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The Nature of Franchising[1]

A. Introduction

Franchised businesses are now prominent fixtures on the Canadian economic landscape. Their importance to our local, regional and federal economies increases day by day. One cannot walk down the street or stroll through the mall without coming across any number of franchised businesses.

Some of the most recognizable franchises are those involved in the fast food industry. It is probably fair to say that every person in this country has at one time or another popped into such an establishment for a quick bite to eat. Regular patrons have come to expect that no matter which store they go to, they will get something that looks, smells and tastes just like it would at any other location. The value of the business, from the point of view of both the franchisor and the franchisee, lies in the high degree of consistency of the goods or services provided at every location in the system.

Customer loyalty is the goal. Franchising as a mode of carrying on business is however, not confined to the food industry. Many other types of businesses have chosen this model as a means of extending the reach of their brand and increasing their market share. The unique commercial relationship that exists between franchisors and franchisees has proven to be successful in a wide variety of contexts. Although the parties in a franchise relationship have different, and sometimes conflicting interests, they are dependent on, and benefit from, each other in many respects.

The relationship permits the franchisee to capitalize on the franchisor's expertise and resources and allows the franchisor to profit from the individual franchisee's desire to be successful. Each is vital to the success of the other's business undertaking.

B. Franchising Defined

Franchising is generally defined to mean a method by which goods or services are marketed and sold under a specified brand or trademark. The vast array of franchised businesses in the marketplace can generally be categorized into two broad categories: distributorship or product franchises and business format franchises.

Distributorship or product franchises involve the sale or distribution by a franchisee of a specific product or service within a given territory under license from the franchisor, being the manufacturer or supplier of the product or service. In this form of franchising the franchisee develops its own business systems and

[1] Adapted from a paper co-authored and co-presented at the OBA 8th Annual Franchise Law Conference, by Peter Viitre, of Blake Cassels & Graydon, LLP and David Kornhauser of Macdonald Sager Manis, LLP, "Franchising 101 — Understanding the Fundamental Aspects of the Franchise Relationship."

methods, and sales and distribution techniques, with limited control by or assistance from the franchisor. The franchisee has considerable independence with the only link to the franchisor, in many cases, being the brand name of product or service being offered. Examples of distributorship or product franchises include those related to the sale or distribution of automobiles, soft drinks, gasoline, and consumer appliances.

Products that have a significant pre-sale or post-sale component are especially well-suited to distribution by product franchising. Business format franchising, on the other hand, involves much greater harmonization of the business identity of the franchisor with that of the franchisee, usually through the requirement that the franchise carry on its business, structure its management, and identify itself in the market in a specified, uniform format. This is what many people have in mind when they think or talk about franchising. In business format franchising, the franchisor provides the franchisee with a license to use the franchisor's comprehensive business format, operating system and marketing plan in order to identify and distribute goods and services, under the trademark owned by the franchisor.

Business format franchising imposes on the franchisee a standardized system of rules and operational parameters to achieve uniformity and consistency over a network of independently owned and geographically disparate locations. To achieve this uniformity and consistency, a franchisor may provide advice and guidance: in analyzing and selecting the location of the premises from which the franchised business will operate; in acquiring the right to use the premises; and in constructing, furnishing, and stocking the premises. Additionally, the franchisor may also provide various other services, including: training in the operation of the franchised business; opening assistance; volume purchasing; collective advertising; and comprehensive ongoing support. Business format franchising can offer the best of both worlds, combining the entrepreneurial skills of individual businesspeople with the organizational and administrative advantages, and wide-ranging experience, enjoyed by larger business entities.

A franchise is not, however, a partnership, joint venture, or employment arrangement. The parties are independent contractors joined together through a contractual, and, ideally, a mutually beneficial relationship. Franchising must be distinguished from other common forms of legal arrangements, such as licensing, which involves the right to manufacture, supply or distribute a product or service using the licensor's patents or trademarks.

Sales or agency arrangements, which involve the distribution of products or services without the sales person or agent taking title to the products or services, and simple distributorships, which does involve the distribution of products or services with the distributor taking title to such products or services, are two more examples of non-franchise relationships.

