

NEGOTIATING A FRANCHISE AGREEMENT:

The Art of the Possible

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The franchise agreement is the central document to any franchise relationship. It is often said that the franchise agreement is a franchisor's document. That is to say that most of what is contained in the often 50 page plus agreement is there to protect the franchisor's intellectual property, brand and financial benefit. Secondly, the franchise agreement provides the franchisor with the tools to protect the system and the other franchisees. As a result, the franchise agreement is often lopsided in favour of the franchisor. For those who have experience with such agreements, the issue is not whether or not the agreement is lopsided, but rather whether the lopsidedness is within industry norms.

Most often, the franchise agreement is presented as non-negotiable. Certainly, that is true within any mature franchise system, in most cases, but there is often scope for some negotiation with the new and immerging franchises in certain circumstances. Other scenarios can also present opportunities for negotiations as might be the case with the purchase of a franchise from a foreign franchisor, the purchase of a franchise from a new master franchisee for Canada, any special qualities the prospective

franchisee might have for the franchisor, i.e. opening in a more challenging location, taking over an existing unit in need of better management or financing, etc.

Process is important as well. Franchisor's should explain ahead of time to the prospective franchisee the nature of the documentation they will be asked to sign and that there are reasons for uniformity in franchise agreements so that there is uniformity in the system as a whole, which protects all franchisees. Franchisors should avoid having face to face "negotiations" with prospective franchisees, unless or until the franchisee's lawyer has provided **all** of their comments in writing. That way, many issues could be eliminated or narrowed, making any subsequent meetings or exchanges more productive and efficient. Sometimes, the franchisee is overly reliant on their lawyer and the party the franchisor is negotiating with is in fact the lawyer. In these circumstances, it may be better to get to a meeting with the franchisee, with lawyers present, sooner than later, so that the franchisee can hear the reasoning for the franchisor's positions unfiltered through their lawyer.

What follows are some comments on a number of requests a prospective franchisee might make for changes to the franchise agreement and possible responses from the franchisor.

Personal Guarantees

While most franchisees will be allowed to incorporate, it is the norm for the franchisor to request personal guarantees. The reason being that the franchisor cannot know what

the financial condition of the corporation might be at any given time and that the decision to grant the franchise was based upon the individual franchisee's strengths and commitment. You may be able to negotiate a limit, whether it be in terms of dollars or time or to breaches of obligations under the franchise agreement, with no liability for business failure, may be acceptable to all sides.

The issue becomes more complicated when there are shareholders in the franchisee corporation who provide capital but are not active in the business and may be uncomfortable signing a personal guarantee. Often, Franchisors will require a joint and several guarantee from all shareholders, officers and directors of the franchisee corporation, and in certain scenarios from spouses of same. In these circumstances, limiting such personal guarantees to only those from active individuals may be possible.

Grant

Depending upon the nature of the business being franchised, the franchisee may be given an exclusive or protected territory. The franchisee will want that territory to be as large as necessary to ensure the viability of the business in the future. The franchisor will not want to grant a territory that is greater than necessary for the success of the franchised business. Hence this is often a negotiated point. The franchisor should be able to justify its position based upon available data or past experience. Typically, the exclusive territory is described by a radius from a location, but, by itself, this does not allow for specific traffic patterns and demographics, which should also be considered.

It is not uncommon these days for franchisors to reserve certain rights from the grant of a franchise, including the right to acquire competing businesses or to engage in parallel distribution within the territories of franchisees. The best approach to this challenge would be to base the request or resist the request by reference to hard data about the likely impact on the franchisee's business of such actions by the franchisor.

Right of First Refusal

Sometimes, franchisees request rights of first refusal on other territories. However, there is a danger in this, because the decision to allow a multi-unit franchise should be based on more than the fact that someone else is interested in a particular location or territory. A franchisor may consider such a request as a "throw away" concession, as there appears to be no real downside to the grant of such a right. However, the decision to grant more territory or multiple units to an existing franchisee should be based upon the franchisor being satisfied that the franchisee has the character, skills and resources to make a success of the additional business, not just because someone else wants to buy a franchise.

Term and Renewal Rights

The length of the initial term of a franchise agreement and the length and number of renewal terms is often influenced by the size of the investment to be made by the franchisee. The total should be long enough for the franchisee to recapture their capital and earn a decent return. What is critical here is that the conditions to renewal should be reasonable and reasonably attainable by the franchisee. Sometimes, a condition is

imposed by the franchisor that the franchisee sign the franchisor's then current form of franchise agreement. While this may be palatable to a prospective franchisee, when the condition also allows the franchisor to increase royalties and advertising contributions, it can present a difficulty to the franchisee, as such increases could render the franchised business not viable financially.

