

**PRACTISING LOCALLY IN A GLOBAL INDUSTRY:**

**7<sup>TH</sup> ANNUAL OBA FRANCHISE CONFERENCE**

**ALTERNATIVE EXPANSION MODELS**

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## **INTRODUCTION**

Franchisors inevitably resort to alternative forms of expansion when they begin to recognize the limits of growth through the traditional form of unit franchising. There is no doubt that the world has become much smaller in the last decade. As franchise systems have begun to saturate their home markets, we therefore have witnessed an even greater interest in moving beyond one's home jurisdiction and into cross-national and international jurisdictions. Franchisors have increasingly begun to adapt and modify their systems in order to achieve success outside of their home markets, that is, to increase profits and market share.

National and international expansion, the latter principally by US-based franchisors, has evolved significantly since the first forays into Russia and China some 20 years ago. Just as franchise systems went through a learning curve as they developed and modified their operating systems, so too have they experienced by "trial-by-error", the trials and tribulations of national and international expansion. Fortunately, over this period of time, we have learned much about the way franchisors expand successfully and the means to avoid the errors of others and to focus on the proven and effective strategies for successful growth.

According to a 2006 report on international franchising sponsored by the International Franchise Association (IFA) Educational Foundation, more than 50% of U.S. based franchised companies responding to a survey conducted by the IFA at that time indicated

that they were seeking franchisees in other countries. In fact, 80% of those respondents said that they were planning to franchise internationally during the next three years (2007-2009). While we have no concrete evidence to substantiate that interest in international franchising in this country has likewise followed the U.S. trend, we have no reason to believe that this is not the case given the experience of the authors of this paper. International and cross-national franchising in Canada remains alive and well.

This paper examines the various methods of expansion through franchising and discusses the advantages and disadvantages of each as well as the general risk factors that a franchisor must be cognizant of before it embarks on an expansion program.

### **FACTORS IN DETERMINING THE TARGET MARKET**

Prior to entering a foreign market, a franchisor must first decide on which jurisdiction it wishes to expand into and the structure of the relationship that is most appropriate, both for the franchise system and the target market under consideration. Many franchise experts have long argued that one should pre-qualify the target destination well before one pre-qualifies the candidate. To do otherwise, a franchisor may be tempted to accept a qualified prospect in an undesirable and unprofitable market.

Some of the relevant factors in determining which market is most appropriate for your client's expansion include the following:

1. What is the political climate and stability of the target jurisdiction and is it hospitable to the business and the franchisor in question?
  
2. Is there a demand for the product or service being offered? Has the franchisor undertaken a market study to determine if its product or service will be received positively in the new market? There are numerous examples of US and Canadian franchise systems that have failed in expanding cross-border, notwithstanding the similarities as between the languages spoken and the cultural proclivities and tastes of their inhabitants. In many cases, the products or services of the franchisor may have to be adapted to meet the tastes and ethnic differences of the population in the target market.
  
3. What is the level of competition for the product and/or service offered by the franchise system within the relevant market? If the franchisor's competitors are abundantly represented in the target market, it may not wish to expand into that particular market. On the other hand, a franchisor may wish to pre-empt its competitors if they have not penetrated a particular market.
  
4. What are the export costs and import restrictions, if any, and the tax issues associated with the expansion of the franchise system into the target jurisdiction? The franchisor should confirm that the products or services are readily available in the target market. If the products, or their raw materials, must be imported, the franchisor must ascertain whether there are import

5. Does the franchisor have the financial and human resources available and necessary to devote to the expansion? Many franchisors have historically underestimated the capital cost of expansion and the fact that valuable other resources (travel time and costs, training, administrative, operating assistance and support and other) are inevitably drawn away from the domestic operations when expanding internationally. In this regard, it is important to consider a “cluster” approach as opposed to what is commonly known as the “shotgun” method of expansion. That is, when expanding through any means, it is preferable to do so in concentric circles surrounding the franchisor’s home jurisdiction, rather than doing so in a haphazard manner, to locations “all over the map.” By adopting the “cluster” approach, a franchisor can better manage support costs (e.g., travel costs, etc.), increase market exposure and control the brand. Having said this, the cluster approach is not always the preferential one, particularly when seeking to embark on an aggressive plan for expansion or where there are a limited number of available locations within the home jurisdiction of the franchisor.

