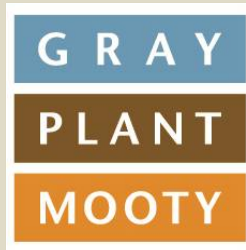

FUNDAMENTALS OF FRANCHISING

International Franchising

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International Franchising

A Chapter co-authored by

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along with

John H. Pratt

from the book

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FUNDAMENTALS OF FRANCHISING

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CHAPTER 7

International Franchising

Mark A. Kirsch and John H. Pratt

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Editor's note: This chapter on International Franchising is new for the fourth edition of this book. It is intended as a basic overview of international franchising for the U.S. franchise practitioner who is taking some early, or baby, steps into the arena of international franchising. Note that the ABA Forum on Franchising published a book in 2013 titled Fundamentals of International Franchising, second edition*, which explores these issues, and many others, in much greater detail.*

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I. Going International

"International franchising," from a U.S. perspective, is a U.S. franchisor "exporting" its brand to a foreign country through some type of licensing, franchising, master franchise, or joint venture relationship. While international franchising also includes U.S. operators or independent business owners becoming franchisees or master franchisees of foreign-based brands, and other country-to-country franchising and licensing, anecdotally, many industry insiders (lawyers, franchise development agents, IFA representatives, and others, consulted by the authors) believe that the largest portion of international franchising (from a revenue and unit growth perspective) is U.S. franchisors granting multiple-unit franchise rights outside of the United States. International franchising has grown steadily since the 1980s. This chapter addresses some of the key strategic, business, and legal issues that franchisors and counsel face as they embark on an international franchise program.

A. Drivers of International Expansion

A franchisor's decision to "go international" may be shaped by different influences. Anecdotal experience indicates that many initial forays into foreign countries, particularly for younger systems, or those that have not developed nationally or even multi-regionally, are opportunistic and not part of a strategic plan. An existing franchisee, or developer, customer, or franchisee of another brand in the same country, approaches the franchisor and asks to become the franchisee in country "X." In these situations, the driver for international expansion is often based on the desire to receive a large up-front fee and a chance to travel to exotic places as part of the franchise development, coupled with the recognition that if the arrangement flops in a far-flung country, the failure will have little or no impact on the brand in the U.S. For some companies, the lure of international expansion is simply the cachet of having an international footprint, regardless of whether the business adds to the bottom line.

Some franchisors approach international development more strategically. For example, franchisors might research countries that may have a consumer market that is receptive to the business or brand; the ease (or difficulty) of local operators/franchisees to obtain inventory, ingredients, or equipment; the similarity of language and culture; the ease and cost of supporting franchisees or a master franchisee in the country; the regulatory and business environment; and similar factors. For these reasons, Canada is often one of the first foreign countries where U.S. franchisors venture out.

B. General Considerations

Whether the motive is strategic, opportunistic, or a combination, franchisors should evaluate the following factors prior to engaging in franchising in a particular country:

1. **Business Climate**
   Is franchising as a method of doing business accepted and well established, or is it growing, in its infancy, or nonexistent in the target country?
2. **Prospective Franchisees or Master Franchisees**
   What is the profile of the ideal franchisee or master franchisee, and does the target country provide a good and strong source of potential candidates, based on education, economy, business experience, or other factors?
3. **Receptivity to U.S. Brands and Franchisor's Product or Service**
   Some countries or cultures are more receptive to (and some are even enamored with) U.S. brands than others, and therefore some markets for the franchisor's product or service may be stronger than others. Also, some franchisor brands or services are dependent on a U.S. or Western lifestyle and culture (for example, elder care), which might not align with the mores and customs in a foreign country (for example, some cultures do not embrace third-party care of the elderly and view that service as a responsibility of the immediate family).
4. **Regulatory and Business Climate**
   Generally, does the foreign country have a regulatory and business climate that is conducive to, and encouraging of, entrepreneurs and small businesses, or are there hurdles for the franchisor and franchisees? Can contracts be enforced in the foreign jurisdiction? And, more specifically, is the franchised business in an industry that may have particular issues or obstacles in that country?
5. **Taxes and Currency**
   Will the franchisor face withholding taxes imposed on royalty payments or other payments from the franchisee or master franchisee? Are income, value-added, or other taxes imposed? What difficulties exist in repatriating currency from the foreign country?
6. **Foreign Investment**
   Are ownership restrictions or conditions imposed on foreign investments in the country?

7. **Import Duties, Tariffs, and Export Controls**
   If the franchised business is dependent upon a source of supply from outside of the target country—whether for inventory, equipment, support services (e.g., advertising) or supplies—what costs, tariffs, or procedures exist that may make the process of acquiring and importing those goods and services more expensive or time-consuming?
8. **Suppliers**
   Are potential sources of supply available within the country, and can the franchisor regularly inspect and certify that the supply of products satisfies the franchisor's brand standards?
9. **Legal and Franchise Climate**
   Do franchise laws or regulations regulate the offer or sale of franchises, require pre-sale disclosure, or require or prohibit certain contractual provisions in franchise or licensing contracts? Does a mandatory or voluntary franchise association require or recommend certain practices or procedures?
10. **Unit Economics**
    Has the franchisor undertaken an analysis of whether the economics of successfully operating a franchised outlet in the U.S. can transfer to operations in the foreign country?

C. Franchisor Resources

Simply determining (or worse, guessing) that a franchised brand or franchised outlet will be successful in a foreign country is not sufficient to embark on an international franchising venture. Unless the franchisor is willing to grant a franchise or license with little or no commitment to support the foreign franchisee or master franchisee (which will have negative implications of a practical and legal nature), the franchisor must evaluate, and must have, its own resources to support the foreign franchised operations. These resources include financial resources, human capital, and infrastructure.

Engaging in foreign franchising requires a financial commitment—legal documents, U.S. and foreign counsel, compliance costs, travel, etc. The level and scope of the costs will depend on the nature, structure, and scale of the proposed international expansion. The franchisor will likely need to divert personnel from U.S. operations, or hire new personnel, to support the foreign franchises. One of the first steps is to identify a franchise development (or sales) person or team, and someone to evaluate and meet with prospects. This will lead eventually to personnel committed to evaluate local resources, suppliers, and real estate; modifying manuals, policies, procedures, standards, and specifications for international operations; trainers of foreign franchisees or master fran-

chisees; and franchised outlet support personnel (particularly for the first outlets in a country). The scope and amount of the franchisor's resources should be commensurate with the franchisor's commitment to the success of the franchisees in the particular country and in a successful international program.

D. Due Diligence Regarding the Target Country

One of the critical early-stage processes in an international expansion plan is analyzing the target country, or countries, where the franchisor may wish to grant master franchises. The franchisor, or its counsel or agents, should conduct due diligence regarding the potential territory. Many of the issues to consider have been noted above—the local economy, market receptivity to the product or brand, protection of trademarks and intellectual property rights, tax structure, supplier availability, legal structure, labor market, franchise laws, pricing issues, currency issues, etc. These issues cut a wide swath across business, financial, and legal terrain. Doing the appropriate due diligence may not provide an answer to whether franchising in a particular country will be successful, but it should identify risks to avoid, and in some cases the results will suggest that it is best not to venture into the country at all.

Many resources exist that a franchisor or franchise practitioner can utilize to assist with the country evaluations. These range from books and treatises to articles, papers, presentations, Internet resources, government resources, and trade or business associations (in the U.S. and the target country). And within this group of resources are subject-specific resources, such as papers and periodicals that describe the legal framework and franchise laws in particular countries, government summaries of treaties and taxes, and materials that deal with such issues of concern as trademark registration, franchise and intellectual property registration and recordation rights, tax and currency issues, etc. The U.S. government has several sources of country-specific information, including guides published by the Department of Commerce, International Trade Administration's U.S. Commercial Service.[1]

Paper or electronic sources are a good start but have only limited utility. A franchisor will need a more firsthand evaluation as part of its due diligence. One source may be the initial prospective franchisee or group of franchisees. Often these individuals are from the country and have firsthand experience. Of course, because they will be trying to obtain a franchise, their comments and data will need to be verified. There are also many international franchise consultants and brokers who can provide background and research services, as well as identify potential candidates. Third, and probably most valuable, will be local counsel in

1. *Available at* http://www.buyusainfo.net/adsearch.cfm?search_type=int&loadn.

the country. Local counsel with significant experience in franchise transactions should be able to provide advice on a broad range of issues beyond the limited role of providing legal advice.

The scope of due diligence will depend in part on the franchisor's plans for that country or market. If the country is isolated from the U.S. or other foreign markets where the franchisor's brand operates, and the franchisor is responding to an opportunistic offer to expand, the franchisor may invest in limited due diligence. However, if the franchisor is planning on committing significant resources to this effort or future efforts, it may be well advised to conduct a more thorough due diligence.

E. Hiring Local Counsel

U.S. franchise expansion into another country will require the assistance of local counsel in the target country. While domestic franchise counsel may be well versed in "international" franchising, and may have participated in many transactions in a particular target country, domestic (generally read as United States) counsel ordinarily are not licensed to practice in the target country, and may not know all of the nuances and subtleties of the local market, business environment, and legal system. The franchisor should therefore identify a legal team, which may include one or more: (1) in-house counsel, if the franchisor has in-house counsel; (2) domestic franchise counsel; and (3) local (or foreign) counsel. In addition to selecting the right team, the franchisor should also determine the role or roles of each team member. For example, in some cases, domestic franchise counsel will operate as the "quarterback" or "general contractor" working with the franchisor, in-house counsel, and foreign counsel. Domestic franchise counsel may be instrumental in identifying local lawyers or firms with expertise in trademark, franchising, taxes, import/export issues, and other matters, and domestic franchise counsel can coordinate advice and work. In this situation, domestic counsel also plays a critical role in overseeing foreign counsel to keep counsel within prescribed boundaries regarding the scope of work and legal fees.

There are many sources for locating competent local counsel for a transaction: referrals from within a domestic attorney's firm; referrals from bar associations and industry associations; and, of course, prior experience with counsel in other transactions in that country. It is important to remember that "franchising" may not be a legal subspecialty in a particular country, and the country may have no specific franchise laws. Therefore, in some cases, local counsel can be commercial lawyers with experience in international transactions and in transactions involving franchised businesses. In addition to experience in the substantive legal area and international transactions generally, local counsel should be able to com-

municate in the franchisor's principal language, and U.S. counsel or the franchisor may wish to find local counsel who have experience with local governmental and regulatory agencies that may impact the franchise relationship, and may even have knowledge regarding the franchisor's business.

One of the first steps in the process of retaining local counsel is to send the prospective counsel a retainer or engagement letter. This letter should identify the franchisor and the prospective franchisees or master franchisee (if known), so counsel can clear any conflicts. The letter (or a subsequent one, if a conflict needs to be cleared) should describe the nature of the transaction and the scope of work that the franchisor desires from counsel. In addition, the letter should request an estimate or budget of legal fees related to the expected and understood scope of work. One method that many franchisors and counsel use to establish the scope of work and keep the scope and fees within prescribed limits is for the franchisor or counsel to send a letter or memorandum to local counsel outlining, or describing in detail, the issues that the franchisor wishes the counsel to review and comment upon. These issues may include governing law and dispute resolution, territorial issues, taxes and currency issues, tariffs and duties, insurance and indemnification, regulatory and registration issues, guarantee requirements, post-execution requirements, etc. As domestic counsel becomes more familiar with international franchise transactions, he or she can better shape the "scope-of-work" memorandum and questions for local counsel to focus on the critical issues and keep the franchisor's costs in check.

