



EXPANDING YOUR FRANCHISE SYSTEM

By: Edward N. Levitt*
and
Jean H. Gagnon**

Dickinson Wright LLP
199 Bay Street, Suite 2200
P.O. Box 447
Commerce Court Postal Station
Toronto, Ontario, M5L 1G4
Tel: (416) 777-0101 Fax: (416) 865-1398
E-mail: nlevitt@dickinsonwright.com
www.dickinsonwright.com

JEAN H. GAGNON
Accredited Expert in Franchising•Mediator•Arbitrator•Lawyer
370 chemin de Chambly
Suite 230
Longueuil, Quebec J4H 3Z6
Tel: (450) 670-0411 Fax: (450) 670-0811
E-mail: jhgagnon@jeanhgagnon.com

© Edward N. Levitt and Jean H. Gagnon, October 8-9, 2003

** Mr. Levitt is the Past General Counsel to the Canadian Franchise Association
and a member of the Franchise Sector Working Team, which has been instrumental
in shaping Ontario's new franchise legislation*

*** Mr. Gagnon is a director of the Quebec Council of the Canadian Franchise Association.
He is the author of more than sixteen books including "La Franchise au Québec" (1200 pages)*

INDEX

1.	INTRODUCTION	1
2.	TIMING OF EXPANSION.....	2
3.	EXPANSION VEHICLES	3
3.1.	DIRECT FRANCHISING	3
3.2.	DEVELOPMENT ARRANGEMENTS.....	3
3.3.	MASTER FRANCHISING.....	5
3.3.1.	<i>Choosing the master franchisee</i>	<i>6</i>
3.3.2.	<i>The territory</i>	<i>7</i>
3.3.3.	<i>The term</i>	<i>8</i>
3.3.4.	<i>Initial franchise fees for territorial rights</i>	<i>8</i>
3.3.5.	<i>Dividing up the spoils and job allocations</i>	<i>9</i>
3.3.6.	<i>Selection of franchisees and locations</i>	<i>10</i>
3.3.7.	<i>Governing law</i>	<i>11</i>
3.3.8.	<i>The unit franchise agreement.....</i>	<i>11</i>
3.4.	JOINT VENTURE FRANCHISING	12
3.5.	ACQUISITION.....	13
4.	GEOGRAPHICAL CONSIDERATIONS.....	13
5.	WHY DO FAILURES OCCUR?	14
5.1.	SOME MISCONCEPTIONS ABOUT CAUSES.....	14
5.2.	INSUFFICIENT INVOLVEMENT OF THE FRANCHISOR.....	17
5.3.	LACK OF CAPITAL.....	18
5.4.	LACK OF KNOWLEDGE OF WHAT IS REALLY HAPPENING IN THE TARGET MARKET.....	19
5.5.	POOR CHOICES REGARDING THE EXPANSION VEHICLE AND STRUCTURE	19
5.6.	POOR CHOICES OF FRANCHISEE/AREA FRANCHISEE/MASTER FRANCHISEE/ AREA DEVELOPER /JOINT VENTURE PARTNER	20
6.	PLANNING FOR SUCCESS	21
6.1.	LEARNING ABOUT YOUR TARGET MARKET.....	21
6.2.	REVIEW OF THE LAWS AND REGULATIONS WHICH MIGHT AFFECT THE SYSTEM IN THE TARGET MARKET.....	23
6.3.	PRELIMINARY RESEARCH.....	23
6.4.	MARKET RESEARCH	24
6.5.	CHOOSING THE RIGHT AREA FRANCHISEE / MASTER FRANCHISEE / AREA DEVELOPER /JOINT VENTURE PARTNER	25
6.6.	PROTECTION OF INTELLECTUAL PROPERTY RIGHTS	26
6.7.	CHOOSING THE RIGHT EXPANSION VEHICLE.....	27
6.8.	COMPLIANCE WITH APPLICABLE LAWS	28
6.9.	TRANSLATION AND ADAPTATION OF THE FRANCHISE AGREEMENTS AND DOCUMENTATION	28
6.10.	PILOT OPERATIONS.....	28
6.11.	PLANNING THE DEVELOPMENT	29
6.12.	PUBLIC RELATIONS.....	30
6.13.	INITIAL DEVELOPMENT FOLLOW-UP.....	31

EXPANDING YOUR FRANCHISE SYSTEM

**By Edward N. Levitt
and Jean H. Gagnon**

1. **INTRODUCTION**

In academic circles it is said that university professors must "publish or perish". In franchising it could be said that franchise systems must "expand or expire". Growth and expansion go to the very essence of franchising. It is chosen as a method of distributing products or services from the other options that are available because of its ability to grow the business quicker and through broader geographical territories.

As a franchise system begins to expand beyond a few units and its market of origin, the franchisor faces an ever increasing array of obstacles and challenges. Expanding a franchise system is not "rocket science", but it has its own unique dynamics and experiences. Failed expansions come from, among other things, serendipitous growth, poor funding, inadequate market research and poor management. Success in a franchise expansion follows the establishment of a firm foundation, careful planning, thorough market research and the evolution of a solid head office management capability.

Many of the issues in a franchise expansion will be the same, whether or not the expansion is from large cities to small towns, from region to region within a province, from province to province or from one country to another. While growth will fuel the financial success of a franchise system, it more often leads to its demise. Post-mortems on failed franchise systems often reveal that the failure was caused by mistakes made in expansion, which were readily foreseeable and avoidable.