Discussion around the renewal fee may also be appropriate. Oftentimes the renewal term will be shorter than the initial term. The renewal fee should certainly be no more than the proportionate amount with respect to the new term, i.e. if the original term was a ten year term and the franchisor offers a 5 year renewal, the renewal fee should be no more than 50% of the then current fee. Conceptually however, a franchisor should consider charging a current system franchisee less than the proportional equivalent, as the work required to prepare and re-sign a renewing franchisee is likely to be much less than the work needed to sign up a new prospect.

Construction

The franchisee needs to know who is going to construct the business premises and, if it is going to be the franchisor, what the budget and terms of payment will be. Additional provisions should be inserted into the franchise agreement that would normally be found in a construction agreement. If the franchisee is to do the construction, then the franchisor's plans and specifications should be appropriate for the circumstances and not require expensive over-building.

Trademarks

A franchisor may need flexibility to add, delete or change the system trademarks, but the franchisee may be justified in requiring that the core trademark not be deleted or changed under any circumstances as that would be too fundamental to the business.

Operating Standards

It is expected, especially these days, that businesses will change and evolve. It is no different for franchise businesses. As a result, it is common to have provisions in a franchise agreement allowing a franchisor to make changes to the system and to require the franchisee to implement them. In a newer system, these changes may occur at a faster rate as the franchisor continues to learn and develop the potential of the business being franchised and their ability as a franchisor. For this reason, it is a more compelling argument that the franchisee be given some protection from being forced to implement too frequent and/or to expensive changes.

Initial Franchise Fee

Interestingly, when concessions are made, say by newer franchisors to sign up their first few franchisees, most often they include some reduction in the amount or relaxation in the timing of payment of the initial franchise fee.

Continuing Royalty Fee

It has been said that royalty fees are the “life blood” of the franchisor and in most functional franchise systems, they are the single most important source of revenue for

the franchisor. Having said that, under the classic franchise model, a franchisor earns royalties (taken usually on gross revenues of the franchisee) even if the franchisee incurs a loss. Given that most startups incur losses for the first 1 to 3 years, there is an argument that the franchisee is justified in expecting a reduction in the royalty rate to cushion the impact of that startup loss. In fact, many less established systems will consider a moratorium with respect to all royalty payments. A moratorium would allow a period from either the date of execution of the Franchise Agreement or the date the business became operational (perhaps for a 3 to 9 month period), whereby the franchisor would not require the payment of royalties. The argument behind such an inclusion is that early on, when a new business is starting out, franchisees should retain all possible profit and spend it on the growth, promotion and marketing of the business in order to ensure its success.

Assignment of the Franchise Agreement

Franchisors have a duty to themselves and the other franchisees in the system to ensure that any new franchisees have the qualities and qualifications to maintain and contribute to the growth of the brand. As a result, invariably, the assignment of the franchise agreement (the sale of the franchisee's business) will require the consent of the franchisor and be subject to certain conditions being met. From the franchisee's point of view the consent should not be unreasonably withheld or unduly delayed and the conditions should be reasonably attainable. Additionally, any transfer fee payable by the franchisee should be justifiable commercially. Finally, if the franchisee is made up of several parties (i.e. multiple shareholders in a franchisee corporation), there exists

a reasonable argument that any sale of their individual interests in the franchisee should not require the consent of the franchisor, provided that the remaining individuals are qualified to operate the franchise.

Indemnification

Franchisees will generally be required to provide an indemnification. An indemnification is a covenant similar to a guarantee. With respect to the indemnification being provided, a franchisee is agreeing to indemnify, defend and hold the franchisor harmless against all claims, obligations, liabilities and damages that result from a typical list of specific items that is intentionally broad. Generally, the list will include claims relating to any action taken by the franchisee. Franchisees may find concern with such a broad list considering that the potential claim on may result directly from franchisor system requirements and standards. Some franchisees will attempt to negotiate the indemnification language to limit the indemnification to claims that arise solely from a breach, violation, non-performance or non-compliance by the franchisee under the Agreement. Franchisees may also ask for reciprocal indemnification language to be inserted, so that they are provided with an indemnification from the franchisor for issues relating to the brand or system requirements.

As previously mentioned, a franchisees ability to negotiate any of the terms of an agreement will relate both to the system's strength and to the franchisee's strength (i.e. the franchisee is a well known and liked multi-unit franchisee already). Not all

franchisees should expect the level of negotiation discussed above, however, when there is room for negotiation and discussion, both legal and business issues should be considered and understood.

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