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Business Aspects of the Franchise Relationship: Interests and Expectations

A. Introduction

The prevalence of franchised businesses in the modern Canadian marketplace has created a broad spectrum of assumptions and expectations on the part of the general public. The consumer has come to expect a sophisticated front-of-shop operation providing a consistently high quality of goods or services regardless of the location they choose to patronize. This is, of course, intentional. It is the mechanism through which brand loyalty and goodwill are generated and maintained.

This dynamic is perhaps no more clearly demonstrated than in the fast food restaurant business, which many would consider to be the exemplar of successful franchising. The average patron gives little thought to how the operation is actually conducted. From a consumer perspective the sole interest is to receive the same quality of product, service, presentation and environment regardless of the business realities of any particular location. When a customer purchases food from a McDonalds or Tim Hortons, they know exactly what to expect in terms of the kind and quality of food, service, environment, and price. That is the magic of the brand.

The assumptions and expectations of the consumer and the interests of both the franchisor and the franchisee in meeting those assumptions and expectations, define and delimit to a large degree the business side of what is the common cause. However, this is not to suggest that the franchisor and franchisee view the business in the same way. In fact, to a limited extent the franchisor and franchisee are in different businesses. While both are deeply invested in the financial success of each other, their interests are not equivalent. What might be in the best interests of the franchisor might not be so for the franchisee. The inverse is equally true.

A further distinction can be drawn with respect to the relevant business experience of each party. As will be discussed below, the franchisor approaches the relationship already possessed of a wealth of knowledge regarding the particular business and industry in question. That experience and knowledge defines to a large extent the franchisor's expectations regarding individual franchisees and the system as a whole. Often, the franchisee has no experience in the business or industry at all, and is attracted by those very aspects that the public finds appealing. In many cases, prospective franchisees will have little understanding of what went into the development of the franchisor's business or how it actually functions but are impressed by what appears to be a slick and seamless operation that represents, at least on the surface, a potentially lucrative opportunity. For their part, franchisors might quite naturally feel that they know what is best for every franchisee, in every location and on every issue affecting the business.

The respective expectations and interests of franchisors and franchisees are, to a large degree, shaped by their differing perspectives on just what it is that the franchised business should be all about. The franchisor/franchisee relationship is rather unique in the business world. Its uniqueness lies in the fact that the relationship is in many ways typical of most independent arm's length business relationships but the fundamental underlying precept of the relationship is the interdependence of the parties. It is essential that franchisors and franchisees understand this dynamic.

This chapter will discuss some of those business expectations from the standpoint of both the franchisor and the franchisee against this backdrop.

They form the prism through which each party views its own interests, both at the outset and throughout the relationship. The franchisor and franchisee must each understand what can and should be expected from the other and which responsibilities are theirs alone.

B. The Prototype Business

Franchised businesses do not start off as out-of-the-box undertakings. In many cases, franchisors begin at a single location that produces a limited range of products or services. Those who are fortunate or visionary enough to have created something for which a demand exists in the marketplace, or to which the consuming public responds positively, improve and grow the business over a period of years or decades with a deep belief in the value of their product or service. In so doing, they develop considerable expertise in the technical side of the business and a nuanced understanding of emerging needs, trends, and tastes in their particular market niche.

The development of that expertise is not, in all but the most fortunate of cases, a linear process. It is acquired through years of trial and error in which some ideas succeed while many others fail. Those franchisors that succeed learn from their missteps and move forward, continuously refining their operations, the products or services they provide and the means through which they are delivered. Such individuals constantly drive the evolution of the business to increase efficiencies and maximize returns whenever and wherever possible. In the process, they amass a vast knowledge base regarding every facet of their undertaking.