This paper will examine the fundamentals of franchise expansions, the options available, the most frequently encountered pitfalls and strategies to maximize the chances of success.

2. **TIMING OF EXPANSION**

Timing is an ever present issue in franchising. Commencing a franchise program before the business concept has been adequately developed can be a mistake from which the franchisor never recovers. Expanding too quickly can stretch financial and human resources to the extent that the franchisor cannot adequately "manage what it sells". Choosing a complex expansion vehicle, such as master franchising, before the franchisor has learned what is needed to franchise the particular business effectively can ultimately bring down the entire business.

Franchising should not be attempted until the business being franchised has been well developed, survived and prospered through a number of fiscal periods and has been operated in a number of varied circumstances. Many franchises are touted on the basis that the franchisee has a greater chance of success, because of the proven techniques and methods of the business being franchised. In business, it takes some time to truly prove such matters to the extent that the franchisor can reliably predict what set of circumstances, including market considerations and location criteria, will bring success for a franchisee.

The speed of a franchise expansion is another crucial issue to be addressed. The franchisor must grow its head office infrastructure in a manner which keeps pace with the expansion of the franchise system and add new capabilities as required. For example, a small franchise system will allow for easy communications between the franchisor and its franchisees. As the number of franchisees increases, the all important communications capability within the system must grow, which may necessitate the creation of websites, intranets and sophisticated computer networks. These structures are not established overnight, nor is it fiscally responsible for the franchisor to overspend for facilities and capabilities that are not required by the franchise system. Again, timing is important.

Once the fundamentals are in place and opportunities arise, the successful franchisor will wisely and aggressively seize expansion opportunities. Subsequently, after a period of rapid growth, most franchise systems will benefit from and grow stronger with a period of consolidation and intentional restructuring in order to ready itself for the next phase of expansion. This pattern should be followed throughout the growth cycle of a franchise system.

3. **EXPANSION VEHICLES**

The franchisor has a number of choices of vehicles for expansion. Each one carries with it its own set of issues, challenges and advantages. Within each vehicle type there are different approaches that can be taken and hybrids can be constructed to suit the particular needs of the franchisor.

3.1. **DIRECT FRANCHISING**

Granting franchises directly to franchisees will, in almost all circumstances, be the first expansion method chosen by a franchisor. In direct franchising, the franchisor shoulders the entire burden of selling franchises and supporting the franchisees. As a franchisor looks to expand in more distant markets, other expansion vehicles become more appealing and, at times, absolutely essential.

3.2. **DEVELOPMENT ARRANGEMENTS**

Multi-unit franchises, area development arrangements and territorial development arrangements are some of the names applied to situations where a single franchisee is given the right to open up two or more franchises in a given territory. Sometimes a franchisee will acquire multiple units by evolution, as the franchisee grows and prospers. Sometimes franchisees acquire multiple units by operation of rights of first refusal originally granted to the franchisee for additional units within areas contiguous to the franchisees original territory. Often, rights of first

refusal are granted by the franchisor as inducements to sell franchises. However, there is one school of thought that it is dangerous to grant rights of first refusal, until the franchisee has proven himself to be capable and trustworthy. Otherwise, the franchisor is permitting the unit franchisee to become a multi-unit franchisee solely because of the interest of another party in purchasing a franchise. The granting of multiple franchises to the same franchisee should never be done unless the franchisee fundamentals are strong.

A cautious approach should always be taken when considering granting to one franchisee the right to open multiple franchise units in a system. Multi-unit franchisees are usually financially stronger and more sophisticated business people. This can be an advantage in good times and a disadvantage when trouble arises, as such a franchisee will be a more formidable adversary and a more demanding "customer". Area or territorial development arrangements will be most advantageous where the area or territorial franchisee has deep knowledge and extensive connections in a market that is more distant from the markets in which the franchisor is already present.

The agreements that support such arrangements need to be carefully constructed. Some important considerations are:

- The territory should be no larger than is manageable by the franchisee;
- There should be clear and appropriate performance criteria that must be met by the franchisee to maintain exclusivity in the territory;
- There should be cross termination provisions among the agreements for each unit;

- The support commitments of the franchisor should be appropriately adjusted, given the greater resources and responsibilities of a territorial franchisee;
- Any special arrangements with suppliers, given the territorial franchisee's greater purchasing power, should be addressed.

3.3. **MASTER FRANCHISING**

When done properly and timed correctly, master franchising can be one of the most effective means of expanding a franchise network. This is particularly so when the expansion is into foreign markets, although it can be advantageous in province wide, as well as national, expansions. Nonetheless, it remains one of the least understood and most poorly implemented expansion strategies in franchising. It is even difficult to arrive at a consensus on the definition of master franchising, as it is used to describe an array of relationships and arrangements, including sales agencies, multi-unit agreements with no subfranchising rights and arrangements by which the franchisor grants exclusive rights for the development of the system within the territory to the master franchisee with the right to subfranchise.

One of the greatest badges of success for a franchisor is the speed at which the franchise system has been expanded. A record number of units, opened over a very short period of time, is often quoted by franchisor and prospective franchisee alike as indicating the great acceptance and rosy future of the particular franchise system. This is a very curious phenomenon, considering how many franchise failures have resulted, either directly or indirectly, from too rapid expansion. A franchisor has to service what is sold and, perhaps more importantly, if the business concept is not fully developed, when a rapid expansion of the system is undertaken, the weaknesses and deficiencies in the concept will proliferate and be much more damaging and harder to correct later on.

