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Case studies

For the Birds: When a New Owner Flies in – How Can Franchisees Stay Aloft?

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Sally has a successful franchise focused on birds, but problems arise when the original franchisor is bought out by venture captialists who decide to reformat the business. In response to this challenge, Sally takes a leadership role in representing the interests of all the franchisees in neogtiations with these new owners, but eventually “goes rogue” and violates the terms of her franchising agreements in order to save her business.

Case Synopsis

Sally invested in a successful franchise focused on birds, and in a few short years, she had the number one and number two stores in the franchise. Problems started when a Venture Capital firm bought out the original franchisor and decided to reformat the business. Sally stepped into a leadership role to represent the franchisees’ interests, but ultimately, to save her units and livelihood, she opted to “go rogue.” Some questions to ponder. How would you assess Sally’s investigation into franchise business options? When a franchisee becomes successful, what implications can this have in a franchise system? How can corporate buyouts take place and be more successful in a franchise business model?

Learning Objectives

- Assess Sally’s investigation process before becoming a franchisee
- Identify what could happen when the original franchisor sells/exits and strategies for mitigating possible issues
- Explain how a franchisee becomes a defacto leader
- Assess the franchisee’s negotiation strategy with her franchisor
- Devise options a franchisee could consider when business erodes due to system changes they cannot control

Case Background

Sally, an avid bird lover and stay-at-home mother was married to Bill, vice president of a department store chain in Seattle. Sally had always wanted to own her own business, and she and Bill believed opening a franchise that she would operate would be a reasonable calculated risk. Early on, Sally and Bill spoke to their financial advisor and accountant to establish parameters around how much they could afford to invest. The couple agreed they would use no more than 70% of their savings (around $500,000) for the upfront funding, borrow any additional capital from the bank, and avoid dipping into their retirement nest egg. They knew that with Bill’s current job, they could manage financially on just his income. This would allow a new franchise unit at least a year or two to gain traction before turning a profit. The key now was to locate a franchise business that Sally found interesting, one within Bill and Sally’s cost-of-entry requirements and one with available locations within the Seattle local market.

With those parameters in mind, Sally began her investigation into becoming a franchisee. First, she read more about franchising online and quickly realized that there were many options. She decided to attend the Franchise Show in Tacoma, as it promised seminars from experts and the opportunity to meet with franchise developers wanting to expand into Washington State. Listening to the presentations, Sally decided immediately that they would invest in a business format franchise in the retail sector. Attending the event was exhausting, but while there, Sally attended a seminar on how to use a franchise broker, and she met a franchise consultant (broker) from FranCon. Sally started talking to Mandy Walker, and they hit it off immediately. Mandy, like Sally, was a mom who had started her own business. In fact, she was a franchisee for the FranCon Broker organization, and her job as a franchisee was to help other individuals identify franchise opportunities. Sally ensured that what she learned at the seminar was true; there would be no charge for this broker service. That Mandy would, instead, be paid by the franchisor if there was a successful match. Reassured of this fact, Sally and Mandy shook hands and agreed to take the next step in the process.

When Sally met Mandy, she reviewed commonalities in how business franchises operate. These included individuals wanting to be a franchisee having to pay an upfront fee to license the brand, monthly royalty payments, and signing a 10-year contract to abide by the franchisor’s guidelines. The franchisor would provide upfront training, operational manuals, and assistance as needed. Once the overview of franchising was completed, Mandy explained that she would locate prospective franchisors for Sally to consider. Those franchise businesses would be based on a profile created for Sally based on her interests, skills, financial goals, available capital assets, and location requirements.

Sally's passion for birds ultimately led to the first business possibility. Mandy brought Sally the opportunity to become a franchisee for a sizeable popular franchise called *"Backyard Bird Feeders"* (BBF). This franchisor had over 200 franchisee locations. These locations were primarily in the west coast area, with several of the franchisees owning multiple locations. They had been in business for nearly a decade with cumulative annual revenues of over $50 million. Sally visited several BBF stores, and she liked their products and services. Mandy arranged for Sally to talk directly to the owner of BBF, Ben Thomas. Sally found Ben to be personable, and he was an expert on birds, but he also had strong opinions about how the business had to be operated.