Local counsel is crucial to a successful international transaction. In addition to the legal and business advice, local counsel can provide additional guidance regarding the country, tips, introductions to potential franchisees and masters, and other commercial counseling and advice.

F. Identifying and Prospecting Countries

It is a big world out there, and all franchisors must use their resources in a smart and strategic manner. Part of the international franchising process is determining where to go and when, and which countries to avoid.

One element of the analysis is evaluating whether the franchisor's marks are registered in a particular country, as well as the cost and timing to do so. (See Part II, below.) Another element is examining the cost to grant and support franchises in a particular country and a return on the investment through initial fees, royalty fees, and/or other payments.

By evaluating many of the factors discussed above, a franchisor can develop a plan for multiple-country expansion. Many of the considerations discussed above—regulation issues, costs, travel, taxes, product logistics, etc.—will

impact the desirability of various countries. In addition, a franchisor should consider the desirability and value of establishing an office in the target country. Various laws and regulations may be triggered, depending on the nature of the physical presence, whether the franchisor's employees will be residents, or whether the franchisor will hire local residents. The franchisor should retain legal and/or accounting professionals to help assess labor, immigration, tax, and visa issues. As the franchisor conducts its due diligence and prioritizes countries, one plan or model will not fit all franchisors.

II. Trademarks and Intellectual Property

A. Introduction

Trademarks are generally the most important intellectual property rights to be protected and licensed by a franchisor. With the exception of international trademarks and European Community (Community)[2] trademarks, both discussed below, trademark protection is national and gives the owner the right to the exclusive use of the mark only within the country where it is registered. A trademark owner cannot enforce its rights in a country unless it has taken steps to protect its trademark within that country. Accordingly, franchisors should take all appropriate steps at an early stage to register their trademarks in countries where expansion is envisaged.

B. Selection/Registration

The first step in obtaining trademark protection is to undertake searches to determine the availability of the mark. Most intellectual property offices have an online search facility that allows applicants to search registers of existing registered marks and, in some cases, pending applications. Some databases allow phonetic and image searches. Local online directories, registers of companies or corporations, and, where applicable, business name registers should also be searched. A thorough search of the available registers, as well as country-specific Google searches, can be used to determine whether or not the brand is available, what other similar marks may be already registered in that country, whether other existing businesses are using a similar brand, and whether or not

2. The "European Community" comprises the following countries: Austria, Belgium, Bulgaria, Croatia, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

they have registered any rights to their brand. When conducting the search, it is important to try different combinations of the proposed brand and search not only for the exact brand but also for similar-sounding marks or marks that visually appear similar. Further, in countries that use a different alphabet, both the English and country alphabet registrations should be obtained of word marks.

In some countries, certain rights may arise by law without registration, and in certain circumstances, where such rights exist they can be used to prevent a third party from registering the same or a similar mark. These rights can also be used as a basis for pursuing infringers, although relying on rights derived from use rather than registration is generally not recommended. Enforcing such rights can be much more expensive and difficult than simply enforcing a registered trademark.

If searches reveal that the mark is indeed available, a franchisor should consider whether the mark should, in fact, be registered in the destination country. Language differences in particular should be considered to ensure that the mark is not, for instance, offensive in the target country's language and that it conveys the message that the franchisor intends it to convey.

Further, the requirement that the mark is distinctive and not descriptive or generic applies in most jurisdictions. Having said that, it is important to be aware of country-specific differences because, for example, trademarks that can be registered in the United States of America ("U.S."), such as surnames, geographic names, or groups of initials, may not necessarily be able to be registered in other countries.

C. Registration

With some limited exceptions, notably the United States, Canada, the United Kingdom (UK), Ireland, and Australia, where prior use by one person may prevent registration of a trademark by another, most countries have what is referred to as a "first to file" system of trademark registration. In those jurisdictions, rights arise only when an application for registration is filed and the person who files the application is in a position to prevent current users from using the trademark, even if those users have been using the trademark before the application was filed. Franchisors who are considering entering countries that use "first-to-file" systems, which include France, Germany, Spain, Japan, and China, should consider lodging applications and obtaining trademark registrations at a very early stage in their international expansion planning.

Registration gives the owner the exclusive right to use the mark within the relevant jurisdiction with respect to the goods and services for which the mark is registered while simultaneously preventing others from using the same or simi-

lar marks with respect to the same or similar goods or services. Applicants need to specify the classes where protection is required. Most of the countries use the Nice Classification system, which was established by the Nice Agreement 1957 and revised at Stockholm in 1967, at Geneva in 1977, and was further amended in 1979 (collectively, the Nice Agreement). As of January 2015, 84 countries have adopted the Nice Agreement. The latest signatory is New Zealand.

Each country that is party to the Nice Agreement is obliged to apply the Nice Classifications in connection with the registration of marks, either as its principal classification system or as a subsidiary classification system, and has to include in its official documents and all publications relating to the registration of marks the Nice Classification number of classes that the goods or services to which the marks are registered belong. For example, it would not be sufficient to state that mark "x" is registered for clothing and headgear; the publication also must state that mark "x" is registered in respect of class 25 (clothing and headgear).

Use of the Nice Classification is mandatory, not only for the national registration of marks in countries party to the Nice Agreement, but also for the international registration of marks affected by the World Intellectual Property Organisation, the African Intellectual Property Organization, the African Regional Intellectual Property Organization, the Benelux Organization for Intellectual Property, and the European Union Office for Harmonization in the Internal Market (Trade Marks and Designs) (OHIM). To assist applicants, OHIM has recently launched a new, free online database called TM Class[3] that can be used to establish the classes in which specific goods and services fall. The Nice Classification is also applied in a number of countries not party to the Nice Agreement.

Care needs to be taken when specifying the classes in which a trademark application is being sought to ensure that the application covers all of the goods and services for which the mark will be used, but no more. Otherwise, if the mark is not being used for a class of goods and services for which it is registered, a third party can apply to the relevant office to have the registration amended to exclude that class, and the trademark owner bears the costs of any such amendment.

D. Community Trademarks

When it comes to registration, depending on the target country or countries and the number of countries in which registration is required, different options may be available. Franchisors who are looking to expand into Europe may consider applying for a Community trademark, which provides European Union–wide protection. The advantage of such registration is not only in the simplicity of

3. TMclass, http://tmclass.tmdn.org/ec2/.

completing one form and paying one fee, but in addition, once the mark is registered as a Community trademark (or a CTM), it is protected throughout the European Union. Further advantages of the CTM system are the priority and seniority rights that can be claimed by the applicants.

A franchisor who has sought a CTM can claim a priority right within six months of filing an application if a trademark applicant has already filed a national application for the same mark with respect to the same goods or services in any of the countries of the European Union, any country which is a signatory to the Paris Convention for the Protection of Industrial Property (1883), or a member of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). This means that the applicant can claim the filing date of the earlier application as the effective date of the later application.

Where a franchisor has one or more existing national registrations, it can preserve those earlier national rights when filing its CTM application by claiming seniority of the national registrations. By doing so, the franchisor then can let the national registrations lapse, thus saving on renewal fees, without jeopardizing the effective date of the earliest of the registrations. Seniority can be claimed only with respect to an identical prior registration. If a seniority claim is not made at the filing stage, it can be claimed within two months of its filing or at any time after registration of the CTM.

The disadvantage of applying for a CTM is that a trademark owner who owns a trademark that is registered in any European Union country can object to the application during the second stage of the process—the publication stage. If the objection cannot be resolved or overcome, the application will fail. It is therefore particularly important to carry out comprehensive searches or risk having to deal with a large number of objections at the publication stage. OHIM has recently launched a new database that allows users to carry out an instant free search across all EU countries to check for any nationally registered trademarks[4] and not just CTMs.

E. The Madrid System

Those franchisors that already have a national registered trademark may be able to benefit from the international system of trademark protection that is often referred to as the Madrid System. The Madrid System is based on the Madrid Agreement and the Madrid Protocol, and a list of the countries that have adopted the Madrid Agreement and/or the Madrid Protocol can be found on the World Intellectual Property Organization (WIPO)[5] website. The Madrid System allows

4. TMview, http://tmdn.org/tmview/welcome.
5. Members of the Madrid Union, http://www.wipo.int/madrid/en/members/.

an owner to extend protection of its existing trademarks to other countries by completing a single form and making a single payment. The advantages are obvious—it can save franchisors a great deal of time and expense—but disadvantages also exist.

First, the Madrid System does not work in the same way as a national or the Community registration system. It cannot be used by a franchisor that does not already have a registered trademark. The Madrid System simply allows trademark owners to extend their existing registrations to other countries by way of a single application. Second, in using the Madrid System, the classification of the goods and services must be identical to the goods and services of the registration on which the application is based. Third, once the application is submitted and accepted by WIPO, WIPO will then forward the application to each of the designated target countries, where separate examination procedures will commence.

Temporary or conditional grant of protection is typically given relatively quickly, but the mark will not be fully protected until and unless the process of examination and opposition is successfully completed in each country. It is not uncommon for the individual intellectual property offices to raise additional queries, and while some countries (for example, the U.S. Patent and Trademark Office) will allow the applicant to respond to those queries online, others will only accept correspondence from a local lawyer who is qualified in that jurisdiction.

In addition, registration obtained using the Madrid System will always be contingent on the original registration, and if the original registration should lapse or be cancelled or revoked for whatever reason, the international registration in all designated countries will also fail unless action is taken to convert it to a national registration, which may involve payment of additional fees and be subject to further investigation.

F. Licensing Issues

In some jurisdictions, franchisors are required to enter into separate license agreements with respect to their intellectual property rights and to register those agreements with a governmental body before franchise agreements can be entered into. Such registration processes may take time and involve associated costs, all of which need to be taken into account when calculating the time scales for starting to franchise in a new country. Where license registration is compulsory, failure to comply may lead to franchise agreements being deemed unenforceable and the franchisor being unable to collect royalties, and may even result in the franchisor losing its rights in its trademark in that country.

Regardless of whether the trademark owner enters into a separate license agreement with its licensees or the license is incorporated within the franchise

agreement, the franchisor has a continuing obligation to protect its trademarks, which includes monitoring and policing the use of the trademark by legitimate licensees. Franchise agreements should therefore contain provisions that deal with ensuring the ongoing nature and quality of goods and services being offered by licensees. It is, however, not enough for the agreement simply to contain such provisions; the franchisor must actively enforce them.[6]

If the franchisor does not exercise its authority relating to quality control, it runs the risk of the trademark license within the franchise agreement becoming a naked or bare license. If that happens, the franchisor may lose its right to the trademarks and its ability to enforce its rights against infringers who may be using the mark or a similar mark without permission. In such circumstances, any third party may apply to the relevant authorities to have the trademark registration revoked.

Franchisors should also put procedures in place and dedicate sufficient resources for ongoing monitoring in each country in order to identify any infringement or conflicting trademarks at an early stage to avoid any unauthorized trademark-related activities that could potentially weaken or otherwise harm their trademark rights. The earlier such conduct can be identified, the quicker the franchisor can take steps to prevent or mitigate damage to its trademarks. Franchisors who do not have the time, the capacity, or the desire to monitor the markets for potential infringement actions in-house can take advantage of trademark-watching services that are now widely offered by third parties. These providers can monitor local trademark registers on the franchisor's behalf, thus looking out for potential conflicting applications. Further, franchisors ordinarily include a provision in their franchise agreement that requires franchisees to inform the franchisor of any apparent or actual infringement and to assist the franchisor with any necessary enforcement action.

