

DISTRIBUTION NETWORKS AND AGREEMENTS

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DISTRIBUTION NETWORKS AND AGREEMENTS

by

Edward N. Levitt

PART 1: GENERAL COMMENTS

1.01 GENERAL PRINCIPLES AND SCOPE OF PAPER

There is virtually no aspect of modern commerce which is not directly or indirectly connected to one or another distribution method and, therefore, affected by distribution issues. Take for example a profession like law. The traditional law practice, with its focus on erudition, personal service and performance has given way to the "business" of law, with an emphasis on the distribution of legal services involving issues of marketing, branch offices, national and international law networks and even franchised law offices.

The most basic distribution method involves the direct distribution of a product or service by the manufacturer or originator, through its own facilities, by the efforts of its own employees. While there are many business and legal matters to consider in such a distribution method, the issues commonly dealt with under distribution law arise once the manufacturer or originator involves the efforts, capital and resources of a third party, who operates, to a greater or lesser degree, independently. This paper deals with the most common forms of distribution methods and networks involving such independent third parties. The focus will be on the documentation and issues that are integral to the creation, maintenance and regulation of the relationship through which the distribution is carried out. There are certain concepts that are common to many of these methods and some that are unique to each one. In either case, this paper will deal only with matters which are fundamental to the method or relationship discussed and will avoid any special considerations arising as a result of the distribution taking place within a specific industry or jurisdiction.

1.02 COMMON CHARACTERISTICS & ELEMENTS

There are certain fundamentals that are common to each method of distribution, which help to define the concept of distribution networks. To begin with there must be a grantor, or a person who is granting to another some bundle of rights. This might be a manufacturer who gives a distributor the right to distribute its products; a distributor who grants to dealers the right to subdistribute the same products; an owner of a patent or process who licences others to produce and market products utilizing the patent or process; or a franchisor who possesses various know-how and owns certain trade marks and licences franchisees to operate businesses under the trade mark, employing the know-how. There then must be a grantee who accepts the grant and the terms under which the grant is made. Although the degree of independence will vary in each case, the grantee is fundamentally a different entity than the grantor for a true distribution network to exist. Needless to say, there must be some material and usually monetary benefit for both parties. For the grantor, this can take the form of sale proceeds from the sale of products to the grantee, royalty revenue based on the revenues of the grantee or a license fee paid by the grantee to the grantor for the use of the bundle of rights. The grantee, in turn, takes these rights and exploits them in one business venture or another. Most often, the grantee is acquiring something in the bundle of rights which it cannot otherwise create or acquire on its own or cannot do so in a more cost efficient manner. While perpetual grants exist, it is far more common for there to be some finite term after which the grant ceases and the grantee must relinquish its rights. Even where the grant is perpetual, invariably there are conditions upon which the grant can be terminated, otherwise there would exist an absolute conveyance of the bundle of rights and a true distribution network would not exist. Beyond these basic elements, other than the imagination of the architect of the particular distribution network, there is no limit on the possible combinations and permutations that such relationships can contain.

Often the perception is that the grantor, being the owner of the bundle of rights, is the more powerful party and therefore in a better bargaining position. Certainly this is a common situation, but by no means always true. There are many instances where the grantee has been much sought after by the grantor and, consequently, able to acquire the rights on its terms. A good example of this situation exists in the case of a manufacturer seeking to distribute its goods in a foreign jurisdiction. The most capable distributor may very well have the upper hand in negotiating the terms of the distribution arrangement, because of its knowledge of the foreign market and its previous success in distributing other products or services in that market. When one considers the substantial investment of time, effort and capital at times required of grantees, it is understandable that they may be very demanding in their negotiations. Grantors, on the other hand, usually want to protect the underlying proprietary interest from which the rights flow, for others in the distribution network, as well as for themselves. These competing interests provide for a wide variety of arrangements and very diverse negotiating experiences.

1.03 THE ALTERNATIVE METHODS OF DISTRIBUTION

There are five principal methods of distribution involving third party networks: sales agents, dealerships, distributorships, licensing and franchising. Precise definitions are hard to come by in any attempt to distinguish these distribution methods. Often the differences are only semantic and the content of the particular agreement is the only true test for classification purposes. The author has chosen to classify documents under the appropriate heading according to the common commercial understanding of the purpose and usage of each one. In that regard, the following are the fundamental criteria used in this paper for discussion and classification:

SALE AGENTS: Agents whose sole purpose is to effect the sale of a product or service, who earn their remuneration to a greater degree based on performance, i.e. commissions, and who may be responsible for their own operating costs in the sale process, but who have no other substantial financial interest in the distribution process, i.e. transportation of goods, purchase of inventory, accounts receivable, etc.

DEALERSHIPS: Independent businesses, which purchase inventory as principals for resale to the enduser and which, while they may be required to have some characteristics in common with other businesses in the dealer network, essentially operate in their own individual style. While a dealer is identified as a business which sells certain products bearing the trade mark of the manufacturer, the dealer does not necessarily carry on business under the trade mark.

DISTRIBUTORSHIPS: Independent businesses, which purchase inventory for resale to other businesses, which will in turn sell to the end-user. The only common ground with other distributors of the same product is the product itself.

