OBA Franchising Law Conference:
Mastering a Recovering Economy

Critical Issues in Site Selection, Leasing and Development

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1. Introduction

A review of the franchise law materials in Canada and the US surprisingly reveals very little critical analysis of the issues surrounding site selection, leasing and development within a franchising relationship. This is curious given that multiple and often complex issues often arise in this seemingly neglected but important area of franchising.

As with many areas of franchise law and of the franchise relationship, the issues pertaining to site selection, leasing and development of a franchised retail outlet are largely governed by the need to manage the expectations of franchisees and to allocate responsibilities and risk as between franchisors and franchisees. Franchisors may attempt to manage these expectations and allocate responsibilities by addressing such issues in the operations manual or during initial training. However, franchisors are strongly advised to address such critical issues in their legal documents as well. Particulars as to who shall be responsible for site selection, lease negotiation and premises development should be set out in the franchise agreement and disclosure document. Given the inherent inequality of bargaining power that often exists in a franchise relationship, the fact that franchise agreements are deemed to be contracts of adhesion and the controls exerted by franchisors over their franchisees, it is essential that a franchisor consider the impact that its decisions may have upon its franchisees when it comes to these issues. Failure to do so may not only expose franchisors to claims of bad faith and litigation, but may also mean that franchisors are ignoring the very factors which often contribute to the success or failure of a franchised location.

2. Site Selection

The franchise agreement will often set out the terms and conditions for site selection and approval, including the time period for securing a site through a binding agreement to lease and for having the franchised business open and operating. First and foremost for consideration by the franchisor is which party is responsible for locating the site, the franchisor or the franchisee and, if the latter, the rights reserved to the franchisor to approve the location. Consideration must also be given to the remedies available to the franchisor, and perhaps to the franchisee, if the conditions for successful site selection are not met.

Among the myriad of disclaimers contained in a franchisor's typical franchise agreement and disclosure document is one intended to limit the franchisor's exposure from claims by franchisees that the franchisor's selected site was a significant and key factor in the failure of the franchisee's franchised business. In addition to such a disclaimer and to further limit their exposure, many franchisors will provide in their franchise agreements that their franchisees are responsible for selecting the site with the franchisors reserving the right to approve or disapprove the proposed sites. The agreement will often further provide that the franchisor will provide the franchisee with the franchisor's site selection criteria so that the franchisee is aware of and abides by certain parameters for the franchised location prior to it spending time and energy

searching out an appropriate location.

However, notwithstanding this onus for site selection placed upon the franchisee, many franchisors, particularly those with more mature franchise systems, will have in-house personnel responsible for locating suitable sites for franchised units or will use a real estate brokerage firm or site selection experts with an ongoing retainer to source suitable locations for the franchise system.

From a practical perspective, it makes sense for the franchisor, either directly or through its representatives, to take the lead in site selection. Aside from its foremost objective to establish a network of successful franchised units to expand the franchise system, it has the knowledge and experience for choosing a site which has the best chance of success based upon the operations of its existing corporate-owned or franchised locations. In addition, through its in-house real estate personnel or through its retained brokerage, a franchisor may become aware of impending future developments or be approached by landlords with available space. A franchisee, on the other hand, with little knowledge or experience, is by default largely if not wholly reliant on the franchisor for advice and direction. A franchisor intent on building a successful system will have the necessary demographic and other marketplace statistics needed to determine appropriate sites, while a franchisee will likely have to "scramble in the dark" to obtain this information before it embarks on its search for a suitable site. A franchisee may be further limited by any territorial rights granted to other franchisees of the franchisor or to the franchisee under the franchise agreement which limit the geographic area within which the franchisee can establish the franchised business.

Consideration must also be given to the remedies available to the franchisor and the franchisee if the conditions for finding a site are not met. Many franchise agreements will provide both parties an ongoing right to terminate the franchise agreement if a suitable site cannot be found within a certain period following execution of the franchise agreement. This option would also provide for return to the franchisee of the initial franchise fee paid, oftentimes with the franchisor able to retain a portion to reimburse it for costs and expenses incurred.

Although many franchise agreements do provide for the right of either party to terminate the franchise agreement if a suitable location is not found within a certain period of time following the entering into of the franchise agreement, this time period may be short and not extend beyond the franchisee's "honeymoon period" as a franchisee. This lack of available sites and the failure by the franchisor to approve proposed sites did lead to one of the first franchise class action suits in Ontario.

In 2005, a franchise class action claim was commenced on behalf of a number of Quiznos franchisees who had signed franchise agreements but were unable to secure sites for their franchised businesses, in some cases more than 4 years after entering into the franchise agreement. The franchise agreement provided that the franchisee secure a site not later than one year from the date of execution of the franchise agreement, subject to a possible 3-month extension, and that Quiznos approve the site in accordance with certain criteria and procedures. Among other things, the claim sought rescission of the franchise agreement, return of the deposit of approximately $30,000 paid by each of the class members which was made up of an initial franchise fee and a site and legal fee deposit fee, both of which the franchise agreement stated were refundable under the franchise agreement, and damages for lost income and lost opportunity. The claim alleged that, notwithstanding the terms of the franchise agreement, which gave the franchisee the authority and the obligation to secure a site, the franchisor assumed control of all aspects of the site selection and approval process. The action was ultimately settled prior to certification and the filing by the defendants of a statement of defence. Nonetheless, the action did serve as a wake-up call for franchisors to ensure that their franchise agreements accurately and properly reflect the

actual process employed for site selection. Further, franchisors should be hesitant to grant franchises without availability of suitable sites and realistic opportunities to secure satisfactory leases for the sites. In addition, franchisors should ensure that their disclosure documents properly disclose the procedure for site selection and approval and the risks involved if an approved site is not secured within a specified period.