G. Domain Names and Social Networking

Domain names do not have geographic boundaries, and domain name ownership does not generate trademark rights. While it is not necessary for a franchisor to register country-specific domain names when expanding abroad, most franchisors choose to do so because by registering the domain name, the franchisor not only gains a new domain in the target country, but also takes that domain name off the market. Registration of domain names is on a first-come, first-served basis. It is possible for different parties to have similar domain names with only minor differences because changing just one letter, number, or symbol creates a new domain name capable of registration.

6. Vishnu Rethinam, Naked Licensing, 11 IP Value, 35–38 (2013).

Each country has a number of registrars who are responsible for registering domain names. In recent years domain names have become precious commodities, and occurrences of domain name scams are increasing. The Internet Corporation for Assigned Names and Numbers (ICANN) has a list of accredited registrars in each country, and it is best to always use one of the accredited registrars for registering a domain name.[7]

Most registrars have a service that allows applicants to search for the preferred domain name. If the exact domain name is not available, the result will often contain alternatives, their status, and cost. The cost of domain names varies depending on the domain name, the level of domain, and the number of years that registration is required. For example, "www.example.com" is likely to be more expensive than "www.example.net."

Where a domain name is unavailable, some registrars offer a back-order service that allows a franchisor to note its interest in a particular domain, with a view to acquiring the domain name as soon as it becomes available.

Where a third party registers a domain name incorporating another party's registered trademark, the trademark owner may be successful in having the domain name transferred to it, but this is possible only where that third party has registered the domain name in bad faith in order to gain a commercial advantage. Where the domain name has been registered in good faith and is being used legitimately, the trademark owner may not be able to force the domain name owner to transfer the domain name.

Another area where franchisors need to be particularly vigilant is the use of social media. Most social media sites are global, and when it comes to international expansion, franchisors may not need to do much more than what they are already doing, except to be aware that what is posted in any one country can instantly be seen worldwide and have an immediate impact on the franchisor's reputation at home and across the globe.

H. Other Intellectual Property Rights, Including Copyright and Trade Secrets

1. Trade Secrets

Most franchisors have a substantial amount of know-how or trade secrets that they make available to franchisees. Precisely what constitutes a trade secret or confidential information should be clearly set out in the franchise agreement, because very few countries have a legal definition of such terms. The franchise agreement should also set out what steps franchisees should take to protect the

7. InterNIC, http://www.internic.net/regist.html.

franchisor's know-how. Unlike trademarks, no international, uniform system applies to trade secrets or know-how. Therefore, it is important to obtain legal advice in relation to any local rules and regulations that may be relevant.

The Trade Related Aspects of Intellectual Property (TRIPs) established current minimum standards for intellectual property protection for all countries that are members of the World Trade Organization (WTO) in 1994. Members of WTO must provide the minimum levels of protection for know-how and confidential information outlined in Article 39(2) of the TRIPs agreement.

2. Copyright

Like trademarks, copyright is territorial in scope. The international system of copyright protection is governed by four copyright conventions:

1. The Berne Convention for the Protection of Literary and Artistic Works 1886 (Berne Convention);
2. Universal Copyright Convention 1952 (UCC);
3. The Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organizations (1961)[8] (Rome Convention); and
4. WIPO Copyright Treaty 1996 (WCT).

The Berne Convention and the UCC create a system of reciprocity with respect to copyright infringement protection that gives copyright owners the right to enforce their rights in a foreign country where their copyright is being infringed. Such copyright holders receive the same level of protection in a foreign country as a national of that country. Copyright laws vary from country to country, but the UCC provides that in a signatory country, nationals who would otherwise be required to comply with certain formalities before copyright can subsist must regard those formalities as satisfied where the copyright owner marks its work with a copyright notice comprising the copyright symbol (© or Copyright) followed by the author's name and year of publication.

In many countries, copyright arises without the need for registration or compliance with any other requirements.

3. Patents

In most jurisdictions, an application for a patent can only be made for as long as the product invention has not yet entered the public domain, because any public

8. *Summary of the Rome Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations (1961)*, World Intellectual Property Organization, http://www.wipo.int/treaties/en/ip/rome/summary_rome.html.

use of the product or disclosure of the invention before filing the patent application precludes protection. This is not the case in the United States, where a patent application is possible after disclosure, as long as the application is filed within 12 months of the invention becoming public knowledge.

Although the phrase "international patent" is sometimes used, no such animal exists. Patent applications are generally governed by national laws, although, as with trademarks, it is possible to file a Europe-wide application with the European Patent Office that makes commercial sense if protection is sought in at least four European countries. It is also possible to file a single application with WIPO under the Patent Co-Operation Treaty designating any of the countries who have signed the Treaty.

III. Structure of International Arrangements

No one-size-fits-all method exists to structure an international franchise program. Franchisors have multiple options for international program design and should consider a variety of factors before choosing a structure, including the expense the franchisor is willing to undertake, the degree of day-to-day control the franchisor is willing to accept or forgo, the control that the franchisor is capable of exercising over international operations, the franchisor's timetable for expanding internationally, the management and human resources the franchisor has available to devote to foreign expansion, and the franchisor's knowledge of the foreign market.

The most common structure for international franchise expansion is master franchising. However, franchisors also have the option of expanding internationally via direct single-unit franchise sales, area/multiunit development programs, and area representative programs. In addition, franchisors may also choose to expand their brands into foreign markets through joint ventures. Each vehicle for international expansion carries its own benefits and risks.[9]

A. Master Franchising

The most common form of international expansion by U.S.-based franchisors is through master franchise programs. Under Master Franchise Agreements, franchisors grant "masters" specified territories within which to develop units by entering into franchise agreements directly with franchisees (as well as de-

9. For a more thorough discussion of the methods or forms of granting franchise rights in the United States, see Chapter 2. Many of those same issues and descriptions of the different forms of franchising are applicable to international franchising.

veloping units for the master's own account). Master franchising is often the most cost effective form of international expansion, because the onus of adapting the concept to the foreign market, drafting the appropriate unit agreements and attendant disclosures, complying with applicable laws and regulations, and hiring personnel to solicit franchisees and administer the franchise system in the foreign market falls on the master franchisee.

Master franchising also has the potential of being the fastest form of international franchise expansion, especially if the master franchisee has the capital, business experience, and management resources to devote to the franchise concept. Master Franchise Agreements theoretically reduce a franchisor's exposure to liability because they involve no privity of contract between the franchisor and the single-unit franchisee. However, the lack of contractual privity with franchisees can result in a loss of influence over unit operations. Franchisors should thoroughly screen any prospective master franchisees to ensure that they are committed to the franchisor's vision for the development of the franchise concept in the territory, and that they have adequate resources to achieve the parties' goal.

Many of the concerns noted below relating to Development Agreements also apply to master franchisee relationships, including granting territories judiciously, establishing minimum development requirements, establishing minimum unit performance requirements, and including cross-default provisions in the Master Franchise Agreement and unit franchise agreements. Franchisors who wish to expand internationally through master franchising should also consider:

- requiring master franchisees who wish to operate units for their own account to sign franchise agreements for those units;
- retaining the right to approve all forms of franchise, development, and other agreement used in the territory;
- retaining the right to approve all unit franchise agreements;
- specifying the initial and ongoing services the master franchisee must provide to unit franchisees;
- including an indemnification clause in the Master Franchise Agreement; and
- including provisions in the Master Franchise Agreement and the agreements used by the master franchisee that address the parties' rights upon termination of the Master Franchise Agreement, including assignment of the master's unit franchise agreements with franchisees to the franchisor, at the franchisor's option.

B. Direct Single-Unit Franchise Sales

Direct single-unit franchise sales occur when a franchisor enters into a franchise agreement directly with a foreign franchisee providing for a single franchised location. This is often the most expensive form of international expansion, because the franchisor bears the burden of adapting the franchise concept and infrastructure to the foreign market, retaining personnel to market the franchise concept to prospective franchisees, preparing all of the legal contracts, handling all regulatory compliance matters, and supporting franchisees and monitoring their performance on an ongoing basis. Direct single unit-franchising may also be the slowest form of international expansion, because the franchisor must develop the international program from the ground up before making a single franchise sale.

Direct single-unit franchise sales are the riskiest forms of international expansion, due to the high cost of entering the market, contractual privity with franchisees, direct exposure to liability resulting from any regulatory noncompliance, and the ever-present risk of vicarious liability resulting from foreign franchisees' operation of their businesses.

This form of international expansion is most often used when franchisors expand into neighboring countries, where they have a better understanding of the local market and have the capacity to provide initial and ongoing support services from their existing headquarters. This form of international expansion can also occur organically when foreign prospects encounter the franchisor's brand and inquire into franchise opportunities in their home country.

C. Area Development/Multi-Unit Development

"Area Development" or "Multi-Unit Development" agreements (Development Agreements) are another vehicle for international franchise expansion. Through this form of international expansion, a single franchisee is given the right to open multiple units in a specified area. Franchisors often use this form of international franchise expansion because of the attributes of a particular multi-unit developer (a Developer), even though multi-unit development carries costs and risks similar to those of direct single-unit franchise sales. Developers are usually better capitalized than single-unit franchisees and have business experience that can contribute to the development of the brand in the foreign market in a meaningful way. For example, an experienced Developer may have its own management team, supplier contacts, and understanding of consumers and business practices in its area. This know-how can benefit the system as a whole.

Conversely, well-capitalized and experienced Developers who are unfamiliar with American franchising practices are often unwilling to take instruc-

tion from the franchisor, which can lead to battles for control over the direction the franchise concept takes in the foreign market. Another drawback of Development Agreements is that franchisors usually commit an exclusive territory to the Developer for a significant period of time. If a Developer is unsuccessful in developing the brand in the territory, the franchisor may lose market share to its competitors.

Therefore, the franchisor should consider several factors when evaluating this particular structure. These include:

- ensuring that the Developer is committed to the franchisor's vision for the brand in the foreign market;
- ensuring that the territory granted to the Developer is proportionate to the number of units to be developed and the Developer's resources;
- creating achievable unit development and unit performance criteria for the Developer;
- ensuring that the franchisor has the right to rescind territorial exclusivity if the Developer fails to meet its minimum performance obligations;
- including cross-default provisions in the Development Agreement and single-unit franchise contracts; and
- ensuring that the term of the Development Agreement lasts no longer than the development schedule for opening units, so that any undeveloped portion of the territory reverts back to the franchisor when the Developer's obligation expires.

D. Area Representative Agreements

Franchisors may also expand internationally through "Area Representative Agreements." Area Representative Agreements grant representatives the right develop multiple units in a specified territory by opening representative-owned units and soliciting prospective franchisees to enter into single-unit franchise agreements with the franchisor. The benefits and risks associated with Development Agreements often also apply to Area Representative relationships. Therefore, among other considerations, a franchisor must also make certain that the Area Representative contract obligates the Area Representative to comply with all local laws and regulations relating to franchise registration and pre-sale disclosure in connection with soliciting prospects in the foreign market.

E. Options and Rights of First Refusal

In addition to Development Agreements and Area Representative Agreements, franchisors often grant options or rights of first refusal for foreign territories to new and prospective franchisees. While these rights are granted to encourage

new franchise development, they may have the opposite effect. Under option agreements, franchisors grant prospects the exclusive option to develop units in a particular area at a later date through single-unit Franchise Agreements, Development Agreements, Area Representative Agreements, or the other forms of agreement. If the prospect fails to exercise its option in a timely manner, a key market may remain undeveloped for a significant period of time.

