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## Recession Has Complicated Franchise Relationships

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Robert Zarco, a partner at the Miami-based law firm Zarco, Einhorn, Salkowski & Brito, is one of the nation's foremost franchise attorneys. The Harvard grad makes frequent appearances on radio and TV shows like CNBC's 'Minding Your Own Business,' is an active lobbyist representing franchisees' interests and says he and his firm have represented a franchisee from just about every major hotel brand.

Zarco recently took some time to chat about the state of hotel franchising and how the recession and wave of distressed properties have affected the often-complex franchisee-franchisor relationship



### **Has the recession affected the relationship between franchisees and franchisors?**

I'm seeing more conflict being created. Franchise sales volumes are down, hotel stays are down so that's lowering the amount of royalties the franchisee pays to the franchisors, so in turn the franchisor is making or imposing more requirements.

### **Any example of what that could be?**

Whether it's by requiring the franchisee to invest more in the physical property, by remodeling earlier, the franchisor wants to make sure the property is nicer, cleaner, more

beautiful. There is conflict with the franchisee because it's easy to spend OPM—other people's money—and because of that, I think you get a situation where conflict arises. The economy has had a major negative impact on the franchisee, the franchisor and is putting a lot of pressure on both. Like you're seeing in the food industry, the franchisor is telling you to sell these value meals for a \$1 when it costs more to make. The pressure is on the franchisee to increase sales, regardless of the impact it would have on profit. Fees come on top line revenue, not profits.

**Not every hotel company is doing this, though?**

Some are, others aren't. The challenge is in order to drive the few customers out there you've got to be the biggest and best with the latest.

**How has the growing number of distressed properties affected franchise relationships?**

Now you have more frequent exchanges of property ownership because of the economic situation and properties going into bankruptcy. What happens to franchise agreements? They are known to be executory contracts, the significance means the relationship still has mutual obligations on both sides that need to be performed. When you get into bankruptcy courts the right to allow the debtor to cancel or reject the contract means in essence the owner loses the right of the brand. Those are issues that are really catastrophic to a franchisee as well as a franchisor. Then the issue of foreclosure, where the franchisee loses the property, that constitutes a breach under the franchise agreement. At that point it depends on what the bank is going to do, who's going to take over operations of the business. Is the franchisor going to approve the bank as the operator or will the franchisor pull the flag from the bank. All kinds of issues arise in those situations.

**When a new owner comes in after a foreclosure, is there any obligation to keep the current flag?**

I think the owner will have the right to do whatever they want. The franchise contract is not with the bank, it was with the franchisee. The bank has control of the property because of the loan. Now that doesn't prevent the bank or new owner from going to the franchisor and saying can we talk.

**What is the biggest issue you're seeing with hotel franchise contracts?**

The most common is the franchisee wanting to get out of the brand because it's not performing, there haven't been strong enough marketing efforts or they're not attracting enough customers. Owners want to deflag and go with another. They have issue with liquidated damage provisions in these contracts and how they work and how enforceable they are.

**How does the hotel industry's franchise system differ from others you represent?**

There's more changing brands on this side, much less on the restaurant side. Restaurants usually close. They're built to look a certain way, have the issue of non-compete clauses and it's very difficult to change brands. In hotels, you have liquidated damage, a mechanism a franchisee can change a brand and continue to use the hotel. Burger King looks very different than McDonalds than Johnny Rockets. Holiday Inn, Ramada Inn, Comfort Inn, they look generally the same.

**Are hotel associations more common than in other industries and do you find them to have more power?**

Associations have as much weight as the franchisor is willing to give them and as much weight as the association earns comes through the participating members. If you have an

association with 10 percent of the system it has a lot less clout than one with 70 percent of the system. The voice and strength is directly related to the number of people that are members.

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