

MASTER FRANCHISING REVISITED

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Although master franchise agreements remain the most popular vehicle used by franchisors in their international expansion, a number of them are beginning to form doubts as to whether master franchising is the most beneficial way to establish a franchise system in a foreign country. These doubts about master franchising are being fuelled by certain legal problems including:

- (i) the difficulties involved in terminating master franchise agreements in view of the impact of such termination on sub-franchisees, as well as;
- (ii) the difficulty of a franchisor to control the manner in which his franchise system is being established in a foreign country. This latter difficulty is of course based on the fact that there is typically no direct contractual relationship between the franchisor and sub-franchisees and as a result, the franchisor may be unable to prevent any abuses of the franchise system by sub-franchisees through direct action.

Although the foregoing legal issues have been the subject of much debate, a third issue is now being raised with increased frequency, which issue is essentially a business one and relates to whether or not there is "enough money in master franchising" to justify its use given that master franchising entails the splitting of initial franchise fees and the continuing royalty fees between the franchisor and master franchisee. Although master franchising arrangements typically provide for the splitting of fees in a proportion that generally favors the master franchisee, the issue nevertheless remains as to whether the fees left in the hands of the master franchisee are sufficient to support the type of organization that a master franchisee is required to build in order to ensure the proper establishment and supervision of the franchise system. The question is just as relevant for the franchisor, who typically receives the smaller proportion of the fees paid by sub-franchisees, and who is now questioning whether the portion of the fees payable to him are sufficient compensation for his continuing efforts to provide support to the master franchisee and for the inherent risks involved in international franchising. For many franchisors, it had previously been assumed that once the master franchise agreement had been entered into with the master franchisee and the master franchisee had been properly trained in all aspects of the franchise system, the master franchisee would basically "now be on his own". Rather, what experience has shown over the last number of years, is that the continued 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 master franchisee, it does involve time and effort on the part of senior management of the franchisor who may be required to spend considerable periods of time in the foreign country. Thus, the continuing costs of supporting the franchise system in the foreign country remains significant. Certainly, in the initial three to five years during which the franchise system is being established in the foreign country, the royalties that will be earned by a franchisor may very well not compensate him for his continued efforts in assisting the master franchisee in establishing the franchise system in the foreign country.

Thus, 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 master franchisee, either as an alternative source of revenue to the master franchisee or in the form of an even more advantageous split for the master franchisee of the royalties paid by sub-franchisees to the master franchisee. In other words, the franchisor would be able to accept a smaller royalty from the master franchisee, thereby leaving the master franchisee 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 emphasised, these alternative sources of revenue must be legitimate and should not, under any circumstances be artificially created. An obvious example of a legitimate source is easily found in those franchise systems where 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 or 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 sold by the sub-franchisee and should be extensively used in the production of the finished product. In other words, the cost to the sub-franchisee to acquire the proprietary products should be relatively insignificant 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 system selling chicken, which spice mix is widely used to prepare the finished product. Such spice mix is produced in accordance with a secret formulae owned by the franchisor, costs relatively little in comparison with the cost of chicken and other products used in the preparation of every piece of chicken, and an alternative source of supply is not otherwise available.

An ideal alternative source of revenue is found in those franchise systems in which the franchisor, in addition to entering into a master franchise relationship with the master franchisee, enters into a transfer of technology license agreement with the master franchisee. Under such a licensing arrangement, the master franchisee is required to establish a manufacturing or production facility to produce a proprietary product making use of the franchisor's patents, know-how or 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 licensee/master franchisee is usually required to pay a royalty on the sale of all such products produced by the manufacturing or production facility to the franchisor. The manufacturing or production facility is, of course, a profit centre for the licensee/master franchisee, even after taking into consideration 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 master franchisee to the franchisor, and the master franchisee has a profit centre in addition to the royalties earned from the franchise operations.

What cannot be over-emphasised 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 master franchisee 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.

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