Similarly, by granting rights of first refusal for additional territories to prospects, franchisors may inadvertently create obstacles to their ability to grant franchise rights to new prospects in a timely manner.

Accordingly, franchisors should understand the opportunity costs associated with rights of first refusal and option agreements and grant them judiciously to new and existing franchisees/developers. As with Development Agreements, rights of first refusal and option agreements should terminate if the franchisee/developer defaults under its agreements with the franchisor. Moreover, all option agreements and rights of first refusal should have an expiration date.

F. Joint Ventures

Franchisors also have the option of expanding internationally through joint ventures. Joint venture arrangements exist when a franchisor retains an equity interest in a single-unit franchisee, developer, area representative, or master franchisee. In addition to preparing the appropriate franchise-related agreements, the franchisor must enter into a shareholders' agreement, partnership agreement, or other arrangement with the joint venture partner relating to the operation of the joint venture business. Franchisors often enter into joint venture agreements when (a) franchisors want to retain a significant degree of control or influence over the foreign franchisee; (b) the prospective foreign franchisee has significant capital but no operating experience; or (c) the prospective foreign franchisee has significant operating experience but insufficient capital.

In evaluating the type of franchise model to employ in any country, the franchisor will weigh the issues of influence over the franchisee and influence over the outlets, the resources needed to sell the franchises and support the franchisees, training of the franchisees, distribution of products, equipment or inventory to the franchisees, modifying the concept for the target country and market, tax and currency issues, the franchisee profile, and the regulatory process and related costs. These factors will have differing impacts in each country. Therefore, the structure of the international franchise program may be different around the world. For example, a U.S. franchisor may feel very comfortable granting single-unit franchises or area development agreements in Canada, but decide to utilize a master franchise in the United Arab Emirates or Australia and a joint venture in Hong Kong.

IV. Legal Issues

A. Franchise Disclosure

1. Disclosure Laws

In 1990, only four countries had enacted disclosure laws requiring franchisors to provide pre-contractual disclosure to prospective franchisees. By 2015, more than 20 countries had disclosure laws, and this number will undoubtedly increase.[10] The very detailed and lengthy disclosure requirements adopted in the U.S. are not the model for what is required elsewhere. In many countries legislators have adopted a "light touch." For instance, in Europe, where disclosure obligations are imposed through statutory disclosure laws in France, Spain, Romania, Italy, Belgium, and Sweden, disclosure requirements are largely based on the requirements imposed by Europe's first disclosure law, France's *Loi Doubin*, which was passed on December 31, 1989. Under this law, prospective franchisees must be provided with a pre-contractual information document at least 20 days before signature of the franchise agreement. The implementing decree[11] sets out the information that must be provided:

- details about the franchisor, including its registration number, trademark details, and registered office;
- bank information;
- history of the business for at least the previous five years;
- description of the relevant market including the local market;
- last two years' annual financial statements;
- description of the franchise network; and
- provisions, including startup costs.

In some countries the challenge for franchise lawyers is to establish precisely what must be disclosed. For instance, in Romania, which enacted a franchise law in 1997,[12] the law requires a franchisor to furnish a prospective franchisee with all such "information so as to enable it to take part in a franchise agreement in full awareness." In civil law countries, the uncertainty about what

10. For a description of the disclosure laws in many countries, see International Franchise Sales Laws (Andrew P. Loewinger & Michael K. Lindsey eds., A.B.A. 2014).

11. Decree no. 91-337 of 4th April 1991 concerning application of the French disclosure law (*Loi Doubin*) (Article R 330-1 and 2 of the French Commercial Code).

12. Government Ordinance 52/1997, *as amended by* Law 79/1998.

to disclose exists because the disclosure obligation arises from a general civil code requirement to “deal fairly” before entering into a contract.

In all countries where disclosure is required, the following questions should be asked:

- Does the disclosure law apply to this transaction?
- Who must provide the disclosure?
- Who must receive the disclosure?
- When must disclosure be made?
- What information must the disclosure contain?
- Are there any other requirements, such as an obligation to disclose in the relevant national language?

U.S. practitioners may also inquire as to whether the U.S. franchise disclosure rules will apply to an international transaction. Under the Federal Trade Commission (FTC) Franchise Rule, amended in 2007, the FTC clarified that international transactions are not subject to the Amended Franchise Rule.[13] The Amended Rule applies to the offer and sale of a franchise that will be located in the United States of America or its territories. However, the authority of the FTC, under Section 5 of the Federal Trade Commission Act,[14] has been held to be broad enough to regulate and enforce unlawful, unfair, and deceptive practices that occur in international transactions.[15] Further, in some of the so-called “franchise registration” states, if the offer to sell emanates from the state, or the offer to buy is sent to or received in the state,[16] the state franchise law may be applicable to a foreign transaction and subject to pre-sale disclosure and/or registration requirements. While there is one case (from 1984)[17] that suggests an international application of the law is possible, no subsequent cases support this. And the FTC’s statement of Basis and Purpose in issuing the Amended FTC Rule in 2007 explained that U.S. disclosure for an international transaction may be of little or no value to the prospective franchisee.[18] The FTC declined to apply the Amended Rule to transactions where the buyer—the franchisee—is a U.S. resident and the offer and sale occurs in the U.S., provided the resulting business is to be operated outside the U.S. and its Territories.[19]

13. 16 C.F.R. § 436.2 (2014).

14. 15 U.S.C. § 45 (2014).

15. Branch v. FTC, 141 F.2d 31 (7th Cir. 1944).

16. *See, e.g.*, the definitions of “offer” or the scope of coverage under the Minnesota and New York franchise registration and disclosure laws: Minn. Stat. § 80C.19 (2014); N.Y. Gen. Bus. Law §§ 681.11–12 (2014).

17. Mon-Shore Mgmt., Inc. v. Family Media, Inc., 584 F. Supp. 186 (S.D.N.Y. 1984).

18. 72 Fed. Reg. at 15,468 (March 30, 2007).

19. Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunities; Final Rule, 72 Fed. Reg. 15,444 (March 30, 2007).

2. Code of Ethics

It should not be assumed, in the absence of a disclosure law, that disclosure requirements are not imposed. In many jurisdictions, disclosure is either required or is desirable in the absence of any disclosure laws. First, some national franchise associations impose disclosure requirements on their members. Second, in civil law countries, general principles of fair dealing may require presale disclosure to be made.

In Europe, for instance, the European Franchise Federation (EFF) has developed a Code of Ethics that, with relatively minor variations, has been adopted by the 20 national franchise associations that form part of the EFF.[20] The code makes it clear that pre-contractual information is a requirement, although, of course, disclosure requirements imposed by national franchise associations only apply to members of those associations. Nevertheless, national courts have used the relevant national code of ethics as a guide to best practices.[21] Even if the courts do not take account of the relevant code of ethics, it is likely that prospective franchisees' lawyers will be aware of the requirements and will assess a franchisor's disclosures, agreements, and actions accordingly. When expanding overseas, it is therefore sensible to obtain copies of the requirements for membership of that country's national franchise association.

3. Civil Law Principles

Further, in civil law countries (but not common law jurisdictions), the principle of *Culpa in Contrahendo* is applied. The principle is akin to an obligation of good faith, except that it applies during pre-contractual negotiations. In Germany, for instance, according to Article 311 of the German Civil Code, parties that intend to enter into a contract must negotiate honestly and openly with each other. The duty to negotiate honestly and fairly includes an obligation to voluntarily disclose any matter that it is reasonably foreseeable would have a decisive influence on a prospective franchisee's decision whether to enter into the franchise agreement or not.

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20. Austria, Belgium, Croatia, Czech, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Netherlands, Poland, Portugal, Serbia, Slovenia, Sweden, Switzerland, Turkey, and the United Kingdom.

21. *Re* Drivertime Recruitment Ltd., [2004] EWHC (Ch) 1637. In this UK case, a franchisor at one time had 47 franchisees, all but one of whom had failed! The court found that the controllers of the franchisor were aware of the British Franchise Association's (BFA) requirements concerning disclosure because one of their previous companies had been a member of the BFA. The court accepted that the BFA is not a regulator and that membership in the BFA is not compulsory, but indicated that "its Code of Ethics provides a good indication of what is to be regarded as fair practice in the Industry. The Code requires franchisors to make various disclosures when selling franchises to investors."

4. Franchise Disclosure Document

Franchisors often provide their U.S. Franchise Disclosure Document (FDD) to prospective franchisees overseas (even if not required by law or regulations). It is likely that master franchisees and/or developers will obtain a copy of the U.S. FDD whether or not it is provided by the franchisor, but significant dangers may flow from providing an FDD. The first is an implied representation to the effect that information contained in the FDD is not only accurate, but also relevant to the target market. It may not be. Accordingly, franchisors do need to specify clearly when providing a copy of their U.S. FDD that:

- the FDD was prepared to provide information to prospective franchisees in the U.S. and that its content may not be relevant to franchisees outside the U.S.;
- the information in the FDD may not be relevant to the target country; and
- no representation is made to the effect that the U.S. market is similar to the market in the target country.

B. Registration/Recording

Some jurisdictions have registration, recording, or government approval requirements for franchise contracts or any contracts that require expatriation of money, and a failure to comply with these requirements may make the franchise agreement unenforceable. These requirements take various forms and include:

1. Trademark Filings and Approval

This is the most common type of government approval, recording, or registration requirement. For instance, Brazil, Mexico, the Philippines, and Russia require all agreements that relate to the licensing of trademarks (including franchise agreements) to be registered and/or approved by their national trademark office. The consequences of a failure to file vary. In many jurisdictions, registration may simply benefit the franchisor by providing evidence that the marks are being used in that country, but in others the consequences are more challenging for franchisors. For instance, in China, failure to register renders the trademark license elements of the franchise agreement ineffective,[22] and in Russia the franchise agreement may be void.

22. Trademark Law (promulgated Mar. 1, 1983). *Zhonghua renmin gongheguo shangbiao fa* [Trademark Law of the People's Republic of China] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 23, 1982, effective Mar. 1, 1983) (WIPO) (China).

2. Foreign Investment Approval

In some jurisdictions governmental approval is required before foreign "investment" can be made in that jurisdiction, and in this context, "investment" can include simply granting a franchise to a citizen/legal entity in that country. Further, many franchise agreements give franchisors the right to acquire a franchisee's business, usually on termination of the franchise agreement, and in such circumstances an investment is made that would trigger the requirement to obtain approval. Such approvals can be time-consuming to obtain, so many franchisors start the process before entering the foreign market rather than when an option to acquire a franchisee's business arises.

3. Franchisor Registration

In a small number of jurisdictions, franchisors must be registered and approved before undertaking any franchise activity or taking a step in the process of finding a franchisee. This is required, for instance, in Spain, Malaysia, and Vietnam. Precisely what information is required to be provided as part of the registration process varies enormously and may be burdensome. For instance, in Indonesia, the Indonesian Ministry of Trade requires franchisors to submit a pre-sale franchisor prospectus registration package that includes an application letter, a copy of the franchise prospectus, copies of documents evidencing the "legality" of the franchisor, and a power of attorney in favor of the registering attorney.

C. Exchange Control/Central Bank Restrictions

India, Brazil, Chile, and South Africa, among other jurisdictions, require approval for foreign currency remittances to be made. The purpose of these provisions is essentially to restrict the ability of nationals to export capital or even make payments from their country. In some jurisdictions, including South Africa, the authorities will review the provisions of the franchise agreement and limit the level of continuing fees that are payable to a foreign franchisor.