Some franchisors who assume responsibility for locating and approving sites often have the franchisee execute a site selection agreement which authorizes the franchisor to, either directly or through its agents, take the steps to locate a site and, on behalf of the franchisee, enter into negotiations with the landlord for a lease. In many cases, this authorization is contained in the franchise agreement which obviates the need for a separate, stand-alone agreement. In any event, once an approved location is found and before the franchisor enters into lease negotiations, the franchisor is well advised to have the franchisee enter into a site acceptance agreement acknowledging its approval or acceptance of the location. Further, at least one of the site selection or site acceptance agreement should provide for a reimbursement by the franchisee of the franchisor's costs and expenses, including those of its real estate brokerage and legal fees, associated with the lease negotiations. Appendix 1 is a sample form of Site Acceptance Agreement.

Franchisors will often incur costs associated with lease negotiations and the construction and development of the premises. Particularly in the case of the construction of a free-standing building which will house the franchised business, significant costs can be incurred for architectural and other drawings, for building permits and other authorizations required for the construction and development. In some cases, drawings must be submitted to a number of municipal departments and then revised to meet different municipal requirements. In such event, the franchisors are well advised to require that the franchisee deposit funds with the franchisor, concurrently with the franchisee's acceptance of the site and execution of the site acceptance agreement. These funds are then available to the franchisors to draw upon when costs and expenses are incurred and the franchisors will not then be out of pocket if they are unable to negotiate a satisfactory lease or the municipality in which the franchised business is to be developed imposes conditions on the development which are not satisfactory or which would significantly increase the cost of development. Provisions for requiring this deposit of funds can be built into either the franchise agreement or the site acceptance agreement. Most importantly, each of these agreements should be included in the franchisor's disclosure document as agreements that the franchisee may be required to sign as part of the franchise grant.

3. Territory

Even where a specific site location is not determined at the time of the execution of the franchise agreement, the territory is more often than not specified within the agreement. This is because a prospective franchisee will inevitably demand an exclusive territory as it seeks some comfort from its franchisor that its territory will not be encroached upon by the franchisor or its franchisees. A franchisee is also (legitimately) desirous of knowing the general whereabouts of the proposed franchised location before it enters into the franchise agreement, and identifying a broader territory in which the retail site will ultimately be located, usually will satisfy a franchisee's demand in this regard. A franchisor will often similarly seek to define the contours of the applicable territory for each of its franchisees at the time of the execution of the franchise agreement. By doing so, a franchisor is thereby better capable of satisfying its franchisees' demands and is better equipped to determine which territories are in fact available for allocation to future

franchisees.

The extent of a franchisee's participation in the determination of the size and boundaries of a territory will vary depending on the franchisor's level of confidence in the franchisee to share such responsibilities and decisions. More often than not, franchisors will unilaterally determine the size of the territories to be allocated to their franchisees, as franchisors rightfully consider themselves better equipped in determining how best to carve up specific regions into the correct number of sustainable territories. A franchisor should be better suited than its franchisees in determining the number of territories within a region, provided that it has properly conducted the appropriate territorial modeling and on that basis, has determined the appropriate size and boundaries of a given territory.

In particular, a franchisor should be very careful not to give away so much territory that it will later regret having so restricted its ability to sell additional franchises. Granting too large an exclusive territory may not only be a serious impediment to a franchisor's growth plans, but could also cause neighbouring existing franchisees, eager for some of the business surrounding the boundaries of the larger territory, to initiate encroachment claims against the franchisee of the larger territory. This mistake of granting too large a territory is something that new and emerging franchisors all too often make when attempting to solicit their first few franchisees.

Similarly, a franchisor should be wary of providing so small a territory that the franchisee cannot generate sufficient sales to provide a reasonable return on its investment. A franchisor should make every effort to provide its franchisees with territories whose size and market can realistically provide a sufficient franchisee revenue stream. At the same time, any grant of an exclusive territory should obviously minimize the incentive to cannibalize other territories in close proximity.

Where a specific location for the franchise unit has not been determined at the time of entering into a franchise agreement, a franchisor should consider its disclosure document obligations when the location is finally determined. Is a franchisor then required to issue a new disclosure document which contains the particulars of the site, or would a material change statement suffice to satisfy the disclosure obligations? When dealing with retail franchised locations, a franchisor will also be offering its franchisee a lease or sublease upon determining the particulars of the specific site location. Given the foregoing and the definitions of "material change" and "material fact", some suggest that the recommended procedure in this scenario is for a new disclosure document to be provided to satisfy the disclosure obligations. There is a difference of opinion between the authors as to whether further disclosure is required once a franchise agreement has been entered into and whether the franchisee under that franchise agreement could be considered a "prospective franchisee" as defined under the Act for purposes of disclosure of the negotiated lease.

It is important to note that in addition to the general obligation to disclose all "material facts", franchisors must address specific disclosure requirements in the various franchise disclosure regulations regarding territory. In Ontario, for example, the franchisor is required to disclose the following:

- A description of any exclusive territory granted to the franchisee.
- If the franchise agreement grants the franchisee rights to exclusive territory, a description of the franchisor's policy, if any, as to whether the continuation of the franchisee's rights to exclusive territory depends on the franchisee achieving a specific level of sales, market penetration, or other condition, and under what circumstances these rights may be altered.
- A description of the franchisor's policy, if any, on the proximity between an

existing franchise and,

i. another franchise,

ii. any other distributor using the franchisor's trade-mark, service mark, trade name or logo or advertising or other commercial symbol,

iii. a franchise owned or operated by the franchisor that distributes similar products or services under a different trade-mark, service mark, trade name or logo, and

iv. a franchise granted by the franchisor that distributes similar products or services under a different trade-mark, service mark, trade name or logo.

Query whether a franchisor is required to have an actual, written policy before the obligation to disclose policy is triggered, or whether a verbal policy or a simple course of action or conduct would suffice to trigger this disclosure obligation. Given the importance attached to providing full, accurate and complete disclosure to prospective franchisees, it is recommended that franchisors provide a negative disclosure statement if no such policies exist. Franchisors should however voluntarily provide disclosures in their disclosure documents of any contractual rights that they may reserve in terms of territory to satisfy their general obligation to provide disclosure of all "material facts".