The problems resulting from expanding too rapidly and too soon will exist with or without master franchising, but will be made worse and the consequences will be much more serious when master franchising is chosen as an expansion vehicle too early in the development of a franchise system. One of the key benefits for a unit franchisee is the knowledge gained from a franchisor experienced in running the type of business being franchised. Similarly, the success of a master franchisee is often rooted in the franchisor's experience in running a successful franchise system. If a franchisor has not yet proven the concept or figured out how the concept is best franchised, the master franchisee could be compared to a student pilot setting out to fly a new prototype aircraft, minus its navigational equipment.

While good agreements are absolutely essential in franchising, agreements alone do not hold a franchise system together. One of the most important elements in keeping a franchise system together and growing is the leadership of a knowledgeable franchisor. If the franchisor is learning the basics along with the franchisees, including, and maybe especially, along with the master franchisees, it will be difficult or impossible for the franchisor to assume this all important leadership role.

3.3.1. Choosing the master franchisee

It is always a challenge to choose the best unit franchisees, but that process pales in comparison to the difficulties in choosing good master franchisees. The mistakes made in choosing master franchisees are often the result of insufficient time and effort being taken to thoroughly investigate, not only the financial capability of the master, but the master's personality strengths and weaknesses and business philosophies as well. Too often a candidate is chosen who has had some prior business success, and thus can finance the franchise expansion and, perhaps more importantly, write a sizeable cheque for the front-end franchise fee for the territorial rights, without regard to the "fit" with the franchisor and the

goals and philosophies of the franchise system. In these situations, the master rights are being viewed too much as investments by both parties.

On the other hand, fatal errors have been made in selecting master franchisees who do not have sufficient financial resources to weather the initial difficulties encountered in establishing the franchise system in the territory. The franchisor may have forgotten how long it took before the system became self-financing initially or, more likely, may underestimate how long it takes someone else to get sufficient revenues flowing in the particular territory. Often the master franchisee cannot perform at the same level of productivity and efficiency as the franchisor and the franchisor is better off planning for a more mediocre performance from a master franchisee.

3.3.2. The territory

Most master franchising arrangements provide that the rights are granted, often on an exclusive basis, for a specific territory. Master franchisees frequently attempt to negotiate the broadest possible territorial rights, which is understandable. One of the most common mistakes made by franchisors, however, is to grant exclusive rights to territories which are far too large, with the consequences that the territory remains underdeveloped and/or the franchisor realizes much less from the territory than would have been the case had the one large territory been broken up into smaller territories. Sometimes this occurs because of the lack of knowledge, on the part of the franchisor, of the potential of the system in the territory and sometimes it occurs because the franchisor feels it would be easier and more cost effective to deal with just one master franchisee in a larger area. While there is some validity to these latter considerations, the franchisor will most often have a stronger, and arguably a more profitable system ultimately, if territories can be kept as small as possible.

By having more master franchisees, rather than less, say in one country or region, the franchisor has some manoeuvring room, if a master franchisee fails or fails to perform adequately. One of the other master franchisees in the country or region can, either temporarily or permanently, move in to fill a void left by the failed master franchisee. It is also less likely that a particular master franchisee, "bites off more than he can chew". The franchisor is also able to exert more control or influence over the performance and conduct of a number of less powerful master franchisees than would be the case with one very powerful master franchisee.

Even if a franchisor is tempted to deal with only one master franchisee in a country or region, careful drafting of the master franchise agreement can help to limit the potential problems. For example, the franchisor can grant to the master franchisee a smaller initial territory, which will increase in size as the master franchisee is proven to be competent and committed and impose performance quotas, which will allow the franchisor to reduce the size of the territory, if they are not achieved in the future.

3.3.3. The term

Similarly, it is a common mistake on the part of franchisors to grant indefinite terms or terms that are too long. With a shorter initial term and more frequent and shorter renewal terms, the franchisor can more easily control the actions of the master franchisee and the quality of development in the territory. At the very least, there should be very clear performance criteria and thresholds which the master franchisee must meet for a variety of things, including the right to renew, the maintenance of exclusivity, the extent of the territorial rights, and the degree of independence of the master franchisee in directing the system in the territory.

3.3.4. Initial franchise fees for territorial rights

One of the most difficult numbers to ascertain in all of franchising is the amount that should be charged for the front-end franchise fee or territorial rights fee for the grant of master franchise rights. This number will be influenced by many factors, including the length of the term of the grant, the history of success of the franchise system, the amount of training and initial support to be provided by the franchisor and the level of additional investment required of the master franchisee. Drawing analogies to other existing systems, with master franchise structures, can be helpful in deciding upon the amount to charge, but it is best to relate the fee to the potential for profit and return on capital of both parties.

From the franchisor's point of view, the most common mistake made in this area is to set the fee too low. One way to alleviate this problem is to set a minimum amount and calculate the final fee based upon the performance of the master franchisee, either by number of units opened or percentage of sales or some other basis that increases the front-end fee as the system is expanded within the territory. Master franchisees often pay too much for such fees upfront, which can drain the master franchisee of much needed capital during the critical early stages of development of the territory. For the master franchisee, the best approach is to fix the amount of the front-fee, but have its payment dependent upon the number of franchises opened over an extended period of time.

3.3.5. Dividing up the spoils and job allocations

Without a doubt, the most poorly handled issue in master franchising is the division of the front-end franchisee fees and continuing royalty fees, for the unit franchises in the territory, between the franchisor and the master franchisee. It is not unusual for the franchisor to base its decision on the allocation of these fees on its anticipated or desired return from the development of the system in the territory without serious or careful regard for how the master franchisee will finance the necessary development and support services for the unit franchisees.