D. International Tax Planning

In general, franchisors want monies to be remitted to their home country with the minimum amount of tax having been deducted. U.S. businesses are taxed in the United States on their worldwide income, but the challenge for U.S. franchisors is that that income may also be subject to foreign tax. In the absence of provisions allowing a U.S. franchisor to offset the amount of tax paid in foreign jurisdictions against its domestic tax liability, the U.S. franchisor may suffer double taxation. To address this issue, the Internal Revenue Code allows this offset by the use of foreign tax credits.

An important point to establish at an early stage is whether a double-taxation treaty is in place with the target jurisdiction. In simple terms, if a U.S. franchisor is deemed to be carrying on a trade or business in the foreign jurisdiction, the franchisor will likely be, in the absence of a double-taxation treaty, taxed in that jurisdiction. Where a double-taxation treaty is in force, a U.S. franchisor will likely only be taxed if it has a permanent establishment in that foreign jurisdiction.

1. Withholding Taxes

In some jurisdictions, some types of income, including royalties or continuing fees payable to a franchisor, are subject to withholding tax. In such cases, a percentage of the gross payment flowing from the franchisee to the franchisor is taxed, and it is the responsibility of the foreign franchisee to pay. This means that the gross amount due to the franchisor, in the absence of any double-taxation treaty, is reduced.

Franchisors use two techniques to reduce the dilution of their earnings in this situation. First, tax gross-up clauses are inserted into the contractual documentation so that any amount of tax that is withheld and paid by the franchisee must be added back to the payment remitted to the franchisor. In this way, the franchisor ends up receiving the same amount it would have received without the deduction of the withholding tax. This is a burdensome and unfair provision on the foreign franchisee, and accordingly, such a clause typically also provides that if the franchisor receives the benefit of a tax credit for the withholding tax that the franchisee has paid, the franchisor will refund the franchisee the amount of the tax credit. The second approach is to attempt to allocate payments so that they do not relate to royalties or continuing fees but instead relate to the provision of listed services by the franchisor, such as training and guidance. Often, withholding tax is not assessed for these types of services. Alternatively, if a withholding tax is levied for these types of services, the rate of taxation is typically lower than the withholding tax payable on royalties or continuing fees.

E. Post-Termination Indemnification/Agency Laws

A number of jurisdictions have introduced laws to protect commercial sales agents upon the termination of their agreements. These laws seek to require the principal to make payments to the terminated agent as compensation for the loss of the agency and/or payment for the business that has been built up and, on termination of the sales agency, is available to the principal. Indeed, in some jurisdictions this payment is required even if the agency has been terminated for good cause. The challenge for franchisors is that these agency laws have, in some jurisdictions, been applied to franchise relationships even where the franchise agreement expressly disclaims an agency relationship.

This situation prevails in many jurisdictions within the European Union where the EC directive on self-employed commercial agents[23] requires compensation to be paid on the termination of a commercial agent. A commercial agent is defined as a "self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person." On the face of it, this definition would not apply to a franchise relationship, and yet in a number of jurisdictions, most notably in Germany and Austria, the courts have held that these provisions do indeed apply to the termination of a franchise agreement. The extent to which other European jurisdictions will follow suit remains an open question.

In some Middle-Eastern countries a similar approach is adopted. In Saudi Arabia, franchise agreements are deemed to create a commercial agency relationship that is governed by the Royal Decree and have to be registered with the Saudi Arabian Ministry of Commerce and Industry. Only Saudi nationals and entities wholly owned by Saudi nationals may be commercial agents in the Kingdom. A similar approach is adopted by the United Arab Emirates and in Kuwait, where a Kuwaiti franchisee may seek compensation on termination of a franchise agreement without cause or on expiry without the renewal of an agreement for a fixed term.

The payment of a termination indemnity can add considerably to the costs incurred by a franchisor in undertaking commercial activities in those jurisdictions and should be evaluated before entering these markets.

1. Local Ownership Requirement

The number of jurisdictions that require either full or at least partial local ownership of the local business has been diminishing over time, but nevertheless this point should be checked if a franchisor is seeking to establish a business in a foreign jurisdiction.

Further, in some jurisdictions, if a franchisor appoints a franchisee, that franchisee may have to be a local citizen or business. In Saudi Arabia, for instance, franchise agreements are deemed to be commercial agency agreements, and only Saudis are permitted to enter into such agreements.

2. Competition Law

Franchising very often gives rise to competition law issues. Indeed, in some jurisdictions, particularly those within the European Union,[24] the competition

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23. Council Directive 86/653/EEC on the coordination of the laws of member states relating to self-employed commercial agents, 1986 O.J. (L 382) 17.

24. Members of the EU: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, United Kingdom.

law issues may be more complex than within the United States. Competition or antitrust issues are often triggered on the grant of an exclusive territory to a franchisee because a franchisor is thereby excluding itself from either operating within the franchisee's territory or granting other franchises within that territory. This clearly reduces intrabrand competition within the territory and may, therefore, be held to be anticompetitive.

Equally, an obligation that requires franchisees to purchase products to be sold in the franchised business only from the franchisor or its designated suppliers, and to sell those products only at a fixed price or at a designated location may well, in the franchisor's eyes, be required to maintain uniformity in the franchise system. But these requirements could be viewed as anticompetitive because such a restriction excludes other suppliers and reduces price competition among franchisees.

Franchisors almost invariably impose both in-term and post-term non-compete covenants on franchisees as part of granting a license to use their brands and trade names and imparting detailed technical knowledge that would be helpful to a business wishing to compete with the franchisor. Generally, obligations on franchisees not to disclose or use confidential information do not give rise to competition law issues, but non-compete covenants, especially post-termination non-competition covenants, do.

One of the founding principles of the European Union is the free movement of goods (including services) within the European Union. The European Court of Justice's decision in *Consten and Grundig v Commission*[25] clearly established that it is a violation of competition law for a supplier to prevent a franchisee from supplying products or services outside its allocated territory. This means that franchisees can be prevented from actively seeking customers outside their territory, but cannot be prevented from responding to unsolicited inquiries from outside their territory.

F. Data Privacy

In relation to data privacy, franchise systems make use of both franchisee and customer data, for example, to benchmark and improve the performance of franchisees or to ensure that franchisees' customers are retained within the franchise network. Franchisors and franchisees typically collect, store, and use potential information in a number of ways, including information from sales documentation and website inquiries. In the context of franchisee recruitment, franchisors collect and save personal information from franchisees and prospective franchisees through franchise application forms, notes of interviews, field assessments, and performance reviews.

25. Consten and Grundig v. Commission, 1966 E.C.R. 299.

Many jurisdictions have developed specific laws dealing with privacy issues, and such laws regularly apply to data retained within franchise networks. These laws differ significantly from the law in the United States. The European Union has perhaps the most advanced regulation of personal data.

Within the European Union, data privacy is regulated by the EU Data Protection Directive.[26] The directive describes minimum standards for data protection that must be adhered to throughout the European Union. The directive generally prohibits the processing of sensitive personal data. There are some exceptions to this prohibition, where, for instance, the data subject has given explicit consent to the processing of his data, or such processing is necessary.

For a U.S. franchisor with franchises in the European Union, the issue is the extent to which data held by a franchisee can be transferred to the franchisor in the United States, because transfers of personal data to a country or territory outside the European Economic Area (EEA) is prohibited "unless that country or territory has adequate levels of protection for the rights and freedoms of the data subjects." Countries outside the EEA that are considered to have adequate levels of protection are listed on the European Commission's website, but the list of countries with adequate data privacy protection does not include the United States. As a result, personal data can only be sent to those companies in the U.S. that have signed up to the "Safe Harbor" scheme.

However, franchisors may still export personal data out of the EU if they:

1. assess the adequacy of the target country's data protection laws and satisfy themselves that those are adequate; or
2. use in their contractual documentation the European Commission's approved model clause; or
3. are a multinational company looking to transfer personal data to one of their foreign offices or to the office of an affiliate of that company, and use binding corporate rules that have been approved by the information commissioner.

In a franchising context, the best, and by far the easiest, way to deal with the transfer of data abroad would be to ensure that the franchise agreement contains the European Commission's model clause. The model clauses cannot be changed in any way if they are to enable the export of data.

26. Directive 1995/46, of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and in the free movement of such data, 1995 O.J. (L 281) 31 (available at http://ec.europa.eu/justice/policies/privacy/docs/95-46-ce/dir1995-46_part1_en.pdf).

G. Import/Export Control

Usually, agreements between franchisors and their franchisees require, either directly from the franchisor or from its nominated suppliers, the supply of various items, including manuals, software, marketing documentation, equipment, and a stock of inventory products. Franchisors must review relevant local law to ensure that these items can be imported into the franchisee's country and, more particularly, the local law regarding the importation of goods and whether import duties or other restrictions apply.

One issue that arises in international franchising is responsibility for the customs duties. Clearly, from a franchisor's perspective, payment should be made by the franchisee, but if franchisees are required to purchase foreign-sourced products or items on which substantial duties are payable, the franchisor should be aware of the financial impact this would have on the franchisee's profitability and should also be aware that franchisees may seek alternative home-country-based products on which duties are not paid. In such circumstances, the franchisor should always investigate the possibility of sourcing products in the local market, provided that quality remains equivalent, if duties are high.

V. The Master Franchise Agreement

As discussed earlier in this chapter, as well as in Chapter 2 of this book, franchisors employ a variety of methods and arrangements for granting franchises and for developing multiple-unit franchises in areas, territories, and countries. While a U.S. franchisor may employ single-unit franchises, area development franchises, joint ventures, or other licensing or structural variations to create franchise networks in foreign countries, the most prevalent method of granting franchises internationally is through master franchising, or subfranchising.[27]

For a number of reasons discussed in Part III.E. above, master franchising is the most common form of franchising for international expansion. First, in many situations, for most franchisors that do not have operations in the target country or in the region of the target county, the cost in terms of time, human resources, and capital to support franchisees in a foreign county is quite high, and a master franchisee can provide those services "on the ground" in the county. Second, a master franchisee should be more knowledgeable and experienced than the franchisor about real estate, commercial locations, regulatory issues, prospective franchisees, the language and local customs, banking and financial sources and relationships, and many other factors concerning operating and supporting the franchised

27. The authors are not aware of specific research data to support this. This statement is based on the authors' collective experience.

businesses. Third, a master franchisee is better equipped to adapt the franchisor's system to competition, the marketplace, and other factors.

While master franchising is the predominant method of international franchising, primarily for the reasons of resources, cost, and culture, many other franchising arrangements are used. One such notable exception for U.S. franchisors is franchising in Canada. Due to the proximity of Canada to the U.S., the same language (except for French in Quebec), and a similar financial, banking, real estate, and commercial environment, many U.S. franchisors venture into Canada using methods that are the same or similar to those they utilize in the United States.

For the purposes of this chapter, we will focus on master franchising and address some of the more critical issues that arise in structuring a master franchise relationship in the international arena. (Please refer to Chapter 2 for a discussion of multiple-unit franchising generally and on master franchising specifically.) In analyzing international master franchise relationships, we have broadly divided many issues into "commercial" and "legal" issues, even though most issues have both a commercial and a legal component.

