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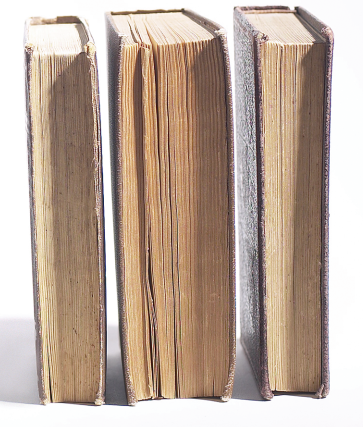

New Site Development

By Darrell Jarvis

When a franchisor decides to franchise a new location, it has a number of choices to make, wholly apart from its decisions as to where to locate the site and to whom to franchise the business.

On or Off the Head Lease

Franchisors generally identify their own sites and negotiate the business terms of the lease or offer to lease. In some instances, franchisees may come forward with sites to be developed (and this is particularly true of non-traditional sites, such as airports or hospitals, where the franchisee may have secured the rights to the venue). A franchisor will generally secure the site by entering into a lease or offer to lease with the landlord (and sublease the space to the franchisee) or it may allow the franchisee to enter into a lease directly with the landlord. It is worth noting that there are also many hybrid arrangements, such as the franchisor entering into the lease but having an option to later assign the lease to the franchisee and be released from the covenant (in some cases after a minimum period during which the franchisor must remain on the covenant) or the franchisee entering into the lease directly with the landlord but with the franchisor guaranteeing the obligations of the franchisee for a fixed period of time, usually on a declining balance basis.

The typical reason that franchisors enter into leases directly with landlords, as opposed to allowing the franchisee to lease the site, is to maintain control of the site. In the event that a franchisee fails to pay royalties and rent, it is generally regarded that the Franchisor will have clearer rights as landlord terminating the franchisee's sublease for non-payment of rent, than it would have acting as franchisor and terminating the franchise agreement for non-payment of royalties. Also, if the franchisor is on the head lease, once the franchisor removes the franchisee from the site, the franchisor can preserve the site in order to re-franchise and re-lease the premises to another franchisee (although it may have to deal with the franchisee's bank to obtain title to the equipment on the premises). The franchisor pays a heavy price for control of the site, however: if the franchisee's business fails, the franchisor is on the hook for all the rent and other amounts owing under the lease until the expiry of the term of the lease.

Alternatively, the franchisor may avoid committing to the lease and allow the franchisee to enter into the lease directly with the landlord. Under this scenario, the franchisor is not on the hook to the landlord for the rent under the lease in the event that the franchisee fails. However, the franchisor cannot exercise the remedies of a landlord if the franchisee fails to meet its obligations to the franchisor. Importantly, if the franchisee fails, the franchisor has no certainty that it will not lose the site to another brand. The franchisor can try to 'have its cake and eat it too' by permitting the franchisee to enter into the lease directly with the landlord, but securing "entry rights" for itself from the landlord.

Entry rights allow the franchisor, in the event that the franchisee defaults under the lease, to take over the franchisee's lease or require the landlord to provide the franchisor with a new lease for the balance of the term of the franchisee's original lease. Typically, in order to exercise those rights, the franchisor would have to pay to the landlord all of the franchisee's arrears and make good on any other defaults by the franchisee. Entry rights are usually either contained in a separate three party agreement (where the parties are the landlord, franchisor and franchisee) or they may be contained in the lease itself. If the entry rights are contained in the lease, the franchisor must be made a party (signatory) to the lease in order to be able to enforce the rights against the landlord (and the lease would indicate that the franchisor is executing the lease solely for the purpose of the entry rights and that it is not assuming any liability for the tenant's obligations under the lease).

Constructing the Franchised Facility

Once the site is secured (regardless of whether it is the franchisor or the franchisee on the head lease), the franchisor has fundamental choices to make in relation to the construction or 'fit out' of the franchised premises. The franchisor can agree to build the franchised facility for the franchisee (often referred to, correctly or incorrectly, as "turn-key") or the franchisor can allow the franchisee to build the facility itself.

Franchisor Builds ("Turn-Key")

The primary benefit to the franchisor in developing the franchised facility for the franchisee is to maintain control. The franchisor controls the quality of the construction and the adherence to the franchise system's design standards. Consistency of brand experience is a fundamental goal of most franchise systems, and the customers' experience often starts with the image and quality of the facility. When the franchisor constructs the facility, it also increases the franchisor's control of timing of the opening of the franchised business (although there will still be a number of uncontrollable factors). The earlier the franchised facility opens for business, the sooner the franchisor will start collecting revenue in franchise fees. Opening a facility on time may also be important in maintaining a franchisor's relationship with key real estate developers. Timing will also be particularly important to a franchisor with publicly-announced development goals. When the franchisor controls construction, it also makes it easier for the franchisor to make design changes during construction, if required.