Once the potential of the localized business has been exploited to the maximum extent possible, successful and forward-thinking owners turn Business Aspects of the Franchise Relationship: Interests and Expectations their attention to expanding their operations. The particular question for any person or business in these kinds of circumstances is how to leverage their accumulated experience and expertise in the most efficient and effective manner possible. Several of the available options were discussed in the preceding chapter. In cases where the business owner simply manufactures patented or trademarked wares, licensing, distribution, or sales agency arrangements may suffice. If, on the other hand, the business provides products or services through a system that is as much part of its identity as the products or services themselves, the owner may feel the need to retain a significant amount of control over the manner in which the business name and products or services are presented and used in the marketplace. In such case, franchising the business may be the best option.

Regardless of the vehicle chosen for expansion, the business expectations of the potential franchisor are largely shaped by its experience over the years invested in building the business to this stage. Not surprisingly, a potential franchisor often believes that its business can succeed anywhere, regardless of who is operating a given location, provided that the operator follows the system developed by the potential franchisor. However, merely believing that to be the case does not make it so. Potential franchisors that are driven more by their sentiments than by concrete planning and analysis may find their dreams for market domination ended before they even have a chance to begin.

C. The Feasibility Study

The first step for the potential franchisor is a feasibility study in which independent professionals evaluate the growth potential of the business to ascertain whether or not it is suited to the franchise model. The particular question to be answered at the outset is: can the growth aspirations of the owner be best accomplished through franchising or some other business format? Accordingly, the feasibility study should explore the other options available to determine if franchising is the best fit.

Feasibility studies have a number of distinct components. However, they are not necessarily sequential. Rather, it is the totality of the information gathered and the analyses performed that will inform the potential franchisor as to whether it should even embark on the path to franchising.

One of the first steps will be an evaluation of the existing business as a going concern to assess the historical adequacy of its cash flow and to determine whether or not there has been a healthy return on capital investment. Financial projections must also be developed to determine, to the extent possible at this stage, the ability of the potential franchisor to bear the costs of expansion.

If the financial condition of the potential franchisor is favourable for expansion, an assessment must be made regarding how easy or how difficult it will be to replicate the prototype. This will depend in part on the degree to which each aspect of the business can be systematized. The process requires the potential franchisor to review in detail the essential components of the business and to identify those qualities of the products or services offered that are essential to the brand's identity and success. The means by which franchisees will be able to reproduce those aspects of the business must also be identified.

Equally important in this regard is the question of portability. That is, an assessment must be made of how well the business will translate in varied geographical markets. The fact that the operation can be replicated is no guarantee that it will be successful as a franchised system if the concept has limited regional appeal. The assessment will involve an examination of local needs for the particular products or services in question and the current and projected presence and activity of competitors in those areas, and their potential effect on franchisees' operations.

The above is by no means a complete list of the issues that ought to be considered in a franchising feasibility study. Rather, it is a thumbnail sketch of some of the main factors that need to be assessed. Having satisfied itself that franchising the business is feasible, the next step for the potential franchisor is the development of a strategic plan for expansion.

D. The Strategic Plan

As the name suggests, the strategic plan is the blueprint for the expansion of the potential franchisor's business. It will serve as the foundation upon which the system will be built. As such, potential franchisors that are serious about franchising will invest the time and money necessary to develop a comprehensive and sophisticated plan to ensure the greatest likelihood of success. Ideally, the plan should crystallize the goals for expansion and set out in detail the operational requirements of its franchisees. It should also lay out the organizational structure that the potential franchisor must put in place to accomplish the expansion and to administer the system. The analysis must be objective and as such it is imperative that the potential franchisor retain experienced professionals to guide it through the process.

Generally speaking, a strategic plan will have several basic components. The first is the development of a detailed model for the business that will actually be carried out by the franchisees. Building on the feasibility study, the potential franchisor must define and describe with particularity every aspect of the business and the procedures that the franchisees are to follow in their operations. In a sense, the business must be deconstructed and put back together again in order to gain an objective view of how it works as a complete package.

