their franchise systems to these multi-unit operators, who in the future may become even more powerful as they add additional units and control ever-larger geographic areas within the franchise system.

If this shift in bargaining power comes to pass in the new millennium, franchisors may wish for the return of the early days of franchising, when franchise systems primarily consisted of mom-and-pop operators.