Sally would have gone with BBF; however, there were two stumbling blocks. First, the territory she wanted was not available. Another territory was offered, but it was not a good location, and she and her husband, Bill, agreed that the distance would make it difficult to manage. Second, Sally talked with two franchisees at BBF. Both said Ben and his leadership team were smart and accessible, but they complained about the old cash registers that had to be used. She thought this was outdated, so she contacted Ben (he had told her to reach out) and asked him about technology. He responded, "my franchisees are not very savvy, and a change would be traumatic for them." She thought this was not very forward or innovative thinking. Sally told Mandy to keep looking.

The next opportunity Mandy brought forward was the *"Ultimate Birds Nest"* (UBN), a smaller competitor of Backyard Bird Feeders. UBN had over 100 locations and appeared more modern and progressive. Sally visited two of their locations and was very impressed. She liked their products and service as well. She talked with the franchisee's owners and then felt even more at ease and comfortable because they were so enthusiastic about their decision to buy their franchise. They thought the standards and guidelines made a lot of sense for the business but felt they had autonomy in how they would operate their business.

UBN was offering a better location in a brand-new high-profile shopping area that she felt would be good for business and prestige. Other retail stores in this new shopping center were Borders Books, Pier 1 Imports, and Talbott's women's clothing store. The location was only five miles from where Sally and Bill lived. The two UBN franchisees that Sally spoke to were friendly and candid. They openly discussed how much they enjoyed having the ability to make decisions to build their units with little bureaucracy from corporate headquarters. Sally did not have an opportunity to connect with the founder of UBN, but Mandy had her talk with the head of franchise development at UBN. Nothing troubled Sally, so she and Bill agreed that UBN would be their franchisor.

Signing up for a UBN franchise

Sally and her husband (at the time) had to invest approximately $225,000 for one store, which covered the building, products, marketing, and computer system explicitly designed for UBN. Their attorney reviewed the franchise agreement and suggested some changes; however, the franchisor rejected those simple changes. The couple was told they could not make any changes to the contract and that all franchisees would sign the same documents. Sally and Bill decided to go ahead and sign on and move forward with the first store.

Preparing to be a franchise owner

There were four days of required start-up training at the franchisor's headquarters in California. Sally attended by herself. Every single detail was explained, even how to use the computer system. During the first training day, she also met George, the owner/franchisor who started the UBN organization. George was very much into birds and talked about how his dad was involved in fish and wildlife.

Sally walked away from training with her head spinning. Knowing she was an owner of her own business was both exhilarating and frightening; she knew she would likely be making 100 decisions a day. Sally read everything she could get her hands on to be better prepared for the storefront and managing employees, which she hoped to have in the near future, even if just part-time. She also visited with other small businesses where she was going to have her store so she could build some friendships and camaraderie. Although she still felt like she didn't know exactly what she was doing, her passion helped her stay committed to her vision of being an owner/operator of her own store.

Store/s

Sally's first store opened in 2007 in a brand-new popular shopping center and was a tremendous success. Sally was so successful (although she said she did not draw a salary for two years); that she ended up being the number one franchise in the entire company. There were 113 locations and more coming on board. UBN's state-of-the-art point of sale (POS) system with customer sales tracking, monthly newsletters, and promotional items was much more advanced than its competitors at that time.

Sally had built a friendly relationship with the owner/franchisor founder, George, over a competitor's dirty trick. One day about six months after she opened her first store, George contacted Sally telling her that he had received a disgruntled letter from one of her customers. That the customer complained about her and her store. She asked for a copy of the letter and did some investigation and found out that it had been sent by her competitor, who had a store about 5 miles from her store. The competitor had sent the fake customer letter to discredit her and hurt her business. She and George laughed after the imposter customer letter had been revealed. While it had caused Sally time and energy to investigate, it enabled her to get to know George personally. She realized that now she had direct access to him, and she regularly brainstormed with him about birds and proposed ideas for her unit. He often gave her the green light, and if the idea worked, he would share those ideas with other franchisees, always giving her credit.