6. Are there any legal and/or business related constraints with respect to the supply of the franchisor's goods and/or services? Franchisors will not be equipped to answer this question unless they retain local legal counsel and other professional advisors within the target market and seek their professional advice and direction.
7. Is the franchisor capable of ensuring that its quality standards can be maintained when supplying such goods and services to the new market?
8. Are the franchisor's trade-marks and other intellectual property available for use in the target market? If not, the franchisor may have to modify the name or logo and other intellectual property associated with its franchise system. This would be the case where a different language is involved which may give the trade-mark a different or secondary meaning or where the trade-mark is otherwise unavailable for use in the target jurisdiction.
9. What are the immigration issues that must be addressed, if any, when representatives of the franchisor are required to visit the target market for franchisee recruitment, training and support?
10. Are there any specific advertising and labelling requirements in the target market?

Notwithstanding all of the foregoing matters for consideration, franchisors are often inclined to forego an analysis of these highly relevant factors and instead simply respond to the unsolicited inquiries and overtures of other parties looking to bring the franchise system into the market in question. These franchisors are often tempted to license their systems on account solely of the fees that they anticipate may be generated through the grant of a unit franchise or area representative or development rights. Other franchisors are attracted to the jurisdiction and the desire of travelling to a particular destination. Franchisors who are tempted to expand for these less legitimate reasons do so however at their own peril, as there are several obvious risks in so doing. One such risk is that the franchisor is not only diverted from its more important domestic operations, thereby losing its organizational focus, it may also be so burdened by the desire to expand in the less desirable market, that it loses sight of other, more lucrative international business opportunities.

### **LOCATING AN APPROPRIATE CANDIDATE**

Assuming that a franchisor has considered the foregoing factors and has determined an appropriate market for expansion, it should then focus its attention on locating an appropriate candidate for the target market. Doing so however is often the most difficult aspect in expanding nationally and internationally. Franchisors should be forewarned of the enormous challenges associated with securing the appropriate party, with sufficient expertise, management skills and business acumen as well as deep enough pockets to

purchase and sustain the long term growth of the franchise. The level of expertise required depends largely on the amount of responsibility assumed by the franchisee for the training, support and management of the franchise system in its domestic market. The licensee must not only have sufficient capital at its disposal to purchase the rights to the franchise, furthermore, but it must also be capable of financing the expansion of the enterprise on an ongoing and long term basis. Finally, it must be of the mind, quality and character capable and appreciative of working with the franchisor as part of a much larger system, while under the strict controls and guidelines of the franchisor and the franchise system.

### **CHOOSING THE METHOD OF EXPANSION**

In addition to determining the most appropriate target market and franchisee candidate, it is critical to choose the best method of expansion for the target market. Choosing the method of expansion is a matter that deserves much more attention than what is unfortunately given to it in most cases. Serious consequences may flow from both a business and legal perspective if the entry structure is inappropriate for the circumstances at hand.

The grant of master franchise rights to a foreign entity, for example, while tempting for the franchisor for various reasons (most significantly, the infusion of cash), may be entirely premature and inappropriate in certain situations. If there is a lack of brand awareness or little demand for the product or service in the targeted marketplace, for

example, the master franchisee may find it entirely impossible to meet the development schedules set by the franchisor. Furthermore, the failure of the master franchisee to succeed may seriously undermine the brand and the reputation of the franchisor's system (even domestically) and ultimately, the franchisor's ability to expand within the master franchisee's territory for years to come.

Conversely, the incremental sale of unit franchises to even deserving and capable franchisees may not always be the most appropriate or cost effective method of expansion. For instance, if the franchisor grants a unit franchise to an individual in a major urban centre with exclusive rights to too large a territory, it may inadvertently preclude or make it very difficult to sell the area development or master franchise rights to a prospective area developer or master franchisee for some time into the future. This is because a party desirous of such expansive rights may not find the opportunity very attractive if a unit franchisee already exists within the target territory. In such event, the franchisor may consider addressing this issue by transferring its franchise agreement with the unit franchisee to the area developer or master franchisee or by carving out the unit franchisee's territory from the territory granted to the area developer or master franchisee, as the case may be. Either alternative, however, may not be very appealing to the franchisor who is often more interested in downloading such rights to its foreign "partner" without much effort or complication.

