CFA Canadian Franchise Association
TheFranchiseVoice

View Points

Q What do I need to know about moving into new markets?

The prospect of expansion into new domestic markets is an exciting one for franchisors. However, expansion brings with it important legal considerations, some or all of which may be new to emerging franchisors. Besides dealing with issues of local law compliance, some of which may be significant, franchisors must consider how best to structure deals with franchisees in the new market. Specifically, franchisors must decide whether to expand on a unit by unit basis or enter into multiple unit franchise agreements, such area development agreements and master franchise agreements. This article provides an overview of the pros and cons of each approach and highlights some key legal protections franchisors that should include in multiple unit franchise agreements.

Expansion using single unit franchise agreements has certain advantages. In particular, the franchisor can retain direct oversight of franchisees in the new market. However, this approach also tends to place the greatest demand on the franchisor to quickly develop field support and inspection capability in the expansion market. Without this capability, the franchisor risks discontent among its new franchisees, who may feel inadequately supported, and also risks potentially wide-spread non-compliance with the franchisor's standards. A unit by unit expansion also leaves the franchisor with sole responsibility for marketing franchises, qualifying pros-pects, providing disclosure, granting franchises and providing training and start-up assistance, activities which require considerable time and money.

The use of area development agreements, while not alleviating all burdens, offers the franchisor potentially greater efficiency in its expansion. These agreements often take the form of a short rider attached to the unit franchise agreement, in which the franchisor grants the franchisee (i.e., the area developer), the right to open a specified number of additional units in the territory on a defined schedule. As in a unit-by-unit expansion, the franchisor will retain direct over- sight of the new franchises and will be required to provide ongoing support; however, certain aspects of the franchisor's workload should be reduced. There will, for example, be no need to market to additional unit franchisees in the area developer's territory, or to undertake a new application process each time the area developer establishes a new unit. Once the initial units are operating, the area developer should be familiar with the franchisor's system and require less assistance to open the remaining units.

Notwithstanding the benefits described above, area development agreements are not risk free. A key risk in connection with area development agreements, and all multiple unit franchise agreements, is the area developer failing to develop the required number of units quickly enough, or at all. If this happens, the area developer's territory, which is normally exclusive, will be underutilized but will remain tied up and unavailable for development by more motivated franchisees. An essential protection for the franchisor that is normally included is a mandatory development schedule for opening the new units and clear remedies, including termination, if the development schedule is not met.

The incorporation of a development schedule, and corresponding remedies, is also essential in the case of a master franchise agreement. However, unlike an area development agreement, a master franchise agreement involves the franchisor's delegation of almost all of its essential functions to a master franchisee within a defined territory. The master franchisee's rights and responsibilities will normally include promoting franchises, qualifying prospects, granting franchises, providing training, enforcing standards and collecting franchise fees, royalties and other payments and remitting the franchisor's share. By ceding control over these and other key activities to the master franchisee, the franchisor exposes its business to the risk of severe disruption and potentially serious financial and brand damage if the master franchisee fails to perform acceptably.

Accordingly, while one of the main purposes of a master franchise agreement is to allow the franchisor to run a leaner head office by downloading responsibilities onto the master franchisee, the franchisor should nevertheless retain significant oversight of the master franchisee's activities. Advisable oversight includes the right to approve or reject new franchisees, extensive inspection rights, a right to review and, if necessary, disapprove the master franchisor's disclosure document and provisions protecting the franchisor's share of the royalties and other fees. This latter protection may include the use of trust language and/or a right in the franchisor to direct franchisees of the master franchisee to remit fees directly to the franchisor in certain circumstances. Particularly, the franchisor should ensure that the master franchisee agrees to indemnify it for all losses the franchisor may suffer due to the operation of the master franchise. In addition, the controlling shareholders of the master franchisee should guarantee the master franchisee's obligations under the agreement. While master franchisees will likely resist including many of these provisions, franchisors are advised to be firm. To manage the franchisor's risk, it is preferable to make some concessions on business terms, such as fees or the development schedule, rather than on these essential legal protections.

Of course, the legal protections a franchisor requires upon expansion will vary from case to case and the matters discussed in this article are by no means exhaustive. This article will hopefully provide emerging franchisors with a general understanding of their contractual options for expansion. However, as always, franchisors are strongly advised to consult with experienced franchise counsel about their specific cases before undertaking any significant expansion.

McINNES COOPER
LAWYERS | AVOCATS

Michael Melvin
Associate
McInnes Cooper
Tel: 506-458-1666
E-mail: michael.melvin@mcinnescooper.com
www.mcinnescooper.com
CFA Member Since: 2009

LEGAL EXPERT