Sally also regularly talked with many of the other UBN franchisees. They respected her tremendously. She would speak at the annual UBN convention and be part of panels to brainstorm how to leverage various suppliers' discounts. George even invested in an intranet to help the franchisees stay connected with each other. Sally went on to open her second store in 2010. When Sally divorced Bill in 2012, George and her franchisee friends were there to lean on. That old saying about franchising proved true: *Be in business for yourself but not by yourself.*

Change happens

In 2014, George decided, due to his health, that he was selling the franchisor corporation to a venture capital (VC) firm. Once the sale occurred, a notification was sent to the franchisees about the transfer of ownership. The new VC firm hired a CEO, Matt Balke, who had worked in retail but had no franchise experience and was not a birder. The new CEO decided to reformat the business in an effort to boost unit volume and sales. Many of the previous corporate office people were replaced.

Sally's phone was ringing nonstop with concerned franchisees about this new owner. The first thing she did was determine if the franchisees had any legal recourse over the sale, given they were not consulted. She quickly learned that the franchise agreement would be the place to locate that answer. Her research revealed that many franchise agreements provide the franchisor with complete authority to transfer their rights in the franchise agreement without consent from the franchisees. Sally also learned (albeit too late) that this could be a negotiation strategy before signing a franchise agreement, requesting any of the following:

- Providing notice to the franchise network prior to a transfer taking place;
- the new franchisor to enter a new franchise agreement with the franchisee;
- the new franchisor to agree to the same terms and conditions of the franchise agreement with the franchisee; and
- the franchisee to have a choice to exit/terminate the franchise agreement if the franchisor decides to sell the franchise.

Unfortunately, the UBN franchise agreement gave the franchisor complete authority to transfer the rights of ownership and notify the franchisees after the sale transpired. The only limitation is that the new owner would assume all obligations and liabilities of the franchise agreements existing at the time of transfer. This proved to be another blow down the line.

At the annual franchise convention, the changes to product and distribution were announced. The Chief Executive Officer (CEO) outlined how the organization was shifting to a single-source birdseed supplier from China. While in theory, this sounds like it would be better, it took away the power of negotiating with vendors closer to the individual franchisee locations away. It also meant that if that one supplier had issues with product or distribution, the entire system would suffer. However, the cost of this new seed was of immediate importance to the franchisees. The new corporate leadership also introduced the new Chief Operating Officer, Crystal Jance. With great fanfare, Crystal announced the new bird seed would be packaged in small-sized bags with front artwork that a famous bird painter had designed. She boasted this change would lead to higher profit margins. Given bird seed accounted for 50-60% of revenue for their businesses, the franchisees were alarmed. When one franchisee in the audience asked about a price sheet, Crystal indicated that they were still finalizing.

When the price sheets arrived after the convention ended, franchisees were dismayed. A 15lb bag of seed was now 25% higher in cost than the previous 20lb bag. Sally immediately re-read her franchisee contract; sure enough, the franchisees were required to use the franchisor's supplier if one was selected. Sally tried to be positive and followed the new mandates. But, her customers were providing feedback such as: "I like you Sally, but there is not enough seed, and it is not good quality. Birds are leaving it for the squirrels to eat". With smaller bags, higher prices, and poor quality, Sally's sales were dropping. Her fellow franchisees were in the same boat.

Taking a leadership role as a franchisee

Sally heard more and more complaints from the other franchisees and started digging to see what could be done. Unfortunately, the franchise agreement also gave the franchisor control over vendor selection. The franchisees organized several conference calls with corporate in an effort to try to be heard in a collective voice. However, these calls were disorganized and just venting sessions that corporate seemed just to blow off and disregard. As franchisees continued to close, the other franchisees became increasingly distressed. After about the first year under new VC ownership, there were only 50 franchisees left. Many had bought in with their retirement money and lost about everything. Sally was one of the strongest franchisees, very well respected, and many thought she had a strong diplomatic voice, so they asked if she would represent their collective concerns to corporate. She agreed but discussed with the franchisees that she would need time to do more research and understand their rights and how elements of potential litigation might surface.