The aim of this aspect of the strategic plan is to develop what is essentially a roadmap to replicating the prototype business. Taking the fast food industry as an example, the potential franchisor will want to ensure that the product delivered to the consumer will have the same smell, feel, and taste that it developed over the years. These are proven successes and the core of the business. To ensure that same standard of quality, the potential franchisor will want to require franchisees to purchase the same ingredients and other products and to use the same types, or even brands of equipment that are currently being used in the prototype operation.

The potential franchisor will also want to require the franchisees' business premises to adopt the potential franchisor's corporate livery in everything from employee uniforms to the dimensions, colour, and feel of napkins. Provision for each detail of the operation must be made in the plan, from the purchasing of supplies and equipment through to delivery of the finished product to the customer.

The second essential aspect of the strategic plan is implementation. The potential franchisor must develop an effective rollout strategy to establish the system. Markets must be identified and a strategy developed for the systematic establishment of franchises in those markets. Specific timelines should be developed for each phase of the expansion. Once markets are identified and the strategy for expansion has been finalized, the potential franchisor must build the capacity to provide the necessary support to franchisees and to administer the franchise system in a profitable manner. The organizational structure that the potential franchisor needs put in place must be able to support the process through each stage of system development from rollout to the continuing operations of the system once established.

The potential franchisor must also give careful consideration to how it intends to finance expansion, including whether and to what extent it is willing to offer financial assistance to its franchisees. This depends on what the potential franchisor can reasonably expect to earn through initial franchise fees, renewal fees and royalties as well as on the ability of franchisees to finance their businesses. In the early stages of system development, the initial franchise fees are often insufficient to cover the costs of the system rollout. Accordingly, the potential franchisor must be in a position to raise capital for the expansion. The extent of the financing that is required for that purpose will determine, at least in part, the fee structure for the franchisees.

The strategic plan will also entail the preparation of the necessary legal and other documentation. In those provinces that have franchise legislation, the franchisor is required to produce a detailed disclosure document for prospective franchisees. Statutory disclosure as a discrete obligation will be discussed in a subsequent chapter. However, it should be noted here that the disclosure document must detail the costs to be incurred by the prospective franchisee in establishing and maintaining the franchise, including the various fees and royalties that the prospective franchisee will be required to pay. It must also contain copies of all agreements relating to the franchise that require execution by the prospective franchisee, the franchisor's most recent financial statements, and other prescribed information to assist the prospective franchisee to make an informed investment decision. Accordingly, the disclosure document must be carefully prepared. The failure to deliver a disclosure document that complies with statutory requirements could allow a franchisee to walk away from the deal, entitling it to a refund of all monies paid to the franchisor as well as to the recovery of any associated losses.

A material misrepresentation contained in the disclosure document affords a franchise the right to sue for any damages that it might suffer. Thus, an inadequate disclosure document can eventually have a significant and negative effect on a franchisor's plan to expand the business.

E. The Manifestation of the Franchisor's Expectations

It is trite to say that the principal expectation of the franchisor is to make money. That being said, the franchisor's expectations and interests regarding the franchise system itself revolve around three fundamental principles:

1) that all franchisees are required to follow the system of procedures for the operation of the franchised business;

2) that provided a franchisee follows these systems, it should be financially successful; and

3) that in having each of its franchisees become financially successful, the franchisor will create synergistic effects, resulting in a value increase for the franchisor's brand and trademarks The process of undertaking a feasibility study and developing a strategic plan, coupled with the years of experience in the business about to be franchised, will determine to a large extent the franchisor's expectations of its franchisees. At a practical level, it is important to understand how the franchisor's expectations and interests manifest themselves in the establishment of the franchise system. Those expectations and interests will be expressed in the various documents prepared on behalf of the franchisor and in particular, the central document defining the legal relationship between the franchisee and the franchisor, namely the franchise agreement. It, together with the operating manual and other documents that govern the relationship, establish the mechanism through which the franchisor hopes those interests and expectations will be met.

