To Grant or Not to Grant: An Analysis of Exclusive Territory Rights in Franchise Agreements

By Chad Finkelstein

"How much is the initial franchise fee?"  "What's the royalty rate?" These questions are, almost invariably, the first two asked by any prospective franchisee when exploring franchise systems to buy into, and two of the first questions that a first-time franchisor will ask itself when structuring its franchise system. However, close on their heels will be questions surrounding exclusive territory - does the franchisee get one? How big is it? Is it conditional on achieving a certain level of sales? Are there any exceptions?

Franchisees are eager to protect as broad a territory for themselves with as few restrictions as possible so as to ensure that the franchisor will not cannibalize the franchisee's business by over-saturating too small a territory with franchises of the same brand. Franchisors certainly want to empower franchisees by providing them with an exclusive territory of a sufficient enough size to give that franchisee a sense of proprietorship, while at the same time exercising enough control to provide for flexibility during future growth of the system and ensuring they are not handcuffed to a top territory with an underperforming franchisee.

The following is a summary of certain options for a franchisor in granting an exclusive territory, if they choose to at all, which should be reflected in any franchise agreement and, of course, disclosure document.

To Grant or Not to Grant?

The first factor to consider in granting an exclusive territory is what type of franchise rights have been licensed to the franchisee. In many cases, the grant of an individual location may be site-specific only, with no additional territory included in the bundle of franchisee rights. Where the franchisor is granting development rights for several units throughout an area, exclusivity becomes more valuable and, likely, expected. And, to the extent that master franchise rights are granted, failing to offer an exclusive territory may kill the deal at its outset.

The grant of an exclusive territory can be a source of friction between franchisors and franchisees, and there are compelling arguments in favour of and against it. On the one hand, franchisors and franchisees want to maximize sales by providing a protected territory that is large enough to ensure that no two franchisees are soliciting the same customers’ business. On the other hand, franchisors may feel that the best way to increase market share is to maximize the number of units across the system.

Ultimately, the decision as to whether a franchisor will grant an exclusive territory or not depends on the maturity of the franchise system itself. New franchisors will have a tough time attracting franchisees if
their unestablished brand is not willing to provide the carrot to franchisees of a protected territory. As a result, franchisees should expect to find exclusive territories granted by new systems, and may also find that the franchisor is more amenable to broadening that territory or loosening some of the conditions attached to it.

The decision of whether and how to grant an exclusive territory is also largely dependent on the type of business and the industry within which it operates. A large franchise system with many locations will likely be less willing to provide exclusive territories since its growth depends on having as many franchise locations in as many sites as possible than a more unique or niche brand, which bases its growth on maintaining some cache and not becoming superfluous on every street corner.

Further, a franchise operating within the quick-service restaurant industry, for example, may not depend on exclusivity to expand the brand in territories because units of that nature need to be accessible in many different types of venues. This would be in contrast to a service industry franchise, such as home health care or a business-to-business franchise which is less concerned with storefronts to generate business. As a result, it will likely need to grant exclusive territories to ensure that its franchisees deliver its services to clients within it, rather than being found by them.

**Right of First Refusal**

Whether or not a franchisor grants an exclusive territory to a franchisee, one point which is likely to be negotiated in the franchise agreement is whether the franchisee may have a right of first refusal to establish a future franchise in the vicinity before any other third party receives the opportunity. This is a common provision in franchise agreements, and should be subject, at minimum, to a franchisee’s compliance with the franchise agreement, as well as other conditions.

**Conditional Exclusive Territory**

From a franchisor's perspective, it is generally never advisable, under most every circumstance, to grant an exclusive territory to a franchisee that is condition-free. Many first-time franchisors who are eager to sign up as many franchisees quickly and expand their brand as aggressively as possible may not always appreciate at the outset how the liberal grant of exclusive territories without strings attached may impact on them later when the franchisee fails to perform. This freewheeling granting of exclusive territories will almost certainly be regretted by a franchisor who finds that, several months or years into the term of a franchise agreement, the franchisee has utterly failed to perform and meet sales expectations.

As a result, performance criteria can be a very helpful control mechanism in binding a franchisee to certain targets as a condition of maintaining its territory. The franchisee's failure to satisfy those criteria can act as triggers for a franchisor to reduce or eliminate the scope of protection regarding the territory so that prime locations are not being held hostage by an underperforming franchisee.