LICENSES: Licensing is the process by which one business shares with another business some intellectual property, know-how, method or image and permits the other business to utilize same for profit and in accordance with roles which vary widely from license arrangement to license arrangement. The licensor typically receives a payment for such permitted use based on the sales revenue of or number of units sold by the licensee.

FRANCHISES: A specialized form of licensing by which the franchisee operates as an independent business, but most often in a manner which is substantially similar, if not identical, to the franchisor and other franchisees in the system. Use of the same trade marks and other identifying characteristics by the franchisor and franchisees in the system is very common in franchising.

1.04 ADVANTAGE AND DISADVANTAGES OF EACH METHOD

Choosing one method of distribution over another always involves tradeoffs. In one extreme, by means of single company chain or branch operations, growth will be slower, require more capital and more distant markets will be harder to penetrate, but control over operations will be greater. In the other extreme, a franchise expansion allows for more rapid growth, utilizing the capital of the franchisee and allows for much broader geographical development, but control over the operations is much more difficult. The main

choices are: faster or slower growth, greater or lesser capital requirements, more or less control over operations and broader or narrower penetration of markets.

SALES AGENTS: This method of distribution cleaves off from the principal company only a portion, albeit an important portion, of the distribution process. The principal company will still have the majority of the burden to capitalize and administer the distribution business, for such things as manufacturing, inventory, storage, transportation and service. Although, depending upon how elaborate the sales effort is required to be, the establishment of a network of independent sales agents could have the effect of shifting a significant part of the financial burden from the shoulders of the principal company. This distribution method is very appropriate where the products can more easily be physically distributed from larger more centralized facilities. By establishing a network of sales agents, the principal company can get closer to its customers and their needs in a more cost effective manner and often expand quicker and more widely than if the sales effort were handled directly by it. The principal company will be able to maintain a high degree of control over the distribution process using this method. Frequently, the agent does not have the authority to bind the principal company.

DEALERSHIPS: A substantial portion of the capital burden in distributing a product is shifted from the principal company to the dealer, as the dealer will normally purchase its inventory and be responsible for sales and service. Marketing and advertising costs may be shared amongst the dealers and the principal company or taken on wholly by one or the other. However, the principal company loses much control over the distribution process, because the dealer typically has the only direct contact with customers and operates its business, to a greater or lesser degree, in its own fashion. This method would be considered as allowing more rapid and broader development of markets than direct distribution or distribution by utilizing sales agents. It could even be a more rapid growth mechanism than franchising, as dealers very often are already operating businesses and simply add on the new product to their existing lines.

DISTRIBUTORSHIPS: The manufacturer shifts the bulk of the capital and administrative burden of distribution to the distributor and concentrates on issues of production primarily. From the manufacturer's point of view, the next level of distribution, i.e. to dealers or to the end-user, is the responsibility of the distributor. This method is particularly appropriate where the products are to be distributed over a very broad geographical area and particularly where the markets are in different jurisdictions or countries. However, the rapidity and depth of growth within a particular market will very much depend upon the strengths and weaknesses of the distributor.

LICENSING: In its purest form, the owner of a patent, know-how or idea leaves the entire distribution effort to another. In this method, the owner has very little or no capital burden and very little or no control over the distribution process.

FRANCHISING: What are known as the traditional franchises or product franchises, in the petroleum, automotive and soft drink industries, more resemble dealerships under the terms of reference of this paper. Here, the term franchise is applied to the ubiquitous business format franchise so common in the fast food restaurant industry. In this arena, there is an attempt to shift a great deal of the capital burden of distribution to the franchisee, while attempting to maintain a high degree of control over the operations of each unit within the system. The reality is, however, that the control can never be as great as with a single company chain. Growth can be more rapid than with a chain expansion, but slows considerably, unless master franchising (discussed later in this paper) is employed, the further it goes geographically and particularly when jurisdictional boundaries are crossed. The franchisor risks the original business in a failed franchise expansion, in part because each franchisee carries on business under the same trade marks, but can achieve much broader and more lucrative distribution of its products or services if it succeeds. In recent years, franchising has been employed more and more frequently in the marketing of services.

1.05 THE REGULATORY ENVIRONMENT

There is a substantial amount of legislation throughout Canada relating to the distribution of goods and services to the consumer. It is beyond the terms of reference of this paper to deal with the relationship between the distributor and the consumer. By contrast, there is a paucity of legislation directly affecting the

relationship of the parties in the distribution methods dealt with in this paper. The Federal Competition Act, should be considered in the establishment of any distribution network, as it has potential ramifications in many aspects of distribution activities. If the distribution is to take place within a regulated industry, such as a profession, the securities industry, real estate industry, petroleum industry and others, the legislation which governs these activities should be reviewed and, where necessary, taken into account.

PART 2: SALES AGENCY AGREEMENTS

2.01 GENERAL COMMENTS

Any agreement can be made long and complex, depending upon the circumstances and/or the style of the person drafting it. Sales Agency agreements are not typically lengthy and complex documents. They most often focus on the authority the agent will have, the territory (exclusive or not) in which the agent will operate, the term of the agreement, the amount and payment of remuneration to the agent and what happens on and after termination.

2.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL SALES AGENCY AGREEMENT

The following is a discussion of a few of the key provisions commonly found in sales agency agreements.

APPOINTMENT: It is important to define the nature of the appointment of the agent. Typically, the agent will be looking for- the appointment to be for the widest geographical area and for the broadest range of products possible. The principal will want to ensure that the agent has not been overextended and that he can do an appropriate job within the area and with the line of products to which the appointment applies. Consideration should be given to new products the principal may introduce in the future.