The duration of the relationship is an important factor in this calculus. The franchisee-franchisor relationship is not unlimited. The franchisor has an interest in granting the franchisee an appropriate period of time, often ranging from five to twenty years, to establish the business and turn it into a profitable undertaking. Weighed against this is the franchisor's interest in charging its franchisees renewal fees, which are often less than the initial franchise fee, in ensuring that its franchisees have been compliant in operating the franchised business in accordance with the system and in requiring its franchisees to modernize the physical premises at which the franchised business is operated. The franchisor must balance the foregoing interests in creating the conditions that will allow its franchisees to establish thriving locations.

Another consideration is site selection. Obviously, franchisors have a keen interest in establishing franchisees in good locations. At the outset, the franchisor will need to determine whether it will want, or be required, to execute the lease with the landlord of the premises. In many cases (e.g. exclusive shopping centres, food courts), the landlord will require the franchisor to execute the head lease because the landlord is more comfortable with the franchisor's ability to pay rent and fulfill the other tenant obligations. If a franchisor enters into the head lease with the landlord, the franchisor must enter into a sublease with the franchisee, which will allow the franchisee to legally operate the franchised business at the leased premises. Under the sublease, the franchisor becomes a sub-landlord and the franchisee becomes a sub-tenant with the result that the franchisee would pay rent to the franchisor, which the franchisor would pass along to the landlord. Conversely, if the franchisee enters into the head lease with the landlord, all three parties must enter into a lease option (or equivalent) in order for the franchisor to retain control of the premises.

Franchisors will also require that its procedures and systems be followed at all times. The reasons for this are obvious. Uniform standards of quality in the products or services purchased by the franchisees' customers are central to franchising. Given the importance of the brand, franchisors will expect franchisees to act in a manner that promotes and protects the brand at all times and further develops the goodwill associated with the trademark.

Franchisors will expect that each franchise will adopt, perhaps without question, any and all new initiatives and make whatever changes to the system that the franchisor deems necessary in its interests. Franchisors will want to protect themselves from any damage they might suffer as a result of the conduct of its franchisees. Accordingly, franchisees are required to carry their own insurance. In addition, a franchisor will normally require its franchisees to indemnify it from any and all damages caused by the franchisees. The indemnity extends to all business losses that result from the failure of the franchisee to meet its obligations. Thus, a franchisee who is unsuccessful and is unable to complete the term of the relationship will be expected to compensate the franchisor for its lost revenue over the duration of the term as well as the costs incurred to take over the location or establish a new franchisee at the premises. Where the franchisee is a corporation, the franchisor will usually require the principal of the corporation to guarantee the performance of the franchisee’s obligations. Franchisors expect their franchisees to pay all amounts due and owing in a timely fashion regardless of whatever setbacks might be experienced by any given franchisee.

Franchisors must also ensure that they have the means to enforce the franchisee’s obligations. Thus, franchisors will want to retain the right to take specific actions in the event franchisees do not meet the required standards of performance or make the required payments. In this regard, the franchisor might establish particular dispute resolution mechanisms to resolve certain types of issues. In all cases, the franchisor will reserve the right to terminate the relationship under certain circumstances or on the occurrence of specified events.

In addition to the disclosure document and the franchise agreement, the franchisor will prepare a detailed operating manual setting out the systems and procedures to be followed by a franchisee in order to replicate as closely as possible the prototype business. The development of the operating manual is a very important aspect of the planning process and merits considerable attention. It is the primary reference document for the manner in which the franchisees will conduct their business and sets out the standards of operation that must be met.

Typically, the manual sets out in detail the procedures to be followed by each franchisee in delivering its goods or services to its customers. However, it will also determine and define how the back of shop operations will be conducted. Not only will the manual set out what must be done, it often directs how it will be done, detailing everything from the equipment that the franchisees are to use to deliver goods and service to its customers, to the systems that must be utilized to account for and report its business activities. The manual is the manifestation of the systems developed for the franchisor’s prototype business.