It is therefore important to discern and consider, as best and as early as possible in advance of any grant, the factors enumerated above as well as the relative cost of expansion by each of the methods of entry identified below, among other matters. Responding favourably to the first overture of interest from abroad by immediately granting rights to the franchisee in the foreign market without sober thought and analysis is not advisable and is often counterproductive in the long run.

A franchisor's choice of the entry structure will often determine the nature and extent of the legal documentation and protection required under the circumstances. A franchisor is encouraged to conduct more extensive due diligence on the interested party and obtain the appropriate legal advice to protect the system in the target jurisdiction in the case where there is a grant of master franchise rights (as opposed to the sale of a single unit franchise) as such a grant inevitably involves greater risk to the franchisor and to the system as a whole. In any event, the legal advice and documentation should be tailored to the specifics at hand, as each situation and relationship will inevitably warrant a different and a unique approach.

No matter how a franchisor ultimately decides how best to expand its system, it is most important not to allow the legal structure of the arrangement to dictate the terms of the business deal itself. Instead, the franchisor should first feel comfortable that the business deal is worth pursuing and only then take steps to ensure that the legal documentation is in place to address and to buttress the terms of the business relationship. Most significantly and as obvious as it may be, the relationship to be pursued should be one

that is profitable for all parties concerned as otherwise, the relationship is bound for failure. Franchisors often underestimate the costs that are required to be incurred by both franchisor and its franchisee in a new territory, particularly where the brand is unknown. Having said that, there are certainly occasions where the legal concerns raised by counsel will in fact trump the terms of the deal itself and may determine and alter the format and nature of the arrangement.

Further, it goes without saying that one should ensure that the franchisor is adequately capitalized before embarking on any of the methods of expansion identified later in this paper. Franchisors are strongly encouraged to consult with their financial planners and accountants to seek their advice and to determine whether they are economically viable and sufficiently prepared for a more aggressive approach to the expansion of their franchise systems. Each method of expansion requires varying yet significant degrees of capital to ensure the success of the strategy ultimately adopted by the franchisor. Franchisors should expect to incur legal, accounting and franchise consulting fees as well as administrative costs in effecting any expansion program.

In addition, and, as noted above, franchisors interested in expansion should recognize the critical need to dedicate sufficient resources in personnel to assist them not only when launching the expansion program, but also to address the increased demand for support (i.e., sales, training, supervision etc.) when embarking in any such endeavour. Such a commitment also requires additional financial resources.

Finally, the choice of which method of expansion to adopt will often be determined by the speed by which the franchisor wishes to grow. Master franchising is generally a much more aggressive growth strategy than unit or area representative franchising.

No matter which strategy for growth is ultimately adopted, it is important to recognize that expansion also carries with it several significant risks. With expansion, franchisors face the possible risk of investing their financial and other resources in a failing endeavour, losing control over the sales process as well as the possible dilution of the brand in the target market. Franchisors should therefore weigh the possible risks with the rewards before embarking on any expansion strategy.

### **LICENSING AND DISTRIBUTION**

Franchising is merely one means of distributing products and services in the market place. Before moving into other markets, one should also consider whether franchising is actually the most appropriate method of expansion for the business in question. Based upon an analysis of a number of factors, including legal and business considerations, it is quite possible that the products or services could be distributed more effectively by means other than through franchising.

In other words, depending upon the nature of a business and the products and services associated with that business, a business owner could consider a simple licensing or distribution structure. By way of example, a manufacturer could grant distribution rights for the product to a distributor in the target market; or an investor which is the owner of a patent or process could license others to produce and market the patented product for sale in a particular market or territory. There are various different means of structuring a distribution arrangement: sales agency, dealership, distributorship, and simple licensing, each of which has its own distinguishing characteristics and each with its own advantages and disadvantages.

A discussion of distribution arrangements is beyond the scope of this paper. However, by structuring its relationship to allow for the mere distribution of its products or services, a licensor/distributor would avoid the requirements and restrictions of franchise legislation that may be in force in the target market as well as perhaps avoid the need to oversee as strictly the operation of the business in that market. Avoiding the application of the franchise legislation is particularly recommended in those circumstances where there is no need for the licensor or distributor to exert significant control over the licensee or customer or to provide significant assistance in the operation of the Licensee's business operations.