A. Commercial Issues

1. Territory

One of the first issues that a franchisor will face is the geographic area for which the master franchise will be granted. While the territory could be a city or region within a foreign country, or multiple cities or multiple regions, or even multiple countries within a region of the world, quite often the master franchise territory consists of one country. Depending on the size of the country (geographically), the population, or the number of major population centers and the number of expected or desired outlets, many countries are large enough to support one master franchisee, but are not so large that one master franchisee cannot operate and service franchisees. There are some obvious exceptions to this rule of thumb—China, Canada, Mexico, Russia, the United Kingdom, and others. The franchisor and the prospective master franchisee must find the right balance. The franchisor does not want to have a master franchisee who has bitten off more than he can chew, and the master franchisee desires enough territory to grow the business without bumping into a competing master franchisee.

Franchisors should evaluate the benefits and risks of granting rights that cover more than one country. If the territory includes more than one country, the differences from country to country with respect to laws, legal requirements, intellectual property rights, franchise regulations, currency, and a host of other issues can complicate the agreements, the approval process, and ongoing op-

erations. Multiple-country operations may also present operational, organization, and legal challenges for the master franchisee. Situations may exist in which the master franchisee must be a citizen (or an entity controlled by a citizen) of the country. Consequently, a multi-country master franchisee may not be able to comply with the ownership requirements under a master franchise agreement that covers more than one country.

It is not impossible to structure multiple-country agreements, but it must be done with care, assuming the franchisor and the master franchisee can reach an agreement on the countries covered by the contract, as well as development schedules, fees, etc. One method is to create a multiple-territory development agreement, or an "umbrella" agreement, that will set forth the parameters of the multiple-country master franchise arrangement. The umbrella agreement may identify the target countries, the development schedules, the fees, and other critical factors and anticipate several single-country addenda. The umbrella agreement should state that the franchise development in each country will be governed by individual master franchise agreements, prepared and executed in compliance with the local laws and customs of each country. A standard form, or template, master franchise agreement can be an exhibit to the umbrella agreement. This process permits and facilitates multiple-country development, but is designed to avoid conflicts that might arise under the laws of different countries.

2. Fees

In granting master franchise rights, two basic questions are: (i) what *types* of fees can be charged by the franchisor, and (ii) how *much* the franchisor can or should charge or collect. No one method, nor one formula, to establish a price for granting master franchise rights works in all situations. And the types of fees will depend on the nature of the franchise business, what other revenue streams flow to the franchisor or an affiliate (such as the sale of products, inventory, supplies, or equipment), the nature and scope of services to be performed by the franchisor and the master franchisee, other fees (such as advertising or marketing, or software support that may be charged), and the economics of the business.

Generally, many master franchise arrangements have three principal fees that are paid to the franchisor:

1. The "Master Franchise" Fee: This is often a lump-sum initial payment that is paid for the right to become the master franchisee for the territory and reserves that territory for the master franchisee, with a grant of exclusive or protected territorial rights.

2. Initial Franchise Fees: This is often a split of the initial franchise fees that the master franchisee charges to its unit franchisees or subfranchisees.
3. Royalty Fees: This is often a split of the royalty fee that the subfranchisee pays to the master franchisee.

Most international master franchise relationships will not include payments to the foreign (U.S.) franchisor as a contribution to the franchisor's system-wide advertising, marketing, or brand fund, program, or costs, as U.S. franchisees do not want their marketing funds diverted to foreign markets, and international master franchisees (and their franchisees) do not wish to support the brand and franchisees in the franchisor's home market. There are, and can be, exceptions to this general practice, but both parties must recognize a mutual value for such an arrangement.

In determining how much to charge a master franchisee, the franchisor should evaluate many factors, including the market or territory size, the number of projected outlets, the services that the franchisor will provide and those provided by the master franchisee, fees charged by competing franchisors, and the expected revenue and expenses of the subfranchisees and the master franchisee. With respect to the master franchise fee, the fee charged need not have any relation to the fees charged in the U.S., or other countries, for master rights, development rights, or unit franchises. Even if the franchisor has a formula for area development in the U.S., and it is reflected in the U.S. FDD, the franchisor is not legally bound in other countries by those documents. Rather, the issues and considerations of what is an "appropriate" or "market" price for master franchise rights in the territory will often be the subject of negotiation between the parties. Of course, prior practice in the U.S. and other countries will inform the negotiation process.

The split of the initial franchise fees is often subject to negotiation as well, with the master franchisee desiring to retain a very large percentage, as it will be conducting the franchise sales and development in the territory, training the franchisees, and typically providing real estate, selection, and unit development assistance. The local master franchisee will often be on the front line of franchise support. As with the royalty fee, the split will often reflect the services and assistance that each party provides. However, the franchisor will want a portion that reflects not only ongoing support, but a payment for the ongoing license for the use of the trademark and intellectual property. These fees and splits vary widely, but the following are fairly typical arrangements or ranges:

Master Franchise Fee:	from several hundred thousand dollars to several million dollars, depending on territory size, expected number of units, etc.
Initial Franchisee Fee:	25% to 50% of the subfranchisee's initial franchise fee will go to the franchisor; and 50% to 75% to the master franchisee.
Royalty Fee:	20% to 33% of the royalty fees paid by the subfranchisee to the master franchisee will go to the franchisor; and 67% to 80% to the master franchisee.

(For example, if the unit franchisee or subfranchisee pays a 5 percent royalty to the master franchisee, 1 percent would be paid to the franchisor and 4 percent would be retained by the master franchisee.)

In some situations, the franchisor will establish in the master franchise agreement the amount, or a minimum amount, that the master franchisee must charge for an initial franchise fee and/or a royalty fee. And in some cases the franchisor establishes a minimum payment to the franchisor. This allows the master franchisee to structure its fees and financial relationship with its subfranchisees, but the franchisor is not at the mercy or whim of the master franchisee's deal or the master franchisee's ability (or inability) to collect fees owed from the subfranchisees. Care must be taken not to violate U.S. or local country laws relating to price-fixing or resale price maintenance by designating a particular fee or percentage charge assessed on a subfranchisee.

3. Unit Development

Development of the franchise system's outlets or business in the target country raises many issues. An initial inquiry will likely focus on how many units can be developed in the territory, and what is a reasonable schedule to develop those units. Another critical issue is who will develop the outlets. Many U.S. franchisors require that the master franchisee must develop, own and maintain a minimum number of master franchisee-owned, or direct-owned outlets. This requires the master franchisee (or an affiliate) to own and operate franchised outlets in the territory, to have one or more sites for subfranchisee training, and to have outlets to test and market new products, designs, and processes. The master franchise agreement will often include a provision that a certain number of master franchisee-owned outlets be developed and operated over a prescribed period before selling subfranchises, that these master franchisee-owned outlets may not be sold or transferred to third parties, or closed, without franchisor approval, and without "replacing" them in the overall development obligation of the master franchisee.

Similar to other multiple-unit franchise agreements, the master franchise agreement may include incentives for on-time development (e.g., lower royalty rates or fees) or penalties for failure to satisfy development schedules, such as a reduction in territory, or a loss of exclusivity or protected rights.

Also, counsel should be aware of, and work with, local counsel concerning local ownership requirements. While a master franchisee may wish to bring in investors or create a joint venture to establish the master-owned outlets, some franchisors may require certain minimum equity and control levels for the master franchisee or its management team. Finally, some countries have local ownership requirements, and the master franchisee must comply with those.

4. Term and Renewal

The initial term of a master franchise agreement and any renewal terms can be delicate issues because of the role of the master franchisee. The initial term should be long enough for the master franchisee to develop its own outlets and to sell and support the opening of the scheduled or anticipated number of subfranchisees' outlets. And that period of time will be decided in part by the development schedule. The more significant issue is how to structure the duration of the master franchise agreement for the period after the conclusion of the initial development schedule. The master franchisee will have subfranchise agreements with the subfranchisees that will run for 5, 10, or 20 years, and may have renewal terms that extend the operations for additional periods of 5, 10, or 20 years. The master franchisee needs the contractual authority and incentive to service and support the franchisees and collect royalties and other payments. Therefore, the term of the master franchise agreement, or a renewal term, needs to be longer than the initial development schedule.

The master franchisee is likely to want a term (or renewal) that extends as long as the last unit is operating. And if the master franchisee is in good standing and is in compliance with the contract, the franchisor is likely willing to permit that. However, as with all multiple-unit developments, determining the right number of units to develop is like looking into a crystal ball. The franchisor does not wish to have unexploited territory or population. Therefore, the master franchise agreement may include an additional term, additional development obligations, and/or a renewal term, some of which may depend on achieving certain development goals, to address these issues. On the flipside, the franchisor should not make the renewal requirements too onerous, because a master franchisee would like to receive the economic fruits of his/her labor, which are generally received in the latter years of the relationship when the franchised businesses are operating smoothly and profitably.

5. System Changes

Most franchise agreements, development agreements, and master franchise agreements reserve to the franchisor broad rights and discretion to make changes to the system, to operating standards, and to other aspects of the franchised businesses. The international master franchise agreement should include similar provisions. However, the franchisor will be distant from the territory and the daily operations—not just geographically, but also culturally. Therefore, the arrangement should recognize the role of the master franchisee in developing and implementing system changes. These can be in the areas of menu (for restaurants), inventory, and store/outlet operations. The master franchisee may have ideas regarding signage, advertising, and "branding" changes. As the issues become closer to the franchisor's core brand and trademark issues, the franchisor will likely be resistant to grant such authority to the master franchisee. The critical consideration is determining—at the outset of the relationship if possible—the latitude that the franchisor is willing to grant a master franchisee for decisions that will likely arise in the future pertaining to the conduct of the franchised businesses in the defined territory.

B. Legal Issues

1. Confidentiality and Covenant Against Competition

The master franchise agreement often includes two critical covenants imposed on the master franchisee: the obligation to retain and not use or disclose confidential, proprietary, and/or trade secret information of the franchisor, and the prohibition on owning, operating, or franchising a competing business. These types of provisions are common in most franchise agreements. Consideration must be given to the likelihood that a qualified master franchisee may already be involved in other franchises, or may forgo investing in one franchisor's system if the cost includes exclusion from others. One issue for franchisors and master franchisees is whether these provisions will be enforceable. In some countries, the protection of confidential information is limited, and such a provision will be narrowly enforced. Likewise, some countries will not enforce non-competition covenants, or will support only those that are very narrowly tailored.

A related concern is whether a confidentiality covenant, or non-compete restriction, even if legal under the target country's laws, will be enforceable in a practical sense. As discussed in Part VI of this chapter, enforcement of contract rights may be problematic in certain countries. Therefore, the expectation of enforceability should help define the scope of protections, and whether the master franchise agreement should be modified to create greater certainty of enforceability.

These types of provisions will likely be included in the subfranchise agreement, and they may be as important to the franchisor as they are to the master franchisee. Not all countries recognize or permit third-party beneficiary rights in contracts. Therefore, the issue of enforceability of the subfranchisee's protection of confidentiality must be addressed in the master franchise agreement.

2. Transfer Restrictions

Master franchise agreements often contain a restriction on the master franchisee's right or ability to transfer or assign the master franchise agreement, the ownership in the master franchise agreement, the assets of the master franchise business, and, most important, the subfranchise agreements without the franchisor's prior consent or stated conditions. Most foreign countries will permit restrictions on transferability. However, the U.S. franchisor and its counsel should focus on (i) the content of the transfer restrictions, (ii) the mechanisms by which the restrictions may be imposed, and (iii) the enforceability of the restrictions. In many countries, the restrictions on transferability must be reasonable, and is some cases it is necessary or desirable to elaborate on the conditions for transfer and to have the master franchisee acknowledge the reasonableness of these restrictions. Some countries have codified their transfer conditions in franchise laws or fair trade laws.

