Addressing Issues That Arise in a Mature Franchise System

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As franchise brands mature, they face a series of challenges that can either push the brand higher and to the next level, or sow the seeds for ultimate destruction. For many during the mid-twentieth century, Howard Johnson's, with its unmistakable orange roof and twenty-eight flavors of ice cream, was a country-wide landmark. "Having withstood a depression, a World War, and gasoline shortages in the 70s, the chain must have done something right."[1] The once iconic brand now has all but disappeared. In the 1970s the restaurant chain grew

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to more than 1,000 units. But in the 1990s, the chain fell hard. Few could have predicted that its number of restaurants would dwindle down to fewer than sixty by 2001, and there is only one left today.[2] "Critics of the chain noted that for years the company was not innovating or responding to changes in the industry."[3]

This article explores the initial development of franchise systems, the signs, and consequences of maturation, and how best to meet the common challenges facing mature franchise systems. Finally, this article discusses the pros and cons of using a franchisee advisory council or independent franchisee association to assist in confronting the challenges of a maturing franchise system.

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1. William Crandall & John A. Parnell, *Howard Johnson's: Rise and Fall of an American Icon*, 19(2) Hosp. Rev. 23 (2001), *available at* https://digitalcommons.fiu.edu/cgi/viewcontent.cgi?article=1347&context=hospitalityreview.

2. *Id.* at 30; *see also Howard Johnson Restaurant to Close; Only 1 Left*, WMTV (Aug. 23, 2016), https://www.wmtw.com/article/howard-johnson-restaurant-to-close-only-1-left/2553107#.

3. Crandall & Parnell, *supra* note 1, at 30.

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I. The Initial Development of a Franchise System

Most franchise systems are born out of a business concept that the developer believes is replicable beyond the initial store, restaurant, or business. The idea for a new product or service may germinate out of the fulfillment of a specific need in the marketplace. For example, specialty automotive repair shops grew and prospered out of the oil shocks of the 1970s when countless gasoline/repair facilities closed, necessitating the development of specialty automotive repair facilities.[4] The ultimate genesis of the ubiquitous salad bar may have gained its foothold as far back as the late 1960s when Norman Brinker, the founder of Brinker International, the parent company of several well-known restaurant chains, added the salad bar to his Steak and Ale restaurants to keep customers happy and busy while waiting for their entrees.[5]

Expansion through franchising has proven to be one of the most effective forms of small business expansion. As of January 2020, there were 773,600 franchise establishments across the country.[6] As noted in an article discussing the growth of franchising, "Given the [franchise] industry's past success and projected future growth, it is only natural for entrepreneurs to wonder whether their business concepts are suited to franchising."[7]

The entrepreneur who believes in the success of the new product or service must answer several questions to determine whether the concept can be successfully franchised. Beyond the legal requirements of franchise registration, the entrepreneur devising the new concept must ask (1) Does the product or service satisfy a basic consumer need or desire? (2) Can the business concept be replicated? (3) Will the business concept be profitable to the franchisee? (4) Will the franchise concept be profitable for the franchisor? and (5) Is there enough "glue" to keep the franchisee in the system after it has learned the business concept?[8]

After the franchise concept is established, the franchisor will begin the process of recruiting franchisees. This initial development phase may start slowly, but, if the concept gains traction, growth can become meteoric.[9] During this development phase, the franchisor will continue to tinker with

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4. Nearly fifty years later as the move to electric vehicles gains traction, there will be new pressures on automotive specialty repair chains to adapt to these technical innovations.

5. Julie Brown-Micko, *Culinary Curiosities: How Salad Bar Allegedly Got Its Start*, FOODSERVICE NEWS (Aug. 2, 2016), https://www.foodservicenews.net/article-archive/culinary-curiosities-how-the-salad-bar-allegedly-got-its-start/article_9f1f9efe-d46b-5e65-9464-5e44e264d458.html.

6. *Business Outlook for 2020*, FRANDATA (INT'L FRANCHISE ASSOC.) 2 (Feb. 6, 2020), https://franchiseeconomy.com/assets/26602.pdf.

7. Corby Anderson & Ted Pearce, *Franchising Is Hot, but Not for Everyone: Before Considerin—Ask Five Questions About Your Business*, JDSUPRA (Feb. 12, 2013), https://www.jdsupra.com/legalnews/franchising-is-hot-but-not-for-everyone-72306.