A franchise is generally defined (in the franchise legislation found in each of Ontario, Alberta and PEI) as containing the following three elements:

1. the right to distribute goods or services in association with the franchisor's name or trade-mark;
2. the payment of a fee or other consideration for the grant of such right; and
3. the imposition of significant controls or assistance by the franchisor in the operation of the franchisee's business.

The definitions of a “franchise” existing in the franchise legislation of Ontario, Alberta and PEI are very broad and inadvertently capture businesses which would not necessarily consider themselves to be franchises. One could therefore conceivably eliminate one or more of the constituent elements found in the definition of a “franchise”, or otherwise creatively structure the relationship, so that the obligations and restrictions that flow from such a designation could be avoided. For instance, a licensor could refrain from imposing significant controls and from offering significant assistance to the licensee to avoid the application of the franchise legislation, legislation which is primarily designed to provide franchisees with certain rights that they would not have but for the legislation.

### **UNIT OR DIRECT FRANCHISING**

Although alternative expansion models have been utilized for a number of years, the terminology used to describe these models is not always consistent, notwithstanding the valiant efforts on the part of some franchise law experts<sup>1</sup>. For the purposes of this paper,

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<sup>1</sup> For example, see Alex Konigsberg's *International Franchising: Commonly Used Terms* (London: International Bar Association, 1989)

the term “multi-unit franchising” will be used to describe generally all of the means of expansion other than by unit, or direct, franchising.

Unit or direct franchising may be described as involving the sale by the franchisor of a unit franchise directly to a franchisee without involving any intermediaries and without selling any other rights to the franchisee (e.g., to represent the franchisor or to develop the territory). While this approach is the simplest method of franchising, it is also often the most expensive and time consuming, particularly if the franchisor ultimately wishes to saturate the market with its franchises on an expedited basis. The franchisor may also grant a franchisee the option (or impose an obligation) to purchase additional franchises within a certain designated territory, and within a specific timeframe. This is very much akin to the grant of area development rights, which will be described later in the paper.

### **OTHER METHODS OF FRANCHISING**

The following methods are used by franchisors to expand other than by direct or unit franchising:

- (A) Area Representation;
- (B) Area Development;
- (C) Master Franchising;
- (D) Joint Venture Franchising; and
- (E) Other Methods of Expansion.

**(A) AREA REPRESENTATION**

In this arrangement, the franchisor grants another the right recruit unit franchisees in a designated (usually exclusive) territory in return for an initial fee paid by the representative. The area representative has no right to contract directly with the franchisees, who enter into their franchise agreements directly with the franchisor. However, certain of the obligations of the franchisor under the unit franchise agreement are delegated to the area representative. These obligations can include training, site location assistance, construction of the unit and ongoing supervision and assistance or any combination thereof. Alternatively, the area representation arrangement could be limited to merely the sourcing of qualified franchisees, with the area representative being compensated through a sharing of the initial franchise fee or some other commission based arrangement. The area representative is generally compensated through the sharing of initial franchise fees and royalties (and in certain circumstances the transfer, renewal and other fees) payable under the franchise agreement. If the designated territory is located far from the franchisor's home territory, the area representative could also be responsible for advertising and promotion within the territory. In such event, all or a portion of the advertising fees payable by the unit franchisee under the franchise agreement will be administered by the area representative.

## **(B) AREA DEVELOPMENT**

In an area development scenario, the franchisor and a developer, who usually is a foreign national of the target territory, enter into a development agreement pursuant to which the area developer agrees to establish and operate all of the outlets of the system in a defined (and often exclusive) territory. The development agreement would then set out the overall obligations of the parties, such as fees, development schedule, termination and transfer rights and the respective obligations of the parties with respect to the territory. Each outlet to be established would then be the subject of a separate unit franchise agreement governing that outlet.

One of the principal advantages to the area development arrangement is that the franchisor need only deal with one, likely (or rather hopefully) sophisticated, franchisee. The franchisor need train only one person who will then be responsible for all site selection, construction of the outlets, hiring and training of staff and operation and management of the franchised outlets. This is cost-effective to the franchisor and does not require that the franchisor use its own personnel or establish additional head office support for the developer's market. The franchisor is thus relieved of using its own head office staff for these purposes.

