

Things Are Seldom What They Seem: Skimmed Milk Masquerades As Cream
By Stanley Turkel, MHS, ISHC

Is hotel franchising important? Since almost 75% of all U.S. hotels are franchised, perhaps you would agree with me that franchising is of major importance in the hotel world.

What should a franchisee expect from a hotel franchisor? Franchising is recognized as an excellent vehicle for capital formation and rapid business expansion. Business franchising is essentially a mechanism of product or service distribution. Typically, any service business must build a system of distribution to develop a market for its services. Building an internal distribution system of company-owned hotels requires enormous capital, substantial risk and many years. Through franchising, the owner of a hotel brand (the franchisor) grants rights to other (the franchisees), to engage in the business of distributing the franchisor's hotel brand using the franchisor's trademarks, trade names, and marketing system. In theory, the franchisee acquires the right to own a business representing a proven service brand, a respected trademark and an established operating system that has been fully "de-bugged" to achieve maximum profit. The franchisor, on the other hand, is able to build a distribution system of branded hotels without the investment of substantial capital and without financial risk.

The essential requirements for a successful hotel brand are critical mass, brand awareness and name recognition by potential customers. If the hotel brand fails in any of these vital areas, the franchisee will suffer failure also. The universal image of a franchisee is of a business person striving to share in the American Dream of business ownership—driven by an entrepreneurial spirit, but cautious enough to buy a franchised business to ensure success of the enterprise.

This model franchise conjures up an image of the franchisor and franchisee working hand-in-hand to achieve financial success. The franchisor has been described (mostly by franchisor organizations) as a partner, a mentor, a big brother, a coach in your corner—all images of a benevolent, experienced, knowledgeable support center and resource who is ready, willing, and able to nurture, support and protect the franchisees of the system for the good of all.

However, the history of franchising in the United States reveals a far different scenario. In 1971, after a rash of scams, rip-offs and franchisor horror stories, the Federal Trade Commission (FTC) held public hearings on these fraudulent business practices. After 30,000 pages of testimony describing some 5,000 complaints, the FTC instituted its Rule on Franchising which mandated that all franchisors must provide a Uniform Franchise Offering Circular (UFOC). This document must disclose all material information to help prospective franchisees to make an informed franchise purchase decision. Nevertheless, franchise agreements are one-sided documents, drafted by franchisor attorney's and presented on a take-it-or-leave-it basis to franchisees. Why do hotel franchisees agree to these agreements? They do it for these vital and important reasons:

- To gain brand name awareness
- To join a system that is identifiable and attractive to the traveling public
- To join a system that has appropriate system growth
- To receive beneficial reservation contributions

Unfortunately, reality trumps wishful thinking and most hotel franchise agreements, especially those provided by the largest franchise companies are heavily skewed in favor of the franchisor. Robert C. Hazard, Jr. writes "They contain as many rights and as few responsibilities as possible for franchisors, while just the opposite is true for franchisees. This franchisor favoritism should surprise no one because high-paid franchisor attorneys offer 100% protection to the franchisor against any and all contingencies including lawsuits."

Despite what you may think, there are no federal rules, no duty of due care, no fiduciary duty even when the franchisor collects franchisee money in pooled advertising funds. The language of the franchise agreement is all that defines the relationship between the franchisee and the franchisor. It is for this basic reason that franchisees should pay careful attention to the various clauses in the franchise agreement.

For the past few years, I have reviewed many franchise agreements on behalf of owners of hotels. Very often, my recommendations have results in substantial and beneficial changes in these agreements. Since the franchise license agreement is one of the most important business documents you will ever sign, you need all the help you can get. I propose to review the major

clauses that appear in most franchise agreements in a series of articles which will appear in future Hotel Interactive columns.

Impact and Encroachment

Peggy Berg, President of The Highland Group, writes (in *Hotel Investments Issues & Perspectives*, Third Edition, Edited by Lori E. Raleigh & Rachel J. Roginsky):

“Impact (called encroachment in other industries) is probably the most contentious issue between franchisees and franchisors in all industries. Impact occurs when a new hotel in the chain takes business away from an existing hotel. It’s a troubling topic, because every \$100,000 in lost revenue to the franchisee means a loss of only \$10,000 to the franchisor (royalties and reservation and marketing fees total approximately 10 percent of room revenues). Meanwhile, the new hotel may represent \$100,000 to \$1 million annually in new revenues to the franchisor. The franchisor stands to earn a substantial net benefit from impacting the franchisee.”

Almost all franchisors will grant same-brand or similar-brand franchises in markets where franchisees already operate. They do so because it increases royalty income and leads to better market penetration, greater name recognition and more profits. And they do so with impunity if the license agreement explicitly states that the franchise does not have a protected territory. It is in the franchise company’s interest to avoid granting an area of protection to franchised hotels. That is why, in general, most hotel franchise agreements do not offer protection from impact. To the contrary, most franchise agreements specifically reserve the right for franchisors to add hotels to any location. Hotel franchisees ultimately have to face the fact that one company’s expansion is another’s encroachment.

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Some franchise companies propose an impact study to determine the revenues that the existing franchisee will lose if an additional hotel is licensed in the same marketplace. The majority of these impact studies are flawed and subjective. It is very difficult to assess 1) the impact of similar-brand identification; 2) the territorial distance in downtown metropolitan markets compared to suburban and rural markets, 3) the impact on occupancy, average daily rate, F&B and other revenue-producing areas, 4) the impact after one or more years, 5) the cumulative impacts from various branding combinations; and 6) the effect of licensing two or more properties in a marketplace over several years. You can bet that if the franchise company pays for the impact study, the results will favor the granting of the new franchise.

Furthermore, if you are fortunate enough to secure an area of protection around your hotel for five years in which the franchisor agrees not to license a new property, remember that markets change and that five years passes very quickly. Negotiate the area of protection as broadly as possible for the term of the franchise agreement. Then guard these clauses as well as possible. Pay attention to your obligations under the license agreement so that the franchisor doesn't claim the right to locate a competing hotel in your protected area.

Don't ever forget that franchisees and franchisors are in different businesses. Hotel franchisees are in the business of leasing hotel rooms. Hotel franchisors are in the business of selling franchises to hotel owners.

My next article on hotel franchising will deal with mediation, arbitration and litigation.

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