Franchisees Sitting on My Board? Never!

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Perhaps it has not come up as an issue in your franchise system—a franchisee on your board of directors. Is this a good or bad idea?

There are many situations today where a group or a constituency wants to make sure that it has a voice at the decision-making table by having a representative on its franchisor's board of directors—a so-called "constituency director." For example, it is commonplace today for investors other than common shareholders to have representatives named to boards of directors. In addition, demands for seats on boards are frequently being made by non-investors, in the technical sense,[1] such as labor unions.[2] Why should or shouldn't franchisee groups or associations receive similar special treatment?

Conflicting Goals

Often the investors in a company with layers of stock embedded in their capital structure will have equity groups or venture capital funds owning common stock, and they may have different views than other shareholders about how to address problems facing a corporation.[3] Illustratively, the preferred shareholders and the holders of common shares may have different goals. When preferred shares are issued, the preferred shareholders might also have been granted special rights to designate board members at the time the holders of these shares made their investment, to make sure their objectives and concerns are not forgotten. So, for example, when a corporation is having severe financial difficulties, the preferred shareholders want to be sure that their interests, which may not be the same as those of the common shareholders, will have input into strategy decisions. The preferred shareholders may prefer a liquidation, for if the corporation is incurring losses, but continues in business, there will come a point at which the preferred shareholders will say enough is enough. If the corporation does not stop the bleeding, there will be nothing to distribute to the preferred shareholders when the corporation decides that there may be no alternatives except to liquidate the corporation, or sell it at a bargain price. However, representatives on the board whose sponsors are equity investors or perhaps all of the common shareholders, may prefer to try to make more risky attempts to turn the corporation around and are willing to take the risk of losing everything in order to have one more attempt to succeed. This situation raises the question: Do the directors have a primary loyalty to the corporation, or to its shareholders, or in the case of constituency directors, to the constituency that elected these representatives?

It is not clear that the corporate law has developed a clear answer to this question.[4] In practice, the goals of all the directors is to make money for their corporation, and under common law, the directors' loyalty should be first to the company. The challenge becomes how to achieve this goal when the constituency directors and the other directors have different views on how to finance and operate the corporation. If one looks at the example above, one should see how much risk to assume is one area where conflicts can easily arise.[5]

When looking at the interests of franchisees in the franchise system, the analysis is somewhat different and more like the situation involving a labor union. Although they are not "investors" in the company in the traditional sense, as previously noted, the franchisees and their financial commitment to the corporation may drastically exceed the investments of those who own the equity of the corporation. Constituency directors, of course, want the corporation to succeed, but they do not necessarily want the corporation's increased profitability to be achieved at the franchisees' expense. In this situation, they are likely to focus upon the interests of the franchisees first, and the overall welfare of the corporation next.

Profitability Challenges

If a franchise company wants to become more profitable, one of the easiest ways to do so is to raise royalty rates or the amount of the initial franchise fees paid by prospective franchisees. Raising royalties may not be easily accomplished, however, because they are fixed by the terms of the existing franchise agreements. Thus royalty rate increases for existing franchisees can only be accomplished over time, when franchises come up for renewals, unless the franchisor wants to trade off certain of its rights in exchange for the franchisees agreeing to an immediate increase in royalty rates. As for new franchisees, it is easy, from a legal perspective, for the franchisor to raise the amounts paid by the franchisees to the franchisor by modifying their then-current form of franchise agreements for prospective franchisees.

But life is not always that simple because most business entities are subject to market limitations. If Company X charges $10,000 for its initial franchise fee, and a competitor, Company Y, already charges that sum, will an increase in the initial fee scare off prospective franchisees?

The challenge of enhancing profitability can also be viewed from the cost perspective. In addition to increases in the amounts to be received from royalty fees or initial franchise fees, another way to increase profitability is for the company to reduce expenses. If the costs of providing field service, if Company X has a ratio of one field consultant for every 10 franchisees, a quick way to decrease costs is to change this ratio to one field consultant for each 11 franchisees. However, again, there are other factors to consider. First, will this decrease in the number of field consultants adversely affect the quality of services or products franchisees provide to customers, and second, will any decrease in service affect the value of the franchise itself, making it more difficult for Company X to sell franchises?

