When a prospective franchisee is looking to purchase a franchise operation, they are generally buying the right to operate in a specific territory. What a ‘territory’ is differs from franchise to franchise.

Territories come in many shapes, sizes and styles so it is extremely important to understand how the territory is defined. The logic behind having a territory is to give
This is often not contemplated by the initial scenario is that the two franchisees may face a large overlap in the catchment from another franchise outlet immediately outside the territory. The reality of this course does not prevent competitors from outside the franchise system competing with the business. It is important to note that having an exclusive territory does not set up another franchise. In many cases a franchise agreement will contain details of an exclusive area in which the franchisor will not set up another franchise. In many cases a map is attached to the franchise agreement to highlight the exclusive area of the franchisee. Depending on the type of franchise this could be anywhere from a specific address or premises, such as a certain shopping mall or defined suburbs, through to cities or even wider geographical areas. Exclusivity of course does not prevent competitors from outside the franchise system competing with the business. It is important to note that having an exclusive territory does not stop the franchisor setting up or selling another franchise outlet immediately outside the exclusive territory. The reality of this scenario is that the two franchisees may face a large overlap in the catchment from which their potential customers are drawn. This is often not contemplated by the initial franchisee, as they may have considered their whole territory to be an exclusive catchment area.

Non exclusive territories

Non exclusive territories often define the area that franchisees are allowed to trade within, but they allow the franchisor to sell franchises to other prospective franchisees within that territory also. Such systems allow franchisees to sell their products or services within that territory but they have restrictions on trading outside it. The freedom of the franchisor to sell other franchisees within that area is retained in the belief that over time the territory could sustain an increase in the number of franchisees as the brand gains traction.

In this scenario the franchisee must trust the franchisor not to over-saturate the market with franchises so that their franchise business will become diluted to the extent that it does not provide an appropriate return. An astute franchisor will not over-saturate the market because such action will lead to dissatisfied franchisees, which in turn leads to major disputes within the franchise system. Disharmony in a franchise system causes a loss of focus for all concerned and can lead to a loss in profitability. However, a prospective franchisee needs to be wary of a franchisor that could be looking for a quick profit from the sale of new franchises into non exclusive territories, especially if that market already has a number of participants. Meeting as many existing franchisees as possible and discussing the system with them is advisable to ensure that not only are they comfortable with the franchise system generally, but that they are also comfortable that the market can sustain another franchise. The better franchisors focus on earning income through the operation of the franchise and the royalties generated through their franchisees’ sale efforts rather than cannibalising franchise territories by selling new franchises into them for an upfront fee, knowing that the addition of a new franchise will not increase the level of franchisee sales at all.

Changes to territories

Many franchise agreements, even those that provide for exclusive territories, give the franchisor the right to change the territory or alternatively start up a new franchise within the territory should circumstances arise that will allow the territory to sustain another franchise operation. Such circumstances may include a change of demographics within the franchise territory or a development in the technology used by the franchise system that results in a much greater demand for the product or service being offered within the franchise system. It is not uncommon to see a provision which requires the franchisor to offer the franchisee the first right of refusal to purchase the new franchise operation commencing within the territory. Issues however can arise where a new operation is being sold just outside of the territory, as any rights of first refusal would not apply. Franchisors often also reserve the right to sell a new franchise into a franchisee’s territory where the franchisee is under performing or failing to meet preset minimum key performance indicators. This is understandable from a franchisor’s perspective as it cannot afford to have

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what could otherwise be a high performing territory failing to produce appropriate levels of income because of the lack of franchisee achievement. In such circumstances a franchisee would normally have received feedback and warnings from a franchisor that its performance is not up to the required standard. It should also have been given training, assistance and/or advice from the franchisor to try to turn the direction of the business around and it will be aware that the introduction of a new franchisee to the territory is one of a number of possible consequences that may be faced if its performance does not improve.

Problems with territories

One of the problems that can occur with exclusive territories is when a franchisee attracts business from outside its allocated territory. Some franchise agreements recognise that this may occur and they attempt to deal with this issue in advance. Solutions range from an absolute prohibition on trading with a customer from outside the territory, to allowing such a transaction to occur but requiring the franchisee to make a payment to the franchisee of the territory that the customer came from. Such problems tend to occur more often in franchise systems where there is a service being offered to customers on a mobile basis, for example gardening and lawn mowing services, where a franchisee receives a customer referral from outside its agreed territory. The problem can also arise when a franchisee has an existing client within its territory and that customer moves premises outside the territory but wishes to continue using the services of their existing provider. A good franchise agreement or manual will have clear guidelines to deal with such issues and rules dealing with the allocation of work. It is not uncommon for some franchise systems to have the main point of customer contact coming through a toll free number. That allows the work to be referred to the franchisee that has control of the territory that the call came from, but they can be referred to other franchisees if the franchisee for the territory is too busy to meet the service guidelines of the franchisee or that particular customer’s requirements. Such situations must be clearly defined and consistently adhered to so as to avoid disputes between franchisees.

Another issue which is not uncommon for ‘premises based’ franchisees is that alluded to earlier in this article. It involves the franchisor allowing a new outlet to open right on the edge of an existing franchisee’s exclusive territory. A savvy franchisor should take steps to minimise risks relating to the territory. First, it should have appropriately modelled what sort of customer base is required to sustain a successful franchise. This may involve having different rules in different areas, for example where socio-economic factors may impact on the size of population that would make a territory viable. All too often territories are based on crude population numbers rather than taking other factors into account. Secondly, a franchisor should have a coherent and clear area development plan that it is up front in providing to prospective franchisees. That way a franchisee has the opportunity to buy a business with all relevant information at hand. Thirdly, the franchisor should implement the plan that franchisees have relied on and not look to make changes without first discussing it with them and obtaining their buy-in based on sound data and logic.

The writer has recently been involved in a dispute within a large international franchise system that has implemented its territory expansion in New Zealand haphazardly. The franchisor created and disclosed to existing franchisees an area development plan which they relied on to become multi-unit operators, only for the area development plan to be changed unilaterally resulting in the potential for them to face increased competition from within their own franchise system. In each case this has created significant disharmony between the franchisee and franchisor. It poses an economic risk that the franchisees would not have taken on had they known the franchisor would alter its plan for the development of the territories. Whilst many franchise agreements contain a disputes resolution procedure, it relies on the goodwill of the parties concerned to try and reach an amicable solution. There is currently no general duty in New Zealand for franchisors and franchisees to act in good faith towards each other so such disputes often result in one party being detrimentally affected whilst the other receives a windfall.

Summary

Every franchise agreement is different, and the rights and privileges obtained under the agreement will differ in each case too. It is extremely important to minimise unpleasant surprises and to properly understand exactly what rights a prospective franchisee is purchasing when buying into a franchise system, including knowing the issues surrounding the territory being purchased.

Taking advice from a specialist franchise lawyer, along with asking the franchisor direct questions about how they plan to expand the system and what impact it may have on the operation being purchased would go a long way to giving a buyer some certainty. Further, liaising with as many existing franchisees as possible gives a buyer the ability to gauge the robustness of the franchise system and the behaviours of the franchisor. Other franchisees already operating within the system will generally give an indication of the general level of satisfaction that franchisees feel within the franchise system.

Finally one always needs to remember that even if there is confirmation that an appropriate exclusive territory is being purchased, it does not prevent the franchisee from facing competition from any person in the same line of business who is not part of that franchise system.

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