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Strategies for Brand Protection During Retraction

By Albert A. DeNapoli, Esq., Partner, Tarlow Breed Hart & Rodgers, P.C. and Michael J. Radin, Esq.


Mr. Al DeNapoli

Concerns And Strategies To Protect Your Core Concept When Growth Slow Down And Retraction Is Necessary.

As the hospitality industry continues to grow, many companies – private and public – are contemplating further expansion. During the exuberance of growth, many successful businesses (those in the hospitality industry being no exception) fail to consider how the commitments they are making today that may restrict them in a cooler market. It is as important to implement sound business and legal plans – hedging if you will – in good times as it is in bad ones.

The adage to "be careful how you treat people on the way up because you will see them on the way down," is very applicable to your legal documentation starting from your very first deals. Often the terms in these documents, although seeming benign initially, can limit the control you have to steer your business through the challenges of slow growth or retraction. Worse, the parties with whom you have done business may have rights that they may want to pursue to your detriment.

The handling of reversals for formerly successful hospitality businesses (as in other industries) starts with a critical evaluation of the commitments made during the exuberance of expansion. Loan documents, leases, franchising and/or management agreements, supplier agreements, employment agreements, and shareholder agreements, to mention the most common, need to be inventoried and evaluated. You need identify and understand the terms such as default and cure provisions, termination clauses, liquidated damage and/or penalty terms, and even non-compete commitments. All of these may limit your options.

This evaluation must include not just written agreements, but also the unwritten "commitments" that field personnel may have created (the proverbial handshake deals that may have been made in the sales process). Importantly, there may be unwritten "warranties" or other obligations which came with the commitments in place (including the obligation of good faith and fair dealing that comes with every contract). You need to know that the labels you may have used to refer to your agreements may not be the ones the law uses – for example, licenses can easily cross the line into "franchises" if there has been too much control in the licensor (and classification as a franchise can dramatically change the parties' rights). Also, you need to differentiate binding agreements (which can be oral) from non-binding "brand" commitments which may have to be modified.

In short, your road map through this adjustment is not just in the fine print – you may have certain associated obligations that need to be considered to avoid costly litigation. In a changing market, difficult compromises on brand-related commitments may have to be made.

Inside personnel can effectively participate in the evaluation only if they are clearly instructed that no rosy "takes" on the situation will be tolerated. You need to recognize the very human tendency to avoid disclosing that one may have created the seeds of an issue: call it the aversion to being the source of a problem. To address this and to benefit from wisdom and expertise (note that the two do not always travel together), outsiders often need to be consulted to bring the sobering reality into focus as fast as possible. Trusted financial consultants (such as "turn around" experts), lawyers, and accountants can be very valuable in accurately assessing your situation and options. Everyone involved needs to realize that if fortunes are to be turned, management needs accurate and unbiased information at every level. Outsiders can identify hazards which may have seemed harmless when times were better. A realistic evaluation of these is critical, as the amount of control you have will vary based on the existence of these items and your understanding of them.

In the brave new world of Sarbanes-Oxley and intense director and officer scrutiny, the board of directors needs to be informed early and accurately of the company's precise financial situation. Financial disclosures must be considered – and when they will be due. As an initial step, the company needs to determine whether it is "insolvent" under the applicable bankruptcy-related rules. If "insolvent," and even if the company is in the "zone of insolvency" (a very unclear status – but one that experienced advisors can help assess), then the duty of the directors and officers experiences a tectonic shift: the duties starting in the zone of insolvency begin to shift from the ordinary duty to protect the value of the company for the benefit of its shareholders, to protecting that value for the benefit of the company's creditors. If the company is insolvent, then bankruptcy specialists should be consulted. The rules are too complex, and the grab for cash too adversarial, to wait to bring these professionals in until there is a cash crisis (such as the need to meet payroll).

Directors and officers need to be advised of this fundamental change, and they must monitor finances with excruciating accuracy. Failure to do this invites claims against directors and senior management personally. Assuming the company is not insolvent, management needs to consider what commitments and alliances have been made which may tie their hands in the now cooler market.

The amount of leverage you used to grow will dramatically affect the amount of control you will have when business cools. You can maintain more control over your concept if you have secured financing with limited recourse (such as using only real estate and fixed goods), and not those elements that define your core concept (such as trademarks, trade secrets and other unique brand elements). Sometimes the documents themselves identify the core brand elements and protect those "defining" components and the protectable goodwill interests which underscores their value. More likely, those elements are protected based on their absence in lists of collateral that have been pledged to lenders or investors. In other words, you may find your plans depend on what is not in the documents.

