

INTERNATIONAL FRANCHISING: PILOTING

Guidance Notes with the Governing Principle at Clause 5

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INTRODUCTION

1. Franchising is founded on the opportunity it affords franchisees to buy into a proven successful business format.
2. Consumer and business client markets (here called “end user” markets) around the world have a great variety of social, economic, demographic, technological, legislative, linguistic, religious and other cultural differences. Such differences are often critical to purchasing patterns in ways that can be unpredictable. Often, though not always, such differences are clustered around nation states or other forms of jurisdiction.
3. In consequence, business success in one jurisdiction does not provide the level of surety that prospective franchisees in another jurisdiction will associate with formats which have been piloted in their own jurisdiction. Because of the difficulties of assessing the differences in end user markets it is also difficult to judge the extent to which that lack of surety adds up to a business format not being “proven”. It is equally the case that there are some notable examples where national jurisdictions and common markets do not coincide - the USA and Canada; Northern Ireland (a part of the UK) and Eire; Australia and New Zealand, amongst others. In these markets with common characteristics, business success in one market may be taken as evidence of potential to succeed in the other providing there are no significant differences in the commercial environments of the two markets to suggest otherwise. For example, significantly different interest rates on borrowing might make a format that is profitable for franchisees in one jurisdiction, unprofitable for franchisees in another.
4. However, aside from these exceptions and cautions referred to in Para. 3, piloting at the unit franchise level (that is the level of operation that sells products or services to end users in a jurisdiction) is the only fully defensible way of offering surety to prospective franchisees in that jurisdiction that the business format is “proven” in their jurisdiction. This does not prescribe who should undertake that piloting, it only suggests that it is not good practice to offer to the conventional prospective franchisee market, unit franchises at the end user level until some individual or organisation qualified to do so has piloted the business in the jurisdiction. These considerations suggest the following principle of good practice in international franchise piloting.

THE PRINCIPLES FOR PILOTING INTERNATIONAL FRANCHISED BUSINESSES

- 5(a) The individual, organisation or other legal entity which first introduces a branded business format into a jurisdiction – before offering franchises in that jurisdiction - should have taken the responsibility, or ensured that an organisation qualified by way of its business experience its funding and the disclosures made to it has taken the responsibility, for proving in the jurisdiction the success of the business format at the level of operation that sells products or services to end users and which are the units of operation that are intended to be franchised in that jurisdiction.**

- 5(b) Exceptionally, where geographically contiguous Nation States have developed with largely indistinguishable markets and commercial environments and with a common language or common fluency in each others languages, business operations in one market may be taken to represent an adequate test of the performance of a business in that form in the contiguous market.**

INTERPRETATION

Master Licensing and Joint Ventures

6. Where an international franchisor seeks to offer a master licence for their branded business format in a jurisdiction, it is a matter of commercial negotiation between the franchisor and their prospective master licensee as to whether it will be the international franchisor who introduces the format to the jurisdiction (and thus takes responsibility for piloting the business at the end user level) or the master licensee. The principle set out in Clause 5 of this guidance only requires that one or the other take responsibility for piloting the business in the jurisdiction. Taking responsibility for piloting the business could be secured by doing it themselves or it could be secured by the international franchisor funding the risk that will be taken by whomever it is that pilots the business format in the jurisdiction. The choices made by the parties to the master licence agreement will be reflected in the commercial terms of that agreement. The same choices will need to be made in the terms of a master licence agreement where the licensee is a joint venture operation with the international franchisor.
7. If the master licensee, or joint venture licensee, takes on the responsibility for piloting the business format in its jurisdiction, then the question arises as to what is to happen if the pilot demonstrates that the format, without fundamental revision, will not work in the jurisdiction. This question is not addressed in Clause 5 because the arrangements for exits for the master licensee, or joint venture partner to a master licence, should be a matter for the commercial negotiation between the international franchisor and their master licence partner.

Area Development Agreements and Sub-franchising

8. Where an international franchisor offers a number of area master licences for the regions of a jurisdiction, where the master licensees will be required to open a significant number of units but all in their own ownership, then it remains open under Clause 5 of this guidance for either the international franchisor or the first of the area master licensees to take the risk of piloting the format in the jurisdiction.
9. These arrangements may apply as well where a prospective master licensee or area developer is required in the first instance to open a single unit, as a unit franchisee. The responsibility here on the international franchisor is to ensure that the prospective master licensee or area developer has sufficient business experience, sufficient funding and sufficient disclosure in respect of the format, to be qualified to make an informed decision to proceed.
10. Under Clause 5, where an area master licensee intends or is required under the master licence to sub-franchise the business format in the area, the same choice remains open to the international franchisor or the first area master licensee as to who takes responsibility for piloting the business. Clause 5 would not entitle the area master licensee to sell a unit franchise before either they or the international franchisor had themselves taken the responsibility for piloting the business at the end user level successfully in the jurisdiction unless they had made arrangements to carry

responsibility for the risk that the unit “founding” franchisee or franchisees would be taking.

Direct Franchising

- 11.** Where the international franchisor intends themselves to franchise at unit level directly into a jurisdiction, then Clause 5 would require that the international franchisor take responsibility for piloting the business in the jurisdiction. As before, “taking responsibility for piloting the business” may be secured by the international franchisor guaranteeing the first “founding” franchisee or franchisees against the risk they are taking, or in other ways providing them with a protected exit route if the business fails.
- 12.** This raises the question of what form such guarantees to “founding” unit franchisees should take. The general principle should be that if the business fails - as a result of shortcomings in the business format as set out for implementation in the new jurisdiction – then the “founding” franchisees should be able to exit the business being no worse off than when they went in. In financial terms this might be expressed as requiring the international franchisor, or their master licensee, to offer to guarantee the costs of entry attached to irrecoverable investments specific to the franchise for such a period as to demonstrate that the business can succeed through at least one business cycle.
- 13.** However, none of these questions concerning guarantees, nor any of the other questions of interpretation in these guidelines even arise if the International Franchisor, or their qualified master licensee, takes the basic step of proving their business in each new jurisdiction at their own risk.

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