Franchisors should also carefully describe the contours and parameters of the territories licensed, preferably both within the franchise agreement and the disclosure document. There are several methods of identifying a territory – through maps, postal codes, census data, major roads and highways other geographic pointers such as rivers, lakes etc. Whatever approach is ultimately utilized, a franchisor should ensure that the territory is very clearly and unambiguously delineated in the franchise agreement, to avoid any dispute as to its boundaries at a later date.

Franchisors will often make the grant of an exclusive territory conditional upon their franchisees having met certain obligations in the franchise agreement. Failure to meet such obligations would then give the franchisor a right to eliminate or reduce the ambit of the exclusivity.

When granting exclusive territories, a franchisor should take significant steps to ensure that it is not encroaching upon the territories of existing franchisees. "Encroachment" is the term used when a franchisor directly or indirectly trespasses on the protected (i.e., exclusive) territory of a franchisee either by itself selling the system's products or services in that franchisee's territory or by allowing other franchisees to sell the products or services within such territory. Encroachment typically occurs when a franchisor sells or establishes a franchise close enough to an existing franchise, thereby negatively affecting the level of sales of both franchisees.

When a franchisee is granted exclusive rights to a given territory, this exclusivity provides the franchisee with a reasonable expectation and assurance that the franchisor and its franchisees will not encroach upon its territory by selling products or services to customers and potential customers within that territory. Even where no exclusivity is granted, a franchisee will occasionally expect that the franchisor will not deliberately compete with the franchisee.

Even where exclusivity to certain territories is granted, franchisors will often reserve various rights to themselves, which ultimately erode exclusivity to some extent. Because franchise agreements generally have lengthy terms, it is incumbent upon franchisors to foresee to the extent possible the various means of distributing products and services that they may ultimately wish to adopt years down the road. As such, franchisors will often reserve a right to distribute their products or services directly to

the ultimate consumers by utilizing various alternate means of distribution, such as the Internet or some other electronic or computerized ordering system, direct mail, mail order catalogues, telemarketing, infomercials and retail stores. In addition, franchisors may also wish to reserve certain rights to maintain direct relationships with national accounts (with or without incorporating methods of remunerating franchisees in such circumstances). Finally, franchisors will often also reserve the right to:

- Develop territories outside of those areas where franchisees have exclusive rights.
- Utilize marks other than those licensed under the franchise agreement, even within the exclusive territories.
- Purchase competing businesses within the exclusive territory.

Of course, some franchisors will not offer exclusivity to their franchisees and specifically reserve the right to sell the same or similar goods or services, either under the same or different trade-marks, anywhere within the vicinity of their franchisees. While encroachment is less of a problem in those systems, there are U.S. cases holding than an encroachment claim may succeed even where exclusivity is not granted to the franchisee, based on the implied covenant of good faith. In Canadian franchise disclosure jurisdictions, however, franchisees no longer need to rely on any such implied covenant of good faith to substantiate a claim of encroachment. The good faith and fair dealing provisions of the franchise disclosure statutes in Canada have bolstered allegations of encroachment as franchisees seek out additional grounds to support their claims of franchisor wrongdoing. Even in non-franchise disclosure jurisdictions, the common law duty of good faith and fair dealing has caught up with the statutory duties imposed by the franchise statutes.

Encroachment has traditionally been more of a problem for mature franchise systems than for emerging ones, as the former attempt to generate more sales from a market that may already be saturated. Mature systems often try to overcome the problem of saturation by one of three means:

1. expanding their systems internationally;
2. aggressively granting new franchises that directly encroach upon the territories of existing franchisees; or
3. seeking alternative channels of distribution or methods of expansion such as co-branding, drive-thrus, kiosks and Internet sales.

The issue of encroachment has not arisen often in the Canadian jurisprudence. However, the following court decisions offer lessons to franchisors in how best to avoid allegations of encroachment and accompanying disputes and lawsuits by their franchisees.

One of the early Canadian cases to deal with the issue of encroachment was technically not a franchise case; *Supermarche A.R.G.* v. *Provigo Distribution Inc.* dealt with the issue in the context of a wholesaler (defendant Provigo) who provided merchandise to a series of independent stores (the plaintiffs), pursuant to "affiliation agreements." Provigo required that the plaintiffs purchase 90% of its merchandise from it, not compete with it, and submit all advertising for its approval. Provigo changed strategies by opening a competing discount line of stores and marketed its products more vigorously through such stores to the detriment of the plaintiffs' stores.

The judgment in favour of the plaintiffs was appealed to the Quebec Court of Appeal. The Court agreed with the lower court on the issue of good faith; there was an

obligation under Article 1376 of the Civil Code of Quebec to perform contractual obligations in good faith. The Court would not go so far as to rule that Provigo could not undertake any activities that could have the effect of competing with the plaintiffs; however, through the affiliation contract, the defendant entered into a kind of partnership with the plaintiffs which "obviously restricts its right to free competition against that party." Furthermore, because of its obligation, the defendant was obliged to "provide its co-contracting party with the tools necessary to commercially counter the competition," which it did not. It failed to provide technical support and cooperation so that the plaintiffs' stores could adapt its methods and techniques to new realities in the market. As such, it was liable to the plaintiff for damages. The case was an early signal to franchisors that the duty of good faith would be a powerful ally to franchisees, even in the absence of express contractual provisions protecting them.

When it comes to exclusivity, another case illustrating the problems associated with a franchisor owning separate and competing franchises is *Flair Franchise Systems (1996) Ltd*. v. *Millebrook Investments Ltd*. The original franchisor had sold all its rights under the franchise agreements to the plaintiff, which also provided services to a competitor framing business. The defendant franchisee began to withhold royalty fees because of the plaintiff's support of the competitor, and the franchisor sought an injunction to prevent the defendant franchisee from continuing its operations. The Court held that the plaintiff could not meet the equitable test for an injunction because the plaintiff was indirectly competing with the defendant through its services to the competitor store, and by encouraging the defendant's franchise stores to move to the competitor. The plaintiff had failed to respect its contractual obligation not to compete with the defendant "in any way" and could not obtain injunctive relief. Indeed, the contractual provisions canvassed in the judgment seem only to protect the defendant franchisee in its arguments for exclusivity. The plaintiff could point to no language that clearly reserved its rights to service the competing business and could not secure an injunction.