Mistakes with this issue will either ensure the demise of the master franchisee or reduce the quality and performance of the system in the territory.

For example, if the continuing royalty is 6% of gross revenue of the unit franchisee and the franchisor decides it is entitled to 3%, when it costs 3% to do a proper job of developing and supporting the system in the territory, the master franchisee is faced with either making no profit on royalties or reducing the level of support to the unit franchisees. If, however, the franchisor keeps some of the responsibilities for administering the system, such as field support, the 50-50 split on royalties might work. The problem is even more apparent in the division of the front-end fees. Such fees are often, at best, compensatory to the franchisor for the costs of properly setting up the unit franchisee. Therefore, where the master franchisee assumes all of the responsibility for establishing the franchises, but the franchisor takes a percentage of the front-end fee, something has to be compromised. The point is that the responsibilities for the development and administration of the system should be decided first as between the franchisor and master franchisee. Then the division of the various fees should be based upon the costs of discharging those responsibilities and only after that should the parties divide up the remaining "profits".

3.3.6. Selection of franchisees and locations

Often, one of the principal motivations for the franchisor in choosing to expand in a territory by means of master franchising is to pass on to the master franchisee the responsibility for finding quality franchisees and locations within the territory. However, it is a common mistake for the franchisor to abdicate the responsibility for final approval of franchisees and locations, before the master franchisee has proven itself capable in these crucial areas. The end result being that, if the master franchise arrangements fail, which happens most often in the early stages of the relationship, the franchisor may be saddled with inadequate franchisees and

second rate locations. It is advisable then, that the franchisor contractually retain the right of final approval for franchisee and location selection, and exercise it in the early years, even if this right is later passed on to the master franchisee. Even if the master franchisee ends up with the *de facto* right of final approval, the franchisor will want to be able to step in and assume those responsibilities if circumstances change.

3.3.7. **Governing law**

A franchisor is understandably more familiar and, therefore, more comfortable with the legal regime in its home jurisdiction. This leads many franchisors to provide that the governing law of the master franchise agreement is to be the law of that jurisdiction. However, it is not uncommon for the law in the franchisor's home jurisdiction to be less favourable to the franchisor than the law of the master franchise territory. This often occurs, when a U.S. franchisor embarks upon a master franchise expansion in a foreign jurisdiction, because of the dearth of franchise law outside of the U.S. An additional consideration is the locus of the enforcement of any court order. The franchisor may simply be placing an unnecessary additional layer of complication upon the problem of enforcement against the master franchisee. Certain remedies, such as injunctions, may be delayed, while the local judge ascertains the rights of the parties under the franchisor's home jurisdiction.

3.3.8. **The unit franchise agreement**

Considering the importance of the unit franchise agreement to the control of the system in the master franchise territory, it is surprising how many franchisors do not insist upon the use of the franchisor's form of franchise agreement for unit franchises in that territory. Even if the local law requires some amendments, it is still better for the franchisor to start with its *pro forma* agreement and make the

necessary changes to comply with the local law. In a similar vein, the master franchisee should be required to obtain the consent of the franchisor to any changes to any unit franchise agreement. This approach avoids the problem of the franchisor inheriting an array of different agreements or agreements with unsatisfactory provisions, if the master franchise arrangements have to be terminated.

The franchisor, in a master franchise situation, is often surprisingly reluctant to require three party unit franchise agreements to be used, where the franchisor, master franchisee and unit franchisee are all parties to the agreement. This fear is most often rooted in the misplaced belief that it will create more liability for the franchisor. Any such increase in liability may be easily alleviated with proper drafting. Further, the advantage of having direct privity with unit franchisees if the master franchise arrangements have to be terminated, may outweigh any other concerns on the part of the franchisor.

3.4. **JOINT VENTURE FRANCHISING**

Joint venture franchising occurs when the franchisor takes an equity position or a partnership role in the franchisee entity. Joint venture franchising can be used in virtually any franchise vehicle, from unit franchises to master franchises. Joint venture franchising has two distinct levels of contractual relationship. At the franchisee level, the franchisor will want to have either a shareholders agreement, partnership agreement or joint venture agreement. In addition, the franchisor will want to have in place its customary franchise documentation between itself, as franchisor and the franchisee entity in which it has an interest. The reasons for creating a joint venture structure include:

- The franchisor's desire for greater control/influence over the franchisee entity;

- The franchisees need for temporary or permanent capital from the franchisor;
- The franchisor's desire for a greater return from the operations of its franchisees.

Sometimes, joint venture franchising is used as a transition towards the full implementation of one or another franchising vehicle, as the franchisee assumes full ownership of the franchisee entity.

3.5. **ACQUISITION**

The acquisition of a competitive business can be one of the quickest ways to expand a franchise system. The target company may be another franchisor or a multi-unit business that is capable of being converted into a franchise network. While the rewards in this type of expansion strategy are great, the challenges and risks are even greater. Such acquisitions raise issues of territorial exclusivity and encroachment, rebranding, changes in business culture and management transition. The franchise issues are overlaid on top of the usual and customary issues in any business acquisition.

