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**ONTARIO EXPROPRIATION ASSOCIATION**

# Interrelationship of Franchisor and Franchisee Claims

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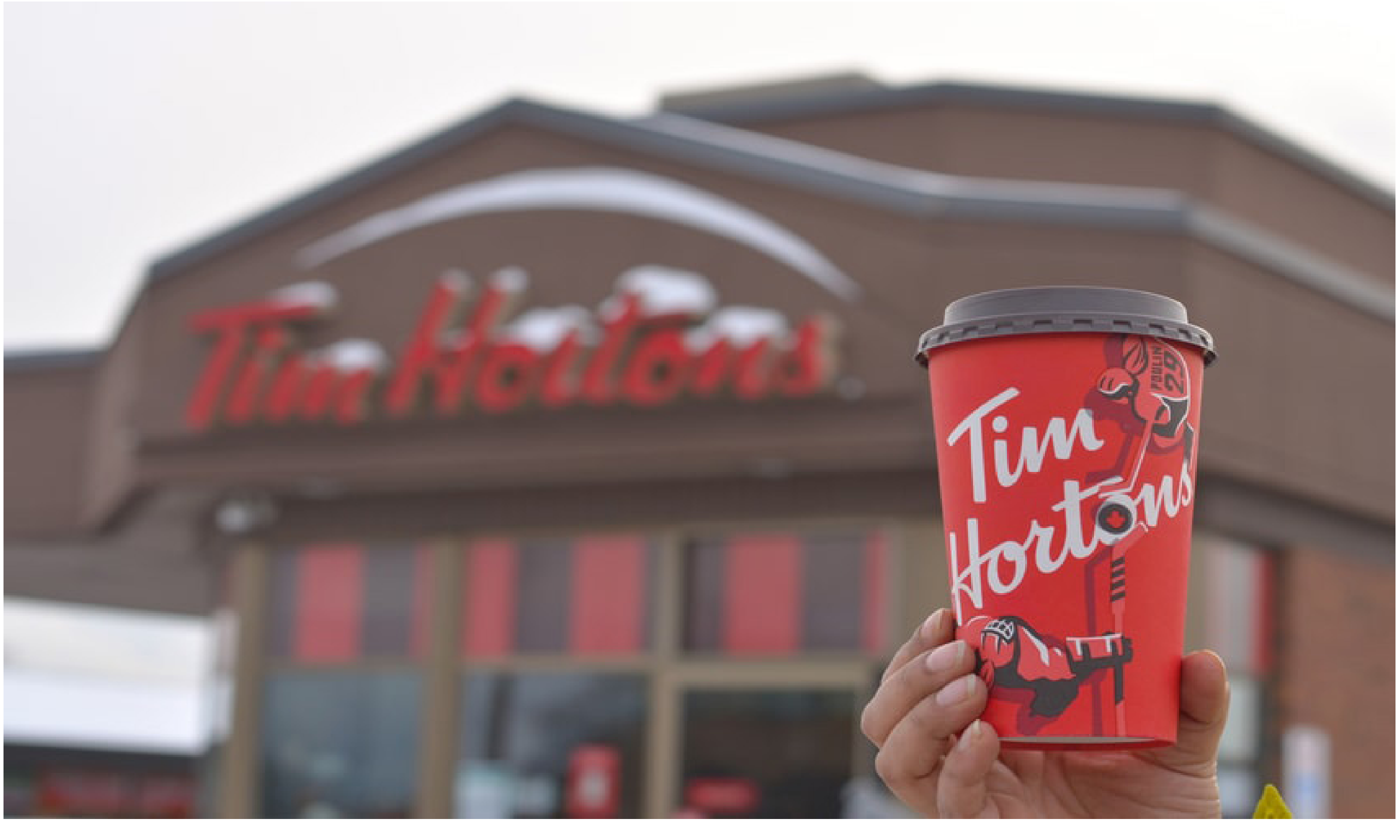
The businesses of franchisors and their franchisees are inextricably connected. Accordingly, when the operations of a franchisee are negatively impacted by an event or wrongdoing, often the operations of the franchisor are too. However, while the source of the harm may be the same, the monetary claims of the franchisor are usually quite different from those of the franchisee.[1] In this article, the following will be discussed:

- The business relationship between franchisors and their franchisees;
- Types of actions involving franchisees and franchisors;
- Franchisee claims compared to franchisor claims;
- Interrelationship of the franchisor and franchisee losses and quantification of same; and,
- Key considerations in estimating the losses of franchisees and franchisors.