EXCLUSIVITY OF APPOINTMENT: Depending upon the nature of the business and the particular industry, the need for the appointment to be exclusive to the apt increases the more the agent commits capital and resources to the development of the market. The agent will often want the exclusive to be for a very wide territory and continue for a long period of time. For the principal, it is difficult to know how extensive such exclusive territories should be and mistakes are often made by being too generous in the early stages of developing a market. The principal might consider tying the exclusivity to minimum performance criteria on the part of the agent.

TERM: Frequently, at the beginning of the relationship between a sales agent and the principal, everyone is uncertain about how long the relationship will last. As a result, the initial term is often short or terminable on short notice, i.e. 30 days. However, an agent who has represented the principal for a long time and built up valuable goodwill with his customers, has a lot at stake and may wish to ensure that termination can occur only after a notice period of sufficient length to allow the agent to make other suitable arrangements to replace the lost income.

STATUS OF THE AGENT: It is important to define the status of the agent, i.e. an independent contractor *or* otherwise, and to provide for any authority the agent might have, for example, to accept orders on behalf of the principal. While contractual expressions of independence are not determinate of the issue on questions of vicarious liability of the principal for the acts of the agent, they are definitely of assistance.

PART 3: DEALERSHIP AGREEMENTS

3.01 GENERAL COMMENTS

Reflecting the wide range of possible dealership arrangements, there is a considerable variety of dealership agreements in usage today. They can be simple and straightforward, like most sales agency agreements or they can approach the complexity and detail of a full blown business format franchise agreement. The most typical areas dealt with in this type of agreement are the territory (exclusive or not), the products, terms of the sale of products, marketing and advertising, service, quotas. the term of the agreement, the use of trade marks, events of default, and what happens on and after termination.

3.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL DEALERSHIP AGREEMENT

The following is a discussion of a few of the key provisions commonly found in dealership agreements.

APPOINTMENT: It is important to define the nature of the appointment of the dealer. Typically, the dealer will be looking for the appointment to be for the widest geographical area and for the broadest range of products possible. The principal will want to ensure that the dealer has not been overextended and that he can do an appropriate job within the area and with the line of products to which the appointment applies.

EXCLUSIVITY OF APPOINTMENT: Depending upon the nature of the business and the particular industry, the need for the appointment to be exclusive to the dealer increases the more the dealer commits capital and resources to the development of the market. The dealer will often want the exclusive to be for a very wide territory and continue for a long period of time. For the principal, it is difficult to know how extensive such exclusive territories should be and mistakes are often made by being too generous in the early stages of developing a market. The principal might consider tying the exclusivity to a minimum performance criteria on the part of the dealer.

TERM: Frequently, at the beginning of the relationship between a dealer and the principal, everyone is uncertain about how long the relationship will last. As a result, the initial term is often short or terminable on short notice, i.e. 30 days, although the term usually increases in tandem with the amounts of money and other resources the dealer is committing to the development of the market. In any event, a dealer who has dealt in the products or services of the principal for a long time and built up valuable goodwill with his customers, has much at stake and may wish to ensure that termination can occur only after a notice period of sufficient length to allow the dealer to make other suitable arrangements to replace the lost income.

OBLIGATIONS OF THE DEALER: The obligations of the dealer can be many and varied. Some of the more noteworthy ones are: to order products from the principal on a timely basis to facilitate production runs and minimize transportation costs; maintaining adequate sales, warehouse and service facilities; maintaining the appropriate level of service; keeping on hand a minimum inventory level; and purchasing a minimum amount of product annually.

STATUS OF THE DEALER: It is important to define the status of the dealer, i.e. an independent contractor or otherwise, and to provide for any authority the dealer might have, for example, to commit the principal to warranty repairs. While contractual expressions of independence are not determinate of the issue on questions of vicarious liability of the principal for the acts of the dealer, they are definitely of assistance.

TERMS AND CONDITIONS OF SALE: It is important to both parties that as many as possible of the terms and conditions of the sale of products by the principal to the dealer over the term of the dealership be settled in the agreement. However, by necessity, some terms and conditions, such as the price of products or carrying charges, cannot be fixed for long periods of time. In these circumstances, the objective would be to maintain a reasonable balance between certainty and flexibility. For example, the principal may be permitted to raise prices from time to time, but not too frequently and not above a given rate of increase.

NEW PRODUCTS: It is of interest to the deal to have the right or first right of refusal to market any new products or services of the principal in the territory. The principal may in fact want to require the dealer to handle all new products and services as they are developed or acquired.

ACCESS TO DEALER'S PREMISES: Although not usually requiring the level of control over the appearance of the business premises that would be the case in a franchise system, the principal in a dealer network may nonetheless want to have reasonable access rights to the dealer's premises to ensure that a minimum standard was being maintained.

WARRANTIES: It should be ascertained who will be providing service under warranty; the dealer or the principal. If it is to be the dealer, then the principal may wish to coordinate a warranty program among all dealers in the network to improve the level of service to customers and to be fair to all dealers.

PART 4: DISTRIBUTION AGREEMENTS

4.01 GENERAL COMMENTS

A distribution agreement resembles a simple dealership agreement in many ways. A pure distribution arrangement, like a simple dealership structure, is merely a continuing relationship between a purchaser and vendor of particular goods.

