Conditional Renewals: Are They Useful in Preserving Franchise Relationships?

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Every franchisor faces difficulties at one time or another when it comes to deciding whether or not to renew a franchise agreement with a franchisee. Whether the decision is being made based on poor performance, failure to abide by the franchise agreement or because the franchisee is negatively impacting the brand reputation of the franchise, the decision is never easy. It is important for both the franchisee and franchisor to be able to evaluate in advance whether the relationship might be salvageable and know the possible options ahead of time when the term of a franchise agreement is about to expire.

There are three basic options when it comes to expiration of the term of a franchise agreement: renew, don't renew, or enter into a conditional renewal.

A conditional renewal can come into play when a franchisor believes a franchise appears headed down a path of non-renewal but hopes that with additional time and training the franchisee can avoid non-renewal. If the relationship is salvageable, and entering into a conditional renewal could allow the franchisee to meet the criteria necessary for renewal, then a conditional renewal could be the best option for both parties. Conditional renewals can allow the franchisee the ability to correct past issues and give the franchisor additional time to evaluate whether the relationship with the franchisee is one that can and should continue.

Setting Yourself Up for Conditional Renewals

Conditional renewals can be best implemented when outlined clearly in the renewal provisions of a franchise agreement. Ideally, the franchise agreement should further allow the franchisor, at its sole option, to enter into a second conditional renewal with the franchisee if, at the expiration of the first conditional renewal, the franchisee has not yet fully met the criteria outlined in the first conditional renewal. Lastly, this type of renewal should also give the franchisor the right to include additional criteria, beyond what is described in the franchise agreement.

If the franchise agreement does not expressly set forth the right to enter into the conditional renewal, then the franchisor may still approach a franchisee with the option of a conditional renewal through a notice of default close to the time of renewal. The notice must comply with both the franchise agreement and any applicable state specific franchise relationship statues. The notice of default should outline the deficiencies and the curable sections of the franchise agreement that have been violated, and the franchisor may then propose entering into a conditional renewal as an option to provide the franchisee additional time to cure the deficiencies and be considered for renewal.

Drafting a Conditional Renewal

Whether the term of a franchise agreement is 3, 5, or even 10 years, a franchisor has the option to set the conditional renewal to a term it feels appropriate, provided that such conditional renewal is in compliance with applicable law. Typically, franchisors consider 6-12 months to be a reasonable period for a conditional renewal. The type of industry in which the franchise operates can also help determine the appropriate length of time for a conditional renewal. If the franchise operation is seasonal, it might be beneficial to adopt a longer conditional term to allow the franchisee to operate through another busy season and assess progress after that point. Some examples of seasonal franchise models that might benefit from this approach include, retail stores, tax preparation, landscaping, moving, and outdoor holiday light decoration.

When drafting a conditional renewal, the franchisor should consider imposing new restrictions or criteria on the franchisee specifically directed to the deficiencies noted in the franchisee's performance. And it should also set clear expectations insofar as those restrictions or criteria for the franchisee to meet, including, where appropriate, specific milestones in order for the franchisee to be eligible for renewal. These milestones could be anything from meeting sales goals, receiving a certain customer satisfaction score, or exceeding previous revenue numbers. However, the milestones should be supported by clear business justifications and should be attainable for the franchisee. For example, setting sales goals that are many times what the franchisee has been able to achieve historically or are out of line with how other franchisees in the system are performing or requiring money to be spent on excessive building renovations or new equipment are examples of criteria that would not be appropriate for a conditional renewal.

Franchisee actions that have a negative impact on the brand or relationship, but don't amount to a material breach, can also be addressed in a conditional renewal, provided that doing so would be in compliance with applicable law. In many circumstances, franchisee actions can have a demonstrative impact on the brand as a whole. Given the reliance of the consuming public on social media, one negative Facebook post or tweet by or about a franchisee can theoretically impact millions of potential customers, particularly if that communication goes viral. For example, a franchisee lashing out in response to a poor online review or making a negative statement about the franchisor online when the franchisee is unhappy about a system change can quickly spread and have a significant impact on the image of the franchise system. Franchisees have a duty to protect the goodwill and nature of the brand, and if specific behavior isn't already addressed in a code of conduct, it can be set forth as one of the criteria for a conditional renewal. Although a franchisor should be cautious in unduly limiting a franchisee's first amendment rights, carefully worded provisions can accomplish the desired outcome.

There can also be instances where a franchisee has been in the system for quite some time but hasn't conformed to regulatory or system changes. In these situations, consideration should be given to structuring conditional renewal language to require a franchisee to participate in additional training or immediately implementing system changes during the term of the conditional renewal to get the franchisee back on track.