8. *Id.*

9. For example, in 1982 the Meineke Discount Mufflers had 200 units, and 800 units by 1986. Likewise, Subway had 200 units in 1981 and 5000 units by 1990 (basically doubling in size every two years). Frank Olito, *The Rise and Fall of Subway, The World's Largest Fast-Food Chain*, INSIDER (Nov. 3, 2020), https://www.businessinsider.com/rise-and-fall-of-subway-restaurants

the concept in ways that it believes will continue to attract new franchisees. At the same time, the franchisor must be mindful of its young franchise base's needs and provide its franchisees with ongoing training and operational support.

It is during this growth period that the franchisor will begin to add or organize its infrastructure to add personnel to assist in managing its franchise system. Expanding the franchise infrastructure may, and often does, include adding personnel to monitor the operations of the franchise system, assist franchisees in finding suitable locations or territories, and assist in the retail advertising and marketing of the products or services. As the franchise system continues to grow, the franchisor may bring some of its infrastructure requirements in-house, such as legal, franchise sales, accounting, and other business functions that previously may have been obtained from outside vendors or suppliers.

According to the Franchise Performance Group (FPG), an organization that specializes in helping brands grow by recruiting franchisees who are likely to thrive in a brand,[10] a franchisor's life cycle mirrors the economist Raymond Vernon's product life cycle. "[D]uring the introduction stage of Vernon's product life cycle, a company needs to focus on marketing to build brand awareness, engage customers to try the product, grow a customer base and gather market share. During Growth, a company runs hard, seeking to establish a dominant position and maximizing the opportunity by outpacing the competition."[11] The FPG life cycle characterizes early-stage growth from anywhere between one and twenty units.[12] At this phase of the development, a franchisor should seek to establish a sense of family and community, or "esprit de corps" with its franchisees, grounded by the symbiotic need to realize the mutual benefits from the nascent system. If, however, franchisees are resentful or unhappy, the franchisor will need to ascertain the roots of this animosity at such an early stage of development. Has the franchisor lived up to the promises it made during the franchise sales process? By the same token, does the franchisee appreciate the hard work involved in making a small business successful?

A franchise concept that has gained traction, and has the support of its franchise system, will likely continue to expand. While expanding beyond this early-stage growth, the franchisor should query whether its concept is still fresh, whether continued demand still exists for its product and/or services, and whether the market remains segmented enough such that the

-2019-9#it-was-relatively-easy-to-buy-a-subway-franchise-so-the-company-easily-grew -throughout-the-80s-and-90s-3.

10. See Mission Statement, Franchise Performance Grp. (2020), https://franchiseperfor mancegroup.com/our-mission.

11. Joe Matthews, *Franchisor Life Cycles*, Franchise Performance Grp. (Aug. 30, 2017), https://franchiseperformancegroup.com/franchisor-life-cycles.

12. *Id.*

franchise system can continue to grow its market share. During this phase, the possibilities for continued unit growth will remain abundant.[13]

II. Signs of Maturity of the Franchise System

No specific time frame in the development of a franchise system signals maturity; it is a combination of a multitude of factors. One must look at the overall development of the system, the franchisees in the system, the market, and the disposition of management. The exigencies of the market, the speed of franchise system growth, and the adaptability of the management will determine when the franchise system has reached "maturity." At some point, however, every franchise system will reach maturity. A franchisor's ability to recognize the signs of maturity will help it strategize how to best handle this next evolutionary period in the franchise system. A number of key issues/ occurrences trigger maturity or a need for change. These triggering events include: (1) shifting consumer preferences; (2) change in demographics; (3) purchasing power of teenagers; (4) ethnic changes; (5) changes in area population; and (6) changes in technology.[14]

A. *Mature Unit Development*

From a franchise development standpoint, maturity likely will correspond to market saturation. After a franchise system expands and saturates primary markets, the few remaining opportunities may only lie in tertiary markets or fill-in locations in already developed markets. As the franchise system becomes more fully developed, franchisors' revenues are more dependent upon royalty income. If the franchisor's royalty stream has not sufficiently developed, then the reduction of initial or development fees from a slow-down in franchise sales will result in the franchise system having less funds available for services like ongoing training, marketing, and operational support. A franchisor's general pullback from these ongoing services may well impact not only further franchise system growth, but also same-store sales of individual franchisees.

B. *Changing Market*

One noticeable sign of maturity is a change in the marketplace. These changes are frequently the result of the franchise system's unique product offering becoming commoditized. One of the great examples of this phenomenon is the frozen yogurt industry. When frozen yogurt franchises first started, they were a unique proposition; there were few if any stores selling

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13. While the franchisor should continue to concentrate its efforts on domestic growth, as the franchisor becomes better known it may receive inquiries about possible international growth. International growth, while seemingly glamorous, is not without its many complexities that may strain the limited resources of the franchisor, and is beyond the scope of this article.