A related issue is the question of training. The franchisee must understand the particular goods or services provided and must be able to utilize the systems and procedures developed to deliver them in order to meet the performance standards established by the franchisor. The franchisor must determine the level of training it will provide to new franchisees, and on an ongoing basis to existing franchisees and their employees. A balance must be struck between the value of training from a business replication and operational point of view and its cost. Usually, a franchisor will provide training to the franchisee but require the franchisee to train its own employees.

Supplementary training is usually necessary as technology advances and the system matures. Whatever level of training is offered, the franchisor will expect its franchisees and their employees to apply the acquired knowledge to all aspects of their operations.

The operating manual is also a storehouse of the business know how amassed by the franchisor over the years. As such, it contains a significant amount of proprietary information, including trade secrets and other intellectual property that the franchisor will want to protect. The manner in which its franchisees utilize patented processes and technologies and how the franchisor's trademarks and names are and are not to be displayed is normally set out in the manual in detail. In this regard, the manual supplements and particularizes the trademark protection provisions contained in the franchise agreement. The brand is everything, and franchisors expect their franchisees to honour not only the letter but the spirit of its directives regarding the presentation and use of its marks.

However, it should be noted that operating manuals differ from the other legal documents that define that relationship in that they are not static. It is the responsibility of the franchisor to continuously refine and update the manual to accommodate the development of newer and better methods of operation. For its part, the franchisee is expected to make whatever changes the franchisor deems fit within the legal limits of the relationship.

It is important to observe that all of the planning for the system, including the preparation of the franchise agreement and the other documentation essential to the relationship, is done through the eyes of the franchisor and is based on its own particular success in the business and its expectations for the system. Franchisors frequently assume that each franchisee in the system will approach its operation with the same commitment and zeal that it does. As noted above, franchisors often believe that the business can be replicated by anyone and in any location as long as the prescribed systems and procedures are followed. This belief may remain strong even in mature franchise systems despite the failure of one or more franchisees. Unfortunately, that belief is not always borne out. Each location and each franchisee brings its own variables that must, at least to a certain extent, be accommodated to ensure as far as is possible the success of individual franchisees and a continued presence in particular markets.

F. The Franchisee's Expectations

It is also axiomatic to say that the primary interest of franchisees is financial. Every franchisee goes into the business expecting it to be profitable. However, that interest rests on considerations that might not necessarily be consistent with the priorities of the franchisor. While it is true that the financial success of the franchisee will benefit the franchisor, the latter's business interests and expectations are not wholly dependent on the individual financial success of any given franchisee. The franchisor is generally more interested in the success and growth of the system as a whole. The franchisee, on the other hand, is largely, if not solely, concerned with the financial success of its own operation.

Commonly, prospective franchisees assume that owning a franchise is tantamount to a guarantee of financial success, particularly if the franchise system has an established presence in the market. It is not unusual for prospective franchisees to have little understanding of the nature of franchises or of the legal relationship between franchisees and franchisors. Although most franchisees will understand that the parties are distinct legal entities, they may not appreciate that their economic and legal interests are not the same as those of the franchisor.

Prospective franchisees are attracted by what they believe is a business that will work under just about any circumstances. Appearances are often the primary motivator, or at least the thing that brings them to the door.

Individuals seeking to become part of what appears to be a clearly successful and relatively straightforward enterprise often have their preconceptions reinforced by the franchisor's carefully prepared sales pitch and, as a result, can place undue reliance on rosy visions of the future. That is not to say that franchisors intend to mislead their prospects. A healthy confidence in the system on the part franchisors, particularly when it is in the early stages, should be expected. Given the dynamic of the relationship between prospective franchisees and the franchisor, it is understandable that those seeking to get into the business might accord unjustified weight to the sales and income projections presented by the franchisor as part of its marketing strategy.[1]

Assuming that the economic interests of the franchisee and the franchisor are in fact the same, franchisees are also likely to believe that the franchisor will support it in every way possible and will successfully lead them out of whatever difficulties they encounter. Too often prospective franchisees rely unquestioningly on the franchisor on all matters pertaining to the business.

