Q What are the advantages and disadvantages of buying into a new or emerging franchise system?

A Purchasing a franchise is often viewed as a way to get into business with less risk and a greater likelihood of reward than starting an independent business. For franchisees who buy into reputable, well established franchise systems, this is often true. However, not all franchise opportunities fit this classic mould.

New and emerging franchise systems, by their nature, do not yet have long-standing track records of success and buying into them may entail higher risk than buying into an established system. However, new and emerging systems tend to have a lower cost of entry and some new franchisors are prepared to grant future development rights or other incentives to franchisees in order to grow their system.

From a legal perspective, it is crucial for a franchisee buying into a new or emerging franchise system to recognize the special risks and opportunities involved and to ensure that the deal is negotiated and documented accordingly. The assistance of an experienced franchise lawyer is essential.

One important risk to consider with a new franchise system is that the franchise concept may be unproven and could turn out to be flawed. This risk is especially relevant if the franchise concept is brand new and has no real operating history. The real key to avoiding this risk is exercising good business judgment in your choice of franchise. If, for any reason, a franchise opportunity appears to be unproven and highly speculative, you should consider passing it up. Only proceed if you are confident that you have the business knowledge and experience necessary to properly evaluate the opportunity. If you do decide to proceed with a highly speculative opportunity, every effort should be made to limit your liability under the franchise agreement and other agreements. Of particular importance, personal guarantees, which are almost always given by franchisees, should not normally be given in respect of unproven, highly speculative franchises.

Even if a new or emerging franchise concept is sound, it may not be in your interest to agree to all of the standard franchise agreement provisions in the early days of the system. For example, the operation of an advertising fund or regional advertising co-operative, which normally allows the franchisor to pool payments from its franchisees to purchase higher value media properties, will not function as intended until a certain minimum number of franchisees are in the system. Until then, it may make more sense for the franchisee to re-direct these payments to its own local advertising. New and emerging franchisors will often be willing to consider such requests and the franchise agreement can be amended accordingly.

Besides containing risks, it is also very important to ensure that the franchise agreement accurately documents any incentives the franchisee has negotiated with the franchisor. New and emerging franchisors will often be very motivated to sign new deals and it may be possible for the franchisee to negotiate financial or other incentives. Financial incentives may take the form of reductions in the franchise fee or monthly royalty payments or of temporary royalty-free or advertising-payment-free periods. Whatever form these incentives may take, it is important that they, and any conditions associated with them, are reflected clearly in the franchise agreement.

Similarly, if a new or emerging franchisor grants the franchisee options or a right of first refusal, these must also be properly negotiated and documented. An option typically confers the right on the franchisee to purchase one or more additional franchises within a defined territory, within a defined time and, often, at a defined price. A right of first refusal obliges the franchisor, if it receives an offer from another prospective franchisee to buy a franchise within a defined area, to first offer the opportunity to the existing franchisee. However, only by involving legal counsel in the negotiation of the contract language can the franchisee be confident of the scope of these rights.

Purchasing a franchise in a new or emerging system may afford the franchisee opportunities it could not obtain in an established franchise system; however, it may bring additional risks as well. As with any franchise investment, the franchisee should thoroughly investigate each opportunity, realistically assess his or her own capabilities and tolerance for risk and involve experienced franchise counsel early in the process. A franchisee who does this should strike the right balance between risk and reward.

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