14. Jeffrey Brimer, David W. Oppenheim & Andra Terrell, *Transforming and Modifying the Mature Franchise System*, Am. Bar Ass'n 29th Annual Forum on Franchising, W–18, at 2–3 (Oct. 11–13, 2006).

frozen yogurt, or "fro-yo," as it became known. At the outset of this craze, franchisees opened a large number of yogurt shops in New York City as well as other places. The maturity of this franchised industry was aptly described as follows:

> [But] businesspeople kept opening new shops even as interest waned, and that's because the logistics of opening a fro-yo shop over a traditional restaurant do seem tempting: Locations don't need to be outfitted with full kitchens, employees don't require much training, and food costs are both steadier and lower than at typical restaurants. (Yogurt and toppings cost operators about 25 percent of the price they can sell them for; a restaurant is lucky if its costs are at 30 percent.) In fact, the model is so popular that the USDA says frozen-yogurt mix is among the few dairy categories to actually increase in production compared to levels from the previous year. (But more operators buying yogurt mix doesn't necessarily mean more customers are buying yogurt.)[15]

Eventually, the unique proposition of frozen yogurt became a commodity available seemingly on every street corner. As one New York City real estate broker commented, "I don't know how many more frozen yogurt places we can handle, but every time I think I'm done, you see another one . . . ."[16] A lack of differentiation further contributed to decreased demand for the product: "That yogurt mix is just one reason these shops all feel the same. Hardly anyone makes much of the fact that almost every business uses the same commercial mixes, produced by a company called YoCream, a division of Dannon."[17] As the differentiation between competitive yogurt brands became hard to spot, it became more difficult to attract a loyal customer base. Moreover, as customers' taste and demand for yogurt began to cool, the supply of yogurt stores began to outstrip the demand for the product.

Eventually, in New York City, the craze for yogurt was supplanted by green juice, a beverage made from the juices of green vegetables.[18] The value proposition for frozen yogurt franchisors and franchisees began to fade. As demand for frozen yogurt began to lag, franchise systems were left with the conundrum of how to build same store sales with a declining product. If unable to increase their sales with yogurt or other products, frozen yogurt shops would slowly be forced to close—and that is exactly what happened. For example, until TCBY reconfigured its business model to focus on self-serve stores where customers can mix and match flavors, it lost more than two-thirds of its 1,500 stores in the two decades following the initial craze in the 1980s.[19]

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15. Hugh Merwin, *Fro-No: How New York City Soured on Frozen Yogurt*, N.Y. Mag. (May 15, 2014), https://www.grubstreet.com/2014/05/new-york-city-frozen-yogurt-boom-is-over.html#_ga=2.125936974.258368446.1605018760-1018389023.1605018760.

16. *Id.*

17. *Id.*

18. *Id.*

19. Daniel McGinn, *The Great Froyo Gold Rush*, Boston Globe (May 26, 2013), https://www.bostonglobe.com/magazine/2013/05/25/pinkberry-orange-leaf-and-more-charting-frozen-yogurt-gold-rush/vZZ5RMe2MVUV6u7g9Eo8tM/story.html.

C. *The Changing Economic Proposition for the Franchisee*

The key component of a successful franchise system is successful franchisees. Without a profitable franchisee base, the franchise system cannot prosper long-term. While this statement is more than obvious, all too often, in practice, franchisors either do not completely understand this proposition or refuse to change their initial business model in response to changes in the market or the franchisee economics.

For franchisees to succeed, sales must cover the expenses of the franchised units and provide franchisees with income and the ability to obtain a return on their initial investments. Ideally, the original economic model will provide long-term sustained growth for franchisees. But this arrangement is not always the case because market and economic conditions are not static and are constantly changing. As explained by Michael Seid,

> Ask any experienced and smart franchise executive—'How's business?'—and 99 out of a hundred times your discussion will be around same-store sales, average unit volumes, customer counts, cost of goods, labor rates, etc. Experienced franchisors are focused on what is required to sustain the system in good times and bad, and unit performance is at the center of their universe.[20]

A material negative change in the demand for the franchise system's core products is one of the key indicators of a maturing franchise system.[21] In the automotive aftermarket industry, the introduction of stainless-steel mufflers in the late 1980s all but eliminated the need for frequent change-out of exhaust systems. When muffler franchises were founded in the early 1970s and before, the fact that customers frequently needed to replace their mufflers or exhaust systems every three to four years was their primary value proposition. In addition, the gross profit percentage for a franchisee for the sale and servicing of exhaust systems was significant. The consumer demand for replacing an exhaust system at those intervals, and with those high margins, made for a consistent and predictable franchised business model. In the late 1980s, however, stainless steel mufflers replaced mild carbon steel, which suffered from poor corrosion resistance when exposed to road salt and exhaust condensate, and substantially reduced the frequent need for exhaust system replacement.[22] Declining revenues forced franchise systems to look to replace their lost income with other products and services such as brakes and oil changes, but these services did not provide the same or similar margins.