**BUSINESS RELATIONSHIP BETWEEN FRANCHISOR AND FRANCHISEE**

A franchisor typically develops a concept, brand and system and the franchisee operates a franchise location under that concept, brand and system. For example, under a fast-food restaurant franchise concept, the franchisor usually develops the concept, brand, marketing, and menu for the restaurants, along with the physical design and look of the restaurants. The franchisees operate the actual restaurants based on the parameters set by the franchisor. The franchisor will also often source the food, beverages, other supplies, and fixtures for the restaurants and the franchisee will be required to buy these items from the franchisor. Examples of fast-food franchise systems include Tim Horton's, McDonalds, and Subway.

The franchisor and franchisee relationship is governed by various types of agreements, which can include franchise or royalty agreements, lease/sub-lease agreements, and possibly other agreements.

A franchise/royalty agreement sets out the obligations of the franchisor and franchisee, the franchisee's territory[2], the amounts the franchisee must pay to the franchisor (e.g. initial franchise fee, royalties on the franchisee's sales revenues, advertising fund payments, profit share amounts) and the services and amounts the franchisor must provide and/or pay to the franchisee (e.g. subsidies, consignment fees).

Franchisors often own or lease the properties from which its franchisees operate and therefore, they will enter into lease/sub-lease agreements with the franchisees. These lease agreements typically stipulate the term of the agreement, base rental payments, additional rental payments (e.g. common area charges, percentage rent based on the sales revenues of the franchisee), escalations (i.e. increases) in the rental payments over the term of the lease, and whether the lease can be renewed and at whose option (i.e. the franchisor or franchisee), among other things.

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## TYPES OF ACTIONS INVOLVING FRANCHISEES AND FRANCHISORS

Legal actions involving franchisees and franchisors can include expropriations, breach of contract, class actions, and product liability claims, among others. For the purpose of this article, the focus is on expropriations. However, the types of losses incurred by franchisees and franchisors are usually similar under other types of actions.

Expropriation, which the is the taking of property by an expropriating authority for public use or benefit, occurs for many different reasons, including road widenings, road/highway construction, building of hydro corridors, transit construction, etc. Certain types of franchises tend to be located on busy roads or at busy intersections (e.g. fast-food restaurants and automobile gas stations/convenience stores) and therefore, are often impacted by expropriations.

An expropriation can involve a partial taking or full taking of property. Under a partial taking, the following options exist for the business (i.e. the franchise):

a) Continue operating from the property post-expropriation;

b) Relocate because the taking is such that it cannot continue operating from the property post-expropriation; or,

c) Cease operations if it cannot continue operating from the property and cannot find a suitable replacement property.

Under a full taking of the property, the business/franchise has the following options:

a) Find a suitable replacement property; or,

b) Cease operations if it cannot find a suitable replacement property.

## FRANCHISEE CLAIMS COMPARED TO FRANCHISOR CLAIMS

The operations of a franchisee can be negatively impacted by an expropriation due to the disruption of the construction activities associated with the expropriation (e.g. noise, dust, temporary loss of access), the loss of land that prevents the franchisee from carrying on all its business activities post-expropriation, or the franchisee being required to relocate its operations. Consequently, the franchisee may suffer lost sales and/or incur incremental expenses due to the expropriation resulting in lost profits. If the franchisee is required to cease operations altogether because of the expropriation, then the franchisee will likely lose the value of the business.

Based on the foregoing, a franchisee's claims may include the following:

- Lost profits on lost sales (e.g. lost sales revenues less the variable costs that would have been incurred to earn the lost sales and other saved expenses[3]);

- Incremental expenses (e.g. increased advertising while the construction was occurring, or moving expenses and cost of new stationery if the business relocated, etc.); or

- Lost business value (net of salvage value of the physical assets of the business).

The claims of a franchisor resulting from a franchise location that has been impacted by an expropriation may include some or all of the following:

- Lost royalties on the franchisee's lost sales revenues (typically calculated as a fixed percentage of lost sales revenues as per the franchise agreement);

- Lost percentage rent on the franchisee's lost sales revenues (typically calculated as a fixed percentage of lost sales revenues as per the lease/sub-lease agreement);

- Lost margin on the goods it would have sold to the franchisee, assuming the franchisor makes a profit on the supply of goods to the franchisee and that the volumes sold decreased due to the expropriation;

- Lost volume rebates on the goods it would have purchased and sold to the franchisee, assuming that the volumes purchased decreased due to the expropriation; and,

- Incremental subsidies paid to the franchisee due to its lost profits, if such subsidies are allowed for in the franchise agreement.

Any expenses saved by the franchisor due to the loss of the above amounts would need to be deducted in estimating its losses. However, typically a franchisor would not have many saved expenses, if any.

