Fair Franchising Is Not An Oxymoron:
AAHOA's 12 Points of Fair Franchising

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In 1998, Asian American Hotel Owners Association chairman Mike Patel identified a set of standards by which to judge the actions of franchise companies. Now, nine years later, AAHOA has updated the 12 points and has embarked on a survey of franchisors to assess their compliance with these fair franchising standards. In each of my next Hotel Interactive articles, I will highlight one of the 12 points.

Point 1: Early Termination and Liquidated Damages
A. Voluntary Buyout or Involuntary Termination and Liquidated Damages:
At the current time, if a franchise agreement is being terminated by either a franchisor or franchisee due to a voluntary buyout or involuntary termination, most franchisors are assessing liquidated damages (LDs) at unfair and unreasonable rates that penalize the franchisee. For example, many franchise agreements provide that the LDs will be calculated based on one of the following formulas: (1) by assessing a rate of $1,000 to $2,000 for each guest room of the facility, or (2) by multiplying the average monthly gross room revenues by the royalty fees payable in the remaining months of the franchise agreement, multiplied by the number of months until the franchisee could have terminated the agreement without penalty, not to exceed 36 to 60 months.

In the interest of fair franchising, a franchisee should only have to pay six months of royalty fees. Specifically, the franchisee should be required to pay as LDs, and not as a penalty, the product of the average monthly royalty fees paid by the franchisee during the prior 12 full calendar months (or the shorter time that the facility has been in the system), multiplied by six months.

Further, in the event of an early termination, if a franchisor has paid any "incentive" money to a franchisee under the franchise agreement (including, for example, a development incentive advance, loan, or grant), the incentive money should be amortized over the total number of months of the term of the franchise agreement, and the repayment of any incentive money should be based on the number of months remaining under the agreement.

Commentary: The current provisions relied on by franchisors for assessing LDs are punitive in nature, and not based on a reasonable estimate of the franchisor's probable losses from the early termination of a franchise agreement. Regrettably, most franchisors have been unwilling to negotiate or change such provisions to provide for a fair and reasonable method of assessing LDs based on, among other things, the actual amount of monetary losses franchisors have experienced in the past as a result of an early termination, or the average amount of time it will take a franchisor to replace a terminated facility.

AAHOA's proposed method of limiting the LDs to six months of average monthly royalty fees for the subject facility is fair and reasonable because it does not provide one side with a windfall or an unfair advantage over the other, and it compels both franchisors and franchisees to work together to avoid an early termination. Indeed, under AAHOA's method of assessing LDs, a franchisor will have six months to locate a replacement facility of the same or a similar brand name as the terminated facility before it faces the prospect of suffering any losses arising from an early termination. Moreover, a franchisee will still be required to pay a significant sum of LDs, but will not be unduly penalized in connection with a voluntary buyout or involuntary termination of its franchise agreement.

If a franchisor has given any "incentive" money to a franchisee, that should not be used as a means of penalizing a franchisee in the event of an early termination. Rather than requiring a full repayment, the amount should be amortized over the term of the agreement, and any monies that must be repaid should be based on the remaining months under the agreement.

B. Windows Provisions:

Most franchise agreements contain "window" or "additional termination" right provisions, which allow the parties to terminate the agreement on specified anniversary dates (e.g., on the fifth, tenth or fifteenth anniversaries) after the opening date of the facility, without having to pay LDs. Regrettably, many franchisors have included "gotcha" clauses in their franchise agreements. These clauses preclude a franchisee from terminating early if the franchisee encountered monetary or operational problems at any time after the opening of the facility, which resulted in an alleged uncured default or low scores on quality assurance (QA) inspections on two consecutive occasions.

Such "gotcha" clauses should be eliminated from the franchise agreements. A franchisee should have the ability to terminate its agreement, with or without clause, and as a matter of right, on the specified anniversary dates by giving at least six months' prior written notice to the franchisor. The only contingency for the exercise of the early termination rights should be that at the time of the proposed termination, the franchisee is not in default, and has paid all fees due under the franchise agreement.

Commentary: In franchise agreements containing "windows" or "additional termination right" provisions, the types of "gotcha" clauses that are most unfair are those that explicitly state a franchisee's rights will automatically terminate, without notice, (1) the franchisee fails to cure any default under the franchise agreement within the time permitted, if any, in the notice of default sent by the franchisor, or (2) the facility receives a poor score on a QA inspection, and then does not receive a higher predetermined score set by the franchisor during a re-inspection of the facility.

Consequently, in many situations, the fact that a franchisee experienced financial or operational difficulties that resulted in a notice of default, or low QA scores, in the first few months or years after the opening of the facility will forever preclude the franchisee from being able to exercise its early termination rights without penalty. This is true even if the franchise subsequently pays all of its fees on a timely basis, and receives excellent QA scores for many years, before attempting to exercise its early termination rights without penalty. These "gotcha" clauses give the franchisors an unfair advantage and should be eliminated from all agreements.

C. Early Termination for Underperforming Properties:
As discussed in Fair Franchising Point 3 below, franchisors should issue minimum performance guarantees to franchisees regarding the occupancy levels of their brand name hotels. In an attempt to address this issue, some franchisors have adopted a "policy" that allows a franchisee to terminate the franchise agreement without penalty if the facility is underperforming and certain conditions are met. At a minimum, franchisors should include provisions of their fair franchising property "policies" as contractual terms in their franchise agreements.

These specific contractual terms should provide that the franchisor will allow a franchisee to terminate the franchise agreement without penalty if the property has achieved an occupancy rate (total occupied rooms divided by total available rooms) that is below 50 percent for a period of 12 months or more. There should be no restrictive or unnecessary conditions placed on a franchisee's ability to terminate the agreement early for low occupancy rates.

Next month Point 2: Impact/Encroachment/ Cross Brand Protection

My book-in-progress "*Great American Hoteliers: Pioneers of the Hotel Industry*" will be published at the end of 2007 by McFarland & Company, Publishers, Jefferson, N.C. You can reserve an autographed copy by sending me an email at stanturkel@aol.com

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