Where the franchisor provides a turn-key facility, the franchise agreement may state that, notwithstanding that the franchisor is constructing the facility, the franchisor makes no representation or commitment to the franchisee as to the ultimate cost of the facility and no warranty as to the quality of the completed facility. The agreement will provide that the franchisee is to look only to the warranties provided by the contractor or suppliers (which warranties may be assigned to the franchisee).

However, when a franchisor delivers a turnkey facility to a franchisee, there will be no doubt in the franchisee's mind as to who to hold responsible for cost overruns, design flaws and construction deficiencies, despite the terms of the franchise agreement to the contrary. The franchisor may become embroiled in disputes between the franchisee and the contractor as to deficiencies and arguments as to what ongoing problems are warranty items (for which the contractor is responsible) or maintenance issues (that are the franchisee's responsibility). The franchisee will also have little interest in whatever events may have led to any cost overruns and look to the franchisor for financial contribution. Some franchisors will avoid constructing the franchised facility simply to avoid the conflict, if not the liability, and instead make construction of the facility the complete responsibility of the franchisee.

One hybrid arrangement is to have the franchisee execute the construction contracts directly with the contractor, and purchase equipment directly from designated suppliers, even where the franchisor is actually constructing the facility, in an effort to remove the franchisor from being in the middle between the franchisee and the contractor. The franchisor would have to be appointed the franchisee's agent under the construction contract in order to be able to direct the contractor, or the franchisor might rely on its overriding relationship with the contractor to have sufficient authority to direct him. If the franchisor is actually managing the construction, however, question whether this arrangement would change the franchisee's expectations as the franchisor's responsibility to deliver a functioning facility on budget and without defects.

Franchisee Builds

Where the franchisee builds the facility, the franchise agreement will provide that the franchisee will build to the franchisor's specifications, standards and designs. The franchisor may arrange for the completed plans for construction, or the franchisee will be responsible for retaining the architect (often the franchisor's architect) to develop the drawings for the franchisee's location, based on the franchisor's prototype drawings or design specifications, for the franchisor's approval. The franchisee will be responsible for obtaining the required permits. The franchisor will have a right of inspection during the course of construction, but the agreement will likely provide that the franchisor has no obligation or responsibility for detecting defects during construction. The franchisee will usually be required to purchase equipment either from the franchisor or from suppliers designated by the franchisor. In some cases, the franchisor will reserve the right to receive rebates from such suppliers based on purchases by the franchisee. In some cases, the franchisor may retain title to items of equipment (such as signage, trade-marked items or computer equipment) and lease them to the franchisee. The franchisor will determine, upon completion, whether the completed facility adheres to the franchisor's standards and specifications and will have authority to require the franchisee to remedy any defects or deviation from the franchisor's standards and specifications or from the approved plans. Usually the franchisee will be required to open the business within a fixed number of days following the completion of construction.

Without a doubt, where the franchise agreement provides that the franchisee will construct the facility, the franchise agreement will contain a number of provisions to provide some means of control for the franchisor, or to mitigate against the loss of control. The franchisee may be required to use the franchisor's designated architect and contractor (who will both be concerned with maintaining their goodwill with the franchisor). In more remote markets, however, the franchisor may not have a relationship with a contractor. The franchisor will have a right of inspection during the progress of construction and the right to require that any deviation from the franchisor standards and specifications be remedied or replaced. The reality, however, is that frequent travel to markets away from the franchisor's head office can be expensive (which can be overcome somewhat by the use of pictures taken by the contractor during construction) and requiring a franchisee to rip out a piece of completed construction can be expensive and a source of conflict. There is a view that because a franchisee is responsible for the cost of construction, the franchisee (and especially a franchisee with prior experience with the brand) will build the facility more cheaply and more efficiently than the franchisor. That view may frighten some franchisors who infer that the franchisee may cut corners or compromise the design in order to reduce costs.

Another hybrid structure requires the franchisee to construct the facility but provides the franchisee with the option to use the franchisor's project managers to manage the construction of the facility (at the franchisee's cost). The intention here would be to add a layer of control, or assurance of adherence to the franchisor's standards, without the franchisor taking on the financial responsibility for the cost of construction.

One determinant of whether the franchisor will provide turn-key construction to the franchisee, or require the franchisee to build, will be the extent of the franchisor's internal resources. A start up or smaller franchisor will simply not have the internal development resources to undertake multiple concurrent construction projects. On the flip side, a large institutional franchisee, especially one opening multiple brands in a non traditional venue (such as an airport, hospital or highway facility) will insist on managing its own construction, regardless of the internal resources of the franchisor.

In a perfect world, none of this would matter. In the real world, however, franchisors should carefully consider their options in structuring their approaches to site development.

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