If the franchisee's losses are expected to continue into the future or if the franchisee is required to cease operations due to the expropriation, then the franchisor may be able to claim the above-noted losses into the future. If this is the case, it is important to consider the following: [4]

- The terms and options for renewals of the franchise and lease agreements;

- The historical profitability of the franchisee and expected future sales revenues and profitability of the franchisee absent the expropriation; and

- Other factors affecting the franchisee's ability to continue operations in the future absent the expropriation.

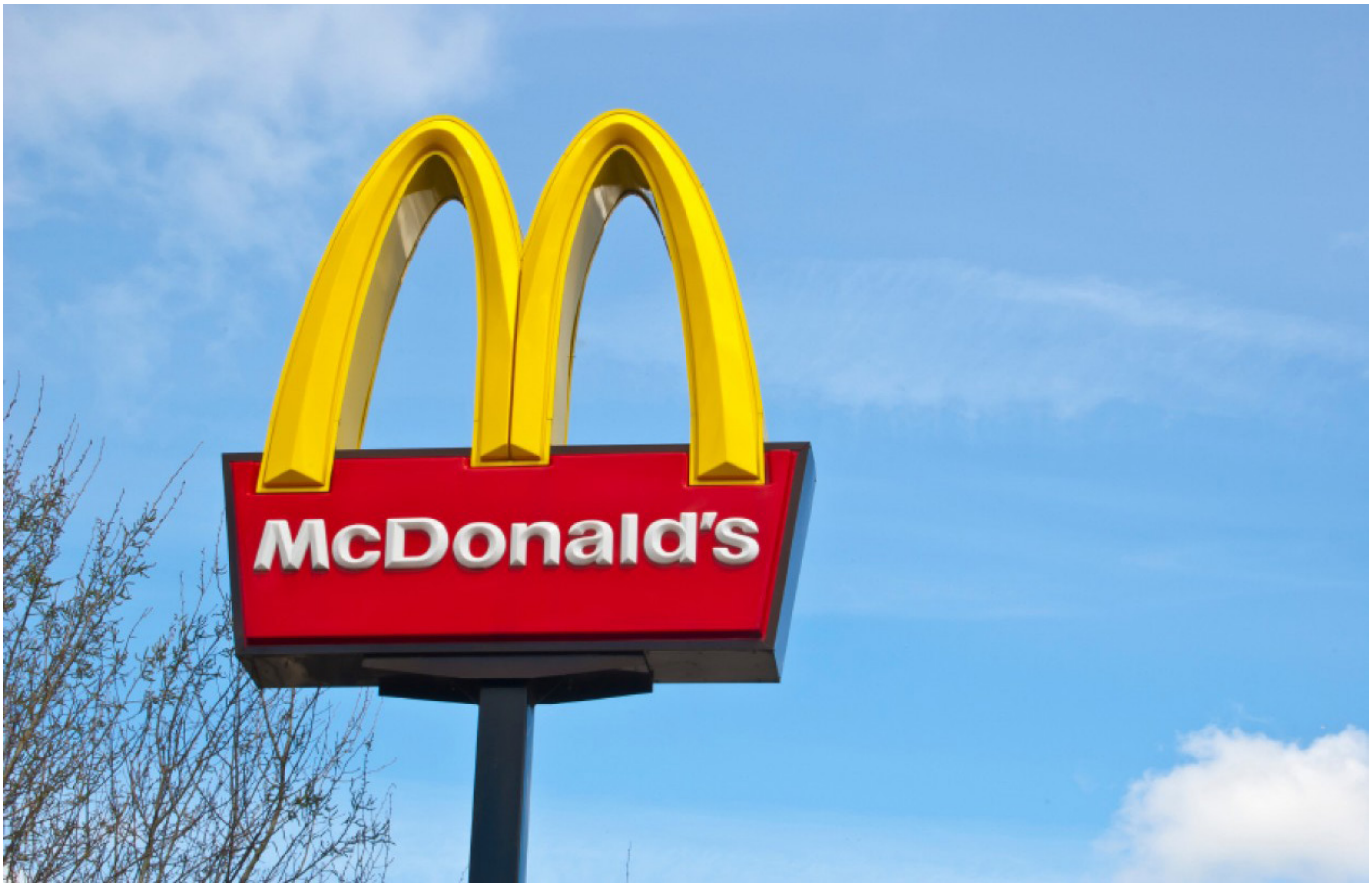
Based on the above, an estimate as to the period of time that the franchisee would have continued in operations absent the expropriation can be made and the franchisor's losses estimated over this period. Depending on the effective date of calculations of the losses, there may be past and future losses to consider.

## INTERRELATIONSHIP OF FRANCHISOR AND FRANCHISEE LOSSES AND QUANTIFICATION OF SAME

As can be seen from the above, the losses incurred by the franchisor are dependent on the franchisee's lost sales revenues (i.e. lost royalties and percentage rent) and the decrease in goods purchased by the franchisee from the franchisor due to its lost sales volumes (i.e. lost margin and volume rebates). As a result, in estimating the franchisor's losses, an estimate of the franchisee's lost sales revenues and decrease in goods purchased by the franchisee from the franchisor due to its lost sales volumes must be made.

