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August 2005 - Franchise Alert - Compensating for "Good Will" on Non-Renewal

Washington's Franchise Investment Protection Act contains several measures that govern the financial relationship between the parties to a franchise and override any contrary provision in the franchise agreement. One such measure provides that if a franchisor refuses a request to renew an agreement for a given outlet, it must "fairly compensate" the former franchisee for (i.e. purchase) certain assets, including the "good will" attributable to the outlet. The obligation to purchase good will does not apply if the franchisor (a) provided notice of non-renewal at least one year in advance *and* will not (except by prohibiting the use of its intellectual property) restrict the right of the former franchisee to compete *or* (b) the franchisor had "good cause" to terminate the franchise agreement. Unless the franchise system is failing financially, "good will" is arguably the most valuable asset associated with any system outlet.

For at least three reasons, the statutory exceptions to the obligation to purchase "good will" are of dubious practical value. First, it can be difficult to reach a decision not to renew in time to meet the one year notice requirement. The franchisor's initial reaction to poor performance is usually to provide additional training, or even direct supervision, in an effort to rehabilitate the franchisee and preserve the outlet. That process is necessarily followed by a period of renewed evaluation and when the rehabilitation fails the cycle is often repeated. Second, an open invitation to compete on non-renewal carries its own risks. Third, shoddy performance alone does not readily equate to "good cause" for termination. As a result, most franchisors rely on buyouts to rid themselves of underperforming, but persistent franchisees.

From the franchisor's perspective, the obvious problem with a buyout is that, particularly when good will is included, the price can be prohibitive. When that is the case, a franchisor with a bad outlet has a Hobson's choice: If the outlet is re-franchised, a poor operator will continue to tie up a potentially valuable location while harming the franchise image. If not, the same operator, using the same outlet, can damage the franchise anyway by competing in the franchised business, even though it does so ineptly and under a different name.

To mitigate the risk of overpayment, the franchise agreement should provide for a buyout mechanism that takes account of good will for the purposes of the Washington statute without providing either party with a windfall. Fortunately, the statute provides an opening for doing that. Given the array of financial, economic, competitive and demographic factors that can influence good will for a given outlet at a given date, there is no formula universally suitable for calculating good will and the statute makes no attempt to provide one. Since prior buyouts are rarely comparable and can set dangerous precedents, the agreement should focus on the negotiating *process*, rather than the analytical method, by which the value of good will is established. The agreement should also allocate a fixed percentage of that value, regardless of how determined, to the franchisor in recognition of the innovation, time, effort and money devoted to the original development and continuous expansion of the franchise system.

To accomplish this, the franchisor should be granted a contractual right to initiate the buyout by proposing a dollar value for the current good will enjoyed by the entire franchise system using any method it thought appropriate. If the franchisee did not agree, the parties would submit the proposal to appraisal or arbitration, but *not* the question of how system wide good will should be apportioned among outlets. The appraisers or arbitrators would be instructed to render their decision promptly and not to establish a value for system good will higher than the highest value or lower than the lowest value asserted by a party. The franchise agreement would then allocate a fixed percentage of system wide good will to the franchisor and apportion the rest among all outlets based on their relative financial performance. Here is a sample provision written in the "Plain English" style now favored by regulators. Obviously, there can be variations.

We will propose a dollar value for the total good will attributable to our entire franchise system as of the expiration date of your franchise. If you do not agree with our proposal, the resulting dispute will be submitted to arbitration in accordance with this agreement, but *not* the question of how much system wide good will should be allocated to you. When the value of system wide good will has been determined, whether by agreement or arbitration, __% of the total will be allocated to us for developing and expanding the system. The remaining __% will be divided by the total number of system outlets operating at your expiration date, including outlets we operated. The quotient will be adjusted upward or downward, and allocated to you, in proportion to the ratio between gross revenue for your outlet for the preceding 12 month period and the median gross revenue for that period for all outlets. We will pay, and you will accept, the adjusted quotient as the full purchase price for your good will.

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