Conditional grants of exclusive territory have utility beyond just enforcing sales criteria, as well. They can also serve as a middle ground to penalize a default of the franchise agreement which straddles the harsh extremes of termination and doing nothing.

**Reservation of Rights**

A franchisor can also maintain some control in granting an exclusive territory by reserving rights for itself with respect to the goods and services which may be offered from within the territory.

First, the franchisor can and should reserve the right to sell, or grant others the right to sell, products and services via alternative channels of distribution from within the franchisee's protected territory. This is
particularly useful in the restaurant industry, for instance, where a franchisor may have granted exclusivity with respect to a particular territory but can still sell private label products bearing the franchisor's brand (i.e. frozen foods, condiments, etc.) from grocery stores within that territory.

Second, the franchisor can and should reserve the right to operate, or grant franchise rights to other third parties to operate, additional brands owned and controlled by the franchisor. By reserving this right, a math tutoring franchise, for example, can grant franchise rights within the territory to its new chain of language tutoring franchises. Of course, the scope of this reservation of rights may be problematic for some franchisees, so franchisors should consider offering a right of first refusal to the secondary brand so long as the franchisee is in compliance with its franchise agreement, and has satisfied a small handful of other conditions.

Third, the franchisor may wish to consider reserving the right to operate, or grant others the right to operate, franchises of the same brand as that being offered to the franchisee at non-traditional locations within the franchisee's territory. A list specifying as many non-traditional locations as possible should be provided in the franchise agreement, and may include (depending upon the industry within which the franchise operates) movie theatres, amusement parks, hospitals, zoos, sports stadiums and arenas, casinos, highway service centres and so forth. The logic behind reserving the rights to develop non-traditional locations within the territory is that such locations have a self-contained and somewhat captive customer base given their unique placements within other venues. Accordingly, a franchisee located outside that venue need not be concerned with a franchisor's cannibalizing the franchisee's business by putting two locations so close together in proximity since they are not necessarily competing for the same wallets anyway.

Fourth, to the extent that the franchise model lends itself to soliciting business from large industrial, regional or national accounts, the franchisor may prefer to reserve that right for itself to either provide services to such valued account, or delegate franchisees to it in its sole discretion.

Soliciting Other Franchisee's Customers

In certain types of service franchises, especially those which are delivered via mobile service, a franchisee may be less concerned with the protected territory surrounding its storefront and more concerned with the actual population within its geographic borders. As a result, franchisees in these types of industries will be paying close attention to how its customers are protected.

For this reason, franchise agreements which grant exclusive territories should carefully consider what the advertising restrictions are for a franchisee, and what might happen if a customer from outside the territory calls the franchisee looking for a product or service.

With respect to advertising, striking a balance between protecting each franchisee's territory and being reasonable by taking business realities into account can be a daunting task. It is simple enough to mandate that a franchisee not distribute flyers outside of its territory, but what about purchasing ads in local or neighbourhood publications which have a wider scope of circulation than just the franchisee's particular territory? And what about advertising online? Whether a franchisee is permitted to purchase banner ad space on the website of a local business or local online directory, or if it is authorized to maintain its own Facebook profile or Twitter account, it becomes impossible to relegate such advertisements to only those individuals residing within the franchisee's territory. Some franchisees may get upset when another franchisee does something as innocuous as sponsoring a little league team which plays within its territory but which patrons may reside in the aggrieved franchisee's territory.

Generally speaking, it may be best to avoid complicated permutations which seek to devise parameters and restrictions on these, and other, types of advertising. The reality is that even the best-intentioned such
provisions will still be challenging to enforce. From a practical perspective, it may be advisable to provide that a franchisee may only advertise within its territory with respect to conventional forms of advertising (so that flyers are not distributed outside of the territory), but that a franchisee is not restricted from online forms of advertising (provided the franchisor even permits it at all) subject to the franchisor's referral policy.

A well-structured referral policy answers the second question raised above, and is likely to be invoked where new media advertising is employed by a franchisee. Whether a franchisee delivers mobile services to a customer's home, engages customers within its location or provides catering/delivery services from its restaurant, if a franchisor grants that franchisee an exclusive territory, the franchise agreement should also provide for what happens when a customer outside of that protected area picks up the phone and requests a service.

One option would be to obligate the franchisee receiving the order to refer that customer to the franchisee whose territory such customer resides within. Another option would be to permit the franchisor to accept the order, but to engage in some sort of profit share in respect of that order with the rightful franchisee. Of course, the risk always exists that a franchisee may not be particularly truthful when reporting such a sale or providing such a referral. Accordingly, some franchisors employ referral fee policies whereby the referring franchisee is awarded a portion of the sale to acknowledge its honesty and compliance with system standards, and to maintain the balance.