20. Michael Seid, *How Do Economic Downturns Generally Impact Franchising?*, MSA Worldwide, https://www.msaworldwide.com/blog/downturn_in_the_economy.

21. *See*, *e.g.*, Brimer, Oppenheim & Terrell, *supra* note 14, at 1 (discussing how changes in consumer preferences, for example, "the popularity of low and no-carbohydrates diets caused a significant, rapid shirt in restaurant menus").

22. The owner of the Mighty Muffler chain reported that "[s]tainless steel exhausts especially hurt the industry . . . because they don't need to be replaced." *See* Lori Lovely, *Mighty Muffler*, SHOP Mag. (Nov. 20, 2009), https://theshopmag.com/features/mighty-muffler. The Mighty Muffler owner then noted: "Seventy-five percent of Mighty Muffler's business is exhaust systems, but because the market is down, . . . the company is diversifying by getting into brakes, shocks, struts and CV axles. However, those are highly competitive markets with smaller margins." *Id.*

The longer time between exhaust system repairs, coupled with products and services not producing the same margins, resulted in the erosion of franchisee per store net profits.

With the original valuation proposition vanishing, so too did the ability of franchisees in this sector to stay in business. Fewer franchises were sold, while existing franchisees left various systems either through sale or closures. Beyond the automotive industry and the example above, a failure to address fundamental changes to a franchise system's original value proposition could result in catastrophic consequences for a franchise system in any sector.[23]

D. *Franchisee Relationship Fatigue*

The lifeblood of a franchise system is its franchisees; the more successful they are, the more successful the franchisor. In part, a franchise system's success will be a function of its franchisees staying motivated to continue to improve their performance during the term of the franchise agreement and beyond. But while their ongoing success is not automatic, over time, their actions likely will become predictable. To determine a franchisee's motivation, a franchisor will need to ask (1) how long will a franchisee remain mentally tethered to the franchise system; (2) when will a franchisee burn out; and/or (3) when will life-style satisfaction begin to de-motivate a franchisee?

Inevitably, a franchisee may tire of the business, especially if a successful franchised business requires the franchisee to manage the operations on a day-to-day basis. Moreover, when a franchisor changes the franchise system and modifies the manner by which franchisees conduct business, long-time franchisees often perceive the changes as unnecessary interference, which leads to relationship fatigue. In fact, an industry analysis reports that "[w]hile the average tenure of a franchisee in a franchise system seven years, the average tenure of a franchisor executive is three to four years. So it is likely most franchisees will have seen off at least two generations of franchisor executives."[24] Some of these past relationships will have been valued, especially where a franchisee has received significant business or personal mentoring. The trust and commitment needed to build a successful franchise

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23. For example, in response to Carvel seeing its sales in franchised stores steadily declining as a result of competition from frozen desert providers who were selling their products in supermarkets and from non-traditional competitors, such as McDonalds and Burger King, who began selling frozen desserts in their restaurants, Carvel commissioned a study, which concluded that it would be in Carvel's best interests to begin distributing in supermarkets. Carvel accepted the recommendation and implemented its supermarket sales program. *See* Brimer, Oppenheim, & Terrell, *supra* note 14, at 11 (discussing Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 57 (D. Conn.1997)).