A transfer restriction should, in the first place, appear in the master franchise agreement, as this will provide the franchisor with a contractual basis to enforce it. However, franchisors may need more support to enforce transfer restrictions, and may require them to be included in the master franchisee's organizational documents, such as the articles of incorporation. To the extent these restrictions apply to real estate, some countries require that such rights or restrictions appear in a deed. And if the rights pertain to personal property, a separate pledge agreement may be required. Again, local counsel should guide the franchisor on local legal and practical requirements and customs.

Even if the master franchise agreement contains proper restrictions, and they are reasonable, there may still be an issue with enforceability. A restriction is more likely to be enforced if the franchisor has included a right to seek injunctive or equitable relief. While injunctive relief is viable in many countries, some countries or judicial systems are reluctant to grant injunctive relief. To enforce transfer restrictions in these countries, local counsel may recommend an automatic termination of the master franchise agreement if the contractual transfer restrictions are violated. (But, as will be discussed below, termination has its challenges too.)

3. Termination and Nonrenewal

One element of many U.S. franchise laws is the restriction, or limitation, of the franchisor's right to terminate or not renew a franchise. These restrictions are also present in some foreign laws (or franchise association rules). Some of these limitations are found in franchise-specific laws, and others are found in general agency laws. To address these issues and restrictions, the master franchise agreement may include conditions for termination that are reasonable and based on "good cause" Also, in many countries, as required by law or local jurisprudence, the contract should include notice of default and an opportunity to cure, with a clear explanation of the grounds for termination.

Another factor that comes into play, particularly with respect to master franchise agreements, is the method by which a franchisor terminates a master franchisee and the need to continue to deliver services to, and support for, the subfranchisees following termination. The master franchise agreement should include clear guidelines and standards for compliance with the agreement and the franchisor's standards and procedures. If the master franchise agreement is terminated, most master franchise agreements provide that the subfranchise agreements will be assigned to the franchisor, a designee of the franchisor, or a person or entity approved by the franchisor. It is critical for the franchisor to provide an uninterrupted operation of the subfranchises. In some countries, the transfer or assignment of an asset—in this case one or more subfranchise agreements—is illegal or impossible without the assignment of the related liabilities. Therefore, to the extent the master franchisee is liable to the subfranchisees, the successor to the master franchisee must assume those liabilities. In many situations the successor will be either the franchisor or an assignee designated by the franchisor. It is important for the franchisor and its counsel to work closely with foreign counsel to understand any limitations on the right to terminate, and address, prospectively and proactively, the issues that might arise.

4. Indemnification Obligations

Almost all U.S. franchise agreements include an indemnification provision by which the franchisee indemnifies and holds the franchisor harmless from actions, claims, and damages that arise due to, or as part of, the operation of the franchised business. Indemnification clauses are generally viewed as an allocation of risks and costs. In the international franchise context, and in master franchise agreements specifically, the franchisor will seek to obtain an indemnification from the master franchisee for all actions, claims, damages, or losses, relating to, ancillary to, or arising out of the operation of the master franchise business, and the operation of the subfranchises. The franchisor will need to determine the types of acts, errors, and omissions for which the master franchisee will be

responsible and whether any exclusions may apply, for example, due to the negligence of the franchisor or actions taken at the direction of the franchisor. This is likely to be a subject of negotiation with the master franchisee.

Most countries will enforce indemnification provisions. However, some countries limit the scope or enforceability of indemnification clauses. In some countries, the indemnification must be reasonable, or applied in good faith, or not burdensome to the indemnitor. These limitations may arise in or be imposed by a court. In some countries, a statute imposes a reasonableness standard. Even if an indemnification is legal or enforceable, a court may modify the scope or limit the damages. In addition, some claims may not be covered if they arise out of the franchisor's gross negligence or willful misconduct.

Most indemnification provisions in many countries will be enforceable without special wording or execution formalities. However, some countries require a notarization or other formality for the master franchise agreement so that the indemnification will be enforceable. Also, in some countries, the spouse of an indemnitor may be required to sign the contract or approve the indemnification. And in India, the enforcement of an indemnification (and guaranties, which are discussed below) require the approval of the Reserve Bank of India.

While indemnification clauses may sometimes be viewed as "legal boilerplate," and they often will not come into play unless problems arise in the business or relationship, they are crucial to both the franchisor and master franchisee. Consequently, reliance on local counsel is necessary for both the drafting and enforcement of these provisions.

5. Guarantees/Letters of Credit

Assurance of financial performance by the master franchisee is of paramount importance to the franchisor. Despite undertaking extensive due diligence regarding the master franchisee, bad things can happen, unforeseen events may occur, and the franchisor may need to look for payment from some person or entity other than the master franchisee. The guarantee in international transaction takes on greater significance than in a domestic U.S. matter because of the difficulty in enforcing contract rights in international tribunals, and, more important, in executing on judgments received in "foreign countries" (that is, a judgment received outside of that country in which the master franchisee operates).

A franchisor may seek a corporate guarantee and/or a personal guarantee. Corporate guarantees in international franchise deals are generally enforceable. But, like other corporate guarantees, whether the entity will retain the resources or assets necessary to guarantee the financial obligations of the master franchisee remains uncertain. Also, the franchisor must follow the proper corporate formalities to enforce a guarantee. Another typical approach is to obtain a per-

sonal guarantee from one or more owners of the master franchisee. Personal guarantees are generally enforceable in foreign countries.

For guarantees to be enforceable, the guarantor must comply with particular rules regarding the wording and execution of the guarantee. For example, the language of the guarantee may require the waiver of defenses, or presentment and demand for payment. Some countries require a notice or warning to the guarantor. Also, some countries require notarization or other formalities related to the signature or execution of the guarantee. In some countries, the spouse may need to execute or approve the guarantee to defeat future challenges.

Many individuals will balk at providing a personal guarantee. So the franchisor may have to look to other means to secure financial performance. One such method is the use of a letter of credit, or "LC." LCs can be very useful, and are an easy tool by which a franchisor can obtain monies owed. The form of the LC must be negotiated in advance, as will the amount and the conditions under which the franchisor may draw on the LC. All of these conditions should be in the master franchise agreement and in the terms and conditions of the LC. For an LC to be of value to a franchisor, the master franchisee (or principal of the master franchisee) must establish the LC with a designated bank and must maintain the minimum funding necessary. Breaches of these obligations are often an express default of the master franchise agreement. The downside for the master franchisee is the need to keep a certain amount of cash, which could total hundreds of thousands of dollars (or more), tied up in the LC. Also, if the franchisor improperly draws on the LC, recourse against the franchisor or the bank can be challenging and expensive.

Letters of credit are a regular element of international commercial transactions. Therefore, they are generally enforceable and easy to use. The challenge arises in negotiating the amount of the LC, and how it protects both parties' interests against certain actions by the other.

6. Liquidated Damages/Penalty Clauses

Liquidated damages, or penalty, clauses are contract provisions that provide a financial payment for a breach where it is generally difficult to estimate the potential monetary harm or would otherwise be difficult to prove. In the U.S., liquidated damages clauses are generally enforceable if they are reasonably related to the breach and the expected harm, or actual damages incurred. In the international context, liquidated damages are also enforceable in franchise matters. However, franchisors must be judicious in drafting these clauses, because the amount of the damages must have some reasonable relationship to the actual damage to avoid being treated as a "penalty" clause. Penalty clauses are gener-

ally not enforceable. In some countries, liquidated damages clauses may be modified by a court if they are excessive or punitive.

For the master franchise agreement, it is important to determine which breaches should be subject to liquidated damages, such as a breach of the confidentiality restrictions, the non-competition requirements, improper trademark usage, or transfer restrictions. Therefore, in negotiating a liquidated damages provision or using an LC, the parties may create a process with the potential for significant damages to the master franchisee. This works to encourage strict compliance by the master franchisee.

7. The Subfranchise Agreement

In a master franchise arrangement, the franchised outlets are operated by the subfranchisees, who execute a subfranchise agreement with the master franchisee. The franchisor cedes a significant amount of direct involvement in the daily operation of the brand to the master franchisee. While the master franchisee as a practical necessity will have the right and ability to sell franchises, provide assistance, and determine whether to enforce certain aspects of the business relationship, brand standards, and the contract, franchisors typically shape that process through the subfranchise agreement.

Many master franchise agreements will include as an exhibit a form of unit franchise agreement that the master franchisee must employ and execute with each subfranchise. The initial form of franchise agreement is often the form that the franchisor used with its home, or U.S., franchisees. A franchisor may prefer that a master franchisee use its standard franchise agreement for several reasons. First, the franchise agreement provides a platform for describing and representing the brand and aligning the parties' expectations. Second, the franchise agreement, along with the manuals, provides the basic building blocks for how to operate the business and deliver the products and services to customers in accordance with brand standards. Third, to the extent the franchisor will receive a share of revenue from the unit operators, the franchise agreement will include provisions regarding the collection, accounting for, and payment of, royalties and other fees. Fourth, to the extent the franchisor may need to terminate the master franchise agreement and take an assignment of the franchise agreements, the franchisor desires to have a form of contract with which it is familiar.

It would be a mistake, however, for the franchisor to assume that its form of franchise agreement will be attached to the master franchise agreement unchanged from its U.S., or standard, form, and it is typically a mistake to insist on such uniformity. The unit franchise agreement, when executed, will be between two parties who are citizens, entities, or domiciliaries in the foreign country (the master franchisee and the subfranchise). So, at a minimum,

the franchise agreement should be modified to reflect the laws and customs of the target country. This could include changes to governing law, dispute resolution, payments and taxes, and any number of provisions. In addition, the master franchisee will be the party enforcing the rights under the franchise agreement, and may have ideas or desires regarding how to administer the system and assistance. One approach is for the U.S. franchisor to start with its U.S. franchise agreement and, working with local counsel, modify the agreement to create a local form. The U.S. franchisor may also wish to receive the prospective master franchisee's input into the form as part of the discussion and negotiations over the master franchise agreement. The master franchise agreement often provides that the form of franchise agreement may be modified by the master franchisee, subject to the review and approval by the franchisor. This allows for flexibility in the future.

In some situations and countries, the unit franchise agreement is very similar to the U.S. agreement. But in other countries, particularly where "western" or "U.S." forms of agreements are disfavored, the unit franchise agreement is drastically different from the U.S. form. The U.S. franchisor and the master franchisee must be assured, however, that the unit agreement is of a form and substance that both can accept, and live with, for many years into the future.

VI. Dispute Resolution

A. Introduction[28]

It is, of course, of fundamental importance to express the parties' rights and obligations clearly and comprehensively in all contractual agreements. This is even more important when the agreement is between parties in different countries and the clarity of drafting has to be established in the context of often lengthy negotiations between parties who may not share a common approach to contractual interpretation. The first part of this section will address the considerations regarding choice of law. The second part will explore the choice of forum, including the use of mediation and arbitration.

B. Choice of Law Governing the Relationship

Generally speaking, the choice of law in international franchise relationships will be a choice between the franchisor's home country and the laws of the

28. For a more detailed review of dispute resolution in international franchising, see Bethany L. Appleby & Erik B. Wulff, *Dispute Resolution: Choice of Law and Form, in* Fundamentals of International Franchising 195 (Will K. Woods ed.), A.B.A. 2d ed. 2013.

country where the franchise will operate, although a number of international franchise agreements provide for the agreement to be governed by the laws of a "neutral" jurisdiction. Very often the laws of England are adopted if a neutral location is required in an agreement involving a U.S. franchisor because both countries share a common law heritage and a common language.