There are, however, significant disadvantages to the development arrangement that must be weighed against the benefits of such an arrangement. A development arrangement may result in slower growth of the system in the designated territory. The developer is

responsible for securing locations and opening each of the outlets in accordance with its development schedule. This typically proceeds much more slowly than the establishment of outlets by a number of franchisees under an area representation or master franchise arrangement which could occur concurrently. Furthermore, each outlet in the area development territory will be operated and managed by a manager, rather than by the developer itself as “owner-operator.” Such managers may be less motivated and have less of an entrepreneurial spirit for the management of the outlet which could ultimately affect its long term success.

The nature of the relationship between the franchisor and the area developer is also prone to considerable risk as the developer is likely a more sophisticated, “well-heeled” investor (as opposed to the unit franchisee) and thus may be more akin to being his own boss. The developer may therefore be less inclined to follow the franchisor’s rules and guidance, thereby placing significant strain on the parties’ relationship and potentially diluting the brand.

If the developer fails, there is a real risk that the whole system within the developer’s territory will also fail unless the franchisor has the financial and human resources to step in and assume operation of the outlets. Determining a realistic development schedule for the foreign market in the area development (as well as the master franchising) scenarios, therefore, is critical to the success of the franchisor and the domestic area developer (and master franchisee). This is often the subject of extensive negotiations between the franchisor and its “partner” in the foreign market.

The consequences of failing to meet the development schedule must also be set out clearly in the agreement so that the franchisor does not find itself shut out from the market for a significant period of time and so that it or its appointee has the means to penetrate the market if the local developer fails to meet the development requirements or its other obligations under the agreement. A franchisor may wish to retain a right to reduce the developer's exclusive territory or to remove the exclusivity altogether in lieu of its right to terminate the development agreement upon the failure of the developer to meet the development schedule. Such a right need not be characterized or perceived as a threat or penalty, but rather as a mere logical consequence of the area developer's inability to meet its development obligations. If the area developer cannot develop its territory within the prescribed timeframe, then the area developer should understand that the franchisor or one or more of its designees will need to step up and fill the gap instead.

### **(C) MASTER FRANCHISING**

Master franchising or sub-franchising has become the structure of choice in international transactions. It is an arrangement in which a franchisor enters into an agreement with a master franchisee, generally for a designated, exclusive territory and often with certain development requirements. The master franchisee is granted the right to establish, own and operate outlets in the territory as well as the right to grant subfranchises to third parties to do the same.

A master franchisee essentially becomes the “franchisor” in the territory with responsibility for managing and controlling many aspects of the franchise system, including the training, site selection, construction and development, sourcing and supply of products, as well as, in some cases, the right to modify the System to meet local market tastes and preferences. The franchisor, however, continues to maintain the ultimate control over the trade-mark(s), the operations manual, the franchise system and possibly even the training and support.

The master franchisee will in turn pay its franchisor a fee for the rights granted which fee will be negotiated and will generally be based upon the size of the territory granted, the projected revenues to be generated from the territory and the rate of return on investment for each of the franchisee and the franchisor and the development requirements imposed upon the master franchisee. The franchisor will also typically share in the royalty stream payable to the master franchisee derived from the revenues earned by the unit franchisees, as well as in the other fees payable to the master franchisee, such as advertising contributions and renewal and transfer fees. The franchisor would also ordinarily reserve the right to terminate the master franchise agreement, or reduce or eliminate the exclusive territory in the event that the development requirements are not met within the periods of time set out in the development schedule.

Experience has shown that it is critical for franchisors to ensure that any such split of the revenue as between the franchisor and the master franchisee should be done with the utmost of care and attention, always considering the particulars of the parties involved and the industry and market in question. It goes without saying that a master franchisee must be assured of a stream of income that would sustain the continued involvement and growth of the master franchisee's business. In some cases, the master franchisee's failure to support itself financially may seriously impact the franchisor's bottom line but also may ultimately lead to the collapse of the entire master franchising enterprise. Franchisors are therefore advised to refrain from allocating lower percentages to their master franchisees in an attempt to take a larger and disproportionate share of the profits for themselves. In such circumstances, the pie may only grow smaller and everyone will ultimately suffer the adverse consequences. This is particularly the case where the master franchisee is not benefiting from other aspects of the franchise system, such as deriving any rebates from product sales to its franchisees (where they are required to purchase product directly from the franchisor for example) or where there is no other stream of revenue available to the master franchisee.

