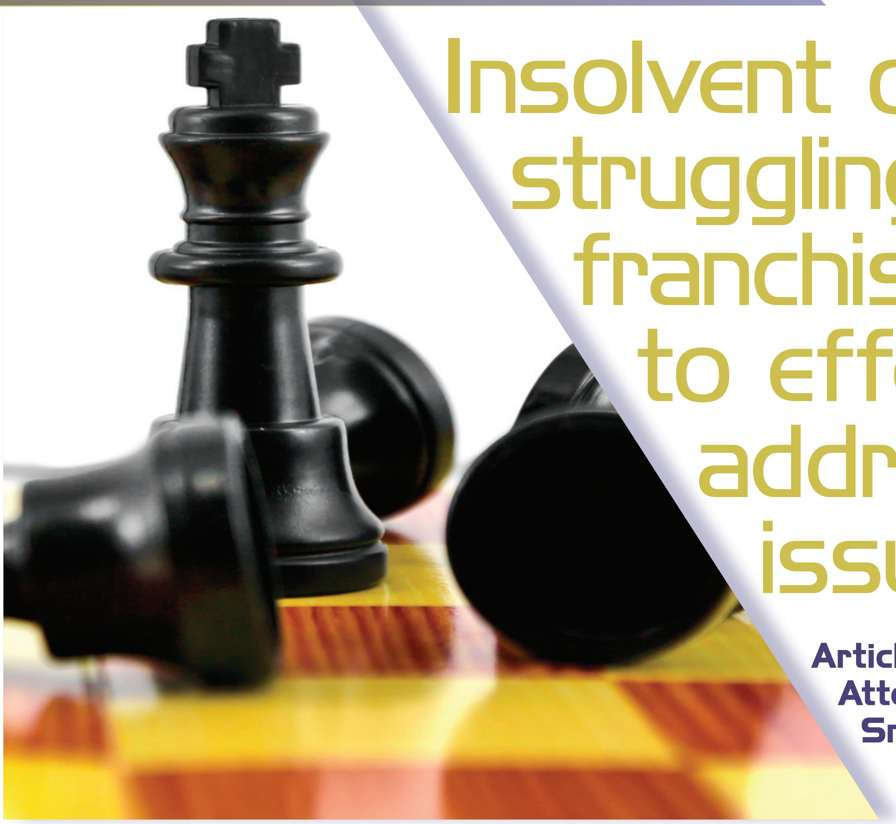

Insolvent or struggling franchisees – how to effectively address the issues

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A franchise system is based on a reciprocal relationship between a franchisor and its franchisees. For a franchise group to expand, one would require the franchisor to contribute and invest in the development of the franchise system, as well as the franchisees to operate the franchise businesses in accordance with the specified operational criteria and brand standards.The benchmark for any franchisor would be to establish, market and sell highly successful franchise businesses. Unfortunately, there are often scenarios where franchisees are struggling or may find themselves in an insolvent situation regarding the franchise business operations.

Reasons for struggling or insolvent franchisees:

From a franchisee's point of view, various factors may cause financial distress, such as: inflated royalty fees or product costs, not receiving adequate supporter training from the franchisor, no proper marketing done by the franchisor, no improvement or development of the franchise system and not having a competitive advantage in the market as a result of outdated systems or products.

From a franchisor's point of view, it may be argued that the reasons for the financial distress are caused by the franchisee's own actions, for example the franchisee did not make adequate provision for financial obligations, no proper financial management or business management exercised by the franchisee, absent franchise managers, franchisee's failure to attending training, franchisee's failure to incorporate new system changes, franchisee's failure to comply with operational procedures and the franchisee may be dealing with unauthorised or inferior products.

Should a franchisor provide additional assistance to struggling or insolvent franchisees?

Struggling or weak franchisees are a burden on a franchise system and failing franchisees have a detrimental effect on a franchise group and the franchise brand. The YES or NO answer on whether a franchisor should provide additional assistance to struggling or insolvent franchisees (assistance beyond basic reasonable assistance and as provided for in terms of the agreements regulating the relationship between the parties) would depend upon the information available to the franchisor, as well as the impact on the franchise group. If there is a chance that the franchisee would recover or grow out of the predicament, one would most certainly advise a franchisor to assist with the franchisee's situation. If there is no prospect of any recovery or rehabilitation of the franchise business, a franchisor may decide that there would be no benefit in additional assistance and it may rather be the best option to terminate the franchise relationship and close the franchise business. Naturally, a franchisor should evaluate the situation and provide assistance before it's too late.

Warning signs to identify struggling franchisees:

Franchisors and franchisees should not turn a blind eye to warning signs within the daily operations of a franchise business, which may be indicative of possible problems. Warning signs may include:

i) Financial problems, for example a franchisee's late payment or inability to pay supplier accounts, royalties and other fees, or decline of credit from financial institutions;

ii) ii) Operational problems, for example a franchisee's failure to comply with operating procedures and customer complaints; and

iii) iii) Relationship problems between a franchisee and the franchisor, suppliers, employees or the landlord.