Whether deserved or not, the application of the laws of a State of the United States will often give rise to substantial concerns for international parties because of the perceived litigation culture in the United States, contingency fees, jury trials, and the inability to recover legal fees even if a party is successful.

In the absence of such concerns, the choice of law will often be dictated by the party with the greater bargaining power, sometimes (but not always) the franchisor—but the choice of the franchisor's "home" law often may not be the right decision for a franchisor expanding overseas unless the law and/or courts of the franchisee are unclear or favor nationals from the home jurisdiction.

More often, franchisors bring claims against their international franchise partners rather than the other way around. Overseas franchisees usually adopt the "self-help" remedy of simply withholding payment from their franchisor. Many disputes in international franchising relate to the recovery of payment from overseas franchisees or enforcing post-termination contractual obligations. These claims are best pursued in the jurisdiction of the overseas franchisee, because a U.S. court judgment will have to be enforced in the overseas jurisdiction. If the franchisee has not participated in the U.S. proceedings, a foreign court may not accept or enforce a U.S. default judgment.

Whatever foreign or domestic laws are applied to the relevant contracts, mandatory laws may not be overridden, so a U.S. franchisor must, for instance, comply with antitrust, bribery, privacy, money-laundering, anti-terrorism, and franchise laws which may apply in the franchisor's home territory and the franchisee's territory. Accordingly, foreign counsel will always have to be appointed to advise on mandatory requirements in the target jurisdiction, even if the laws of a State in the United States are chosen as the applicable laws.

A franchisor should also consider whether the laws of its home country may be more favorable to a franchisee than the laws of the host country. The franchisor's home state may impose disclosure requirements and regulate the franchise relationship, while the target country may not. Deciding which laws will be designated by contract to govern the franchise agreement is undoubtedly a more complicated process than simply ensuring that the laws of a franchisor's home country should apply.

C. Choice of Forum to Resolve Disputes

The choice of forum to resolve disputes is complex when placed in the context of international franchising. Convenience and familiarity will often lead a franchisor to designate the courts in its home state, but bringing an action in a franchisor's home courts may make enforcement against the franchisee more challenging because the franchisee's country's courts may not recognize overseas proceedings and enforce their judgments, particularly judgments obtained in the U.S. The United States is not a party to any treaties regarding the enforcement of foreign judgments, and as such, the enforcement of a U.S. judgment in the host county is a matter of international comity.[29] In Europe the situation is different, as judgments can be enforced in other member states of the European Union through the Treaty of Brussels. However, in general, multilateral and bilateral treaties in relation to the enforcement of foreign judgments are rare. It is because of the challenges in selecting the appropriate courts to resolve disputes that arbitration is often used in international franchising—as noted in Section D below.

Nothing prevents the parties from choosing the laws of a State in the United States and recognizing jurisdiction in the courts of the foreign country, but this is done very rarely. When bringing proceedings in a foreign jurisdiction based on the laws of a U.S. State, expert evidence would have to be available to the foreign court as to what the law of the designated State is and what it means. Few franchisors would relish the prospect of paying for two sets of lawyers!

Often franchisors will need the ability to enforce provisions, such as non-compete provisions, very quickly by injunction proceedings, and franchisors should consider reserving to themselves the ability to seek injunctions in the franchisee's jurisdiction, perhaps with the additional ability to apply local laws to the agreement.

D. Mediation and Informal Dispute Resolution

Mediation is a private, non-determinative, voluntary, and informal facilitated negotiation. It involves the use of a neutral third-party mediator who will assist the disputing parties in reaching a voluntary resolution of their dispute. One would expect an international franchise agreement that contemplates mediation to specify the mediation procedure that the parties wish to adopt. The agreement should specify the informal dispute resolution body that will appoint the mediator, the language and venue of the mediation, the maximum duration of the

29. Bethany L. Appleby & Eric B. Wulff, *Dispute Resolution: Choice of Law and Forum, in* FUNDAMENTALS OF INTERNATIONAL FRANCHISING 195, 199 (Will K. Woods ed.), A.B.A. 2d ed. 2013.

mediation, and the responsibility of the parties for the cost. In some jurisdictions, the courts require disputes to be mediated before litigation; otherwise, they may impose cost sanctions on a party that unreasonably refuses to participate in mediation. Cultural issues may also push the parties toward a more conciliatory form of dispute resolution in international franchise disputes. Some countries, such as Japan, regard litigating a dispute as dishonorable; therefore, the parties to an international dispute should approach the dispute from a conciliatory perspective before considering litigation or arbitration.

Various international organizations, such as United Nations Commission on International Trade Law, the International Institution for Conflict, Protection & Resolution, the International Chamber of Commerce, and the London Court of International Arbitration, have guidelines that set out the procedure by which a mediation/conciliation should take place.

E. Arbitration of Disputes

Because of the popularity of arbitration as a means by which international commercial disputes are resolved, it has been promoted by numerous international bodies, including the United Nations. The United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) has been adopted by 146 member states, including the U.S. and virtually all developed nations. Several international arbitration institutions, such as the International Court of Arbitration of the International Chamber of Commerce, have also seen a steady growth in the number of international arbitrations.

As a consequence of the widespread acceptance of arbitration in many countries through their adoption of the New York Convention, parties are, in theory, able to avoid the protracted and expensive proceedings that arise in connection with judicial resolution of disputes as to jurisdiction and parallel proceedings in different countries. Despite this theoretical benefit, many practitioners believe that international arbitration has become at least as expensive and complex as litigation in public-sector judicial systems.

One of the perceived advantages of international arbitration is that it offers a neutral forum. While many developed countries have court systems that are generally competent and unbiased, a lack of familiarity with relevant procedures by a foreign franchisor can give the “home” party an advantage.

Because of the widespread adoption of the New York Convention, an undoubted advantage of arbitration is that arbitration agreements and awards are more easily and reliably enforced in other countries. This can be contrasted with the lack of multinational treaties dealing with the enforcement of foreign judicial awards. The U.S., for example, is not a party to such treaties.

Arbitration also allows for flexibility in establishing the procedural rules for the resolution of the dispute. Although the rules of arbitration for the major international arbitration organizations are similar, the parties have the ability to modify or supplement those rules.

International arbitration usually involves significantly less discovery than U.S. court proceedings. Some international arbitration guidelines make it clear that discovery should be limited.[30] Lack of comprehensive discovery can be perceived as either an advantage or a disadvantage, depending on the circumstances of a particular case.

As with domestic forms of arbitration, arbitration proceedings are private, may be kept confidential, and do not establish a binding precedent. This lack of precedent of tribunal decisions can lead to unpredictable results or even be counterproductive in resolving disputes that affect more members of the franchise system than the immediate parties to the dispute.

F. Laws Governing International Arbitration

Arbitration proceedings will be governed by substantive and procedural laws and regulations. The substantive law may be stipulated through a choice-of-law provision in the franchise agreement. The procedural law will consist primarily of the procedural rules of the arbitration service provider. Those procedural rules can be the comprehensive rules of the chosen international arbitration organization or the rules that the parties have chosen for themselves in ad hoc proceedings (most commonly the UNCITRAL rules). The rules can be modified, but a procedural framework should be considered in light of the laws on arbitration in the country where arbitration proceedings are to be conducted.

Arbitration proceedings should be conducted in a country that has adopted legislation supporting the arbitral process. This essentially calls for using a country or state that limits the court's role in arbitration and has laws supporting the enforcement of arbitral awards. It is preferable to conduct the arbitration proceedings in such a country to avoid judicial interference with the process. This allows the parties autonomy to determine how the arbitration is conducted. Some countries, such as those in Latin America and the Middle East, take a cautious view to international commercial arbitration and reserve to their courts the ability to review arbitral awards.[31] Many other countries, including the U.S. and

30. International Institution for Conflict, Protection & Resolution, *CPR Protocol on Disclosure of Documents and Presentation of Witnesses in Commercial Arbitration* 5, CPR, *available at* http://www.cpradr.org/Portals/0/Resources/ADR%20Tools/Clauses%20&20Rules/ CPR%20Protocol%20on%20Disclosure%20of%20Documents%20and%20Witnesses.pdf.

31. Gary B. Born, International Commercial Arbitration: Commentary and Materials 29 (Kluwer Law Int'l, 2001).

many countries in Europe, have adopted a supportive approach. Further, in order to promote international commercial arbitration by passing laws that make it difficult to challenge arbitral awards through the courts, the United Nations Commission on International Trade Law has created a model law on international commercial arbitration, which a number of countries have adopted. The model law contains, among other things, provisions concerning the scope of judicial intervention in the enforcement of arbitration agreements and the composition of arbitral tribunals.[32] The impact of the model law depends ultimately on its interpretation by national courts.

G. Arbitration Procedures

When determining procedural law, the parties may agree to use an institutional arbitration agency or organization such as the International Institute for Conflict, Protection & Resolution (CPR), the International Chamber of Commerce (ICC), the International Centre for Dispute Resolution (ICDR), or the London Court of International Arbitration (LCIA). Neutrals such as the World Intellectual Property Organization (WIPO) or the Stockholm Chamber of Commerce (SCC) may also be used. Each of these organizations has its own set of procedural rules and can also provide assistance in the selection and location of an arbitration tribunal. However, substantial administrative costs may be associated with using these organizations.

The ICC, which is based in Paris, is the most commonly used institution for international arbitrations and has the greatest institutional involvement in the proceedings, although the fees for using ICC can be significant. Using WIPO may be advantageous in disputes concerning intellectual property matters, because its arbitrators have expertise in this area. Alternatively, the parties may wish to adopt their own procedural rules, which may involve using the UNCITRAL rules or adapting those rules.

The parties should weigh carefully the respective advantages and disadvantages of using international institutional arbitration procedures as opposed to their own ad hoc procedures. Using the procedural rules of a respected international institution may add a certain "legitimacy" to arbitration proceedings that can help with the enforcement of an arbitral award. However, the fees for using such institutions can be significant. Therefore, the parties should consider the amounts that are being claimed and the cost benefit of arbitrating in this way. Some franchising institutions and bodies, such as the British Franchise Association, have their own set of procedural rules for arbitration that the parties to an

32. United Nations Commission on International Trade Law, UNCITRAL Model Law on International Commercial Arbitration (1985), with amendments as adopted in 2006, 4–8.

international dispute may wish to adapt ad hoc because those rules will be geared toward domestic franchise disputes.

H. Other Issues That Impact International Arbitration

The site at which the arbitration proceedings take place can be significant. In the United States, the section of the Federal Arbitration Act (FAA) that governs international arbitrations only recognizes awards to entities in countries that are signatories to the New York Convention and the Panama Convention. It is also important to consider the extent to which judicial interference in the country hosting the arbitration may interfere in the procedure or requirements that issues of law are determined judicially.

Normally, an arbitration tribunal will consist of one or three arbitrators. There are obvious cost advantages to selecting a single arbitrator, but a larger panel may lower the risk of an erroneous award. Some organizations discourage use of an arbitrator from the same country as one of the parties. The extent of discovery is generally at the arbitrator's discretion. This means that discovery may be limited or extensive, depending on the arbitrator's background. However, the extent of discovery is likely to be less than in court proceedings. Monetary relief is a typical award in arbitrations, although injunctive relief may be possible. Awards may resemble a formal judicial decision or they may simply state what relief is awarded.

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As noted at the outset of this chapter, there is no one-size-fits-all approach to international franchising. However, the legal, commercial, and cultural factors, as well as cost and franchisor control issues, will shape the international franchising arrangements and agreements. And these may vary by country, even for the same franchise system.