4. **GEOGRAPHICAL CONSIDERATIONS**

There is a franchise expansion *faux pas* that is repeated again and again to the detriment and sometimes fatality of a franchisor. The scenario begins with the success of a few franchises in the franchisor's market of origin, say Toronto, followed by a solid and enthusiastic enquiry from a prospective franchisee in, say, the Maritimes, Edmonton or Vancouver. The enquiry might even come from the United States or another country. The franchisor, eager to expand, enticed by a healthy up-front payment for territorial rights and enamoured with the thought of becoming a multi-jurisdictional franchisor, gets seduced into focusing its attention and limited resources on completing the deal. One

justification for doing such a deal, often sighted, is that the distant market is so far away from the franchisor's market of origin that a failure there will not have much of an impact on the growing franchise system. Experience proves otherwise. The fledgling franchisor will find that the more distant franchisee will be harder and more expensive to monitor, nurture and deal with. Additionally, the franchisor's marketing and promotional investments in its market of origin will be almost useless to the distant franchisee. It will be harder to develop a "corporate culture" for the distant franchisee and such franchisees frequently must do more for themselves, i.e. establishing good sources of supply, which eats away at the leadership position a successful franchisor must occupy in a franchise system.

Unquestionably, the strongest growth pattern in the initial stages of a franchise expansion is concentric circles. Geography can kill a franchisor quicker than any other factor. The franchisor, in its initial stages of growth, needs to be able to maximize its contact with franchisees, utilization of marketing and promotional dollars and business relationships with suppliers, landlords and bankers in a market. By way of illustration, it may be a better strategy for a Toronto based franchisor to expand into the Northeast United States, notwithstanding the challenges of an expansion into the U.S., than it would be to expand to Western Canada.

5. **WHY DO FAILURES OCCUR?**

We have all heard the horror stories about franchise expansions that did not succeed.

The explanations given by the franchisors to explain their failures are many and varied. Unfortunately, in many instances, the real causes of the failure have not been properly identified, with the result that it is difficult to learn from them.

5.1. **SOME MISCONCEPTIONS ABOUT CAUSES**

Very often, the following factors are advanced as the causes of such failures:

- Different legal systems;
- Language issues;
- Cultural differences;
- Unexpected competition or level of competition;
- Bureaucratic problems and delays (licenses, permits, administrative issues, tax issues, legal issues, etc.);
- Lack of commitment of the partner (franchisee, area franchisee, master franchisee, area developer or joint venturer).

However, these causes are more apparent than real and, therefore, constitute, in many instances, misconceptions as to the true reasons why the expansion has failed.

For example, in almost any market in the world, one can find very competent lawyers, accountants, financial advisors, tax advisors, marketing consultants, etc. who are willing to assist franchisors (and their legal counsels) coming from other jurisdictions to adapt their franchise, operation and marketing agreements and documentation for use in the target market. There are also good and competent translators almost everywhere.

Translation to another language and adaptation of agreements to the law system of another jurisdiction can be quite costly, but should not constitute, on a long term basis, a major impediment to the expansion and growth of a franchise system.

Cultural and geographic differences are also, most often, more an apparent cause than a real one.

In few cases, a franchise system may not be able to develop in a particular market because of cultural or geographic differences. For example, a franchisor operating

in the winter sports equipment retail sales business may have some difficulties to develop its system in the Caribbean countries and the situation may also be difficult for a franchisor wishing to develop a franchise system of ice cream outlets in the Yukon or the Northwest Territories.

These, however, represent exceptions.

Obviously, there are cultural differences between markets. Even within the same province we see cultural differences between different areas (for example, certain food items which sell very well in Montreal may be more difficult to market in Chicoutimi or in Gaspé).

These differences do not, however, prevent many franchise systems (for example, McDonald's, Tim Horton's, Second Cup, Shoppers Drug Mart, The Forzani Group, etc.) from developing their systems in many different markets.

Why are some systems able to succeed in different markets, despite cultural or geographic differences, while others do not seem able to do so?

The same reasoning applies to the lack of involvement of the chosen partner in a new market.

If we encounter difficulties with our chosen partner in any target market, the problem may not lie only with our partner but also with the way we have proceeded to (a) learn about the market, (b) adapt our franchise system to the target market, (c) choose our partner, (d) train our partner, (e) share with our partner our respective goals and expectations in regard to the target market and to the best ways to reach them, and (f) support our partner.

Without a doubt, the expansion of a franchise system in a new market (whether it is another Canadian province, the United States or any other country) is a process which requires investments of money, time and human resources. Failure to make these investments greatly increases the risk of failure.

5.2. INSUFFICIENT INVOLVEMENT OF THE FRANCHISOR

Quite often, expansion into another market is not triggered by a well planned strategy developed by the franchisor, but is the result of an unsolicited opportunity which has presented itself to the franchisor.

In many cases, franchisors have been approached by either operators, investors or consultants from another market who have proposed to develop the franchise system in their own market, at their own risk and with their own money.

A franchisor may be tempted to accept this kind of offer, as it could bring money and opportunities for which it had not planned (at least for the time being). Furthermore, under this scenario, it may appear to the franchisor that the prospective partner is taking all the risks and will be making all the investments necessary to develop the franchise system in that market while also paying important and/or significant sums of money to the franchisor. Unfortunately, this is an illusion.

In almost all the situations where the initial trigger for the expansion of a franchise system in a new market was such an offer, the proposed expansion has resulted in a costly failure for the franchisor.

In these cases, it is easy for a franchisor to underestimate the time commitments and the investments in money and people that will be necessary to adequately train and support its new franchisee, area franchisee, area developer, master franchisee or joint venture partner.

The franchisor is further deluded by the fact that the governing agreements provide that all the costs and risks associated with the development of the system in the target market will be borne by the prospective partner, in addition to the initial and continuous fees which will be paid to the franchisor.

