BUYING INTO THE AMERICAN DREAM
BY
EDWARD (NED) LEVITT*

In the world of franchising, Canada occupies a unique position. Geographically, we share a common border with the U.S. franchise behemoth, as does Mexico, but Canadians are more like Americans than any other people on the planet. This means that American franchise successes are more likely to be repeated in Canada than anywhere else. With that promise of success, for decades many Canadians have sought out and invested in U.S. franchises; some have achieved incredible results (witness the success of McDonalds's Canada) and some have failed miserably (anyone had a Red Barn burger recently?).

There are so many reasons why one such franchise investment succeeds and another fails that it would take at least a book, if not several, to do justice to the question. However, what follows is a brief look at some of the most common and arguably obvious factors that spell the difference between success and failure.

Will the Concept Work in Canada?

While we Canadians look, dress and talk (sort of!) like Americans, there are some real differences in our cultures and buying habits. The problem is, however, these differences are not obvious. Which means Canadian franchise investors and, for that matter, U.S. franchisors, often make assumptions about the Canadian market that are not true or not true enough. Foregoing a sufficiently thorough market study for the concept in Canada is like operating a piece of heavy equipment blindfolded. Local knowledge may lead to the investment being rejected or the concept being adapted properly for the Canadian market. Either way, the potential investor comes out a winner.

Can the U.S. Franchisor Support the System in Canada?

In most cases, one of the principal reasons for buying the rights to a U.S. concept, is to acquire the know-how in that business by capitalizing on the franchisor's experience and knowledge gained over many years and with much investment. Sounds good! But if the U.S. franchisor does not have a sufficient infrastructure to provide the critical and inevitably needed support to the Canadian investor, all of that great knowledge will be of little value. This should lead to an examination of the franchisors capabilities to support the Canadian expansion, at least in the early years.

Is There Enough Capital?

A Canadian expansion of a U.S. franchise system, is, in many ways, a startup. Of course, with the know-how of the franchisor, it is much further along than a brand new business concept, but the need for working capital will be significant while the business is being established in Canada. The Canadian investor will have to fund the initial payments for the rights to the U.S. franchisor, staffing costs, professional fees, initial marketing costs, possibly building costs or sub-franchise selling costs and then living expenses for the investor until a positive cash flow is achieved. The root cause for failure can often be traced to the lack of adequate capital, which in turn often results from inadequate information provided by the franchisor on the magnitude of the needed capital. This problem is most common where the U.S. franchisor is more interested in "closing" a deal than making the right deal with the right party.

Does the Deal Make Sense?

A good concept with a bad deal for the investor, still ends up in failure. It is very common for Canadian investors to purchase master franchise rights from U.S. franchisors for parts of Canada or for the entire country. Master franchising means the Canadian investor will be selling sub-franchises and sharing the revenue from those sub-franchises with the U.S. franchisor, i.e. initial franchise fees, royalties, renewal fees and transfer fees. Problems arise when the shared portions of such fees do not match up with the cost of delivering the services upon which the fees are based. If, for example, on a 6% royalty rate it takes 4% to support the system properly in Canada (which is not unrealistic) and the U.S. franchisor demands 3% of the 6% as its cut, then disaster is lurking just around the corner.

One of the most difficult numbers to ascertain in all of franchising is the amount that should be paid for the front-end franchise fee or territorial rights fee for the grant of master franchise rights. This number will be influenced by many factors, including the length of the term of the grant, the history of success of the franchise system, the amount of training and initial support to be provided by the franchisor and the level of additional investment required of the franchisee. Drawing analogies to other existing systems, with master structures, can be helpful in deciding upon the amount to charge, but it is best to relate the fee to the potential for profit and return on capital of both parties. In one survey[1], of the master franchisees studied, 36% invested $100,000 to $250,000, 28% invested less than $100,000, 21% invested $250,000 to $500,000 and 17% invested more than $500,000,000.

Another very common mistake made in master franchise deals is with the establishment of unrealistic quotas on the opening schedule of units. According to one study[2] 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 6 master franchisees met or exceeded their development commitments. It is important to agree on clear growth (and unit maintenance) targets for the master franchisee. On the other hand, most targets in master franchise arrangements are not met.[3]

Other Matters

Some other important considerations are:

1. Is the term of the master franchise agreement sufficiently long to ensure that a reasonable return on investment can be achieved?

[1] From a 2000 survey of master franchisees by John P. Hayes, Ph.D, Hayes/Worldwide

[2] Arturs Kalnins, *Biting Off More than They Can Chew: Unfulfilled Development Commitments in International Master Franchising Ventures*, 5.12 CHR Reports 1, 8 (2005).

[3] *Ibid*

2. Will the master franchisee have to adhere strictly to the franchisor's form of unit franchise agreement in all circumstances or will there be some flexibility?
3. Will the master franchisee administer a regional advertising fund for the territory or will it all be controlled by the franchisor?
4. If there are critical inventory items, who supplies them to the franchisees, the master franchisee, the franchisor or third parties and who benefits from volume purchases?

Conclusion

There is lots more to consider, but this is a good start.

* Edward (Ned) Levitt is a Certified Franchise Executive, a partner at Dickinson Wright LLP, Toronto, Canada, and provides legal services to Canadian and international clients on all aspects of Canadian franchise law. He was General Counsel to the Canadian Franchise Association (2000-2007) and is a member of the American Bar Association Forum on Franchising, the International Bar Association and the International Franchise Association. As a member of the Ontario Franchise Sector Working Team, Ned was instrumental in the creation of Ontario's franchise legislation. Among his many publications is the leading text, *Canadian Franchise Legislation* (2001, LexisNexis/Butterworths). Ned can be reached at 416.646.3842 or nlevitt@dickinsonwright.com.