For example, in instances where the franchisor is actively involved in site selection, prospective franchisees are apt to assume that any location chosen or approved by the franchisor will be successful. They might also assume that the franchisor has done an exhaustive survey of competitors in a particular market and have determined that the business not only can, but will be successful. Franchisees who rely entirely on the franchisor's assessment for a particular site without taking steps to determine whether those predictions are sound could find themselves in for a surprise.

Franchisees must take a hard look at a proposed location's potential to generate adequate revenues. In particular, franchisees must be satisfied that their revenues will justify the fees payable to the franchisor and the capital expenses associated with acquiring and establishing the franchised business. In this regard, franchisees benefit from a longer initial franchisee term. A longer term affords a franchisee a greater opportunity to establish the business as a going concern and to recoup its initial investment before it is required to renew the relationship and incur the associated costs of doing so.

Franchisees will also want assurance that they will receive the appropriate training to operate the business. Ideally, the franchisor will have put in place comprehensive training programs for franchisees' principals and employees. That is not always so. Franchisees must therefore determine to the best of their ability that the training and technical support offered by the franchisor will allow them to operate the franchised business in the manner contemplated by the parties.

Franchisees will also be concerned with changes to the system, including those related to the franchisor's trademarks and corporate livery, as well as any upgrades to the equipment required to operate the business. More often than not, franchisees will not be able to influence when or how such changes will be implemented. Thus, it will be important to ascertain whether or not the franchisor offers financial assistance or provides other supports, technical and otherwise, to facilitate such changes.

Another common franchisee expectation relates to suppliers. Franchisees are often required to purchase supplies and equipment from sources determined by the franchisor at its sole discretion. Franchisees are right to assume that a franchisor can negotiate discounts for wholesale purchases from suppliers.

However, franchisees should not assume that they will always benefit from those savings. It is not unusual for franchisors to receive concessions from suppliers for bulk purchasing and yet require franchisees to pay the regular wholesale price or mark up the prices it charges for those very same supplies. However, depending on the franchisor and the relationships it cultivates with its franchisees, it

[1] **In those provinces which have franchise legislation, if an estimate of annual operating costs or an earnings projection is provided, the disclosure document must contain a statement specifying the basis for the estimate or projection, the assumptions underlying the estimate or projection and a location where information is available for inspection that substantiates the estimate or projection, as the case may be.**

might be possible to negotiate more favourable terms for the purchase of supplies or other advantageous changes to the procurement system.

Franchisees will also want to protect themselves from the potentially adverse consequences they could face in the event that the business is not a success. The reasons for franchisee failure are many and varied. Whatever the cause, franchisees should determine beforehand whether or not they have the right to assign their franchise to other operators. While the franchisor will in most cases hold franchisees responsible for any losses it incurs, the right to assign the franchise can be an effective tool to minimize the economic costs of failure.

As stated, the expectations of the franchisor are largely expressed in the franchise agreement and the operating manual. Both are prepared by or on behalf of the franchisor. In this, the franchisor has a distinct advantage. In most cases, the prospective franchisee is presented with the agreement on a take-it-or-leave it basis, with little or no chance to negotiate more favourable terms. Unfortunately, some individuals are so intent on becoming franchisees that they pay scant attention to the terms of the agreement they are signing. This is a mistake. It is of the utmost importance that prospective franchisees inform themselves about what they are getting into. All of the material provided by the franchisor must be carefully reviewed and understood in detail, in order to empower the franchisee to make an informed decision about entering what can be a long and all-consuming business relationship. The more realistic a franchisee's expectations are, and the better the franchisee understands the franchisor's interests and expectations, the greater the chances are that the franchisee will be successful.

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