Negotiating a Master Franchise Agreement — Getting to "Yes"

Negotiating can be complex, challenging and demands careful thought and patience.

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International expansions of franchise systems have been increasing at a rapid pace for years. For some franchisors, such expansions have proved to be very successful, but for others, the experience has been costly and frustrating. Often, one of the greatest areas of frustration is getting the master franchise agreement settled and signed, even when the candidate and the fundamentals of the deal are right. This article examines some of the most common issues that arise in the negotiation of an international master franchise agreement and suggests some solutions which might help to get the deal done.

THE TERRITORY, FRANCHISE FEE AND PERFORMANCE CRITERIA

Most international master franchise arrangements provide that the rights are granted, usually on an exclusive basis, for an entire country or group of countries, such as the Middle East. The prospective master franchisee often wants to lock up the broadest territory possible in the event the franchise expansion proves successful. However, serious problems can arise when the exclusive rights granted are to territories which are far too large for the capabilities of the master franchisee.

Frequently, two sticking points in the negotiations are the amount of the initial franchise fee for the territory and the performance criteria, (usually the number of units required to be open each year) which, if not met by the master franchisee, are grounds for termination. If the franchisor can forego the larger initial franchise fee for a series of smaller payments based on a per unit opened measurement, then a deal can be more easily achieved by allowing the master franchisee to "earn" the right to ever-increasing exclusive territories within the target country or group of countries. This approach overcomes the fear for master franchisees who are paying a lot of money for a concept that is yet unproven in their country or region and still provides the franchisor with control over the development of the system within the broader territory.

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THE TERM

Prospective master franchisees want the term of the master franchise agreement to be virtually and sometimes actually, perpetual. Franchisors want to limit the term (including renewal rights) to a period of time that allows the master franchisee enough time to earn a good return on its investment and perhaps generate some capital gain on a resale.

Assuming the franchisor would be happy with a successful and thriving system in the territory regardless of the length of the term, the number of renewal terms could expand based upon specific performance criteria that achieve that result for the franchisor, beyond the usual number of renewal terms. The message to the master franchisee is, "You can have a very long term, if you earn it."

DIVIDING UP THE SPOILS AND JOB ALLOCATIONS

Without a doubt, the most poorly handled issue in master franchising is the division of the front-end franchisee fees and continuing royalty fees for the unit franchises in the territory between the franchisor and the master franchisee. It is not unusual for the franchisor to base the decision on the allocation of these fees on the anticipated or desired return from the development of the system in the territory without serious or careful regard for how the master franchisee will finance the necessary development and support services for the unit franchisees. Mistakes with this

(Continued on page 50)

(Continued from page 49)

issue will either ensure the demise of the master franchisee or reduce the quality and performance of the system in the territory. Additionally, presenting unrealistic numbers to a sophisticated prospective master franchisee can wreck the deal.

The responsibilities for the development and administration of the system should be decided first as between the franchisor and master franchisee. Then the division of the various fees should be based upon the costs of discharging those responsibilities and only after that should the parties divide up the remaining "profits." Being able to provide proof of a careful analysis of these matters will go a long way to getting the deal done with the best candidate.

SELECTION OF UNIT FRANCHISEES AND LOCATIONS

Often, master franchisees want the right to select unit franchisees and locations within their territory, but franchisors do not want to abdicate the responsibility for final approval of franchisees and locations before the master franchisee has proven to be capable in these crucial areas. By proposing an initial fixed number of franchisor approvals, subject to specific achievements of the master franchisee, with a resumption of the requirement of franchisor approvals in the future if other criteria are not met, the franchisor can overcome a common challenge to concluding negotiations.

GOVERNING LAW

Both parties are understandably more familiar and, therefore, more comfortable with the legal regime in their respective home jurisdictions. To avoid another obstacle to getting the deal done, the franchisor should consider having the governing law of the agreement be the most appropriate law depending upon the issue, with some issues being determined by the law of a third jurisdiction acceptable to all. While the governing law provision of the agreement will be more complex than usual, the extra comfort level of the parties will make it easier to finalize the agreement.

Franchising is one of the best and most efficient ways of expanding a business. Once a solid foundation is built for the success of the system in the home jurisdiction, international expansion is a sensible and potentially profitable strategic choice. A poorly executed international expansion can drain the resources of the franchisor to the point of destroying the entire system. The moral being that it is less important what you do than how you do it.

Getting to yes, with the best candidates, for the right master franchise agreements can go a long way in ensuring that international expansions are profitable and satisfying for the franchisor. The foregoing has only touched the surface of a complex and challenging area of negotiations. It is not "rocket science," but it does demand careful thought and patience. ■

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SOURCES OF INFORMATION

International master franchising remains one of the least understood and most poorly implemented expansion strategies in franchising. According to Arthus Kalnins, Ph.D., a Cornell Univ. professor who released a survey in 2005, "Biting Off More Than They Can Chew: Unfilled Development Commitments in International Master Franchising Ventures," out of 142 restaurant master franchisees, only 55 were in business at the end of the development term, 21 master franchisees did not open a single unit and six master franchisees met or exceeded their development commitments. It is important to set clear growth (and unit maintenance) targets for the master franchisee. On the other hand, most targets in master franchise arrangements are not met, the survey adds.

In a survey by John P. Hayes, Ph.D., of Hayes Worldwide from 2000 that looked at the initial franchise fees for master franchise rights, of the master franchisees studied:

- *36 percent invested $100,000 to $250,000*
- *28 percent invested less than $100,000*
- *21 percent invested $250,000 to $500,000*
- *15 percent invested more than $500,000*