In contrast, in *Simpson v. First Choice Haircutters Ltd.*, the language of the contract made clear the limits of the grant of exclusivity under the franchise contract. The applicant franchisee sought a permanent injunction to restrain the franchisor from operating haircutting shops under other names, arguing that the term "Shops" was to be given a generic meaning under the contract, thus broadening the grant of exclusivity. Farley J. made reference to the plaintiff's attempt to rely on the Ontario Act's provision regarding good faith, and its attempt to rely upon the doctrine of *contra proferentem*, but found that the matter could be simply resolved on the face of the contract itself. He approved the defendant's examples illustrating the absurdity that would result in giving a generic meaning to the term "Shops". Clearly the plaintiff's rights of exclusivity under the agreement were limited to the opening of other First Choice Haircutters franchises in the area; the contract did not preclude the defendant from opening haircutting shops within the territory under other names.

Despite the encouraging signs of *Simpson* that franchisors should be able to rely upon the four corners of the contract, the subsequent caselaw has made use of the concept of "good faith", often to the detriment of franchisors. These cases make even clearer the need for franchisors to draft carefully, and reserve its rights by using unequivocal language.

In *Shelanu Inc*. v. *Print Three Franchising Corp*. the Ontario Superior Court of Justice and the Ontario Court of Appeal had occasion to consider the issue of encroachment and its interaction with the duty of good faith under the Ontario Act. In that case, an existing franchisee of the Print Three franchise system made allegations of encroachment against its franchisor. The franchisee, Shelanu, argued that the franchisor's operation of a lower cost franchise system (under a different trade-mark

and brand, Le Print Express) was a breach of its duty of fair dealing and good faith and was considered to be "commercially unreasonable", contrary to the good faith and fair dealing provisions of the Ontario's franchise legislation. The allegation was made on the basis that the franchisor's newly introduced competing system was directly encroaching upon the franchisee's existing territory. The franchisee also argued that the newly introduced competing system was diverting valuable resources of the franchisor away from the franchisee and other franchisees to the detriment of the Print Three franchisees.

The Ontario Superior Court of Justice ruled in favour of the franchisee by stating as follows:

> It seems to me to be intrinsically troublesome for a franchisor to develop a concept for a new franchise operation that will operate in competition with its existing franchise operation…the establishment of such an enterprise by the very person who owned and controlled the defendant was fundamentally at odds with the defendant's obligations, including the obligation to deal in good faith, to its franchisees.

Though the Court found that the franchisor did unlawfully encroach upon the franchisee's territory, the Court stated that it would have ruled in favour of the franchisee because of the common law duty of fair dealing and good faith, even absent the statutory duty of fair dealing and good faith under the Ontario Act. In other words, the statutory duty of fair dealing under the Ontario Act did not create a new legal obligation of good faith, but simply codified existing common law principles.

On appeal to the Ontario Court of Appeal, Weiler J.A. held that, while the trial judge did not err in recognizing a duty of good faith at common law, he did err in finding that the franchisor had breached this duty to the franchisee. Weiler J.A. found it unnecessary to decide whether the Ontario Act was applicable, since acts in issue took place prior to the coming into force of the Act. Weiler J.A. concluded at paragraph 107:

> I would, therefore, hold that the appellant has met the high standard required to overturn a trial judge's finding of fact that Le Print Express competed with Shelanu and took business from it. My reasons for doing so may be summarized as follows: 1) the different nature of the business engaged in by Le Print Express; 2) Shelanu's delay in complaining about the establishment of that business; 3) the lack of evidence before the trial judge as to Shelanu's consequential loss of income; 4) the trial judge's findings that there had been no misrepresentation concerning what Print Three was to provide in exchange for royalty payments and that Print Three had done the minimum required to discharge those obligations; and 5) the trial judge's finding that the decline in Print Three franchises was primarily due to prevailing economic conditions. The finding that Print Three breached "reasonable commercial standards" must also fail for the same reasons.

Despite reversing the lower court's finding and allowing the appeal on the issue of encroachment, the Court of Appeal's decision does confirm that the Ontario Act merely codifies the duty of good faith in this context and that the common law principles apply as well.

Following Shelanu, there have been cases that have empowered franchisees to make use of the duty of good faith to win against franchisors in cases alleging lack of exclusivity. In *Katotikidis* v. *Mr. Submarine Ltd*., the Court relied on the trial level decision in Shelanu to once again confirm that franchisors owe a duty of good faith to their franchisees even absent the statutory duty of fair dealing under the Ontario Act. The Court in Katotikidis also awarded punitive damages to the aggrieved franchisee

whose franchisor encroached upon the franchisee's territory. The Court, in our respectful opinion, was in error in characterizing the franchisor-franchisee relationship as being "similar to a partnership". The Court erroneously elevated the franchised relationship to one of a partnership. This characterization has no basis in law. The existence of these precedents makes ever clearer the need for franchisors to clearly draft their agreements so as to retain their rights.

While such express reservations of rights may not necessarily overcome a franchisee's reliance on the common law or statutory obligation of fair dealing, the franchisor will still arguably be in a better position to defend its actions as it will be able to contend that the express provisions of the contract should prevail over any such duty of good faith. A franchisor could further argue that the Courts are obliged to give due regard to the reasonable expectations of the parties to the franchise agreement. After all, a franchise agreement is often negotiated, a franchisee is regularly encouraged to seek the benefit of legal counsel and it certainly does have the freedom to choose whether to enter into the contract, notwithstanding the often one-sided nature of franchise agreements. Franchisors should also not offer franchisees exclusivity as a right per se, but rather as a privilege that is contingent upon franchisees meeting or exceeding certain performance criteria. By emphasizing the fact that exclusivity is earned by, rather than owed to, their franchisees, franchisors may accomplish two separate objectives: providing incentives to franchisees to better their performance and allowing franchisors to pursue additional and alternative opportunities for expansion.