24. Greg Nathan, *The Challenge of Supporting Mature Franchisees*, Int'l Franchise Ass'n (Sept. 16, 2016), https://www.franchise.org/franchise-information/franchise-relations/the-challenge -of-supporting-mature-franchisees. In his article, Nathan lays out eight considerations when working with mature franchisees, which he characterizes franchisees moving through the "Zone of Creative Tension." *See also* Engel Schmidl, *Why Is Tenure So Important to Franchisee Satisfaction and Recruitment?*, SmartCompany (Sept. 10, 2012), https://www.smartcompany .com.au/business-advice/franchising/why-is-tenure-so-important-to-franchisee-satisfaction -and-recruitment.

relationship take time and energy, and mature franchisees will have been through this process several times. Franchisor executives joining a franchise network should consider that their mature franchisees may be thinking "Here we go again."[25]

What are the signs of franchisee burn-out? While there is no exact science on this point, a franchisor should question whether a franchisee's downward trajectory of sales or increased customer complaints could be a symptom of franchisee burnout. According to the founder and CEO of Pi Slice, commenting on clinical research papers and statistics on the rise of depression and burnout in the general workforce:

> [There are] two types or burnout: circumstantial and existential. Circumstantial burnout stems from workplace challenges, neglect of personal life, and not taking some time off. Existential burnout stems from loss of meaning in one's profession, lack of self-validation, loss of understanding of professional identity, and loss of connectivity with colleagues and clients.[26]

Many franchisees who are highly motivated and passionate about their business can also be obsessive about it. It is often hard to separate them from their business. As a result, they can suffer a high degree of burnout.

Conversely, the success of a franchisee's business may also result in franchisee relationship fatigue. As the franchisee becomes more successful, the owner may reach the point where he or she has achieved lifestyle satisfaction, such that continued growth of the franchised business takes a backseat to maintaining and/or enjoying the newly won lifestyle. At that point, the franchisee no longer seeks improved operations or increased revenues, but instead becomes satisfied with the status quo. In both cases, the maturity of the franchise relationship becomes an impediment to the growth of the franchise system.

E. *Management Fatigue*

As there are life cycles of businesses, so too are there life cycles of franchise management teams. At the outset, founders typically focus on developing and tinkering with the system to make the concept as usable as possible for the franchisees and customers. However, even if franchise system founders are active in designing the system during the development stage, they may not have the skills required to grow the system or to manage the system once a certain level of complexity or complication is reached. Likewise, a management team heavily invested in the product or service that formed the basis of the franchise system may be so tethered to the business concept that it is hard to see or accept the changing marketplace and the need to change or update the products and services that served as the core for the business concept.

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25. *Id.*
26. Genny Ghanimeh, *Understanding Entrepreneurial Burnout (And How to Deal with It)*, Entrepreneur Middle East (May 19, 2019), https://www.entrepreneur.com/article/333631.

Why do problems between franchisees and franchisors arise during this period? At this stage of the franchise relationship, the franchisor's and franchisee's goals can conflict with one another, which can result in a shared feeling of failure. For example, "[a] lack of trust and communication between both parties worsens this cycle."[27] Consequently, these types of issues can spur and hinder potential success. Therefore, it is worth facing these problems head-on in order to maintain a mutually beneficial relationship between the parties.

Franchisors need to be adaptive in managing their franchise system. Not only must the franchisor identify necessary modifications to the franchise system, it also must merchandise them to the franchisee community. Management of the franchise system will be evolutionary. For the franchisor executive, "[a] management style that worked well in designing the franchise system may not be successful in developing and managing the franchise system. "Franchise management will find it problematic managing a maturing franchise system if it does not understand both the market and the ever-changing relationship model."[28]

Bad management can wreak havoc on the best of franchise concepts. A good franchisor must pay attention to all aspects of its franchise system, including its overall vision for the chain, system standards, communicating with its franchisees, operational measurements, accountability, and enforcement. "Bad management can infect an organization in a thousand different places and in a thousand different ways. And even good managers can be guilty of it on occasion. Franchising offers many advantages to those desiring growth. But it's not without risk and it's certainly not easy."[29]

III. The Consequences of Maturity in a Franchise System

A. *Underperforming System*

Often, a franchise system that experiences the signs of maturity described earlier starts to underperform. Underperformance manifests itself in loss of market share, lower same store sales, higher franchisee turnover, decreasing franchise system sales, and restive franchisees, leaving the long-term prospects of the franchise system at risk. The Franchise Disclosure Document (FDD)—specifically, Item 19: Financial Performance Representations; Item 20: Outlets and Franchisee Information; and Item 21: Financial Statements—provide prospective franchisees with helpful information for evaluating the status and trends of a franchise system. Moreover, prospective franchisees who speak with existing franchisees may be left with the sense

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27. AJ Beltis, 7 *Issues That Harm Franchisor, Franchisee Relationships*, 7 SHIFTS | BLOG, (Dec. 11, 2019), https://www.7shifts.com/blog/franchisor-franchisee-relationship.

28. Mark Siebert, *Why Do Franchisor's Fail?*, ENTREPRENEUR (Aug. 26, 2008), https://www.entrepreneur.com/article/196676.

