

## **Modern Recruitment Strategies: Targeting Your Most Valuable Resource—Successful Multi-Unit Operators**

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As franchising has matured as a growth strategy, so too have its operators. Multi-unit operators generally have more financing options, are better capitalized, have existing "back of house" operations and are familiar with local real estate opportunities. In fact, many franchisors are actively recruiting existing multi-unit operators from other systems, in an effort to consume capacity in existing infrastructure. These development opportunities are appealing for existing operators for a variety of reasons, particularly as territories become built out, or future development becomes comparatively less profitable.

The franchisors with successful multi-unit operators would probably prefer to restrict franchisees from pursuing other development opportunities, and perhaps require them to continue to grow the franchisor's brand into other territories. The fact is that multiple unit operations are often territorial in nature, and most operators would rather grow more units in their existing trading areas using existing infrastructure. Some franchisors have acquired other brands in an effort to capture and exploit their existing operators need to expand. Others have developed guidelines, which attempt to define the type of third party development they will permit. In developing such guidelines, all but McDonald's recognize the franchisees' right to engage in a non-competing business (like a QSR franchisee developing units for a muffler franchisor). As the third party concept converges on the existing franchisor's concept, some franchisors preclude development of particular products, like hamburgers, or expansion with specific brands, on the theory that it is simply not possible to prevent the seepage of a franchisor's confidential information to brands, which offer similar products.

According to a recent Franchise UPDATE survey of 45 franchise systems with multiple unit operators, most franchisors condition their approval of non-competing development opportunities on the separation of key personnel, adequate assurances of ability to meet future development obligations, and capacity in existing infrastructure.

### **How do franchisors enforce these kinds of restrictions?**

Most franchise agreements contain best efforts clauses (which require the franchisee to use its full time best efforts in connection with the operation of the franchise business) and some form of in-term restrictive covenant (which often prevents the franchisor from engaging in competing businesses during the term of the franchise agreement). Franchisor's can also use trade secret laws to protect their proprietary information. In addition, most states recognize a claim for tortious interference with existing contractual relations, which could create a claim against a soliciting franchisor for attempting to induce a franchisee to breach its franchise agreement, by operating a competing business.

### **Best Efforts**

In a mom and pop single unit operation, best efforts clauses are often interpreted to require that the individual franchisees or principals participate in the full time operation of the franchised business. However, "best efforts" clauses take on a different meaning when applied to a multiple unit operation, where the franchisee is

contractually obligated to operate multiple units through an approved infrastructure where the franchisee's individual contribution is less significant. Moreover, if a unit is operating profitably despite the lack of the franchisee's full time and best efforts, it is hard to imagine how a franchisor could demonstrate good cause to terminate on the basis of a breach of the best efforts clause.

McDonald's view, by far the most parochial, is predicated on a super "best efforts" clause, which requires its franchisees to "keep free from conflicting enterprises or any other activities which would be detrimental to, or interfere with the business of the restaurant." The enforceability of this clause has never been tested probably because McDonald's units themselves are so marketable, such that if you determine that exploiting multiple brands is in your best interest, you can sell your McDonald's units and pursue the opportunity. Even if you purchase one of McDonald's own concepts, you must agree in advance to divest the concept if the franchisor ever becomes disassociated with McDonald's.

Some mature systems require that a concept dedicated "Designated Manager" who has successfully completed the franchisor's training program, be physically on site during all business hours and that a firewall exist between personnel operating the different concepts.

In one of the few reported decisions explaining the relationship of these contractual clauses in a franchise context, Burger King successfully enforced a termination of a multiple unit franchisee based on its operation of a Hardee's franchise in another state, in contravention of Burger King's policy preventing the operation of other "hamburger" businesses. The trial court found that the franchisee transferred key Burger King personnel to the Hardee's operation; one of whom was alleged to have provided Hardee's with results of Burger King studies, copies of its operating procedures and manuals, and architectural drawings for unit construction. In affirming the termination, the Court of Appeals found that the in-term covenant was essential and reasonable in order to protect Burger King Corporation's marketing strategies, operating methods and policies from competitors. Moreover, the court found that such covenants reinforced other policies of the franchise agreement, including the "best efforts" clause.

Similarly, in a distribution case involving Royal Crown Cola, Co., the court upheld the termination of a Royal Crown distributor based upon its agreement to market a competing product for a competitor. The court made clear that it was not the act of entering into a contract with the competitor, but rather the distributor's post-execution conduct, including the extent to which the distributor had (i) transferred key personnel, (ii) diverted sales, shelf space and other marketing opportunities, and (iii) engaged in disparaging advertising concerning Royal Crown's product which breached the Franchise Agreement. The court found that the distributor's conduct was manifestly harmful to Royal Crown and would so dilute the distributor's efforts on behalf of Royal Crown that it breached the "best efforts" clause in the distributor contract and permitted the termination of the distributorship.

### **What Lies Ahead?**

So what does the future hold for multi concept franchising? Aggressive franchisors will no doubt sacrifice contractual control in order to attract strong operators to their systems. The sheer number of franchisors pursuing existing operators will further shift the balance of power to the operators. Moreover, once in your system, it may

be impractical to alienate your largest operators, and you may be forced to under-enforce system standards or award future opportunities to them.

However, there are limits. While franchisees can use their operational expertise and portions of their infrastructure to construct, fit out, open and operate units for a third party franchisor, franchisees cannot simply export their franchisor's intellectual property to the next development opportunity. Practically, it may be impossible for the construction team, for example, to distinguish between some operating procedures, funding techniques, supplier relationships, lease terms, pricing structures and methods of promotion, which the franchisee obtained during the course of the existing franchise relationship, which are presumably entitled to protection, and those which the franchisee can exploit for the benefit of a third party. Expect the courts to further define the scope of protection for a franchisor's proprietary information, as franchisees continue to test the limits of its actual operational use. Expect the outcome of cases in this area to be very fact specific, and largely turn on the franchisee's post execution conduct with its new franchisor.

As franchisors actively recruit operators from other systems, expect in term and post term non competes to become more specific, in many cases restricted to Aflagship@ goods, and best efforts clauses to contemplate multiple unit, and multiple concept operations. As a counter-measure, most mature systems will use their most attractive attribute, namely their liquidity, to divest those franchisees with multi concept aspirations. With so much activity in this area, and so little law, the future will surely be interesting.