Since the definition of "franchise" is broadly drafted in the franchise legislation that exists in various provinces of Canada caution must be exercised by the lawyer drafting an agreement on behalf of a licensor, to ensure that the legal arrangement does not create unintended obligations, as a result of the characterization of a business arrangement as being a "franchise". The characterization of a business arrangement as a "franchise" is a matter of substance rather than form. The intention of the parties is not necessarily determinative.[2]

[2] For a more detailed discussion of these issues, please see Chapter 4— "Canadian Franchise Legislation: An Overview."

C. Basic Elements of Franchising

Franchises exhibit three basic characteristics. Firstly, they carry on their business under a system of operations and merchandising developed and maintained by the franchisor in conjunction with an identifiable trade name or trademark. Secondly, there is a grant by the franchisor to the franchisee of the right to operate its business in accordance with the franchisor's system and to identify itself with the franchisor's brand. Thirdly, the relationship between the franchisee and franchisor is governed by a contract outlining each party's rights and obligations, including, in most cases, the obligations of the franchisee both to operate the business within the system parameters established by the franchisor and to pay fees in consideration of the right to utilize the system, trade name and trademarks.

D. Advantages of Franchising

Franchising has a number of advantages over other forms of business organization. From a franchisor's point of view, it facilitates the expansion of the business within or beyond particular territories and allows the franchisor to achieve market penetration using far fewer resources than can be achieved by expansion through vertically integrated operations and without having to incur the same degree of financial risk. Expansion into smaller communities is more readily achieved by harnessing the knowledge of local business people who already have close connections to their communities.

In addition, franchising generates a broad spectrum of public recognition for the franchisor's trademarks, which, if successful, translates into higher franchise fees and a greater ability to generate additional franchise sales. Most successful businesses are owner-operated rather than management-operated. Franchisees are normally heavily invested, both personally and financially, in the business, and are highly motivated to make the business successful. This degree of motivation may be lacking in management.
The franchising model allows franchisors to harness the entrepreneurial spirit of individual franchisees to improve and grow the business.

Franchising as a business model shifts the responsibility for operations to the system's franchisees. Franchisors are relieved of the operational burdens associated with running individual locations, which are not limited simply to the delivery of products or services, but include, for example, responsibility for compliance with local licensing requirements and liability for the acts of employees. Franchising thereby enhances the franchisor's ability to focus on developing and implementing an overall strategy for the continued success of the business, on refining systems and procedures and developing new products or services. Moving the burden of everyday operations to franchisees allows the franchisor to focus its efforts on strategic issues.

From a franchisee perspective, franchisees benefit from working with a proven, successful business model and gain marketing leverage through increased brand recognition. Customer familiarity with a well-established and well-recognized trademark usually allows franchisees to commence their business more quickly right from the outset. As well, franchisees generally receive ongoing assistance and support from the franchisor. In many cases, lower prices for inventory and supplies due to aggregated system purchasing power may also be realized. Similarly, franchisees are often in a position to pool resources together with the franchisor for advertising and promotional purposes, effectively leveraging individual contributions to reach a greater number of potential customers for each particular location.

E. Disadvantages of Franchising

While franchising has its advantages, there are several potential disadvantages. From a franchisee's perspective, it might be difficult to implement the franchisor's system of operations and to replicate the success of the franchised business in different markets or territories. A franchisee might also find it hard to balance his or her entrepreneurial spirit with a willingness to accept the imposition of the franchisor's system of operations. Furthermore, operating a franchise involves additional costs above what a business person operating the same business outside of a franchise would incur. There can be significant initial and ongoing costs to be paid for the right to be associated with a successful and established trademark.

Notwithstanding the cost of acquiring and establishing a franchised business, membership in a successful system is no guarantee of success. Individual franchisees, may have to work very long hours with little benefit to establish the profitability of their franchised businesses. These issues could negatively impact the relationship between franchisee and franchisor. Franchisors, on the other hand, face a different set of challenges. They might encounter more resistance in implementing changes to the system compared to corporate-owned locations. They might also have to deal with problematic or unhappy franchisees. Significant resources, in terms of both time and money, might have to be expended to enforce the termination provisions in the franchise agreement and to protect trade names and trademarks.