4.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL DISTRIBUTION AGREEMENT

The following is a discussion of a few of the key provisions commonly found in distribution agreements.

APPOINTMENT: It is important to define the nature of the appointment of the distributor. Typically, the distributor will be looking for the appointment to be for the widest geographical area and for the broadest range of products possible. The principal will want to ensure that the distributor has not been overextended and that he can do an appropriate job within the area and with the line of products to which the appointment applies.

EXCLUSIVITY OF APPOINTMENT: It is common for a distribution agreement to give the distributor the exclusive right to distribute the products or services of the principal within the stated territory. The distributor will often want the exclusive to be for a very wide territory and continue for a long period of time. For the principal, it is difficult to know how extensive such exclusive territories should be and mistakes are often made by being too generous in the early stages of developing a market. The principal might consider tying the exclusivity to a minimum performance criteria on the part of the distributor.

SUB-DISTRIBUTION: It may be that the distributor is given the right to establish sub-distributors. If so, the principal may wish to have a degree of control or influence on the selection and activities of the sub-distributors. Additionally, the distributor would want to provide for what happens to the subdistribution agreements on termination of the main distribution agreement, i.e. are they to be automatically assigned to the principal. Otherwise, it is common for distributors to sell to all manner of dealers in the products and services of the principal within the authorized territory only.

TERM: The distributor is often committing substantial financial and other resources to the development and servicing of the market for the principal's products and services within the authorized territory. Accordingly, most often a distribution agreement will have a fixed term of significant duration, with reasonable renewal terms.

QUOTAS: It is not uncommon to require that the distributor purchase a minimum amount of product each year and/or to require a minimum purchase volume be achieved before a renewal of the term is granted.

OBLIGATIONS OF THE DISTRIBUTOR: The obligations of the distributor can be many and varied. Some of the more noteworthy ones are: to order products from the principal on a timely basis to facilitate production runs and minimize transportation costs; maintaining adequate sales, warehouse and service facilities; maintaining the appropriate level of service; and keeping on hand a minimum inventory level.

STATUS OF THE DISTRIBUTOR: It is important to define the status of the distributor, i.e. an independent contractor or otherwise, and to provide for any authority the distributor might have, for example, to commit the principal to warranty repairs. While contractual expressions of independence are not determinative of the issue on questions of vicarious liability of the principal for the acts of the distributor, they are definitely of assistance.

TERMS AND CONDITIONS OF SALE: It is important to both parties that as many as possible of the terms and conditions of the sale of products by the principal to the distributor over the term of the distribution agreement be settled in the agreement. However, by necessity, some terms and conditions, such as the price of products or carrying charges, cannot be fixed for long periods of time. In these circumstances, the objective would be to maintain a reasonable balance between certainty and flexibility. For example, the principal may be permitted to raise prices from time to time, but not too frequently and not above a given rate of increase.

NEW PRODUCTS: It is of interest to the distributor to have the right or first right of refusal to market any new products or services of the principal in the territory. The principal may in fact want to require the distributor to handle all new products and services as they are developed or acquired.

WARRANTIES: It should be ascertained who will be providing service under warranty; the distributor or the principal.

PART 5: LICENSE AGREEMENTS

5.01 GENERAL COMMENTS

As in the case of dealership agreements, license agreements can be simple and straightforward or long and complex, governing many of the aspects of the licensee's commercial exploitation of the item being licensed. In its simplest form, a license agreement deals primarily with the licensor's remuneration for granting the license rights and passing on to the licensee the necessary information and know-how. When the license arrangement is more involved, it may also deal with such matters as the mode and standard of production, future improvements, territory, term, quotas and marketing. Due to the fact that the licensor's remuneration is often a function of the sales activities of the licensee, a license agreement will frequently allow for some financial monitoring process on the part of the licensor.

5.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL LICENSE AGREEMENT

The following is a discussion of a few of the key provisions commonly found in license agreements.

DEFINITIONS: Definitions can be quite important in a license agreement. The patents, products, licensor's specifications, and improvements among other things should receive fairly precise definition so that ambiguities and uncertainties can be kept to a minimum.

KNOW-HOW TRANSFER: Consideration should be given as to whether the licensor will undertake to transfer all his knowledge to the licensee about every aspect of the production, distribution and servicing of the products.

FRONT-END FEE: It is quite common for the licensor to require an initial payment for the licensee's rights to manufacture and market the products in the territory. The amount of this payment varies widely and does not lend itself to precise calculation in most situations. Of course, its size will have to bear some relationship to the revenues that can be generated by the licensee and should also reflect the cost to the licensor to transfer the know-how to the licensee.

EXCLUSIVE TERRITORY: In light of the fact that the licensee will likely be establishing a production facility, as well as a marketing and service capability, it is to be expected that the rights of the licensee in the territory will be exclusive for the term of the license agreement. However, exclusivity could be tied to reasonable performance criteria to enable the licensor to reenter the territory if it is being under developed.

TERM & RENEWAL: The length of the term of the license agreement is a function of the amount of money being invested by the licensee. The licensee will want a sufficiently long term to recoup his investment and earn a reasonable rate of return.

