

## A MEETING OF THE MASTER-MINDS



**William Graefe, Franchise Attorney at Fisher Zucker, explains the importance of pre-sale negotiations for both parties when creating a master franchise agreement**

**A**s an attorney, I rarely find a time when I am not advocating for one side or the other in the negotiations leading up to a new master franchise relationship. When I kept hearing mentions of a franchise system alignment from a number of top franchisor executives at the International Franchise Association's recent Annual Convention, it made me realise its importance in connection with a new master franchise relationship where, at least initially, the franchisor will be looking to the potential master to essentially be its franchise system in a foreign country. To that end, it is useful to examine the primary aspects of a new master franchise relationship, and where it is critical that the parties' interests and expectations are in alignment.

### GETTING STARTED

Building a strong foundation in a master franchise relationship is rooted in a transparent and mutual due diligence period, during which both parties have an opportunity to investigate and ask questions to determine whether or not there is a fit. This period also helps to clarify how the parties handle brand development and the primary business terms of the relationship should they decide to move forward. When representing the franchisor, that means asking questions that go beyond the liquidity and overall financial position of the potential master, including an investigation into: the prior experience of the master and its affiliates and principals in the applicable industry (e.g. restaurants or retail) and with other



franchise systems; any existing infrastructure that the prospect might have in the geographical area at issue; any other indicators that tend to demonstrate the prospect's experience and savvy with respect to jurisdictional-specific issues, such as real estate selection and product importing and exporting. Franchisors should also have a good look in the mirror to evaluate whether the franchise system, infrastructure and brand culture are replicable in the contemplated territory.

For a potential master, the main focus should be on the historical performance of the brand and what tools and resources the franchisor has available to help the master replicate success in the proposed territory. Among other things, the prospect should ask questions regarding: the historical development of the brand both domestically by the franchisor, and internationally via other master franchises; whether the franchisor



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has protected the marks in the jurisdictions that will make up the territory; the type of sourcing and distribution needed for the franchise system to work, and whether the franchisor has experience or plans with regards to ensuring sourcing and distribution in the contemplated territory; the initial and ongoing training programmes and where such training will be provided (given barrier to U.S. entry concerns); and finally, the type of manuals, marketing materials and other 'brand development' items that will be provided by the franchisor.

Too often we work with potential masters who are reluctant to 'kick the tyres' on a brand because they are afraid it will deter a franchisor from wanting to do a deal, when in fact I have found the opposite is true. Franchisors, especially those with prior experience in international master deals, know that the prospect groups that conduct the most

thorough due diligence will typically be the groups that make the best stewards of their brand if and when a relationship is formed. Even if they also tend to be the groups that try to negotiate the most with respect to the underlying agreements.

#### THE FOUR PILLARS

If a mutually active and transparent due diligence period is the foundation of a successful master relationship, then the pillars that uphold that relationship are the primary business and development terms negotiated as part of the master franchise agreement. And like all pillars, the provisions addressing these key aspects of the relationship must be properly placed and aligned in order to help meet and exceed the parties' reasonable expectations.

The first pillar of a master franchise relationship is the size of the territory that the prospect will be granted and the corresponding development schedule. In order to ensure a practical meeting of the minds, we often find ourselves counselling clients to be realistic in terms of territory, while the client – whether a franchisor or potential master – will push for the largest area they can negotiate. Franchisors want to grant a large territory because a larger area typically means a higher master franchise fee and, from a potential master's perspective, a bigger territory means a larger pool of prospective sub-franchisees, and more areas wherein these sub-franchisees can open up franchised locations. In other words, a higher market to saturate.

As counsel negotiating for either party, however, we often advise that our clients seek to grant or purchase a reasonably-sized territory which is coupled with a realistic development schedule that is based on the demographics and experience of similar brands in that territory. If either party becomes concerned about the territory size and corresponding commitment, we would typically recommend that the parties agree to an initial area that will be granted under the agreement, while also granting the potential master a right of first refusal or other option to develop surrounding jurisdictions down the road if certain conditions

are met (including compliance with the development schedule). This allows the parties to avoid a situation where (a) the territory is too big for the potential master to fully exploit the entire area, (b) the development schedule cannot be met, or (c) either or both parties are not able to provide the necessary infrastructure and support throughout the entire area. Any one of these issues could leave the master franchise relationship in a shambles.