When acting for a franchisor interested in negotiating a master franchise agreement, it is prudent to encourage the parties to agree upon a binding letter of intent (LOI), provided that the prospective master franchisee provides the franchisor with a non-refundable deposit. There is no issue in accepting such a deposit in non-disclosure jurisdictions, where no franchise disclosure statute prohibits the acceptance of monies prior to the delivery of a disclosure document and the waiting of a certain cooling off period (usually

14 days). In this manner, one could be better assured that the prospective master franchisee is serious about negotiating a deal with the franchisor, and not simply searching for confidential details regarding the franchise system or otherwise wasting the franchisor's valuable time and resources.

One important prerequisite for granting master franchise rights often imposed by franchisors is that the prospective master franchisee must demonstrate its commitment and aptitude as a franchisee by first opening and operating a unit franchise for a period of time. Some franchisors may even require their master franchisees to establish, own and operate and/or own and sublicense a number of units before embarking on any sub-franchising efforts. This is good practice as it permits both the master franchisee and the franchisor to better work out any issues prior to taking the more serious step of sub-franchising the business to a whole host of unit franchisees. Such a practice would also provide a franchisor with an opportunity to "test drive" the master franchisee before permitting it the right to pursue its master franchising objectives. Should it then decide that the master franchisee is appropriately suited to master franchise, a franchisor may in such instance permit or at times even require its master franchisee to sell the units then owned by the master franchisee to its prospective franchisees.

One issue which requires specific attention when drafting master franchise agreements is the question of who is responsible for the subfranchisees should the franchisor terminate the master franchise agreement. In such event, a franchisor will want to be assured that it or its designees be allowed to assume some or all of the franchise agreements previously

entered into between the master franchisee and its subfranchisees and that such right of assignment and assumption is built into each and every unit franchise agreement. This may be achieved by having the franchisor a third party beneficiary of the unit franchise agreement between the master franchisee and the unit franchisee (though some jurisdictions will not recognize such a legal construct). Alternatively, a franchisor may wish to have a three-way agreement with the master franchisee and the unit franchisee so that it could directly assert its rights vis-à-vis the unit franchisee.

Other issues include the following:

- i) Should a franchisor permit a master franchisee to maintain and own its own website? Who should pay for any necessary adaptations to the website, operations manuals and any other support systems to accommodate the language, measurement and currency conversion requirements, as needed?
- ii) How involved should the franchisor be, if at all, in the subfranchising initiative before it potentially exposes itself to vicarious or direct liability to the subfranchisees? The more direct interaction a franchisor has with its subfranchisees, the more likely will subfranchisees see the franchisor as a possible target for any law suit it may have as against the master franchisee.

- iii) Should a franchisor insist that its master franchisee set up a separate marketing fund for the target market, or should it itself establish one so that it may better control the marketing and promotion of the brand?

#### **(D) JOINT VENTURE FRANCHISING**

The joint venture is a simple agreement between two equal partners, the franchisor and a party from the prospective new market. It is the least risky approach to expansion, representing shared risk but also shared control.

In joint venture franchising, the franchisor takes on a partnership role or an equity position in the franchisee entity. The franchisor may bring to the venture its proprietary franchise system and knowledge and, as well, contribute capital to the franchisee entity. The local joint venture partner will also make a capital contribution and will also be the operator and manager of the franchise system in the territory. The franchisee entity then enters into either a territorial development agreement or master franchise agreement with the franchisor which agreement will govern the development of the franchise system in the target market. Each franchise outlet is then governed by a separate unit franchise agreement, either with the franchisor (in a territorial development arrangement) or with the franchisee entity (in a master franchise arrangement). The franchise entity should also be the subject of a shareholders' or partnership agreement in order to govern the relationship between the franchisor and its joint venture partner.

