

ISSUES FOR A CANADIAN COMPANY WISHING TO ACQUIRE A MASTER FRANCHISE FROM A FOREIGN FRANCHISOR

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I. INTRODUCTION

Before discussing the different issues that a Canadian company should take into account before acquiring a master franchise from a foreign franchisor, it would be appropriate to agree on a definition of the term "master franchise".

The acceptable description of a master franchise is the grant by a franchisor to a sub-franchisor (sometimes referred to as a "master franchisee") of the exclusive right to (i) use the franchisor's trademarks and franchise system in connection with the operation of franchised outlets as well as the right to (ii) grant sub-franchises to third party sub-franchisees to use the franchisor's trademarks and franchise system in connection with franchised outlets, in what is typically an exclusive territory. Thus master franchising involves sub-franchising by the sub-franchisor, who, for all intents and purposes, acts as the "franchisor" in the exclusive territory.

Readers are cautioned that it would be unrealistic to try and deal with all the issues that should be taken into account before acquiring a master franchise. For those who would like to access an in depth analysis of these issues, they are referred to two books, one entitled International Franchising by the author of this article and which is published by Juris Publications Inc, Executive Park, One Odell Plaza, Yonkers, NY, 10701 and the other is entitled Guide to International Master Franchise Arrangements, which is published by the International Institute for the Unification of Private Law, in Rome, Italy.

II. ISSUES

Some of the most important issues that should be taken into account include:

1. Acceptability of Products and/or Services

The fact that a product and/or service is accepted in a particular country does not necessarily mean that it would be equally acceptable in another country. Thus it would be prudent to have a market study carried out so as to verify the acceptability of the product and/or service. Whether it is the franchisor or the sub-franchisor who should have the responsibility to carry out the research and the depth of the research, is a matter of negotiation between the parties. The same reasoning goes for the acceptability of the trademarks to be used in connection with the franchise system. This is especially true where the trademark may have a secondary or even different meaning in the country in which the master franchise is to be implemented.

2. Commitment of the Franchisor

In previous years, it was accepted by the franchise community that in granting a master franchise, all that was necessary, was for the franchisor to spend several weeks training the sub-

franchisor in all aspects of the franchise system, sit back and collect royalties, and leave the entire implementation of the franchise system, including the adaptation of the franchise system, if necessary, to the sub-franchisor alone.

Experience has shown, that this position rarely works. Not only must the franchisor train the sub-franchisor in the franchisor's country, but he must also provide in depth training in the franchise system in the exclusive territory, including being actively involved with the sub-franchisor in adapting the franchise system and identifying products and/or services as well as suppliers of products and/or services. In addition, the franchisor should be involved in the opening of the first franchise outlet(s) by being present both immediately prior to and following the opening.

The franchisor's willingness and even insistence, in carrying out these functions will provide the sub-franchisor with a good indication as to the franchisor's commitment in assisting the sub-franchisor in implementing the franchise system in the exclusive territory.

Many potential sub-franchisors, in order to save on fees, try to cut back on the amount of training and other involvement by the franchisor in the implementation of the franchise system. This is entirely counter productive.

3. Experience of Franchisor in International franchising

It would be important for the sub-franchisor to be aware of the different international master franchise arrangements, if any, that have been entered into by the franchisor and whether or not the master franchise arrangements have been successful.

4. Initial Master Franchise Fee

Most master franchise agreements provide for the payment of a non-recurring fee that is payable by the sub-franchisor to the franchisor upon the execution of the master franchise agreement.

The amount of this fee is typically the subject of a great deal of discussions and many a deal has floundered over the inability of the parties to agree on the amount of the fee and even the terms of payment, if any, for such fee.

There are many factors that must be taken into account , most of which are dealt with in the chapter on master franchise agreements in the book entitled International Franchising and referred to above. Included, amongst the most critical factors are i) the amount of training and degree of involvement by the franchisor in the initial stages of implementation of the franchise system in the exclusive territory, including the number of trips and the duration of time of each trip, the franchisor is obligated take at his own expense, the number of franchised outlets that can be reasonably be established in the exclusive territory; and ii) the notoriety or recognition of the franchisor's trademarks in the exclusive territory.