The reality often proves to be quite different when the proposed development is not taking place as agreed, the development is not done properly, the first franchised outlets are not successful or the development of the franchise system is not profitable (either for the franchisor, its partner or the individual franchisees) in the target market.

If the franchisor then wishes to avoid the costs, delays and inconvenience associated with disputes, frivolous or real, and the deterioration of goodwill in the target market, it will have to intervene directly in the market. In some cases, it may also have to compensate the franchisees in order to take over its partner's position or to withdraw from the target market with as few negative consequences as possible .

It is a mistake to believe that an expansion in a foreign market can be successfully completed without a significant investment in time, money and human resources on the part of the franchisor.

5.3. LACK OF CAPITAL

Expansion through franchising is certainly not the way to resolve problems related to a lack of liquidity or of capital.

Even if such a development can generate new sources of income for the franchisor, it generally requires more money than it generates for an initial period which, depending on the market and on the growth strategy chosen, can often be from two to seven years or more.

Therefore, franchise expansions into new markets require that the franchisor have sufficient capital available over and above what will be generated from the expansion.

The short and long term budgeting and planning of any franchise expansion are key to its eventual success. The franchisor should also provide, in the preparation of its expansion budgets, for some cushion to take into consideration the delays and problems which will inevitably be encountered from time to time.

5.4. LACK OF KNOWLEDGE OF WHAT IS REALLY HAPPENING IN THE TARGET MARKET

Another cause of failure is the fact that the franchisor has not been properly and timely informed of what is really happening in the target market.

In those instances, the franchisor may be relying solely on the information received from its prospective franchisee, area franchisee, area developer, master franchisee or joint venture partner as to the depth and viability of the target market and adaptations which might be required to improve the chances of success.

Unfortunately, as a source of information, a franchisee, an area franchisee, a master franchisee, an area developer or a joint venture partner is not completely impartial nor independent.

Initially, this factor does not seem to be important but, in the long run, if the franchisor does not have a correct picture of the target market, problems develop, are not properly resolved and accumulate to the point where the development of the franchise system finally fails.

5.5. POOR CHOICES REGARDING THE EXPANSION VEHICLE AND STRUCTURE

There are many expansion vehicles which can be chosen to expand a franchise system and, within each, there are different structures which are each more or less advantageous for a franchisor's situation.

The issues in choosing the most appropriate expansion vehicle and the structure are too often overlooked or dealt with in a summary fashion, with catastrophic consequences.

For example, until recently, master franchising was the most popular mode of franchise expansion into new markets. However, there are several weaknesses in this expansion vehicle, which have resulted in failures, particularly in regard to inter-provincial expansions and expansions in the United States.

Joint venture arrangements and area development arrangements, which have been used more frequently in recent years, have distinct advantages for franchisors who do not wish to open corporate stores or grant individual franchises in the new market.

When an inappropriate expansion vehicle or structure has been chosen, it is very difficult, after the development has begun, to modify or replace it.

**5.6. POOR CHOICES OF FRANCHISEE/AREA FRANCHISEE/MASTER FRANCHISEE/
AREA DEVELOPER /JOINT VENTURE PARTNER**

Finally, but not least of all, a poor choice of franchisee, master franchisee, area franchisee, area developer or joint venture partner is one of the (if not the) most common cause of failure of a franchise expansion.

In many instances, it is not the franchisor who has chosen the party to expand the system into the new market. Instead, the franchisor has been approached to expand the franchise system in that party's market.

In either case, the franchisor has to make the necessary efforts and has to take enough time to properly evaluate the prospect in order to ensure that he is the right person to work with the franchisor for the development of the franchise system in the new market.

The evaluation and selection of the right party takes time, requires research and many discussions and may also require that the prospect work in the franchisor's offices and/or in one or several franchise units for some period of time, before a final decision can be made by the franchisor.

6. **PLANNING FOR SUCCESS**

As with any important business decision, the expansion of a franchise system requires a great deal of planning and, in most instances, the assistance of competent advisors with experience in undertakings of this nature. The following are some of the steps which might help a franchisor make the right decision in this regard (the decision not to expand being sometimes the right one) and to implement its expansion strategy to maximize the chances of success.

6.1. **LEARNING ABOUT YOUR TARGET MARKET**

Whether you are approached by an eventual franchisee, master franchisee, area franchisee, area developer or joint venture partner or whether you decide by yourself to look more closely at the possibility to expand your franchise system into a new market, you first need to learn about the market. You need third party, reliable and objective information other than from the party who will do the expansion.

There are now more and more reliable sources to get information on almost every market in the world and a competent franchisor should use all the means

necessary to learn and understand the differences of the new market as compared to the markets already penetrated by the franchisor.

The sources of information which are now readily available to learn about a market include, without limitation:

- Trade associations;
- Franchise associations;
- Governments;
- Governmental bodies and agencies collecting statistics;
- Embassies and consulates, both in the franchisor's own country and in the prospective market (which offer many useful services unknown to many franchisors);
- Foreign trade departments;
- Banks;
- International accounting firms;
- Websites;
- Products and services suppliers;
- Last, but not least, trips and visits by the franchisor's principals to the target market in order to see, first hand, how things work there.

Creative franchisors can find many other ways to get pertinent and useful information on a target market.

This step is too often overlooked or dealt with in an insufficient manner. It has also certainly been one of the causes of failures of many franchise expansions.