Identifying problems

When identifying possible problems and causes regarding the franchisee's struggles or financial predicament, one should investigate the entire franchise system, considering all aspects which may be of relevance. It is of utmost importance that a franchisor conducts a system evaluation (including the entire franchise model and concept) to determine whether the franchisee's underperformances may be isolated, or whether the entire franchise group may experience the same difficulties. System issues may include high product or supply costs, outdated financial structures, outdated branding and appearance, outdated software systems and uncompetitive product offerings.

The franchisor should furthermore also do a specific franchisee evaluation, focusing on the franchisee's individual business to determine whether the franchisee's problems are unique or whether the franchisee may be faced with individual problems such as location, unfavourable financing or lease obligations. It would be advisable to conduct a review based on the financial and operational information at hand, as well as any new or special circumstances with which the franchisee experience that may explain, mitigate, or even excuse the performance issues.

Action Plans

Once the reasons for the franchisee's struggles or insolvent situation have been identified, an end goal should be set, either to exit the system or to improve the franchisee's performance. Options in this regard may include:

- Financial assistance such as franchisor-financing or an abatement of franchise fees;
- Conversion of a franchise outlet to a franchisor company owned outlet;
- A franchisor-assisted sale to a third party or another franchisee;
- Relocation or joining of one or more franchise outlets;
- Temporary management or additional services to be provided by the franchisor;
- Debt counselling or debt review procedures.

A franchisor may also develop a specific financial model, based on existing data and future projections, to assist struggling or insolvent franchisees. Financial models should preferably provide for worst, expected, and best case scenarios over the anticipated time periods. Financial models may include specific financial arrangements regarding royalties, rent or repayment terms and should at all times be reasonable and achievable. Setting expectations, milestones and targets regarding financial recovery and a franchisee's performance rehabilitation, should be properly communicated between a franchisor and a franchisee. Measurement of a franchisee's progress and positive results may be very encouraging after previous revenue and profitability disappointment.

Challenges of a struggling or insolvent franchisee

A struggling franchisee may feel that although assistance has been provided by the franchisor, it would still face significant challenges to retrieve itself from the predicaments, such as:

- Capital investment and cosmetic improvements may be required before significant improvements will be seen;
- Substantial time and effort may be required to educate and inform customers of the upgraded and improved operations;
- Additional training would be required for staff, which may be a time consuming exercise;
- It may take a long period of time to achieve targets and reach financial profitability; and
- Small to medium growth of the franchise business may not be sufficient to eliminate the insolvent situation.

Exit Strategies

If there is no prospect of growth or rehabilitation regarding the franchisee's business, the franchisor and the franchisee may consider an exit strategy. The exit framework should be determined with due regard to the recovery of investments (both from the franchisor and the franchisee) as well as how to mitigate losses. Exit strategies may include a sale of business (with due regard to the fair market value of the franchise business), a mutual termination arrangement or termination by one of the parties. In the event of termination, a mutual termination arrangement between the parties would be preferable as this would ensure a controlled termination process to limit damages.

Mutual termination would also generally include a settlement arrangement with creditors, which may limit a franchisee's risk and exposure regarding formal liquidation or sequestration. Should the franchisor and the franchisee not be able to conclude a mutual termination exit strategy, their relationship and agreement(s) will in all probability be subject to formal legal proceedings, which are time consuming and expensive.

Franchise Agreement

It should be noted that although the parties may at any time agree to any arrangements when a scenario is faced regarding a franchisee's struggles or insolvent circumstances, neither the franchisor or the franchisee would be obliged to agree or comply with such arrangement(s) if not specifically agreed upon or included in the initial franchise agreement. It would therefore be of utmost importance that the parties contemplate the probability regarding a franchisee's struggles or insolvent situation, especially in as far as the provisions of the franchise agreement are concerned. A franchisor would be well advised to include definite provisions in the franchise agreement regarding a franchisee's breach of its contractual obligations including the consequences regarding an act of insolvency and a compromise with creditors. A franchisor should also ensure that sufficient provision has been made in the franchise agreement regarding post termination obligations and restrictions on the franchisee; especially in as far as the protection and preservation of the franchisor's intellectual property rights are concerned.

When faced with a scenario of a struggling or insolvent franchisee, both parties should act proactively, within the scope of the franchise agreement, to determine whether the difficulties may be capable of being resolved or rectified. It would be advisable that an action plan be implemented as soon as possible as undue delays may result in exponential losses. Successful franchisors would testify to the fact that they are actively monitoring the performance of its franchisees to ensure that financially distressed franchisees are being assisted as far as reasonably possible, in order to ensure that possible risks and damages to the franchise system, are limited.

Q: Who does FASA represent?

- Practicing franchisors with a proven trading and franchise record.
- Developing or new franchisors in the process of developing a franchise business.
- Professional Service Providers – these include law firms, banks, financial institutions, insurance companies, franchise consultants, brand & marketing companies and IT companies.
- Suppliers to the franchise industry.
- Franchisees – whether their franchisors are FASA members or not.