5. Continuing Royalty Fee

Most franchise agreement provide for the payment of a continuing royalty fee by the sub-franchisor to the franchisor. This royalty is typically calculated as a percentage of the royalty the sub-franchisees are required to pay to the sub-franchisor. Again, this is a matter of negotiation between the parties. However, it is extremely important for the sub-franchisor and even the franchisor to understand that there are precious few franchise systems that can survive where the

sub-franchisor retains less than four percent (4%) of the revenue from each franchised outlet. Thus, in a franchise system where the royalty payable to the sub-franchisor by the sub-franchisees is five percent (5%), what is left to be paid to the franchisor would be one percent (1%). For most franchisors, a one percent royalty, is simply not enough to warrant the efforts that most franchisors are now being called upon to exert in the foreign country. Thus, unless the franchise system is one where the amount of the royalty to be paid by the sub-franchisor is at least six percent (6%) and/or where the franchisor has access to other legitimate sources of revenue, it would be difficult for the master franchise to succeed. Because master franchise entails a splitting of continuing royalty fees between the franchisor and sub-franchisor, more and more questions are being raised as to whether there realistically is "enough money in master franchising" for both the franchisor and sub-franchisor, once these fees have been split.

As was pointed out above, franchisors are questioning whether the portion of the royalty fees that are payable to him are sufficient compensation for the continuing efforts to provide support to the sub-franchisor and for the inherent risks involved in international franchising. The previous assumption under which many franchisors operated in the past, that once a master franchise agreement has been entered into with a sub-franchisor and the sub-franchisor has been properly trained in all aspects of the franchise system, the sub-franchisor would "now be on his own" has, unfortunately, too often not worked. Rather, what experience has shown over the last number of years, is that the continuing involvement of the franchisor in the foreign country is essential in order to ensure the viability of the franchise system. Although this involvement does not typically take the form of an investment in the affairs of the sub-franchisor, it does extend to the time and effort on the part of the senior management of the franchisor who is typically required to spend considerable periods of time in the exclusive territory. Thus, it is extremely important for both the sub-franchisor and franchisor to come to grips with this issue and to fully examine the respective obligations of each of the parties and the financial repercussions that result from these obligations.

For master franchising to be effective in many franchise systems, the franchisor must be able to seek out sources of revenue that must be both legitimate and be in addition to royalties. These sources of revenue could then be made available to the sub-franchisor, either as an alternative source of revenue or in the form of an even more advantageous split for the sub-franchisor of the royalties paid to the sub-franchisor by the sub-franchisees. In other words, the franchisor would be able to accept a smaller royalty from the sub-franchisor, thereby leaving the sub-franchisor with a greater share of the royalty in so far as the franchisor would have alternative sources of revenue.

However, as was pointed out above, and it cannot be over emphasized, these alternative sources of revenue must be legitimate and should not, under any circumstances, be artificially created. An obvious example of a legitimate source of revenue is easily found when, as part of the franchise system, the franchisor is the supplier of certain proprietary products. By proprietary products, it is meant, products that are both sold under the franchisor's trademarks and are produced by or on behalf of the franchisor using the franchisor's recipes, processes, formulae, know-how, patents, etc, and which are not otherwise available on the market, in the same form.

Ideally, such proprietary products should be relatively cheap as compared to the finished product produced and sold by the sub-franchisor, and should be extensively used in the production of the finished product. In other words, the cost to the sub-franchisor to purchase the proprietary products should be insignificant when compared to the cost of all the materials required to produce the finished product. A good example of such a proprietary product is the spice mix used by several franchisors of franchise systems that are centred around the sale of chicken, which spice

mix is widely used to prepare the finished product. Such spice mix is produced in accordance with the secret formulae owned by the franchisor, costs relatively little in comparison with the cost of the chicken and other products used in the preparation of every piece of chicken, and an alternative source of supply for the specific spice mix is not otherwise available.