In addition, franchisors should develop encroachment policies whereby they would, for example, reserve the right to encroach upon the territories of their franchisees in return for financial compensation or the grant of other incentives to their franchisees. By implementing such encroachment policies, franchisors may assuage the concerns of franchisees and any prospective franchisees that they might be encroached upon, as the detrimental effect of encroachment may be adequately offset by the financial rewards or other incentives offered by the franchisor.

For franchise agreements that pre-date the World Wide Web, franchisors should address their Internet expansion plans with their franchisees before implementing any such Internet sales programs or other methods of distribution that may not have been contemplated at the time that the franchise agreement was entered into. Open communication with franchisees is a useful means of dealing with the possible objections of franchisees and pre-empting unwelcome litigation.

For example, a franchisor may find it prudent to explain to its franchisees that there are valid economic grounds to support alternate forms of distribution within an existing franchise network, notwithstanding the possibility that some of the existing territories may be encroached upon. One may argue that there are certain synergies at work when various channels of distribution work together to increase demand for a product or service. While encroachment may result, the franchisee may ultimately benefit due to increased exposure and a heightened awareness of the product or service. Instead of experiencing a reduction in the level of sales, encroached-upon franchisees may in fact witness an increase in demand due to broader awareness of the product or service. By conferring with their franchisees in advance of introducing a new channel of distribution, therefore, franchisors might avoid unnecessary conflict and litigation with their franchisees.

Both franchisee and franchisor may find themselves at a significant competitive disadvantage, moreover, if they are solely focused on avoiding the possibility of encroachment at the expense of a greater threat of a competitor system saturating the

marketplace with its outlets. That is, encroachment concerns, whether or not addressed by the franchise agreement, may cause the franchisees and franchisor to ignore the occasionally-larger concern of permitting or even encouraging the influx of competitive systems. So while balanced franchise agreements may prevent franchisees from being encroached upon by their franchisors, there are clear disadvantages associated with the strict enforcement of anti-encroachment policies. Encroachment policies, therefore, should be weighed against the prospect of inadvertently restricting system growth, impeding wider brand-name recognition and limiting the system's ability to saturate the marketplace with its products or services.

4. **Control over real estate - premises lease options and advantages & disadvantages**

For franchised businesses which operate out of a retail or commercial location, the franchise agreement should set out the means of securing leased premises. It is important that the franchisor have rights to the premises from which the franchised business is operated in order to maintain the goodwill of the brand in the local market and to permit continuity of operation of a franchised business upon termination of a franchise agreement.

The most advantageous arrangement for a franchisor to achieve such objectives involves the franchisor becoming the tenant under the lease and subletting the premises to the franchisee. The benefit of this arrangement to the franchisor is that it permits the franchisor all of the remedies available to a landlord under a lease to terminate the sublease and re-enter the premises upon breach of the sublease or franchise agreement. The franchisor is then in a position to continue to operate the business, either as a corporate-owned unit or as a franchise with a new franchisee. It also precludes a franchisee or a third party assignee of the lease from operating a competing business from the premises and capitalizing on the franchise system's goodwill in the local market area. In addition to retaining control over the premises upon expiry or non-renewal of the franchise agreement, the franchisor is in a better position to monitor the financial health of its franchisee and will become more quickly aware of financial problem experienced by the franchisee, rather than having to rely upon a notice of default from the franchisee's landlord. Finally, the franchise agreement and sublease should provide for cross-default, entitling the franchisor to take steps under either agreement arising from a default under either of them.

One of the disadvantages to this arrangement is the assumption by the franchisor of ultimate responsibility for the lease obligations. The franchisor may not want to assume the contingent liability associated with the franchisor being party to the lease, which may negatively affect the franchisor's financial statements, nor the obligation to step in and pay rent if the franchisee/subtenant does not. Some of these risks can be reduce by having a company that is affiliated with the franchisor, rather than the franchisor itself, enter into all leases for the franchise system.

The next best option for a franchisor is to have the option to assume possession of the premises upon termination of the franchise agreement or where the landlord is in a position to terminate the lease. Under this arrangement, referred to as a conditional or collateral assignment of lease, the franchisee contacts directly with the landlord for leased premises with the lease containing certain provisions pursuant to which the franchisor has the option of assuming the lease upon the termination of the franchise agreement or upon notice from the landlord that it will be terminating the lease. A collateral assignment of lease right requires either that the franchisor or its affiliate, sign the lease in order to assume the benefit of these provisions or the franchisor, franchisee and landlord enter into a three-party agreement which sets out the rights of the

franchisor to assume the lease, at its option. The collateral assignment agreement often also contains provisions which entitle the franchisor to receive information from time to time on the status of the lease and oblige the landlord to copy the franchisor on any notice of default given by the landlord to the franchisee. Although in this arrangement the franchisor does not have available to it landlord-type remedies to re-enter the premises or to terminate the lease, it does not carry the lease liability on its balance sheet yet maintains some control over the premises by way of its option to assume the lease in the circumstances described above. Sample conditional assignment provisions are set out in Appendix 2.

Whether the franchisor directly contracts with the landlord for the lease premises or uses a collateral lease assignment mechanism, the franchisor has an interest in ensuring that the terms of the lease are favourable to the franchisee, so that the franchise unit has the best chance to be successful and, in the event of a breach by the franchisee, the franchisor or another franchisee assumes the lease upon termination of the franchise agreement.