Where a customer is calling from a territory where no such franchisee yet exists, the franchise agreement may provide that it is fair game, and the franchisee receiving the call may service such a customer. On the other hand, the franchisor may prefer to handle such calls itself so that it can dole the business out appropriately, and may require in its agreement that all such calls be referred directly to head office. For this reason, and many others, some franchise systems maintain a central call number so that the decision with respect to which franchisee will service which customer will be made entirely by the franchisor.

*How to Grant an Exclusive Territory*

There are several ways by which a franchisor may assign a particular protected territory to its franchisees, and the following examples are not meant to be an exhaustive list.

First, a franchisor can simply print a map of a specified geographic region and physically draw the borders around it which represent the franchisee's exclusive territory. This method is preferred by some franchisors because it is clean, straightforward, unambiguous and not generally open to interpretation. The downside is that it is not easily modified without amending the agreement in the event that populations and demographics shift within and around that territory over the term of the franchise agreement.

Second, a franchisor can specify the geographic borders by naming street names and boundaries in each direction, for example, "North to Main Street, South to Elm Street, East to the park and West to the lake". While similar to the drawing of a map, this method may sometimes be open to creative interpretation by franchisees.

Third, an exclusive territory may be based upon postal codes or populations derived from census data, online reference sources or Statistics Canada. The benefit of this method is that the exclusive territory is somewhat fluid, and can be altered with ease (in principle) once a population exceeds the protected number, at which point the franchisee may be granted a larger territory, or can exercise its right of first refusal to the adjacent territory. The challenge in implementing this method is that it still does require some structure in the way of geographic borders in order to be remotely identifiable by franchisors and
franchisees, and does pose the problem of aggravating an adjacent franchisee when its population is affected by a growing territory nearby.

**Modifying Exclusive Territories**

Beyond the rights which a franchisor can reserve with respect to modifying a territory based upon performance criteria, many franchise agreements specify that, upon the renewal or transfer of a franchise agreement, the exclusive territory may be altered from that which was originally granted. This may be problematic in negotiating with franchisees. From the franchisor’s perspective, there is not likely to be any bad faith intended in amending the territory at various points during the life of the franchise agreement, but franchisees may not see it that way.

For a franchisee signing a new agreement, this reservation of rights by a franchisor may indicate a certain degree of uncertainty for a franchisee who cannot predict what its territory may look like after the initial term of the agreement has expired. Further, a franchisee may be concerned that the franchisor’s right to alter the territory on a resale may hamper the franchisee’s ability to sell its business, wherein the size of the territory is a critical selling point in connection with valuating the business.

Franchisors should make clear, in this case, that the ability to reduce or vary the territory after 5, 10 or 15 years (for example) is of vital importance since they are not clairvoyant and cannot anticipate what the market and the franchise system will look like at one of these junctures. Accordingly, the franchisor’s retention of this flexibility is necessary for the benefit of growing the system.

**Disclosure of Exclusive Territories**

Of course, the Regulations to the *Arthur Wishart Act* explicitly require that the disclosure of certain information as it pertains to exclusive territory be included in the disclosure document. In particular, the disclosure document must describe:

- any exclusive territory that is granted to the franchisee;
- the franchisor’s policy regarding exclusive territory, if any, including whether the franchisee’s rights to such exclusive territory are contingent on its satisfying various performance criteria; and
- the franchisor’s policy, if any, on the proximity between an existing franchise, other franchises, any other business using the franchisor’s trade-mark or any other business operated or franchised by the franchisor that distributes similar goods and services under a different trade-mark.

As set out above, franchisors cannot see into the future, so it is critical that exclusive territory provisions be continually reviewed and updated to reflect future challenges and business realities. Despite the best of intentions, the grant of an exclusive territory is not an exact science and errors can occur. Where the territory granted results in too many franchises in too small a market, franchisees may raise allegations that the franchisor has acted in bad faith. Where the territory granted is too large, it may result in slow development of the brand.

Accordingly, there is no one-size-fits-all approach when it comes to the drawing up and granting of exclusive territories. The decision to grant one will depend on a number of factors, but the imposition of a reasonable number of conditions for the franchisee to retain that exclusive territory may be advisable and should be properly described in the franchise agreement and disclosure document.