29. *Id.*

that the maturing franchise system has lost its vitality and will not feel comfortable in investing in a system that appears to be on a downward trend.

B. *Restive Franchisees*

New franchisees have numerous expectations. A new franchisee's primary expectation is that it will profit from the day-to-day operations of its franchise unit. The franchisee's ultimate payoff, however, often is leveraging the value of the franchised business to create wealth (whether in fact the franchisee monetizes that investment, passes the business onto family members, or uses its investment for leverage to purchase additional franchises). When the franchise system does not meet these twin goals for franchisees, the franchisee may become either apathetic or restive. In either case, these attitudes will not bode well for the franchise system.

An apathetic franchisee may "go through the motions," but sooner or later, it will suffer from underperformance. The underperformance may force the franchisee to sell at a discount or even worse, prematurely close the franchised business if a sale is unlikely or will not provide the franchisee with enough cash to pay off its current business creditors. If there are enough underperforming franchisees within a franchise system, it can cause a downward spiral of franchise closures, thus undermining a franchisor's ability to attract new franchisees and customers. In an article discussing reasons that franchisees fail, an industry expert, Ed Teixira, says that "one of the reasons a franchisee is likely to fail is because the franchisee believes that success is easier to achieve than it really is."[30]

Equally as troubling are apathetic or restive franchisees who become so frustrated with their under-performance that they question the franchisor's ability to manage the franchise system. In that situation, franchisees may collectively confront the franchisor either informally or through an independent franchisee association.

While the presence of independent franchisee associations may benefit franchisees, the basis for an association's formation may create a relational challenge for a franchisor. Unfortunately, too many independent franchisee associations are borne out of conflict or frustration with the franchisor. Historically, franchisors feared franchisee associations because they often signified a breakdown between the franchise system and franchisees and a vote of no confidence. Franchisee associations were generally hostile to the franchise system.[31]

Franchise advisory councils (FACs)[32] are generally not meant to be confrontational. Instead, they are meant to act as a communication vehicle

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30. Ed Teixira, *5 Reasons Why Franchisees Fail*, Franchise Help, https://www.franchisehelp.com/franchisee-resource-center/5-reasons-why-franchisees-fail.

31. Rupert Barkoff, *Franchisee Associations: Nothing to Fear but Fear Itself, Usually*, Int'l Franchise Assoc. (Dec. 12, 2018), https://www.franchise.org/franchise-information/franchisee-associations-nothing-to-fear-but-fear-itself-usually.

32. A franchise advisory council is a council usually formed by the franchisor that is comprised of a number of franchisees in the franchise system that may be elected by the franchisees

between the franchisor and its franchisees. However, if franchisees believe that the FAC is merely an extension of the franchisor, they will become less supportive of this communications vehicle.

A franchise system can suffer all or some of the above-described consequences of a maturing franchise system, which, if not recognized early on, can lead to significant conflict between the franchisees and the franchisor and endanger the long-term health of the franchise system.

IV. How Can a Franchisor Best Meet the Challenges Posed by the Maturing Franchise System?

A. *Review the Product/Service Offering and the Value Proposition for the Franchisees*

Monitoring the continuing demand and relevance of its products and services, so franchisees maintain their profit potential, is one of the most elementary things that a franchisor can do to address maturation issues. If demand and relevance are decreasing, the franchisor must consider changing its product and service offering and/or adding new products and/or services that will meet the public's needs. While franchisors may be hesitant to update their business model and veer away from their original concept, a franchisor will surely suffer the consequences if it does not adapt its system to the ever-changing market.

In some franchise systems, the new products or services may already be core or supplemental products and services of competitors. In that case, the franchisor will need to differentiate itself further. Changing the franchise system's product and/or service offerings will be fraught with its own set of challenges as franchisees who are used to and comfortable with the existing product and service offering may resist change. More importantly, the franchisee may not realize the same profit margins from the new products and/or services. A franchisor's best chance at seamlessly implementing these necessary changes is to coordinate with its franchisees through a well-functioning FAC or an independent franchisee association.

The franchisor also may need to examine its value proposition to its franchisees relative to the distribution of its products and services. Can the franchisor supply its franchisees with the necessary products and services at competitive prices with nationwide distribution in a manner that will prove profitable to its franchisees? If the new products and services do not allow franchisees to profit, the franchisor may even need to consider adjusting its royalty and/or advertising contribution rate. While royalties are largely sacrosanct to a franchise model, in a maturing franchise system it may become necessary to adjust certain aspects of the franchise system through changes

or chosen by the franchisor. An FAC usually operates under the auspices of the franchisor, whereas an independent franchisee association is usually governed solely by franchisee members.

to the franchise agreement, including, when appropriate, adjustments to the royalty rate.