With your licensing arrangements, you may have leveraged your core concepts by giving the licensee certain rights, including additional rights that may be triggered based on slowing growth or adverse financial developments. We advise clients to resist the temptation of too much leverage in their licenses (particularly their early licenses) to protect their core concept from entanglements which may later inhibit its value. The areas deserving attention are rights to exclusivity (such as geographic or market segmentation), duration, royalties calculated on gross sales (not net revenue), and assignment/sublicensing. Control over rights granted to your licensee is key. Remember, your core concept (with its continued refinements) is the foundation for new growth. As long as you control how your concept is managed in each channel, you have the ability to limit how others might try to break away from your control. You will need to monitor your licensees to confirm that their quality control meets your standards and they will stick with you through your difficult times, even though it may take away precious resources.

If your licensees used their licenses to secure financing, you should check the agreements you may have signed to identify any protections for their investors or lenders that limit your control. Be careful, however, that your licensing does not create an "accidental" franchise, as franchise rules can bring significant limitations (such as limits on your rights to terminate or make amendments) which may further hinder your control. If you need to secure concessions from your licensees, consider granting additional rights to them (such as expansion rights), with a greater percentage of their gross at the first and/or existing site(s), but a lower percentage on additional sites where their growing knowledge of running their business and your reduced oversight can, (in theory), create greater margins.

Your documents should protect your rights to change your system as the market evolves and matures, and you set the course through that change. To the greatest extent possible, use a "reservation of rights" clause which allows you to modify your operation's practices, by stating that there are no rights granted except those specifically stated. Clauses tempered by standards such as "commercially reasonable" and "legitimate business practices," can be tempting, but the flexibility they offer to adjust to the changing business climates also can invite second guessing later.

One area where a brand's equity can be mined is where there may be a technical breach of an obligation (either by the company or another party), but no notice has been given by the other side or there is still a cure period. Management can put time on the clock by convincing other parties to hold off sending such notices, or can begin a dialogue with the other party to acknowledge the situation and work towards a desired outcome based on mutual interests. Using its "reservation of rights," anyone can later send out the necessary notices to turn-up the legal enforcement if needed. Otherwise, breach or default notices can cascade (such as triggering the stoppage of draws under working capital lines of credit), leading the business into the unwelcome arms of bankruptcy protection where everyone gives up control over their situations. This realization should be part of the negotiating arsenal.

Be careful to closely review the status of your intellectual property registrations (such as trademarks, patents, copyrights) and calendar renewal dates. Carefully examine the licensing laws (such as hotel and liquor regulations), which vary widely from state to state, to avoid any violations in your re-positioning. The company (or a committee of the board of directors) should review and re-assess key employment contracts so as to secure the services of executives vital to your brand and image while allowing you to make changes where desired.

The company's original business plans likely will have been put aside at the start of the crisis, but should be reviewed and updated to give your planning a strategic component. Once a realistic evaluation of the company's position has been obtained, the business plan should be re-examined, and parts that still have value should be refreshed.

With the glut of capital available for buying companies, management should be prepared for a possible sale of the company (or its assets) at their highest value. Indeed, depending on the company's financial condition there may be a legal duty to do so. Hopefully, the existing commitments have accounted for and protected the "defining" components of the concept, including any protectable trade secrets and goodwill, and allow you to make a sale.

Otherwise, you may need approvals from third parties who may seek unwelcome concessions or payments. This will, if nothing else, yield value in any possible outcome, including if the weather clears and the company can return to growth.

In the midst of all the uncertainty of the crisis, one thing is certain: through it all there will be new insight and analysis generated by all parties working to protect and advance their interests. If you treated your interests properly while respecting others' interests on the way up, you may have some flexibility as you act to stop any slide down.

Al DeNapoli is a partner of the Boston-based law firm, Tarlow Breed Hart & Rodgers, P.C. Mr. DeNapoli is chairman of the firm's hospitality practice group and provides legal expertise on issues such as franchising, leasing and licensing to clients that range from nationally known chains to local restaurants and lodging businesses. Additionally, he concentrates a portion of his practice in the areas of civil litigation, including complex business issues that relate to contract and shareholder disputes, and employment problems. Realizing the importance of community and industry involvement, Mr. DeNapoli is affiliated with numerous boards and associations. In 2006, Mr. DeNapoli was elected as an editorial board member for the national publication, Hotel Business Review. He is a member of the Massachusetts Lodging Association and was recently named to the Massachusetts Restaurant Association board of directors. He can be contacted at 617-218-2024 or adenapoli@tbhr-law.com

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