The meeting between disgruntled franchisees and the franchisor

Within two months of the group's designation of Sally being the franchisee's collective leader and voice, it was time for the meeting with the new corporate. Sally was extremely nervous. However, she would have several other franchisees in the meeting with the corporate, but she would be the spokesperson. She had identified their grievances, and this small group had brainstormed options to solve the issues. She had these bullet points and a solid understanding of what to do next if they could not come to any type of "next steps forward" in their discussions.

The meeting takes place on a Friday afternoon at the time the new corporate owner designates. Minutes are taken during the session, so there is a formal feeling in the air as it begins. Sally begins by thanking the new owners for attending and taking the time to listen. She continues by presenting slowly the bullet points of the issues and the reasons why there are issues that have been collected from the franchisees. She asks after each bullet point if there are any questions or comments. Corporate has none each time. The meeting becomes more tense with this silence. Sally concludes with ideas that the franchisees think would be positive and mutually beneficial. Corporate ends the meeting with a thank you and a warning that each franchisee has signed a legally binding agreement and intends to fully enforce that agreement to the full extent of the law. They do not want to deviate from their new plan or make any concessions.

The dilemma of what to do next

Sally had to close down one of her two locations. She was very sad and could not eat or sleep. She had been making about $100,000 a year and now was dropping quickly and had to cut staff. She was barely making a living with high rents to pay and a child still living at home.

While the UBN franchise was good for her initially, it was not now. She decided to take it upon herself around 2019 to save her business. She returned to buying from the previous vendor, using seeds in the weights and prices customers were accustomed to paying for. Knowing she needed to stay under the corporate radar, she did buy minimal amounts of the China seed. She knew she was in total violation of her franchising agreements. This strategy worked for six months, but then the letter arrived from corporate headquarters. She was in violation but would be allowed to remain in the system if she returned to following the vendor requirements. Sally figured she had three choices.

1. Just let them sue you and declare bankruptcy. Then, get a job with a bird store to keep making ends meet.
2. Apologize and agree to sell the franchisor's seed. Meanwhile, recruit the other franchisees to band together and create a franchisee association that would pressure the franchisor into providing the franchisees a seat at the table.
3. Hire an attorney and fight them in court as an individual franchisee. While investigating her situation, Sally noticed that her FDD, returned from the franchisor, did not have a signature or date, a legal violation.

Conclusion

This case example outlines how an individual investigated franchise opportunities, built a successful franchise, and became a leader in the system. The situation changed, however, when new ownership came in with a new vision for operating, and changes were mandated. The sale of a franchise is a relatively common phenomenon, so individuals investigating franchises must read the contract carefully to understand the implications. Prior to signing is the best time to negotiate clauses for the protection of such events. At the very least, the franchisees should actively engage the new owner as soon as possible to ensure that their ideas and concerns are considered as changes to the system are contemplated. That can be accomplished by the franchisees having effective leaders such as Sally approach new ownership on behalf of the other franchisees. Hopefully, having an open dialogue at that time can assist the parties transition into an improved system while maintaining the franchisor-franchisee relationship.

Class Discussion Questions

1. What did Sally do right when she was investigating franchise options?
2. What could Sally have done better when investigating franchise options?
3. What could be done upfront to mitigate the impact of a major change, such as a transfer of ownership?
4. When the ownership of UBN changed hands, what could have been handled better by the franchisor
5. How could the franchisees banding together have worked more effectively?
6. What options, besides the three Sally thought of, are available to her?
7. What would you do if you were Sally?
8. How can franchisees and franchisors work together to innovate and make continuous improvements while still forging ahead with a steady customer satisfaction and profit model?

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