B. *Examine the Demographics of the Franchise System*

When addressing challenges of a mature franchise system, a franchisor should consider the demographics of its franchise system. What is the age of the units in the franchise system? What percentage of the units are owned by franchisees who have been in the system from the beginning? Are any of these franchisees suffering from relationship fatigue? If there is a growing apathy within its franchise system, the franchisor will need to decide how best to address that apathy. In some cases, particular franchisees may be unwilling to participate in the changes that the franchisor believes are necessary to address the maturation issues. Enlisting competent franchise counsel to help navigate changes to the system is very important because any changes may be limited by what is in the franchise agreement, franchise disclosure requirements, and state franchise relationship laws.[33] If the franchisor cannot convince its franchisees to implement changes to the product and/or service offering, it may need to suggest to the franchisee(s) to exit the system, ideally through a sale, as opposed to termination of the franchise relationship.

C. *Other Creative Options*

A franchisor may need to implement a series of creative solutions to combat accelerating consequences from previously unaddressed maturation issues. For a franchise system losing market share in a tightening market, co-branding (i.e., the marketing of a product or service under two or more brand names as part of a strategic alliance) is one method of freshening a franchise system. "Co-branding is used in franchising as a strategy to stimulate and rejuvenate growth, particularly in a mature franchise sector."[34] Likewise, it is critical for a franchisor to discover new marketing techniques that meet today's advertising exigencies. Older systems may have relied on television, radio, and the Yellow Pages to build its reputation. However, social media has replaced many of the more conventional means of advertising used by franchisors a generation ago. Today, a franchise system that does not employ the newest forms of marketing will be left behind in the ever-changing marketplace.

D. *Authority to Implement Changes*

Before implementing system-wide changes, a franchisor must ensure that it has the contractual authority to do so. As expressed in a franchise workshop on the implementation of franchise system changes, by franchise attorneys

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33. For a comprehensive look at what must be considered before endeavoring to make material changes to the franchise system see generally Brimer, Oppenheim & Terrell, *supra* note 14.

34. Kerry Miles, *Co-Branding Pros and Cons*, FranchiseED (Feb. 7, 2018), https://www.franchise-ed.org.au/franchising/franchise-marketing/co-branding-pros-and-cons.

David Kaufman, Robert Zarco, and Kenneth Cutshaw, "[t]he ability of a mature franchisor to effect such system/concept changes largely derives from the reserved contract right to do so. Franchise agreement language addressing this subject is critical."[35] Moreover, the franchisor's operations manual likely requires the franchisee to abide by the systems and standards set out in the manual, as the franchisor may change from time-to-time.

On this issue, courts have historically sided with franchisors facing challenges from franchisees as to whether the franchisor's implementation of system changes violated a legal duty owed to the franchisees.[36] For example, in *In re Frusher*, the court agreed with Baskin-Robbins when it refused to provide its franchisee with its new product line because the franchisee had failed to implement systemic changes to the franchise system.[37]

However, even if the franchise agreement and operations manual provide ample authority to require franchisees to undertake systemic changes, franchisees have succeeded in challenging system-wide changes in some cases. For example, in *Amos v. Union Oil Co. of California*, the U.S. District Court for the District of Oregon found that an oil company's sudden lowering of octane in its gasoline, and a discontinuance of a popular leaded gasoline, constituted a breach of the implied covenant of good faith and fair dealing.[38]

Practically speaking, however, even if a franchisor has the legal right to enforce system-wide changes, bludgeoning franchisees with its ability to do so is like a red rag to a bull and will do more to tear the system apart than it will to support the franchisor's system-wide changes.

E. *Work with the Independent Franchisee Association*
   or Franchisee Advisory Council

Rather than command franchisees to comply with system-wide changes, franchisors are generally better served addressing system maturation issues through a FAC or an independent franchisee association. FACs are usually formed under the auspices of the franchisor, and its members are either appointed by the franchisor or democratically elected.[39] In some cases, however, franchisees are concerned with a lack of independence; they may believe that the FAC is nothing more than a tool of management that pays lip service to the franchisees' needs. In that case as discussed earlier, the franchisees may establish an independently run franchisee association.

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35. David J. Kauffman, Robert Zarco & Kenneth A Cutshaw, *Implementing System Upgrades and Enhancements: Business And Legal Considerations*, Int'l Franchise Ass'n 44th Ann. Legal Symposium, at 1 (May 15, 2011).