6.2. REVIEW OF THE LAWS AND REGULATIONS WHICH MIGHT AFFECT THE SYSTEM IN THE TARGET MARKET

In many markets, specific laws and regulations apply to different sectors within the market.

A franchisor should learn well in advance, and certainly before signing any agreement (whether a letter of intent, an offer or any other agreement), about any such laws and regulations which might be applicable to the development and operation of its franchise system.

For example, in the Province of Quebec, certain sectors of activities, including drugstores, opticians, travel agencies, real estate brokers, insurance agencies, etc., are subject to laws which are different than those of the other provinces and may cause some concerns to any franchisor wishing to expand into Quebec.

Knowing these applicable laws and regulations in advance might, in some cases, prevent the expenditure by the franchisor of substantial amounts of money in trying to develop a franchise system which does not or cannot comply.

Advance study of the laws and regulations which may apply to the development and operation of its franchise system in a target market will allow the franchisor to adapt its franchise system or decide that the expansion is impractical.

6.3. PRELIMINARY RESEARCH

Depending upon the type of business being franchised, research may be required on various topics including:

- Present economic situation and trends;

- Sales' statistics in the franchisor's sector of activities;
- Known and foreseeable market trends;
- Availability of potential franchisees having the necessary qualifications and financial resources;
- Direct and indirect competition;
- Availability of adequate sites meeting the franchisor's standards;
- Availability of prospective and competent suppliers (including in regard to the designing and construction of the franchised units, and for the furniture, improvements, equipment, accessories, technology and inventory).

Such preliminary research should assist the franchisor in determining the feasibility of an eventual expansion and in evaluating the associated risks and costs.

6.4.MARKET RESEARCH

If the results of the preliminary research are encouraging to the franchisor, before making a final decision, the franchisor should go a little further and have a competent firm in the target market complete some initial relevant market research.

This research should enable the franchisor to know more about the target market, to decide on its initial expansion strategy and to choose some specific areas in which to begin its expansion.

6.5.CHOOSING THE RIGHT AREA FRANCHISEE / MASTER FRANCHISEE / AREA DEVELOPER /JOINT VENTURE PARTNER

If a franchisor decides to work with a third party, whether it is a master franchisee, an area franchisee, an area developer or a joint venture partner, for the purpose of the expansion of its franchise system in a new market, it will have to take the necessary time and make the necessary efforts to chose the right person.

This rule applies even in the case where the expansion process has been initially triggered by an approach made by this party.

This choice is one of the, if not the, most important factor in the success of any expansion of a franchise system into a new market.

The right decision in this regard will require, among other things, that the franchisor (a) comes to know and understand the prospect well, (b) thoroughly canvasses the prospects' objectives, values and strategies, (c) has the prospect work closely for some time with the franchisor's executives (whether at the franchisor's offices, or at a franchised unit) and, (d) ensures that the prospect has a workable business plan.

Also, a franchisor should make sure to obtain relevant background information about the prospect. Such information is generally available from financial institutions, credit agencies, accounting firms, trade associations, franchise associations, suppliers, consultants, lawyers, etc.

It is better to know in advance of any potential problems with a prospect than to learn, after the fact, that the prospect has a bad reputation, has been involved in unsuccessful businesses, or, even worse, has a criminal record.

6.6.PROTECTION OF INTELLECTUAL PROPERTY RIGHTS

With the rapid development of technology and communications throughout the world, more and more, we encounter situations where a franchisor's trade-marks or other intellectual property rights have previously been registered by third parties in one or several countries where the franchisor may eventually wish to develop its franchise system.

Therefore, it is important that, as soon as possible, a franchisor proceed, in any prospective expansion market, to complete the registrations necessary to adequately protect its intellectual property rights (more specifically, its trade-marks, its copyrights and its industrial designs (which are, in many countries, called design patents)) in order to be able to eventually use and license them to others.

Compared to the overall costs of an expansion, the costs required to complete such registrations are generally quite reasonable.

In addition to protecting the franchisor's rights in a timely manner, these registrations will also permit the franchisor to be informed well in advance of any eventual or potential problem in relation to the use and licensing of its intellectual property rights in a target market.

It has happened that the franchisor has waited after signing a master franchise agreement to register its trade-marks in the target market, only to learn then that they have already been registered by a third party. This has led to enormous expenditures to buy back the rights to the trade-marks in the target market and for lawsuits launched by master franchisees. The costs of settling these issues have far exceeded the costs which the franchisor would have had to incur to register its intellectual property rights from the beginning.

6.7.CHOOSING THE RIGHT EXPANSION VEHICLE

The traditional use of master franchising for franchise systems' expansions has proven problematic in many situations. Master franchising can really only work if the following criteria are met (a) the target market is unknown to the franchisor, far from the franchisor's offices and very different from the markets in which the franchisor is already operating, (b) if the master franchisee is already an established and well managed business in the target market, and (c) if the franchisor is also an established and well managed company.

In most other cases (including those in which the expansion is to take place in another Canadian province), the methods of structuring the development of a franchise system which might improve the probability of its success are, in no particular order of preference (a) a development by the franchisor itself (through corporate units or through the granting of individual franchises) with the assistance of one or several full time employees in the target market, (b) the granting of one or a few area development rights which, initially, should be granted only for relatively small, specific and pre-identified areas of the target market in which the franchisor desires to initially launch the expansion of its franchise system (instead of executing only one area development agreement for the whole market, which will leave to the area developer the choice of where the franchise system will begin its expansion within the target market), (c) the granting of one or more area franchise agreements, again for relatively small, specific and pre-identified areas in which the franchisor wishes to launch the expansion of its franchise system in the target market, or (d) a joint venture agreement between the franchisor and someone interested in taking an active part in the expansion of the franchise system in the target market and who has the necessary financial, technological and human resources, and the willingness and the expertise to do so.