The second pillar of a strong master franchise structure are the marks that are being licensed by the franchisor. Unlike the territory issue above, the parties are not typically pulling for the same position here. The potential master wants assurances that the brand, or mark, at issue is available and registered for use in the territory before they pay the franchisor any type of master franchise fee. Meanwhile the franchisor is often reluctant to expend the funds to get such marks registered until it knows that the potential master has signed a master franchise agreement or otherwise committed to moving forward. In order to align the parties, we recommend a middle ground. First, the franchisor obtains and reviews a search report for the primary marks to help determine that there are not confusingly similar marks already being used in the territory, and provides the potential master with that opinion prior to signing. Next, the parties agree that the franchisor is not making any representations about such marks other than what it found, or did not find, in the report. Finally, if the parties decide to proceed, they split the costs associated with getting the marks registered in the jurisdictions comprising the territory. Regardless of how the parties agree to protect the marks, the franchisor should rightfully own the marks and any registrations licensed as part of the master franchise.

The third pillar is effectively dealing with distribution and sourcing, especially in retail or restaurant concepts that involve the sale and distribution of proprietary or branded items. While there are various ways to set up distribution in a given territory, including: (a) having the master and its sub-franchisees

purchase from the same suppliers that the franchisor uses in the U.S. or with other international masters; or (b) the franchisor agreeing to grant the potential master the rights to manufacture, distribute or otherwise serve as a 'co-packer' with respect to the proprietary products at issue, the key here is to make sure that whatever structure is set up, it is well thought out as part of the due diligence process and accurately fleshed out in the language of the master franchise agreement. It is not uncommon for new clients to come to us with existing agreements that say little or nothing about how product distribution will actually work.

The final pillar necessary for a master franchise relationship to thrive is compliance with any pre-sale disclosure, and registration laws of the territory being granted to the potential master. Potential masters typically seem to adopt the mindset that 'since all the liability is on the franchisor to comply, why should I worry?' – but that is not necessarily the case. In most jurisdictions that require the franchisor to provide pre-sale disclosure or register themselves, or their franchise offering, with a governmental agency in order to sell a master franchise, those same requirements and regulations will apply to the master when dealing with its prospective sub-franchisees. Regardless, making sure that the master franchise being offered is properly disclosed and, if necessary, registered in accordance

#### ★ MEET THE AUTHOR

Bill helps oversee and manage the international franchise practice at Fisher Zucker, LLC, a boutique law firm located in Philadelphia, PA that specialises in franchising and has more than 150 franchisor clients across the United States and internationally. Bill has represented numerous U.S.-based franchisors as they expand into foreign jurisdictions via master franchising, direct franchising and other international licensing arrangements. Bill has spoken on the topic of international franchising at the International Franchise Association's Legal Symposium and a number of other conferences. He was recently selected as a 2016 'Legal Eagle' by The Franchise Times for the second year in a row in recognition of his work at both the international and domestic level.



with the laws of the territory, is critical to ensuring both parties get the benefit of the bargain they intended. At the same time, such compliance helps avoid liability in the form of damage claims by the other party or administrative penalties from the applicable governmental authorities. Since the non-compliance of a franchisor can easily trickle down to a new master and affect its abilities to sub-franchise, both parties should be very aware of the disclosure and registration requirements of the territory.

#### A HAPPY FUTURE

In closing, it is important to highlight the need for patience, understanding and reasonable expectations throughout the formation and ongoing performance of a master franchise relationship. This article intentionally focused on the pre-sale negotiations and contract drafting because I strongly believe in the saying 'an ounce of prevention is worth a pound of cure'. It is much easier to instil transparency and establish alignment if these principles are emphasised by both parties during their initial

interactions and incorporated into the DNA of the documents that memorialise how the parties will work together over the whole development term.

Having a strong group of legal and business advisors with experience in master franchise deals is a good way to make sure that you are asking the right questions and also addressing them in a manner that will give you the best chance of establishing a true meeting of the *masterminds* when developing a new master franchise relationship.