ONGOING ROYALTY FEES: Ongoing royalty fees are the lifeblood of any license system. They are usually payable periodically, such as monthly or quarterly, and are most often determined as a percentage of gross revenues or on a per item produced basis. It is not uncommon to see a minimum annual royalty in a license agreement.

RECORDS & AUDITS: Due to the fact that the licensor will likely be earning royalties based in some manner on the performance of the licensee, it is to be expected that the licensee will be required to keep comprehensive records and to make them available for inspection and audit by the licensor.

QUALITY CONTROL: A licensor will want the licensee to implement and follow a quality control system, to ensure consistency in the products. Periodic inspections and product sampling are an important part of many licensing systems.

INTELLECTUAL PROPERTY: Patents, copyrights and trade marks are all very important assets of a licensor. Accordingly, a license agreement frequently contains provisions by which the licensee acknowledges the licensor's ownership and agrees to use the intellectual property strictly as required by the licensor. The licensee, on the other hand, will want the licensor to covenant that no one else has a claim to the property and that he will defend the licensee's right to the use of the property. The ownership in improvements to patents is also frequently dealt with in license agreements and most often are stated as belonging to the licensor.

DEFAULT & TERMINATION: All license agreements must have clear and comprehensive default provisions. The consequences of default should also be thoroughly set out. Termination will be one of those consequences and the events to follow termination, such as repurchase of assets by the licensor and non-competition on the part of the licensee, should be dealt with. The licensee will also want to have the right to receive notice of the default, specifying how the default can be rectified and a reasonable time to cure it.

PART 6: FRANCHISE AGREEMENTS

6.01 GENERAL COMMENTS

Business format franchise agreements are usually the most complex and comprehensive of all of the agreements used in distribution relationships. Additionally, the franchise relationship requires the greatest number of ancillary documents such as subleases, security agreements and secrecy and confidentiality agreements. This complexity is necessary, because, in addition to the distribution issues in common with the other distribution methods, franchised units in the system are usually indistinguishable from franchisor owned units. As a result, the franchisor has a great deal at stake in maintaining the quality and appearance of the franchisee's operations.

6.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL FRANCHISE AGREEMENT

The following is a discussion of a few of the key provisions commonly found in business format franchise agreements.

THE PARTIES: For tax and liability reasons, the franchisee may wish to have the franchise granted to a corporation. Rarely, will a franchisor object to this approach, but will usually require the franchisee to personally guarantee the corporation's obligations, financial and otherwise, under all of the franchise documents. It is also advisable for the franchisor to exact a covenant requiring the individual to remain as the controlling shareholder. If the franchisee is to be a partnership, similar restrictions on the change of control of the partnership would be in order.

SITE: At times a franchisor will sell a franchise, without first having selected a site for the unit. If this is the case, the franchise agreement or a collateral agreement should ensure that the franchisee and the franchisor have a means of unwinding the transaction, in the event that an acceptable site is not selected within a reasonable period of time. In most situations, the franchisor must be satisfied, in his sole discretion, that the site is acceptable.

EXCLUSIVE TERRITORY: While it is not uncommon for a franchise agreement to provide for protected, exclusive territory for the franchisee, this approach is not mandatory. Some franchisors, particularly in the more mature franchise system, will not give the franchisee an exclusive area and will insist that the franchise is for a specific location only. However, it is important for a franchisee to have some assurance that another franchise in the system or a franchisor owned store will not be established in such close proximity as to draw customers from the market needed to support the franchisee's business.

When a franchise system is first being developed, it is difficult to know how wide such exclusive territories should be and mistakes are often made by being too generous with the size of the territories. Frequently, exclusive territories are defined by a stated radius from the business premises of the franchisee or municipal boundaries, however, it should be kept in mind that traffic patterns can be as important or more important than geographical areas.

TERM & RENEWAL: The length of the term of the franchise agreement is a function of the amount of money being invested by the franchisee. The franchisee will want a sufficiently long term to recoup his investment and earn a reasonable rate of return. Often the term of a franchise is from 10 to 20 years. However, there is a trend to shorter franchise terms, which parallels a similar trend in retail leases. It is advisable for the franchisor to split the desired franchise term into segments of say 5 or 10 years, with renewal provisions subject to specific renewal criteria. These criteria can give the franchisor the opportunity of ridding himself of a franchisee who is not in technical breach of the agreement but who may not have been abiding by the spirit of the agreement or the franchise relationship. On renewal, the franchisor can also reserve the right to adjust royalty and advertising rates or require a further franchise fee. On the part of the franchisee, it is most important that the renewal criteria be objective and reasonably attainable.

TRAINING: Both the franchisor and the franchisee have a substantial interest in the training process. The franchisee wants to learn all there is to know about operating the particular business and the franchisor wants to ensure that the right people are well trained to be operators in the system. The provisions of the franchise agreement dealing with training most often require the franchisee to participate in a specific training program and to complete the program to the satisfaction of the franchisor. In addition, the franchisor will want to have the right to require the franchisee and his staff to undergo periodic retraining. Usually, the franchisee is required to pay for travel and lodging costs, but there is no extra fee charged for the initial training. Of concern to a franchisee are training provisions which require the franchisee and/or his staff to travel on a too frequent basis to the franchisor's distant training centre for retraining.