There are many other ways to structure the expansion of a franchise system and, in any given situation, the franchisor, with its advisors, should carefully examine choices and choose the one that is the most appropriate.

6.8.COMPLIANCE WITH APPLICABLE LAWS

If the franchisor decides to go ahead with the expansion of its franchise system in any new market, any action required to comply with applicable laws will have to be undertaken in a timely manner in order to ensure that, at the time of launching the expansion, the franchisor, alone or together with another party, does not breach any such laws.

6.9.TRANSLATION AND ADAPTATION OF THE FRANCHISE AGREEMENTS AND DOCUMENTATION

The translation and adaptation of the franchisor's standard franchise agreement and related documentation should be done well before starting to look for development opportunities.

However, in some cases (like in the Province of Quebec), the translation of these documents may be delayed for some time if the franchisor desires to begin its development in areas where it is easy to find persons who can understand the franchisor's agreements in the franchisor's language (like, for example, in the Greater Montreal Area).

Whether the costs of such translation and adaptation are ultimately to be borne by the franchisor or the other party in the target market, the franchisor should always keep direct control over the adaptation and translation process and on the selection of the firm retained to complete such adaptation and translation.

6.10. PILOT OPERATIONS

Whether the franchisor decides to develop its franchise system by itself (through corporate units or by granting individual franchises) or with one or several area franchisees, area developers, master franchisees or joint venture partners, it should look at the target market in the same way that it looked at its initial market when it first launched its franchise system.

This means that the franchisor, alone or together with the other party, should initially open one or few corporate units and operate these for some period of time before starting to grant individual franchises and to expand more aggressively in the target market.

Experience has shown that, very often, there are differences between markets which cannot be detected by surveys or market studies alone. By opening test units the franchisor can (a) verify if the franchise system appeals to customers in the target market, (b) make any necessary adjustments to optimize the performance of its system in the market, (c) acquire some initial experience as to how the system will be perceived by both prospective franchisees and customers, (d) demonstrate its commitment and confidence to the development of its franchise system in this new market, (e) use these corporate units as showcases to facilitate the recruitment of franchisees, and (f) use these initial units as training facilities for new franchisees and their employees.

It is suggested that these initial units be operated for a period of at least six months to one year, with adequate and close monitoring of their operations, of their successes and of their shortcomings, before the franchisor, or its partner in this market, begins recruiting franchisees and developing the franchise system at a faster pace.

6.11. PLANNING THE DEVELOPMENT

As with any business expansion, careful planning in all the aspects of the franchise expansion will be an important factor in the success of the franchise system in the new market.

In this planning process, the franchisor should carefully consider the following:

- The allocation of a sufficient amount of time for the franchisor's principals to be actively involved in the decision making and implementation of the expansion strategy;
- The budgeting of sufficient resources (financial, technological and human) to maximize the probabilities of success of the expansion strategy;
- A close monitoring of all phases of the initial implementation and development of the franchise system in the target market;
- The appointment of a person (either an employee, a professional or a consultant), independent of the area franchisee, master franchisee, area developer and/or joint venture partner, who is physically present in the target market and who knows it well; whose mandate will be solely to (a) represent and promote the franchisor's interests in regard to the development of its franchise system in this market, (b) represent the franchisor in dealing with the area developers, area franchisees, master franchisees, joint venture partners, suppliers, contractors, consultants, etc., and (c) keep the franchisor informed on all aspects of the development of the franchise system in the target market.

6.12. **PUBLIC RELATIONS**

Before opening the first unit in any new market, it is advisable for a franchisor to conduct a public relations campaign to influence both prospective customers and prospective franchisees.

This public relations campaign should be repeated at critical stages of development in the new market.

6.13. **INITIAL DEVELOPMENT FOLLOW-UP**

Even if the franchisor has decided to expand with an area franchisee, master franchisee, area developer or joint venture partner, the franchisor should establish an effective support and monitoring system for the new market.

In many cases, it is advisable to appoint one of its employees to work regularly with the expansion party regarding all aspects of the development of the franchise system in the target market.

Until the party is fully capable, the franchisor should retain at least partial control over critical decisions regarding such things as unit franchisee and site selection. It is critically important that the first few units in the new market succeed.

7. **CONCLUSION**

The expansion imperative is an ever present reality for franchisors. How, when and where to expand a franchise system are challenging questions that need careful consideration and planning to address. Choosing the right expansion vehicle for the system can be crucial in determining the success or failure of an expansion initiative. Expanding too soon in the system's evolution or too quickly can stretch the franchisor's resources to the point that the franchisor cannot properly support the franchisees. Taking on too distant or too different markets can wreak havoc on the image and bottom line of a franchisor.

It is easy to fail and it is easy to succeed. The difference between the two is often the degree of planning and research the franchisor is prepared and able to do before an expansion initiative is undertaken. Insufficient commitment of resources and time from the franchisor,

lack of knowledge about the target market, and poor choices of an expansion party are some of the most common reasons franchise expansion fail.

While there are no guarantees of success, a franchisor can dramatically increase the chances of succeeding with the expansion by careful and thoughtful research and planning. There are lots of questions and issues and lots of answers and solutions.

TOR_LAW\6640934\1