Franchisors could be also required to disclose confidential information, including trade secrets, and could find it difficult to enforce the restrictive covenants of the franchise agreement relating to such matters. In addition, income streams are lower when compared to chain store systems.

F. Alternatives to Franchising

Franchising is not the only vehicle that can be utilized by a business to expand operations and deepen market penetration. Vertically integrated chain store operations can accomplish this simply by opening additional corporate stores. In so doing, the business retains complete control of all its operations and over the use of its trademarks and other intellectual property. If the knowledge and expertise needed to open new outlets already exists in-house there is no need to bring an independent third party up to speed to commence operations. The business also reaps the entire benefit of the profits generated by new locations.

There are, however, downsides to this type of arrangement. Employing the corporate model means the business assumes all the risks and bears all of the losses for each location. In addition, the startup costs and ongoing expenses for each site are not shared with a third party as they would be under the franchise model. Having no direct stake in the profitability of the undertaking, the management and staff at new locations might not be as motivated as a franchisee, who has an interest in the business over and above a salary and other employee benefits, would be in ensuring the operation is a success. At worst, the cumulative effect of these factors could impair the ability of the business to exploit new opportunities or to meet its plans for expansion.

Licensing, which, as mentioned above, involves the right to manufacture, supply or distribute a product or service using the licensor's patents or trademarks, is another alternative to franchising. In this type of relationship, the licensor grants its licensees the right to use its trademarks, patented technologies or know how to manufacture goods or deliver services associated with the brand. In such an arrangement, the licensor is primarily concerned with protecting its trademarks and other intellectual property and collecting the royalties for their use. The licensee is essentially free to conduct its business as it sees fit and without the active participation of the licensor. The degree of licensor involvement will differ according to the nature of the business but in most cases a licensor will only become actively engaged if it is not being paid or its intellectual property rights are being jeopardized by the licensee. Although the licensor incurs minimal costs, it sacrifices the ability to control how businesses associated with its trademarks are actually run.

The sales agency or representation agreement is yet another potential business model. This format involves the delivery of products or services to the customer without the agent or representative taking title to those products or services. That is, the agent or representative merely acts as a bridge between the manufacturer and the consumer. As is the case with respect to licensing, manufacturers or suppliers generally do not take an active part in an agent's business or in the agent's relationship with the ultimate purchaser of the goods or services in question. However, these types of arrangements are not always exclusive, and agents and representatives might not be committed to the promotion of any particular label or brand. There is also the distinct possibility that agents and representatives could be more interested in their commissions than in the promotion of any given manufacturer's brand or the protection of its trademarks and trade names.

A fourth alternative is the simple distributorship. Here, the distributor purchases inventory from the manufacturer for resale to the public. As in the licensing and sales agency or representation formats, the manufacturer has little involvement in the distributor's business. As well, there is a similar lack of control over how the manufacturer's product is delivered to the consumer and the degree of respect accorded by the distributor to the manufacturer's trademarks and other proprietary information might be found to be less than desired.

There is another potential downside to licensing, agency arrangements and distributorships. As mentioned above, franchising is more a matter of substance than of form. In provinces where franchise legislation currently exists, each of these formats could fall within the statutory definition of "franchise" depending on the particular relationship between the parties and the business realities on the ground. If the business relationship falls within that definition, the manufacturer or licensor, could be saddled with obligations it had no intention of assuming and be subject to the assertion of rights that the legislation affords to the party that would be considered to be the franchisee in the relationship. While the risk might be reduced for simple distributorships, the legal characterization of the arrangement as a franchise could have significant ramifications. Manufacturers and licensors must be aware of this possibility and should in all instances consult experienced legal counsel to determine the risks and the potential obligations of being found to be what is often referred to as an "accidental" franchisor.

G. Conclusions

Franchising has proven to be a very successful business platform. There can be little doubt that franchisees benefit from brand recognition and loyalty. A stroll through any food court will certainly bear that out. Franchisors for their part are free to devote their energy and resources to improving the brand without having to assume the burden of day-to-day operations. Franchising has shown over the course of its recent history to be a proven means of conducting business and will continue to increase in prominence in the Canadian marketplace for the foreseeable future.