In a franchise relationship, a number of issues could arise that might make the franchisor question whether to move forward with renewal of a particular franchisee. In these scenarios, the conditional renewal can address a combination of items to be satisfied depending on the franchisor's strategy. Conditional renewal requirements should be specific to the franchisee and tailored each time it is utilized. Unlike a franchise agreement, there is not a one-size-fits-all conditional renewal.

Steps for the Franchisor to Take During the Conditional Renewal

Once a conditional renewal is implemented, the franchisor should carefully monitor where the franchisee stands in meeting the criteria outlined in the conditional renewal. Having reports and dashboards that allow the franchisor to review daily, weekly, or monthly where a franchisee stands is a helpful tool. The franchisor should also document, in writing, the franchisee's progress, or lack thereof, on a regular basis. By doing so, the franchisor can build a case for a non-renewal if necessary and the franchisee will better know what to expect at the end of the conditional renewal.

As a precursor to the parties entering into a formal conditional renewal agreement, the franchisor might wish to require the franchisee to visit the franchisor for a re-engagement meeting. Sometimes meetings in which issues and expectations are addressed in a face-to-face setting can have the biggest impact. During this meeting, different subject matter experts within the franchisor can meet with the franchisee to provide advice and assist in areas where the franchisee appears to be struggling. For example, the franchisee might need assistance in recruiting new employees or ramping up marketing efforts in its territory and the subject matter experts might have new tactics for the franchisee to try. It can also be worthwhile to have employees of the franchisor visit the franchisee to do an on-site assessment in order to have a better idea of the struggles the franchisee is facing. After the visit, an action plan can be developed which can be memorialized within the conditional renewal agreement that identifies any areas of deficiency and what steps need to be taken by the franchisee. Both of these options can provide valuable insight to the franchisee's operation, and allow the franchisor and franchisee to connect on a higher level.

Notification to Franchisee

If the franchisee isn't meeting minimum performance standards in the franchise agreement or the franchise is negatively impacting the brand's reputation, the franchisee should be provided notice of these issues prior to entering into a conditional renewal.

There are 19 states that regulate franchising with state-specific laws. Notice for non-renewal varies from state to state so it is important that the franchisor and franchisee are aware of any notice requirements in the state in which the franchise is located. A franchisor will need to implement the conditional renewal within the states' required notice period before the franchise agreement expires. If a franchisor and franchisee enter into a conditional renewal, the franchisor will then need to provide notification of renewal or non-renewal within any applicable notice period as well.

Some states also require good cause to non-renew a franchise agreement, which will require the franchisor to demonstrate clearly any material breaches of the franchise agreement. Oftentimes, the good cause requirements imposed by states don't include within the definition of good cause perceived underperformance by a franchisee. The franchisor, therefore, should clearly set forth in the franchise agreement and/or conditional renewal the breaches that have occurred constituting good cause under these state laws, such as failing to meet certain milestones or failing to pay royalties. Extending the franchise agreement for an additional 6 or 12 months through a conditional renewal may result in a renewal or a non-renewal, if the franchisee is unable to cure the breaches identified by the franchisor and good cause exists. In situations where the franchise relationship cannot be salvaged, this period may also provide time for the franchisee to sell its business. Documentation of the reasons leading up to a conditional renewal should ideally start at least 13 months prior to expiration of the franchise agreement.

Terminating After a Conditional Renewal

Franchisees often invest many of thousands of dollars into opening and operating their franchise over the course of the franchise agreement with the hope of recouping their investment and making a profit. A franchisee's livelihood can depend on the renewal of its franchise. Accordingly, depending on the condition of the franchise, it might be in the both parties' best interests to allow the franchisee a specific length of time to transfer the franchise if the deficiencies in the franchisee's performance identified by the franchisor cannot be cured and the franchise relationship cannot be salvaged after going through the conditional renewal process. Shutting down a franchise can also have a significant impact on the franchisor's future development and sales in that market, and so a transfer can be in the franchisor's best interest as well. Depending on the industry, a franchise transfer can take anywhere from a few months to an entire year.

If the franchisor doesn't want to extend the franchise agreement for an additional period of time beyond an initial conditional renewal term with a franchisee, then it is important that the franchisee is aware months in advance of the need to start looking for a buyer before the initial conditional renewal expires.

Renewing After a Conditional Renewal

If the franchisee meets the criteria set out in the conditional renewal before the term is up, then the franchisor can either enter into a renewal agreement with the franchisee or the franchisee can choose not to renew the agreement. There is always the possibility that the franchisee could revert back to how it was operating its franchise once a renewal agreement is executed, but it's important to weigh this consideration against non-renewing a franchise.

If set up properly and documented well, conditional renewals can be beneficial to both the franchisor and franchisee. With proper communication, notice, clear criteria, and advanced planning, conditional renewals can be useful tools in dealing with struggling franchisees and improve the relationship between the franchisor and franchisee.