Depending on the terms of the franchise agreement, the franchisor may be required to pay additional subsidies to the franchisee based on its lost profits. In such cases, the profits of the franchisee absent the expropriation must be estimated and compared to the franchisee's actual profits in order to calculate the incremental subsidies paid by the franchisor.

Accordingly, the losses of the franchisor are very interrelated to those of the franchisee.




**KEY CONSIDERATIONS IN ESTIMATING THE LOSSES OF FRANCHISEES AND FRANCHISORS**

The first step in estimating the losses of a franchisor and/or franchisee, is to thoroughly review and understand the terms of the legal agreements between the franchisor and franchisee (e.g. the franchise agreement, lease agreement, etc.). As discussed above, these agreements set out the obligations (both financial and otherwise) of the two parties, as well as the duration (i.e. term) of the agreements.

In estimating the lost sales of the franchisee due to the expropriation, various information may be available to review and analyze that would not otherwise be available, if the business was not a franchise. For example, the following information may be available:

- The operating results of other franchises in the chain that were not impacted by the expropriation. The operating results of the franchise that has suffered losses can be benchmarked against those of other franchises in the chain in estimating its losses. Care must be taken to ensure that the other franchises being considered are somewhat comparable to the subject franchise for which losses are being estimated in terms of size, location, historical sales and profitability level, and any other relevant factors;

- Historical performance evaluations for the franchise for which the losses are being estimated. These are typically completed by area or territory managers of the franchisor on a periodic basis. Such performance evaluations will indicate how the franchise was performing prior to the expropriation and can be used to determine if factors, other than the expropriation, contributed to the decline in sales (e.g. history of declining performance, if the franchise was in need of renovation/refresh, a competitor had entered the market, etc.); and,

- Sales revenues of franchises in the chain before and after renovations/rebranding, as well as renovation/rebranding expenses, if it was determined that the subject franchise would have undergone renovations/rebranding absent the expropriation. This information can be used to estimate the subject franchise's sales revenues and renovation/rebranding expenses absent the expropriation or other cause of action.

Further, information with respect to the cost of a new franchise and/or sale prices of existing franchises may be available from the franchisor, which may be relevant in estimating the fair market value of the subject franchise assuming it was required to cease operations due to the expropriation.

Consideration must also be given as to whether any new franchises granted by the franchisor (or new company-owned locations) represent a replacement for a franchise that ceased operations due to an expropriation. As indicated above, the franchise agreement for the expropriated franchise will normally specify the exclusive territory or trading area for the franchise, meaning that another franchise or company-owned location cannot be opened in the trading area of the subject franchise. If a new franchise or company-owned location is outside of the trading area of the expropriated franchise and the franchisor would have granted the new franchise or opened the company-owned location absent the expropriation, then it likely would not be considered a replacement for the expropriated franchise. In which case, the franchisor would not have mitigated its losses.

## CONCLUSION

As discussed at the outset, the businesses of a franchisor and its franchisees are inextricably connected. As a result, the losses of the franchisor cannot be estimated in isolation of those of the franchisee, as the losses are interdependent. However, as described above, the nature of the franchisor's claims are different from those of its franchisees.

In estimating the losses of the franchisor and/or the franchisee, it is essential that the business relationship between the two, as set out in the various legal agreements between the parties, is thoroughly understood and considered. Further, it is important to obtain additional information that may be available from the franchisor with respect to other franchises in the chain and the subject franchise to ensure that all relevant information is considered and the loss estimates appropriately supported.[5]

## END NOTES

1 *This article is not intended to, nor should it be interpreted as expressing either legal advice or legal opinions, as such matters are outside the author's area of expertise.*

2 *The franchisee's territory may be exclusive, meaning that the franchisor agrees not to establish either a company-owned or franchised outlet selling the same or similar goods or services under the same or similar trademarks or service marks. The franchisee's territory is often also referred to as its "trading area".*

3 *Such variable expenses can include the cost of the goods that would have been sold, and royalties and percentage rent that would have been paid on the lost sales. Saved other expenses can include labour expense if employees were laid off due to the decline in sales and saved base rent if the franchisee negotiated a reduction in rent due to the disruption of the expropriation.*

4 *Assuming the franchisor has the legal right to make these claims (e.g. they own or lease the lands expropriated and therefore, are an "owner" under the Expropriations Act).*

5 *The franchisor may have confidentiality obligations such that it is prohibited from sharing some or all of this information for purposes of estimating its losses or a franchisee's losses.*