

## **Deferral Agreements – Considerations for Extending Relief to Troubled Franchisees**

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Deferral agreements, or workout agreements, are a favorable option for franchisors seeking to restructure and manage the obligations of a struggling franchisee before more draconian measures, such as termination of a franchise agreement and litigation. These agreements allow parties to agree to restructured conditions under a franchise agreement and/or postpone certain events before further action is required. The most common example is the franchisee who is having problems paying royalties or performing contractual obligations on a timely basis. The failure to make payments under a franchise agreement usually indicates a larger problem with the franchisee's business, and bankruptcy court may be the next avenue if things do not improve.

In a default scenario, the franchisor is then left with the choice to exercise a termination right, which may spur expensive litigation from the franchisor in pursuing its rights, including binding arbitration and, possibly, defending a counter-suit, among other considerations, or to allow the franchisee to continue down the road that could lead to graver long term concerns for the franchisor. This is a scenario where a deferral agreement could be used in place of termination.

In addition to protecting a franchisor, a deferral agreement also provides flexibility for a franchisee so it can hopefully improve its financial situation, which might be suffering due to circumstances beyond its control, such as loss of business as a byproduct of the COVID-19 pandemic. The terms and conditions of a deferral agreement will depend on the circumstances, but there are several approaches to consider. A common strategy is to take a promissory note from the franchisee and principal/guarantors for all past due receivables, with an agreed amortization schedule for payment of the past due balance with interest. The goal is to get the franchisee "caught up" over time, while making regular payments.

In difficult cases that involve unforeseen events, similar to those described above, the franchisor may consider allowing the franchisee to close certain locations that are losing money. In such a situation, the franchisor may even consider conditional debt forgiveness, particularly in connection with the location that the franchisee is allowed to close. While this is a particularly generous concession, it can make sense for a franchisor to provide it to protect the reputation of its brand or preserve the viability of an important or high-profile franchisee who otherwise operates successful locations.

Another benefit of a deferral agreement is that it can set firm conditions for the deferral that is

granted. The conditions imposed can exceed what is in a typical franchise agreement in terms of restricting the operation of a franchisee's business. This allows for tighter controls by a franchisor in overseeing the struggling franchised business. For example, the franchisor can seek more frequent reviews of the franchisee's financial records. The franchisor can also require actions to be taken to improve or renovate the business to help sustain a turnaround.

Significantly, the agreement should also provide that all amounts that were subject to deferral will become immediately due, in full, in the event of default. Franchisor will also insist that franchisee agree to waive and release all claims against the franchisor as part of the deferral, which will help minimize the issues subject to further dispute upon the occurrence of an event of default.

Another advantage of a deferral agreement, which demonstrates why prompt intervention with a franchisee is critical, is failing to agree to terms of a workout could open up a franchisor to waiver and estoppel defenses by a franchisee. Waiver and estoppel are defenses commonly argued by franchisees who challenge a franchisor's right to exercise its remedies under a franchise agreement if the franchisor was relaxed in enforcing the agreement for a protracted period. For example, if a franchisee faces no repercussions for paying a reduced royalty fee for several months or years, it could argue that the franchisor, through its inaction, has created a tacit agreement concerning the obligations of the parties going forward. This is clearly not an argument a franchisor wants to defend. To avoid this, prompt and clear written communications regarding non-compliance with a franchise agreement are critical, as well as documenting any agreement for relief through a formal deferral agreement.

In sum, there are many advantages to entering into a deferral or workout agreement for a franchisor. If a franchisor faces a default scenario with a franchisee, a strategy should be promptly devised.

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