CONSTRUCTION OF THE FRANCHISED UNIT: The franchisor must decide whether to allow the franchisee to build the franchised unit (usually in accordance with prescribed plans and specifications) or to require that the franchisor build for the franchisee on a "turnkey" basis. For some franchisors, this is an additional revenue centre. Often franchisors take on the responsibility to do such construction in order to assure consistency throughout the system. Ideally, the franchisor's greater expertise and buying power will enable him to construct the unit for the franchisee more cheaply than the franchisee will be able to do so on his own. From the franchisee's perspective, it is advisable, whether in the franchise agreement or by a collateral document, that the franchisor be required to state the construction price or formula for calculating it and to commit to the usual general contractor provisions, such as doing the work in a good and workmanlike fashion. It is also appropriate for the franchisor to provide customary warranties for work done and materials supplied.

TRADEMARKS: It is customary to insert provisions confirming the ownership by the franchisor of the system trademarks and regulating the use of the marks by the franchisee. The franchisee might want to see provisions whereby the franchisor agrees to defend and indemnify the franchisee from any action by others for infringement of the trademarks.

ADVERTISING CONTRIBUTIONS: A central concept in most franchise systems is the national or regional advertising pool. The franchise agreement usually provides that the franchisee will contribute to an advertising fund to be administered by the franchisor. The amount of such contributions will vary, but

most often are between 1 and 3% of gross revenue of the franchisee. In a newer franchise system, it might benefit the franchisee to have a provision whereby he is not required to contribute to an advertising fund until a minimum number of units are established in the system, and requiring franchisor owned stores to contribute on a *pro rata* basis.

OPERATING STANDARDS: Virtually all franchise agreements contain extensive provisions requiring the franchisee to operate the franchise strictly according to the standards and procedures set by the franchisor. Often there is a reference to the operating manual as the document which contains the operating standards and procedures which must be followed by the franchisee. All franchise systems change over time, if for no other reason than market changes and innovations in the particular industry. Accordingly, the franchisor has some interest in retaining the right to alter the system standards and procedures to accommodate such changes and innovations and to require the franchisees to abide by the new standards and procedures. A problem can arise, however, when the franchise system is new and the changes are too frequent and substantial, because the franchisor was not experienced enough in the first place to structure the business and the franchise system in the best way. The franchisee might want to consider an annual limit on the frequency and cost of such changes.

FRONT END FEES: The front end or initial franchise fees charged by franchisors are typically viewed as reimbursement of the franchisor for the cost of sourcing the franchisee, site selection, lease negotiations, training the franchisee and opening assistance or "hand holding" for the franchisee. Occasionally, there may even be an element of profit in the front end fee. The amount of this fee has to be decided with care and only after thorough financial analysis. As the system grows and matures and there is an increased demand for franchises, the front end fee can be increased. Frequently, the front end fee in new franchises is set at \$15,000 to \$25,000.

ONGOING ROYALTY FEES: Ongoing royalty fees are the lifeblood of any franchise system. They are usually payable periodically, such as monthly or weekly, and are usually determined as a percentage of gross revenues. Such fees should be sufficient to provide the franchisor with the desired return, while at the same time allowing the franchisees to prosper. The rate for such royalties can differ greatly from one franchise system to another, but are usually between 4 to 8% of gross revenues.

ASSIGNMENT: Some franchise agreements provide that the franchise is strictly personal to the franchisee and is not assignable to others. However, most often the franchisee is permitted to sell the franchise to others, subject to the franchisor's prior approval. The franchisee will want a provision requiring the franchisor to act reasonably in granting such approval. It is advisable for a franchise agreement to provide for a transfer fee to compensate the franchisor for the expenses he will incur on an assignment for training the assignee, executive time, lost revenue, as the assignee learns the business, and legal, investigative and accounting costs.

PURCHASES BY THE FRANCHISEE: Some franchise systems, by their nature, require that the franchisee purchase all inventory from the franchisor i.e. where the franchisee sells clothing produced under only the franchisor's label. In many franchise systems, the franchisees are required to purchase equipment from suppliers designated by the franchisor. Inventories and supplies are similarly required to be purchased from designated suppliers, but often the franchisees are permitted to purchase elsewhere subject to the approval of the supplier and the products by the franchisor. In this area, the franchisor's interest is to control quality and assure buying power for the system and the franchisee's interest is to be assured of a consistent and reliable supply network at reasonable prices.

DEFAULT & TERMINATION: All franchise agreements must have clear and comprehensive default provisions. From the franchisor's perspective, it is important to ensure that the franchise agreement and each ancillary document (i.e. sublease, security agreement) specifically provide for "cross default" provisions, whereby for example, default under the franchise agreement will be deemed default under the sublease. This will provide the franchisor with a greater number of available remedies on a default. The consequences of default should also be thoroughly set out. Termination will be one of those consequences and the events to follow termination, such as repurchase of assets by the franchisor and non-competition on the part of the franchisee, should be dealt with. The franchisor will often reserve the right to repurchase the

franchisee's business assets in order to more easily continue the operation of the franchised business at the particular location. The franchisee's concern will be that the formula chosen for valuing these assets is fair. The franchisee will also want to have the right to receive notice of the default, specifying how the default can be rectified and a reasonable time to cure it.