Many initial foreign transactions have been structured as joint ventures, rather than true franchises, for a number of reasons. Under the law of certain countries, the joint venture is the only structure under law open to foreign investors. McDonald's foray into Russia was a joint venture notwithstanding that it was promoted as a "franchise". A joint venture arrangement may also permit easier access and availability for government subsidies and favourable tax status, which may not be available to other structures.

A joint venture franchise arrangement permits a franchisor greater control or influence over the franchise entity and a greater participation in the anticipated return from development than is available through direct franchising. Further, if there are difficulties at the unit franchisee level, the franchisor will have an opportunity to identify them earlier and will likely have greater contractual rights to step in and assume full control.

#### **(E) OTHER METHODS OF EXPANSION**

Franchisors may also wish to consider expansion by granting rights to franchisees in non-traditional locations such as hospitals, sports stadiums, kiosks, airports and other such venues or by co-branding complementary concepts with an existing franchise system which already has a presence in the domestic marketplace. Each of these approaches have their advantages and disadvantages. Franchising in non-traditional locations and through co-branding are two unique approaches that could assist a franchisor in its effort to initiate an aggressive expansion program. On the other hand, these non-traditional methods of expansion require specific franchising and legal expertise to address the

peculiarities and complexities of initiating and managing these approaches, failing which the franchisor and its brand may be exposed and undermined.

Other franchisors may adopt a dual distribution approach whereby they expand through a combination of franchising as well as through the establishment of corporate locations. Once again, dual distribution carries with it certain advantages and disadvantages. With a dual distribution system, franchisees of such a system may perceive that a conflict of interest exists even where such a perception is not warranted if they believe that the franchisor is favouring its corporate units over its franchised ones. On the other hand, dual distribution systems allow franchisors to test new markets, and to demonstrate value on their balance sheet, all while continuing to franchise its other units.

Another specialized approach to expansion is conversion franchising. In particular, a franchisor may deem it most convenient and expeditious to instead convert an existing business or businesses to its franchise system and thereby expand its businesses in that manner. By doing so, a franchisor may be assured of a number of existing prospective franchisees, each possessing some minimal relevant experience in the specific industry, thereby reducing the amount of training and ongoing support necessary to convert such businesses into the franchised business. On the other hand, a franchisor that pursues conversion franchising may however experience franchisees that are less amenable to being trained in accordance with the franchisor's system, given that they may have extensive experience in the business in question and are inflexible in adopting new or revised procedures.

Finally, many franchisors utilize a combination of several approaches to expand their systems. Each such method of expansion should be carefully considered as part of any growth plan as they each carry certain risks and rewards. Specialized agreements are necessary to address the particularities of each of the said approaches and legal expertise is especially required when such approaches are combined to ensure that they are implemented effectively and legally.

### **DISCLOSURE DOCUMENT ISSUES**

In addition to the laws of general application which may be applicable to the business arrangement in place to expand into a new market, a franchisor should investigate the specific franchise legislation that may govern the relationship in that market. For this, a franchisor can either rely upon its franchise “partner” or, more advisably, retain local counsel to advise it on the legal issues and other requirements applicable to the relationship. These could include, in the United States, for example, disclosure legislation, the requirement, in some states, to have the franchisor’s disclosure document registered and relationship-type statutes which govern or apply to certain provisions of the agreement between the parties such as notice periods for termination. In particular, with respect to relationship-type laws, a franchisor should have the benefit of local counsel to ensure that the agreement ultimately negotiated between the parties does not run afoul of any particular statute or the common law in effect in the target jurisdiction.

The requirement to retain local counsel is an additional expense of global expansion that the franchisor must bear when expanding outside of its home market.

The disclosure document to be provided to the unit franchisee, area representative, or master franchisee, if required, must be tailored specifically to reflect the applicable agreement that has been negotiated and ultimately entered into by the franchisor and its global “partner”. The franchisor cannot merely make slight modifications to its domestic unit franchise disclosure document as the nature of the business to be undertaken by the unit franchisee, area representative, area developer or master franchisee is substantially different from the operation of a franchised unit in its home market. Again, the franchisor is well advised to retain local counsel to prepare or, at the very least, to confirm that the disclosure document to be provided complies with the local franchise legislation in force in the target jurisdiction. Of particular importance in the preparation of the franchisor’s disclosure document, whether to be provided to the unit franchisee, area representative, area developer or master franchisee in the target jurisdiction, is the insertion of an express statement that the franchisor has no experience or past history in the new jurisdiction (if that is in fact the case) and that accordingly, the information pertaining to such matters as costs, competition and local market conditions are based upon the franchisor’s experience in its home market only.