Accordingly, even in those situations where the franchisee enters into the lease directly with a landlord, the franchisor may want to assume the right to negotiate the lease with the landlord on behalf of the franchisee. Particularly with more established systems, the franchisor will typically have greater access to more favourable locations and will have greater bargaining power to negotiate favourable lease terms. The franchisor will likely also be more knowledgeable regarding what provisions are essential or fundamental to a lease within its franchise system. These provisions can include exclusivity rights, rights to sublet the premises without landlord consent, restricting the right of the franchisee, as tenant, from negotiating amendments to the lease without the franchisor's consent, and provisions regarding the design of the premises.

In order to avoid any claim by the franchisee that the lease negotiated by the franchisor was detrimental to the franchisee's interest, the franchisor should obtain the franchisee's consent and authorization to negotiate the lease on behalf of the franchisee. This form of authorization can either be contained in the franchise agreement or be set out in a separate agreement to be executed by the franchisee either concurrently with the franchise agreement or upon selection of the proposed premises for the franchised business. This authorization should also provide that the franchisee will reimburse the franchisor for the costs and expenses incurred by the franchisor in connection with the negotiations. Terms for authorization to undertake the lease negotiation are included in the Site Acceptance Agreement attached at Appendix 1.

Finally, if there is a lease or offer to lease in place for the premises, the disclosure document or statement of material change should include a copy of the lease or offer to lease and set out the essential terms including the initial term of the lease and any renewal rights, base and additional rent amounts and any tenant allowance that may be payable in connection with the construction and development of the premises.

5. Options for Build-out of Franchised Unit and Development of Franchised Unit

There are two basic approaches to site development. Franchise agreements will often outline one or both of the following two possible ways of addressing the build-out of a franchised unit:

(a) franchisee is required to construct its own unit. This option is more rarely provided to franchisees for the reasons enumerated below; and

(b) franchisor undertakes the construction and development of the unit for and on

behalf of the franchisee.

Each approach has its advantages and disadvantages. A franchisor that constructs the unit itself often does so because it has the experience and knowledge and in order to:

a) maintain control over the manner in which the unit is constructed, to ensure that its specifications and those of the landlord and all applicable governmental bodies are more readily and precisely met. By utilizing and managing its own appointed trades people, a franchisor is in a better position to exert its control over the process;

b) control the costs associated with the construction process;

c) obtain the full benefit of any leasehold improvement allowances, rebates or commissions earned during the construction process; and

d) ensure that the project is encouraged and then completed in a timely manner.

A franchisor that wishes to maintain control over the construction process needs to consider the following disadvantages associated with so doing:

a) the need to exert more time and to dedicate more of the franchisor's personnel to the project, since franchisor representatives supervise and manage the construction process;

b) potential exposure to liabilities which may arise during the construction process or even thereafter with each of the landlord, the franchisor's trades people and suppliers and governmental authorities, for example liability for errors, omissions or discrepancies and claims of faulty workmanship in the construction; and

c) if the franchisee is dissatisfied with the work undertaken by the franchisor or if the franchisee is required to incur additional and unexpected expenditures as a result of cost overruns in the construction process, this dissatisfaction and resentment may carry forward during the balance of the relationship with the franchisor and poison the relationship from the outset.

It is also essential that all applicable agreements and other evidence of the franchisee's ultimate responsibility for the construction, development and operation of the franchised business are in place. Often, a lease is entered into for premises within a new development to be established, but the premises is not often fully constructed until a significant amount of time has passed following the execution date of the lease. Owners of development properties often will want to ensure that their proposed new developments are fully leased before seeking site plan approval. Furthermore, and particularly with the construction of a free-standing building, common for many full-service restaurant systems, extensive modifications may need to be made to the franchisor's standard plans in order to accommodate the particular specifications of the leased premises and the requirements of the landlord and municipality in which the building is to be constructed. As a result, significant time will have passed and substantial funds will have been invested before the "shovel hits the ground" for construction. Additionally, the cost of construction can increase over this passage of time and the specific design of the franchised business may also change if during the period the franchisor re-invents or re-images the system to the public.

To illustrate the significance of providing full disclosure with proper disclaimers

regarding the extent of the possible investment to be made by the franchisee, it is quite conceivable that years could pass between the signing of a franchise agreement and the commencement of construction of, say, a free-standing full-service restaurant. Furthermore, bankruptcy of a landlord could disrupt and delay construction or development of the franchised unit pending administration of the bankruptcy and the sale of the land. Although the franchisee may not be obliged to remain at the premises, it will have incurred significant costs, which will be thrown away if it decides to re-locate (assuming it has that option). If the franchisor's disclosure document accurately disclosed that the estimated initial investment was merely an estimate and if the franchisee executed all necessary documents authorizing the franchisor to negotiate the lease and undertake all requirements for construction on the franchisee's behalf, the franchisor will not be liable for any of the lost costs and expenses. Furthermore, if the franchisee deposited initial construction funds with the franchisor, the franchisor would at no time be out-of-pocket for the lost costs.

Where a franchisor requires or permits a franchisee to construct its own unit, the franchisor will often oblige its franchisees to construct the unit utilizing the franchisor's prototypical architectural and design plans and specifications (the "Plans") and certain designated contractors and suppliers. Whether franchisor or franchisee constructs the unit, the franchisor should be committed to ensuring that the unit is constructed in a manner that reflects the trade dress of the franchise system (eg. use of designated signage, menu-boards, if applicable, and the total image and overall appearance of the unit) and otherwise meets the franchisor's and the government's minimum requirements in terms of health, safety, design, equipment standards, construction guidelines, plans and specifications.

It is important to note that the landlord may require use of its own contractors and may impose certain of its own particular design and build-out specifications. In such circumstances, the parties should carefully examine the specifications to ensure compliance. Landlords however will more likely require that they approve the tenant's Plans in advance of any work being conducted. As a result of the possible exposure that a franchisor may have in respect of the construction process, it is important for it to secure adequate and suitable insurance and an indemnity from its franchisees for any losses due to faulty workmanship etc.