PART 7: MASTER FRANCHISE AGREEMENTS

7.01 GENERAL COMMENTS

The term "master franchising" is used to describe several different distribution relationships. Rather than attempting to define the term, it is better to have regard to the common characteristics of the business arrangements usually regarded as master franchises, which are as follows:

- a) The franchisor delegates one or more of his fundamental rights or responsibilities in the franchising process to another party (the "Master Franchisee"). For example, the Master Franchisee may be given simply the right to select and approve multiple sites to be operated by him or simply the right to select and approve other franchisees to operate individual units ("Unit Franchisees"). In the other extreme, the Master Franchisee may be granted the right to carry out virtually all of the responsibilities of the franchisor, including the right to subfranchise directly to the Unit Franchisees;
- b) The arrangement extends to a specified territory; perhaps a group of municipalities, a province, a state or an entire country, within which a number of outlets are to be established;
- c) The Master Franchisee has some ongoing involvement with the operation of the outlets in the territory. For example, the Master Franchisee may operate the outlets directly or be responsible for the supervision of the Unit Franchisees; and
- d) The Master Franchisee has some continuing benefit to derive from the operation of outlets in the territory, whether by way of revenues directly earned from operations or by sharing franchise fees and/or ongoing royalty payments with the franchisor.

While there are many different arrangements which qualify as master franchising, master franchises can be divided into one of two broad categories; those that permit subfranchising and those that do not. In the latter case, the agreement used is often referred to as a "Development Agreement". When subfranchising is permitted, the agreement is by necessity more complex, though there are common provisions found in agreements in both situations. Where there is subfranchising, matters get more complicated because there are three rather than two parties with a stake in the operation of the Unit Franchise.

7.02 COMMENTARY ON KEY PROVISIONS OF A TYPICAL MASTER FRANCHISE AGREEMENT

The following is a discussion of a few of the key provisions commonly found in master franchise agreements.

GRANT: The master franchisee is granted the right to "establish franchises in the territory". This may mean directly by the master franchisee or by others as subfranchises or a combination of both. If there is no right to sub franchise, the agreement, with the exception of a few provisions, like ones dealing with quotas on unit openings, would closely resemble an ordinary unit franchise agreement. The unique portions of a master franchise agreement deal primarily with issues surrounding sub franchising. A franchisor will commonly charge a substantial initial fee for the rights granted to the master franchisee.

EXCLUSIVE TERRITORY: A master franchisee is usually called upon to invest significant amounts of money and to commit a number of resources to the development of the franchise network in the territory. This, coupled with the complications which would arise if more than one master franchisee were

developing the system in the territory, typically results in the master franchisee receiving exclusive rights within the territory. However, it is not uncommon for these exclusive rights, if not the entire master franchise agreement, to be tied to performance criteria, such as total unit openings within stated time periods.

TERM & RENEWAL: The length of the term of the master franchise agreement is a function of the amount of money being invested by the master franchisee. The master franchisee will want a sufficiently long term to recoup his investment and earn a reasonable rate of return.

DUTIES & RESPONSIBILITIES: A franchisor has many duties and responsibilities in developing a franchise network. In a master franchise context, decisions have to be made as to the division of these duties and responsibilities as between the franchisor and the master franchisee.

Selecting franchisees: It will have to be decided who will have the final approval of new franchisees entering the system. Additionally, the cost of marketing franchises within the territory will have to be allocated, but most often it is the responsibility of the master franchisee.

Compliance with standards: Frequently, the master franchisee is responsible for ensuring that unit franchisee comply with the standards of the system. However, where for example the master franchisee's responsibilities are mainly in the area of franchise marketing, the franchisor may be the party in charge of enforcing the standards.

Training: The responsibility of training unit franchisees is as likely to fall to the master franchisee as the franchisor. Often, the franchisor will do the training in the initial stages of development. **Advertising:** The administration of any common advertising fund is also an issue to be decided and varies widely from one system to another.

THE UNIT FRANCHISE AGREEMENT: In the more established franchise systems, it is common to require that the unit franchisee will execute the franchisor's standard form franchise agreement; possibly adapted for the local laws, language and customs. In order to ensure control over the system in the territory in the event that the master franchise agreement is terminated or expires, the franchisor will want to either be a party to each and every unit franchise agreement or provide that the unit agreements will be assigned by the master franchisee to the franchisor upon the termination of the master franchise agreement.

REVENUE SHARING: There are three principal sources of revenue for a franchisor: initial franchise fees, continuing royalty fees and the sale of inventory and supplies to the franchisees. One of the most important and most difficult matters dealt with in the master franchise agreement is the division of these revenues between the franchisor and the master franchisee. It is important that the division take into account the various duties and responsibilities assumed by each party. Difficulties arise where one party's costs of discharging these duties and responsibilities exceed the revenues generated.

TRADEMARKS: It is customary to insert provisions confirming the ownership by the franchisor of the system trademarks and regulating the use of the marks by the master franchisee. The master franchisee might want to see provisions whereby the franchisor agrees to defend and indemnify the master franchisee from any action by others for infringement of the trademarks.

ASSIGNMENT: Some master franchise agreements provide that the master franchise is strictly personal to the master franchisee and is not assignable to others. However, most often the master franchisee is permitted to sell the master franchise to others, subject to the franchisor's prior approval. The master franchisee will want a provision requiring the franchisor to act reasonably in granting such approval. It is advisable for a master franchise agreement to provide for a transfer fee to compensate the franchisor for the expenses he will incur on an assignment for training the assignee, executive time, lost revenue, as the assignee learns the business, and legal, investigative and accounting costs.