Various other pieces of disclosure and sections of the franchise documentation will often need to be modified as well to properly reflect the business conditions in the target jurisdiction, including the following:

- i) the costs of establishing the franchised business;
- ii) the applicable currency of the payments to be made under the agreement;
- iii) withholding tax obligations or restrictions on payment of money outside of the country;
- iv) purchase and supply of products.

In a master franchise arrangement, the master franchisee will be required to provide its own disclosure document to the prospective unit franchisees in the territory. The obligation regarding disclosure and the grant of franchise rights by the master franchisee must be clearly and explicitly set out in the master franchise agreement. These obligations include the following requirements:

1. to comply with all franchise and other laws in effect in the territory governing the grant of franchises and the operation of the master franchisee's business;
2. if required, to provide a disclosure document to prospective franchisees in compliance with the franchise law in the territory;
3. to modify the franchisor's standard form of unit franchise agreement and all related agreements for compliance with local law; and
4. to translate into the language in the jurisdiction the franchise agreement, all related agreements and the operating manuals and other materials applicable to the franchise grant or the operation of the franchised business.

The franchisor's standard form of unit franchise agreement which is to be used in the jurisdiction, whether entered into by the franchisor in an area development or area representation arrangement, or by the master franchisee in a master franchise relationship, should also be modified to comply with local laws and must reflect, as necessary, the particular franchise arrangement in place in that jurisdiction. For example, in a master franchise arrangement, it will be the master franchisee that will grant the franchise rights and provide the training, support and services to the franchisee, while in an area representative scenario, the franchisor will grant the franchise rights but it will be the area representative that may provide certain of the training and on-going supervision of the franchisee.

In the latter case, therefore, the unit franchise agreement should set out that the franchisor may delegate certain of its obligations to its area representative. Also, the franchisor may require that the franchisee direct payment of royalties to the area representative rather than the franchisor under the agreement. As noted above, these unit franchise agreements will also have to provide for the consequences of termination of the master franchise or area representative agreement. In most cases, the franchisor will have the right to step in and assume the obligations of the master franchisee or area representative under the unit agreements which would include the right to payment of all fees payable by the unit franchisees under their respective franchise agreements.

The master franchise agreement should include the requirement that the franchisor have the right to approve all modifications made, in particular those made to its unit franchise

agreement, and should, as well, have the right to review or approve the master franchisee's disclosure document. However, because the unit franchise agreement and disclosure document to be used by the master franchisee may be in a foreign language, the franchisor may again be required to retain local counsel and translators to undergo the necessary review of the documents.

### **CONCLUSION**

The decision to expand a franchised business outside of a franchisor's home market, whether provincially, nationally or internationally, cannot be taken lightly. It requires immense planning, investigation and resources, both financial and human. Consultation and advice from the franchisor's professional advisors, both at home and in the target market, is a must to ensure that the venture meets the political, legal and cultural conditions of the target market and to avoid having to face head-on a myriad of "surprises" once the franchisor has already granted certain rights in the foreign jurisdiction.

There are, of course, numerous examples of franchised systems that have successfully expanded beyond their own borders, as witnessed by the proliferation of mostly U.S.-based fast food or quick service restaurants in Europe, Asia and the Middle East. However, there are also numerous examples of attempts that have gone awry, leading to a retreat by certain franchisors from global expansion and the potential loss of opportunity in various target markets.

Franchisors are advised to proceed cautiously in expanding to any new market, and to undergo a complete analysis of the target destination from a legal and business point of view before they secure a truly committed and well-suited “partner”. Although this does not assure success, a cautious, well-planned move abroad may protect you and your clients from a “venture gone bad” and preserve the value of the brand and the franchise system, goals that are certainly worth pursuing.

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NOTE: This paper is intended to provide our general comments on the law. It is not intended to be a comprehensive review nor is it intended to provide legal advice. Readers should not act on information in the paper without seeking specific legal advice on the particular matter.

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