Often a franchisor will require that its franchisees use the franchisor's Plans when constructing their units. At the same time however, a franchisor will require its franchisees to acknowledge in their franchise agreements that the plans do not constitute a representation, warranty or guarantee that they are accurate or free of error. A franchisor should not be held accountable if the plans cause damage to its franchisee, even where the franchisee has strictly followed the specifications and all applicable laws. A franchisor should also disclaim any representation or warranty as to suitability of the leased premises or that the work to be conducted in accordance with its plans will meet the franchisee's needs, notwithstanding that the plans have been reviewed or approved by the franchisor.

A franchisor may, however, be exposed to a bad faith claim in this scenario. For example, a franchisee may object to following the plans out of concern for, say, a design flaw which it brings to the franchisor's attention. In this case, it would be questionable whether the franchisor could successfully rely on and enforce the above-noted acknowledgment. If, however, the franchisor has an honest and reasonable belief in the integrity of the design, and it turns out after the fact the design had problems not reasonably foreseeable, the franchisee may not necessarily have a valid bad faith claim against the franchisor. This is because the franchisor had no reason to believe that there would be a problem, though it refused to warrant the result and it put the franchisee on

notice to do its own due diligence and assume the risk. Franchisors are nevertheless well advised to require that their franchisees conduct their own due diligence in advance of implementing the Plans and to specify this clearly in the franchise agreement and disclosure document.

Following written acceptance by a franchisee of the franchisor's Plans, a franchisor should require that its franchisee provide proof satisfactory to the franchisor that the franchisee has:

- Scheduled milestone dates for completion of the various components of the unit's development so as to better monitor and manage the progress of the project.
- Acquired letters of good standing from the Workers Compensation Board.
- Obtained the landlord's approval of the Plans and paid all design review fees to the landlord.
- Secured all necessary insurance in accordance with the terms of the franchise agreement and lease.
- Obtained all required licenses and government approvals to offer and sell the system's products at the outlet; special attention should be given to obtaining the necessary licenses to sell alcohol (if offered by the franchisee), and both parties should recognize the lengthy timeline involved in so doing.
- Obtained approvals from all authorities having jurisdiction for the work to be conducted including building, plumbing, mechanical and electrical permits.
- Purchased or leased only those brands or types of fixtures, furnishings, equipment and signage that the franchisor has approved as meeting its then current standards for serviceability, function, appearance, design, and performance.
- Promptly commence and diligently pursued construction of the unit using a general contractor appointed or approved by the franchisor.
- Provide to the franchisor, upon request, a copy of the construction contract and all supplementary agreements and invoices in respect of the construction of the unit.
- During construction, provide the franchisor and landlord with such periodic progress reports as may reasonably be requested.

In addition, a franchisor should reserve the right to:

- Conduct an inspection of the completed unit within a reasonable time after the date that construction is completed, to ensure compliance with the applicable build-out requirements. A franchisee is typically required not to open the outlet for business without its franchisor's written authorization, which will be conditioned upon franchisee's strict compliance with the franchise agreement.
- Assume control over the construction if the franchisor is unsatisfied with progress or otherwise.

- Make such onsite inspections as it may deem reasonably necessary to evaluate the progress of development of the unit.

- Undertake itself all or any part of the unit's development on behalf of its franchisee.

- do such other things as may be necessary to complete the unit's development should the franchise be construction unable or unwilling to do so.

In consideration of a franchisor providing such supervisory and project management services, the franchisee should pay the franchisor a development fee, the franchisor's related professional fees and disbursements, and all applicable taxes.

Under franchise disclosure legislation, the franchisor is required to include in its disclosure document a cost estimate to establish the unit. When providing such estimate, the franchisor should contemplate the possibility of design changes, cost overruns and delays during the course of construction. Such delays may considerably add to the cost of construction and increase the need for the franchisee to utilize its working capital to remain afloat during the delay. Given that one of the leading causes for franchisee failure is insufficient working capital, particularly in the first year of operation, it is important for a franchisor to include a realistic estimate of working capital requirement within the disclosure document.

Where a franchisor provides its franchisee with a turn-key build out, it typically requires that the franchisee enter into a construction management agreement. Where the franchisee is permitted to construct the unit itself, the franchisee is required to do so in accordance with franchisor's detailed specifications and to utilize the franchisor's approved contractors, trades and other suppliers. The franchisor should ensure that in this case too, the disclosure document be as detailed as possible regarding the requirements for construction and that the cost estimates are subject to appropriate disclaimers.

6. Concluding Remarks

Development of a franchised unit, on time and on budget, and that meets the expectations of a franchisee are critical to maintaining the trust that is at the core of establishing a successful franchisor-franchisee relationship. Accordingly, it is essential that the franchisor fully advise and obtain buy-in from the franchisee of all matters pertaining to the development of the franchised unit from the outset of the development process, from territory and site selection, finalizing the leasing arrangements, managing or completing the construction of the premises and through to preparing the unit for opening. The franchise agreement and disclosure document must, therefore, explicitly set out the parties' respective responsibilities for all aspects of the development process so that a unit can be established and readied for opening as efficiently and as soon as is reasonably possible following the execution by the parties of the franchise agreement. Where the franchisee is not fully aware of the development process, its expectations may not be properly aligned with the franchisor. Such non-alignment will surely bring only disappointment to the parties and possibly litigation.

Joseph Adler gratefully acknowledges the assistance of David Seevaratnam, Associate at Hoffer Adler LLP.

NOTE: Do NOT rely on the following precedents, as each situation warrants special consideration. The following is simply provided for illustrative purposes only.

Appendix 1

SITE ACCEPTANCE AGREEMENT

_______________________________ (the "Franchisor") and ____ (hereinafter referred to as the "Franchisee") are parties to a Franchise Agreement dated [ ], (the "Franchise Agreement") and desire to supplement its terms, as set out below. Capitalized terms not defined herein shall have the meaning given thereto in the Franchise Agreement.