Here, too, there is a clear conflict of interest facing a franchisee constituency director. Should that director look at what is best for the company as a whole, or first look at protecting the interests of his constituency? Again, keep in mind that the franchisee has no equity investment in the company; thus increased profitability may not be the greatest concern of the constituency director or his constituents. The franchisees, and correspondingly, the franchisee constituency director are usually more likely to look at how these changes might affect *their* profitability.

When Conflict Arises

Success for a franchise system cannot be readily accomplished if the franchisor and its franchisees are not *both* financially successful. So the ultimate question becomes: What should a franchisee director do when a conflict arises? A franchisee appointed director might find that his best solution is to resign or abstain from the decision-making process on this issue—a decision which is of almost no value to his constituents. Is that the coward's way out? Or is there a better solution?

Another example of a constituency director finding himself having a conflict of interest is when the board of directors is considering making an expensive sea change in the scope of the corporation's business. Suppose the corporation wants to add one or more product lines to the scope of its business, but there will be a significant investment required of franchisees to do so. Although the change may help the franchisor to maintain its competitive position, the franchisees may perceive that it will not increase their profitability and might even reduce it. The franchisee constituency director will have early knowledge of this proposed change through his presence on the board, but many times once the board makes a decision to follow a strategy, it may be difficult for the franchisee community, once it learns of this change, to try to convince the board to reverse or modify its decision. The franchisee constituency director may feel compelled to warn the franchisees of this impending change, thereby allowing them to have the chance to challenge the board's predilection before it is too late. Should this director keep the board's strategy a secret from the franchisees, who may become angry when they learn their representative did not give them a heads-up?

As noted earlier, under traditional corporate law, a director has a duty of loyalty to the corporation, not to any particular constituency. Moreover, each director also has a duty to maintain the confidentiality of board decisions until they are made available to the public or the director has approval from the corporation to make these disclosures available to outsiders. For the constituency director to remain silent may result in severe consequences to his constituents. But to leak the information to his constituency would clearly violate his duties as a director to maintain the secrecy of the board's decision making. An improper disclosure may also make critical information available to competitors who may decide to adopt measures to counter the impact of the corporation's strategy. Without careful planning as to how this information should ultimately be released to the franchise community, it might also cause turmoil within the franchise community. In addition, the disclosure of confidential information in this manner may violate or lead to violations of federal (and possibly state) securities laws if the corporation's securities are publicly traded. Again, how should a director resolve this dilemma?

So Why Have a Representative?

There is no magical solution to the problems created by having a franchisee on the corporation's board. However, in analyzing this problem, one must ask: Why does a franchisee group need a representative on the board? Clearly, one representative will not have the power to change a board decision.

In practice, franchisor corporations generally do take the franchisees' interest into the decision-making process. They create franchise advisory councils, and in some cases independent franchisee associations are formed, to represent the franchisees' collective interests. These, however, by themselves, will not guarantee that the franchisees' input will be obtained before a final decision has been made. But in many instances, certain members of the board or management will circumvent this potential problem by giving a trusted franchisee a hint at what the corporation is planning to do, so that the waters can be tested as to what the franchisee community's reaction might be. Most often, this process is accomplished without the board's blessing, made with the other directors looking the other way. From the corporation's standpoint, this is risky if the information is truly confidential and misused.

It is frequently said that one of the elements of a successful franchise system is an effective communications link between the franchisee community and the franchisor. This ad hoc approach, in large measure, meets the franchisee community's timely need for information, and, at the same time, minimizes the risk to the corporation of making a decision, the wisdom of which will be challenged by the franchisees. The process can be formalized by creating a formal written agreement or protocol, but that solution might create an array of other issues. As they so often say in the franchise community, keep it simple.

Endnotes:

1. Frequently, franchisees collectively have put more capital into a franchise system than the owners of all the equity

2. See R. McCormick, "Union Representatives as Corporate Directors: The Challenge to the Adversarial Model of Labor Relations," 15 U. Mich. J.L. Reform 219 (1981-1982).

3. The analysis should be identical if the franchisor were a limited liability company.

5. See M. Geller & G. Helleringer, "Lift Not the Painted Veil! To Whom Are Directors' Duties Really Owed?," 2015 U. Ill. L. Rev. 1069 (2015); see also R. Spandorf and R. Barkoff, "Close Encounters: Franchise Association and Councils," 26th Annual Forum on Franchising, Volume 2 (2002).

5. See E. Veasey and C. Di Guglielmo, "How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors," The Business Lawyer, Vol. 63 (May 2008).

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