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WHAT SHOULD I LOOK FOR

WHEN VALUATING A MASTER FRANCHISE OR AREA DEVELOPMENT OPPORTUNITY?

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Careful consideration and thorough due diligence is critically important in the purchase of a single franchise.

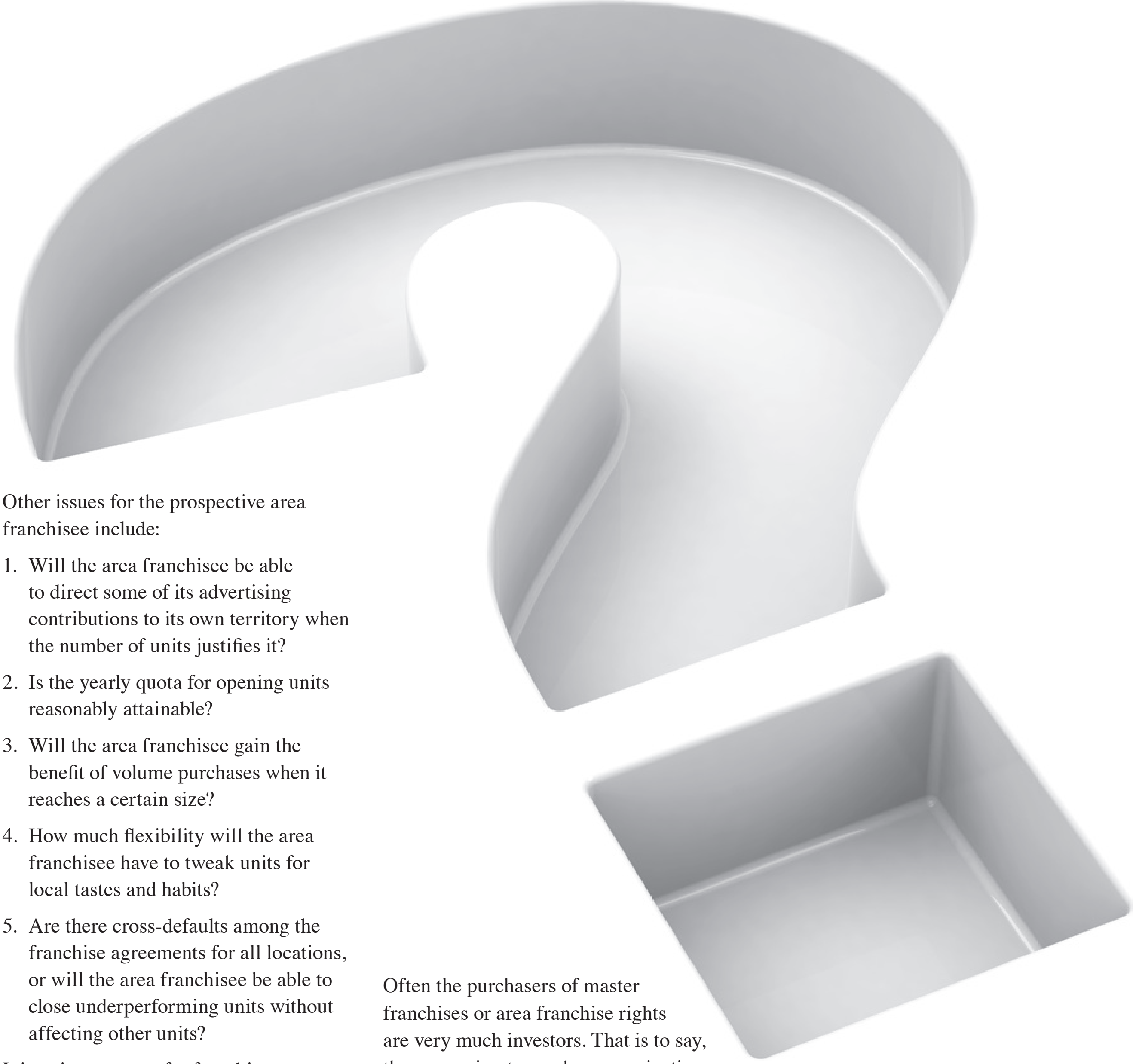
For the purchase of master franchise rights (the right to sub-franchise to others) or area franchise rights (the right to open multiple single franchise units in a given area) there is another layer of complexity, challenge and risk. Commonly, the investment needed for such purchases is fairly high to very high; and therefore, the consequences for a failure in these scenarios are substantial.

In the case of a master franchise, the master franchisee usually plays the role of the franchisor in their territory, which can be a region, province or the entire country. However, the division of responsibility between the master franchisee and the franchisor can differ from system to system. The master franchisee, in many instances, shoulders all responsibilities of the franchisor in the territory. In other situations, the franchisor provides specific resources or performs specific functions, such as training new franchisees. Once it is known who is going to do what, then, and only then, can the split of front end franchise fees and ongoing royalties between the franchisor and the master franchisee be determined with any degree of fairness. All too often the franchisor has a pre-determined idea of what they want from the master franchisee without proper regard for the cost of running a franchise system in the territory well, and whether the arrangement is profitable for everyone.

Other issues for the prospective master franchisee include:

1. Is the term sufficiently long enough to ensure that a reasonable return on investment can be achieved?
2. Is the yearly quota for selling sub-franchises reasonably attainable?
3. Will the master franchisee have to strictly adhere to the franchisor's form of unit franchise agreement in all circumstances or will there be some flexibility?
4. Will the master franchisee administer have a regional advertising fund for the territory or will it all be controlled by the franchisor?
5. If there are critical inventory items, who supplies them to the franchisees, the master franchisee, the franchisor or third parties?

For area franchise rights, the length of the term of the overall grant is important, but it is equally important to ascertain what happens to each franchise when the overall grant term expires. Can the unit franchises continue to be operated for the term of the franchise agreement? If the area franchisee is going to have to pay a new front-end franchise fee for each franchise location, will that fee be reduced in recognition of the fact that such fees include elements of the cost of franchise sales and initial training? This is important to know because both are absent in an area franchise beyond the initial unit.



Other issues for the prospective area franchisee include:

1. Will the area franchisee be able to direct some of its advertising contributions to its own territory when the number of units justifies it?
2. Is the yearly quota for opening units reasonably attainable?
3. Will the area franchisee gain the benefit of volume purchases when it reaches a certain size?
4. How much flexibility will the area franchisee have to tweak units for local tastes and habits?
5. Are there cross-defaults among the franchise agreements for all locations, or will the area franchisee be able to close underperforming units without affecting other units?

It is quite common for franchisors to charge initial franchise fees for master franchise and area franchise rights. The purchaser of these rights should scrutinize such fees to both make sure they make sense from the point of view of return on investment, and to determine how they compare to other franchise opportunities. Usually there is an initial term and rights to renew the term granted to a master franchisee or an area franchisee. It is also usual to find a long list of conditions, which have to be met before the master or area franchisee is allowed to renew the term. These conditions need to be reviewed carefully to determine whether they are likely to be met.

Often the purchasers of master franchises or area franchise rights are very much investors. That is to say, they are going to need an organization to actually carry out their duties under their various agreements. In addition to the issues described above, such an investor should have a viable plan for acquiring, training and retaining the right employees to assure success.

Edward (Ned) Levitt is a Certified Franchise Executive, a partner at Dickinson Wright LLP, Toronto, 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 Committee of 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 and has had significant input in the franchise legislative process throughout Canada. His publications include *Canadian Franchise Legislation* (2001, LexisNexis/Butterworths).

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