Another ideal source of revenue is found in those franchise systems in which the franchisor, in addition to entering into a master franchise relationship with the sub-franchisor, enters into a transfer of technology or license arrangement with the sub-franchisor. Under such a licensing arrangement, the sub-franchisor is required to establish a manufacturing or production facility to produce a proprietary product making use of the patents, know-how and other intellectual property owned by the franchisor. Such products are in turn sold to all sub-franchisees, insofar as such products form an integral part of the franchise system. In some circumstances, the product may also be sold to third party users who are not part of the franchise network. In this form of license arrangement, the sub-franchisor is usually required to pay a royalty to the franchisor on the sale of all such products produced by the manufacturing or production facility.

The manufacturing or production facility is, of course, a profit centre for the sub-franchisor, even after taking into account the royalty that is paid to the franchisor. Under the foregoing circumstances, the franchisor has an additional source of revenue, in addition to his share of the royalty on retail sales paid by the sub-franchisor to the franchisor, and the sub-franchisor has a profit centre in addition to the royalties earned from his franchise operations.

What cannot be over-emphasised however, is that these additional sources of revenue cannot be artificially created by the franchisor selling a product that is not truly a proprietary product to the sub-franchisor or sub-franchisees. Should the franchisor attempt to do so, it will be seen as an artificial creation resulting in resentment amongst all parties to the master franchise relationship.

6. Other payments to the franchisors

Master franchise agreements usually provide for other payments, such as for example, a payment of the portion of the initial franchise fee that is payable by a sub-franchisee to the sub-franchisor upon the grant of a sub-franchise. However, by and large, these additional fees are not crucial to the success of the master franchise arrangement, even though they are important.

7. Supply and availability of product

It is of course important to know that all the products and services that are necessary to implement the franchise system are readily available in the exclusive territory. To the extent that some products must be imported into the exclusive territory, it is important to know if there are any import restrictions such as quotas, custom duties, etc which may be applicable.

Other important issues to address is identifying the suppliers of the products that are essential to the franchise system and whether the franchisor is himself a supplier, whether there are designated suppliers and, if in the affirmative, the price at which products are to be supplied, including the treatment of volume discounts, rebates, etc.

8. Exclusive Territory

The size of the exclusive territory, including the number of franchised outlets that can reasonably be developed, is another factor that must be taken into account. Although most sub-

franchisors would want to have the largest territory possible, it should be understood that the initial master franchise fee will reflect the size of the territory. In addition, the sub-franchisor will have to open or sub-franchise a larger number of franchised outlets to reflect a larger exclusive territory. It would therefore be important for the sub-franchisor not to "bite off more than he can chew" in negotiating the size of the exclusive territory.

9. Availability of resources

Remember the sub-franchisor acts, for all intents and purposes, as the "franchisor" in the exclusive territory. Thus he must make sure that he has available to him the necessary financial and human resources to develop the franchise system in the exclusive territory in a reasonable period of time. For this reason, the preparation of a five year budget is indispensable, and should be as realistic as possible.

III. CONCLUSION

The foregoing are only some of the factors that must be taken into account by a Canadian company considering acquiring a master franchise for all or part of Canada. Being a sub-franchisor is a serious business and entails a great deal of responsibility, apart from the resources, that are required. By assuming the role of a "franchisor" under a master franchise arrangement, the Canadian company must carefully and truthfully assess its own abilities and experience that is required to fulfil the role of a "franchisor". Thus franchising experience is almost indispensable, insofar as acquiring this experience "on the job" may prove to be a costly endeavour.

This article does not in any way try to cover many of the issues that must be negotiated in a master franchise agreement, or those matters which are more legal in nature as opposed to business issues. Experience in negotiating International franchise arrangements is, accordingly, indispensable.

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