1. The Franchisee hereby authorizes the Franchisor to negotiate the terms of a lease (the "Lease") for premises situate at _______________________________ (the "Premises") with the landlord thereof which Lease shall be entered into by the Franchisor or its Affiliate or by the Franchisee, as tenant, in the sole discretion of the Franchisor. The Franchisee hereby further authorizes the Franchisor to arrange for the preparation of architectural and other drawings for the Franchised Business, retain as required Geotechnical Engineers to conduct soils investigations, retain planning consultants and other professionals as required and make application for building permits and other authorizations as may be necessary or required for the Development of the Premises.

2. If the Lease for the Premises is entered into by the Franchisor, as tenant, the Franchisee shall forthwith following execution of the Lease, execute and deliver the Franchisor's standard form of sublease in respect of the Premises and shall comply in all respects with the terms and provisions of the Lease as if the Franchisee was a signatory thereto including without limitation paying to the landlord of the Premises any rent or security deposit payable thereunder and posting as security a letter of credit in such amount and on such other terms as may be required by the terms of the Lease.

3. The Franchisee hereby accepts the Premises as the location to establish and operate its [franchised business] pursuant to the Franchise Agreement and hereby acknowledges that it has conducted an independent investigation of the location of the Premises, the competition in the area surrounding the Premises and such other investigations and analysis as it has deemed necessary. The Franchisee acknowledges that he has not received, any representation, warranty or guarantee, express or implied, as to the potential volume, profits or success of the [franchised business] to be operated by the Franchisee at the Premises.

4. The Franchisee shall reimburse the Franchisor on demand for all costs and expenses incurred by the Franchisor in connection with and arising from all negotiations leading up to the execution of the Lease by the Franchisor, its Affiliate or by the Franchisee and for all architectural and other drawings, building permits and other authorizations required and hereby indemnifies and saves harmless the Franchisor or its Affiliate from all losses, costs, damages and expenses (including without limitation legal fees and expenses) suffered or incurred by the Franchisor or its Affiliate arising therefrom, whether or not such Lease is finalized and executed or the Premises developed.

5. This Site Acceptance Agreement shall be considered an integral part of the Franchise Agreement between the parties hereto and shall enure to the benefit of and be binding upon the Franchisor, the Franchisee and their respective successors and assigns. Any default by the Franchisee shall be deemed to be a default by the Franchisee under the Franchise Agreement

IN WITNESS WHEREOF, the parties hereto have duly executed this Site Acceptance Agreement this _____ day of _________________, 20__

Signed, Sealed and Delivered) [Franchisor]

in the presence of)

)

) Per: ____________________________

) I have authority to bind the Corporation

)

) [Franchisee]

)

) Per: ____________________________

) I have authority to bind the Corporation

Appendix 2

CONDITIONAL ASSIGNMENT PROVISIONS

(a) Notwithstanding anything to the contrary contained in this Lease, it is agreed that if the franchise agreement ("Franchise Agreement") dated the ____ day of __________, 201_ among the Tenant, ________________________ (the "Franchisor") and others expires or is terminated for any reason whatsoever, the Tenant's rights hereunder shall, at the option of the Franchisor, be transferred and assigned to it. This option may be exercised by the Franchisor giving the Landlord notice in writing within thirty (30) days following the expiry or termination of the Franchise Agreement, such notice to specify, inter alia, the date of such expiry or termination. The Tenant acknowledges and agrees that the Landlord may rely upon such notice and shall not be required to enquire into the due execution thereof or the accuracy of the statements set forth therein. It is further agreed that such notice shall, without further act or formality, operate as an effective assignment of the Tenant's rights hereunder to the Franchisor and the assumption by the Franchisor of the covenants herein required to be observed or performed by the Tenant. The Franchisor shall thereafter have the right to assign or sublet the Premises to a bona fide franchisee of the Franchisor without necessity of obtaining any consent thereto. Notwithstanding the foregoing, the Franchisor shall, forthwith upon the exercise of such option, execute such documents evidencing its agreement to thereafter keep and perform or cause to be kept and performed all of the obligations of the Tenant arising under this Lease from and after the time of the exercise of such option.

(b) The Tenant agrees that the Landlord may upon the written request of the Franchisor disclose to the Franchisor all reports, information or other data in the Landlord's possession in respect of sales made in, upon or from the Premises.

(c) The Landlord shall give written notice to the Franchisor (concurrently with the giving of such notice to the Tenant) of any default by the Tenant under this Lease, and the Franchisor shall have, after the expiry of the period during which the Tenant may cure such default, an additional fifteen (15) days to cure, at its sole option, any such default If the Tenant fails to cure any such default which will entitle the Landlord to terminate the Lease, the Landlord shall give notice thereof to the Franchisor and the Franchisor shall have the option of assuming the Tenant's rights under the Lease, as contemplated in Paragraph (a) above mutatis mutandis.

(d) The Landlord acknowledges that the Franchise Agreement contains a right on the part of the Franchisor, in the event of the expiry or termination of the said Franchise Agreement for any reason whatsoever, to enter the premises hereby demised and to operate the business for the account of the Tenant for a period as set forth in the said Franchise Agreement. The Landlord further acknowledges that such entry by the Franchisor shall not constitute an assignment of this Lease nor a subletting of the Premises.

(e) The Tenant and the Landlord agree that the premises hereby demised shall be used only for the operation of business carrying on business under the name & style ____________________.

(f) The Landlord and the Tenant agree that the Franchisor shall have the right from time to time to enter the Premises to make any modifications necessary to cause the Premises to conform with the standards and specifications of the Franchisor's franchise system.

(g) The Landlord and the Tenant agree that the Tenant may not sublease the Premises or assign its interest under this Lease without the prior written approval of the Franchisor.

(h) The Landlord acknowledges that the Franchisor is executing this Lease solely for the purpose of acknowledging the provisions contained in the foregoing clauses and agrees that such execution by the Franchisor shall in no way be construed so as to obligate the Franchisor for the performance of any of the terms, conditions, obligations and covenants contained herein except as specifically set forth in Clause (a).