DEFAULT & TERMINATION: All master franchise agreements must have clear and comprehensive default provisions. The consequences of default should also be thoroughly set out. Termination will be one

of those consequences and the events to follow termination, such as repurchase of assets by the franchisor and non-competition on the part of the master franchisee, should be dealt with. The franchisor will often reserve the right to repurchase the master franchisee's business assets. The master franchisee's concern will be that the formula chosen for valuing these assets is fair. The master franchisee will also want to have the right to receive notice of the default, specifying how the default can be rectified and a reasonable time to cure it.

PART 8: THE NEW ONTARIO FRANCHISE LEGISLATION

8.01 THE NEW ONTARIO FRANCHISE LEGISLATION

After decades of debate and false starts, Ontario, Canada's most populous province, now has franchise legislation. The new statute is called the Arthur Wishart Act (Franchise Disclosure), 2000 and is primarily concerned with pre-sale disclosure for franchise purchases, with a smattering of relationship regulation. While the relationship provisions were proclaimed in force on July 1, 2000, the bulk of the Act and all of its regulations dealing with disclosure came into force on January 31, 2001.

The Alberta Franchises Act served as a model for the new Ontario Act, but the Ontario lawmakers chose to deviate from that statute in some subtle and not so subtle ways. Like in Alberta, franchisors in Ontario are required to deliver a disclosure document to prospective franchisees 14 days prior to the franchisee entering into binding agreements or paying any money. Unlike in Alberta, franchisors in Ontario are not allowed to take any refundable good faith deposits or to require franchisees to sign agreements to keep what they learn in the sales process confidential without first providing the prospective franchisee with a disclosure document. This is going to prove to be very cumbersome for franchisors, particularly at franchise trade shows.

The definition of a franchise in the Ontario Act is very broad and will most probably capture distribution businesses which have not traditionally thought of themselves as franchises. The Ontario Act clearly applies to the classic business opportunity offering. While there are a number of narrow exemptions from the operation of the Act or simply from the disclosure requirements, there are no exemptions by industry sectors or for larger franchise systems. However, under certain circumstances, larger more experienced franchisors can obtain exemption from financial disclosure only. Without the franchisee residency requirements of the Alberta Act, master franchise deals for Canada as a whole will require compliance with the Ontario Act.

On the relationship side, Ontario, as in Alberta, protects the right of franchisees to freely associate. Both statutes impose on the parties to a franchise agreement a duty of fair dealing in the performance and enforcement of the agreement. Ontario goes further by establishing a statutory right to sue for breach of this duty and by including in the fair dealing obligation, the duty to act in good faith and in accordance with reasonable commercial standards. The big question with this is whether or not these implied duties will prevent franchisors from relying on the express provisions of their agreements.

In addition to those items prescribed in the regulations, the disclosure document must contain all "material facts" about the franchisor and the franchise system. The prescribed items contain no surprises, but the regulations themselves are peppered with technical drafting errors, which one would hope would be corrected eventually. What is a "material fact" will depend upon whether or not the fact would reasonably be expected to have a significant effect on the value or price of the franchise to be granted or the decision to acquire the franchise. U.S. franchisors would like to be able to use their own disclosure documents in Canada and Alberta specifically allows this, provided a "wrap-around" addendum for compliance with the Alberta Act is included. The Ontario Act does not allow or prohibit the use of foreign disclosure documents, nor does it prescribe the form of a disclosure document. However, it does require that the disclosure document be accurate, clear and concise, which would indicate that many U.S. disclosure documents should not be used in Ontario. Material changes occurring after the initial disclosure must be disclosed before the franchise sale is completed and for all renewals and extensions of franchise agreements.

Not content with holding the franchisor and everyone who signed the disclosure document liable under the statute, as was done in Alberta, the Ontario Act also imposes various degrees of liability on the “franchisor’s associate”, the “franchisor’s broker” and the “franchisor’s agent”. To complicate matters, there is no definition of a “franchisor’s agent” in the Ontario Act or its regulations. If the ordinary common law definition of agent applies, the liability net will be cast very widely. An amendment to the statute is anticipated to rectify this problem. For franchise brokers, it will be important to be closely involved in the creation of the disclosure document of their franchisor clients. We will likely see the use of agreements by franchise brokers which contain representations and warranties as to the completeness and veracity of the contents of disclosure documents. We might even see franchise brokers requiring indemnity agreements from their franchisor clients. The very powerful remedy of rescission is available to franchisees who never receive a disclosure document or who receive it later than required. Essentially, the franchisee receives back everything paid to establish the franchise, as well as any losses incurred.

Following a trend in such legislation, the Ontario Act requires that Ontario law be applied and Ontario forums be used for any matters covered by the Ontario Act. However, any rights and remedies not covered by the Ontario Act are specifically preserved and would not have to be determined in Ontario or under Ontario law.

In its worst light, the new Ontario franchise legislation will impede the expansion of franchise systems, add to the expense of franchising, create more uncertainty and generate more litigation. In its best light, the new legislation will help franchisees make better decisions about purchasing franchises, make it harder for unscrupulous franchisors to operate and increase the overall quality of franchising in Ontario. Reactions to the Ontario Act will be as important in determining the direction of franchising in Ontario as the contents of the Ontario Act and the regulations themselves.