36. *Id.* at 4 ("Over the years, virtually every court asked to rule on a mature franchisor's ability to modify its system and concept have sided with the franchisor.").

37. *In re* Frusher, 146 B.R. 594, 598 (Bankr. D.R.I. 1992).

38. Amos v. Union Oil Co. of Cal., 663 F. Supp. 1027 (D. Or. 1987).

39. *See* Roger Schmidt & Harris Chernow, *Managing the Organization of a Franchise Association*, Am. Bar Ass'n 32nd Annual Forum on Franchising, W–13, at 2 (Oct. 14–16, 2009) (discussing FACs).

If a franchisor is prudent enough to recognize the need for constructive communication with its franchisees, it will have already established a well-working FAC, or established a working relationship with an independent franchisee association, to foster open and direct communications for issues like system-wide changes to address maturation problems. Franchisors who manage their franchise systems without seeking franchisee input, and franchisee buy-in, will likely find franchisees resistant to unilateral pronouncements. As explained by one franchisor lawyer, "[F]ranchisors who are not pro-active in establishing these lines of communications will likely have it thrust upon them. As a franchise organization grows, franchisees will want to continue to be heard through some representative group, whatever form that may take."[40]

As discussed earlier, the consequences of unchecked maturation can be problematic and even catastrophic for a franchise system. If a franchisor is willing to engage with an FAC or an independent franchisee association, it should discuss the strengths, weakness, and threats facing the franchise system. Franchisees are often better positioned to understand the problems facing the business concept. For example, it is the franchisees who will directly hear customers complaining about prices or menu offerings or décor. While sometimes the interactions between franchisor and an independent franchisee association are acrimonious, two-way communication is essential to understanding franchisees' concerns and problems. Bilateral communications between the franchisor and the franchisee are a cornerstone of a successful franchise system. A franchisor cannot identify and solve operational problems without significant input from its franchisees. Accomplished franchise systems recognize this need and include their franchisees in many of their system-wide decisions. Take for example the A&W® Restaurants system:

> Because A&W is now almost entirely franchisee-owned, they operate on the word of those running the stores. And with that much input for change and growth, it's obvious it could take a bit of time to get everyone on the same page. "Every change A&W wants to make needs to be approved by the same people who live and run the brand on a daily basis . . . ."[41]

While meeting with discordant franchisees takes tremendous amount of resolve and patience from the franchisor, this bilateral communication may be the only way that a franchisor will truly understand endemic problems in the franchise system. Moreover, if franchisees cannot voice their concerns and make recommendations to their franchisor, they may perceive the franchisor as autocratic and not interested in the well-being of is franchisees and the overall franchise system.

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40. Erik B Wulff, *Advisory Councils: Effective Two-Way Communications for Franchise Systems*, Int'l Franchise Ass'n, Franchise Relations Comm., at 5 (rev. 2005).

41. Molly Allen, *The Untold Truth of A&W*, Mashed (Aug. 8, 2019), https://www.mashed.com/161394/the-untold-truth-of-aw/?utm_campaign=clip (quoting A&W's then Chief Executive Officer Kevin Bazner).

While there is no guaranty that working with an FAC or independent franchisee association will solve maturation problems, at the very least the franchisor will understand, and have the opportunity to focus on, the issues that franchisees perceive to be the genesis of the problems facing the franchise system. Moreover, when the franchisor develops a course of action to address the maturation issues, it will need all the assistance that it can muster to convince franchisees in the system to undertake these changes. Peer pressure is often the best means of successfully merchandising changes to the franchise system, and an independent association of a franchisee's peers may be the best vehicle to help accomplish these needed changes.

When the author was general counsel for Meineke, the company worked with the independent franchisee association (Association of Muffler Dealers) for almost three years to address many of the issues relating to the changes in the marketplace. These discussions resulted in a new franchise agreement that obtained the Fair Franchising Accreditation seal from the American Association of Franchisees and Dealers. Without the cooperation, patience, and the spirit of compromise between the franchisees and the franchisor, the parties would never have developed this new franchise agreement that met the needs of both the franchisor and the franchisees.

V. Conclusion

Maturity of franchise system is inevitable. The question is not if, but when. The rapid changes in the marketplace likely will dictate when maturity occurs, but no franchise system can escape it. Unlike the Howard Johnson's and other vanishing trademarked systems of the world that became irrelevant in little more than ten years, it is critical that franchisors not only recognize the signs of a maturing system, but also develop a strategy for addressing necessary changes.