

Avoiding Common Mistakes In International Franchising

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DEDICATION

The authors dedicate this article to the memory of John R. F. Baer. John practiced franchise and distribution law for over four decades, serving as a colleague, mentor and friend to the authors and many others in the franchise bar. John was a leader of the U.S. and international franchise bar and he was a prodigious author and lecturer on many of the issues that we discuss in the article. His selfless willingness to help others and low-keyed approach endeared him to franchise lawyers throughout the world. He served as leading example of what it means to be a great franchise lawyer and a great man.

Avoiding Common Mistakes In International Franchising*

Introduction

Lawyers should play a key role in advising franchisors and prospective international franchisees about the many complex issues that frequently arise in international franchising transactions and relationships. Although most lawyers will never have thorough knowledge of each new country that their franchisor–clients target for expansion, they should be prepared to advise their clients about the best practices, which will enable them to identify and avoid the most common international franchising mistakes. Similarly, lawyers for prospective international franchisees should alert their clients to anticipate the common issues that foreign franchisors confront when entering new markets. They should anticipate potential difficulties arising out of the operational and legal differences between foreign markets and franchisors' home markets.

Every franchisor and prospective international franchisee should recognize that they are prone to making unwarranted assumptions about doing business in each other's countries and how their franchise relationship would work in a new market. "You don't know what you don't know." Hence, one of our goals in writing this paper is to identify issues that Franchise Parties¹ often overlook, and to reduce the number of mistaken assumptions that they will make.

In the ensuing pages, we explain the most common issues Franchise Parties confront in international franchising. First, we identify common planning deficiencies and methods of overcoming them. Second, we explain how to identify and address franchisee training, support, and adaptation challenges. Third, we explore how to efficiently identify local law and real estate leasing/acquisition issues that affect profitability. Fourth, we discuss supply chain problems and potential resolutions. Finally, we will examine end-of-franchise relationship issues and the unique challenges that master franchising poses. We will then suggest strategies for overcoming many of these challenges.

The problems we discussed are subject to four types of remedies:

1. For many, the problem can be identified, defined and limited through due diligence. This will typically include market research, and consultation with local franchise counsel. By reviewing published market intelligence reports, and by providing local counsel with a list of issues that concern the franchisor, franchisors can be equipped with the knowledge they need to decide whether to pursue a market or a transaction that involves the market.

¹ For convenience, when referring to both international franchisors and international prospective franchisees and international franchisees, this Article will use the term "Franchise Parties."

2. Following the due diligence, the Franchise Parties can develop more realistic plans which will guide them in their decisions about whether and how to execute an international franchise relationship.
3. Franchisors can use our discussion of the various costs that arise in international franchising, and the outline of costs that flow from the use of different franchising strategies to select the franchising strategy that will be best for the country and the transaction they are considering.
4. After a review of the many issues that should be addressed in international franchise agreements, lawyers for franchisors and franchisees can evaluate the international franchise agreements that they now use by determining whether and how well they address the issues and potential solutions we have suggested.

We now turn to the common problems.

1. Planning For International Expansion

1.1 Failing To Plan Is Planning To Fail

Experienced international franchisors emphasize the need to plan where, when, and how to expand internationally.² In contrast, many less experienced franchisors embark upon international franchising transactions in response to solicitations received over the Internet or at franchise expositions. They are less likely to understand the range of costs and other issues that will affect the viability and profitability of their early international experiences. Their failure to address the issues outlined below adds significantly to their risk of an unsuccessful international franchise relationship.

1.2 Is The Franchisor Really Committed To International Franchising?

Because of the time required to close deals and to generate profits in international transactions, international franchising efforts are unlikely to succeed without the commitment of the franchisor's CEO, board of directors, and significant investors. The time and expense associated with recruiting international franchisees and adapting the franchise concept to the new country are usually much greater than the time and cost associated with opening additional franchises in the franchisor's home country. The time and costs also frequently exceed initial expectations. Only by performing due diligence and basing budget estimates upon the results can the stakeholders be prepared for the twists and turns of each new transaction.

A franchisor's commitment to international franchising must be embraced by virtually the entire franchisor organization. As Yoshino Nakajima, Chief Development Officer of

² See generally Carl Zwisler, Jim Hartenstein, Benjamin Simon & Yoshino Nakajima, How to Analyze an International Market for Expansion—Best Practices, Presentation at International Franchise Association 2015 Annual Convention (Feb. 15–18, 2015) (program materials will be available at <http://www.franchise.org/international-program-materials>).

Home Instead Senior Care, told a 2015 International Franchise Association (IFA) convention audience, “Everyone in the company needs to know that they are no longer an American company with one or more international franchisees. They are an international franchising company which happens to be based in the United States.” Executives just embarking on international franchising must recognize the natural challenges that occur when franchisees are many time zones removed from the franchisor’s headquarters, and of the difficulties of communicating in different languages. Foreign franchisees will need support during hours when a purely domestic franchise organization may typically be closed. In virtually every department, the franchisor’s staff must be available to assist foreign franchisees with their unique challenges, including challenges that may require more thought and time than is required to support domestic franchisees.³

Prospective international franchisees should confirm that the commitment and support they will need is available from the franchisors they are evaluating.

1.3 What Should Franchisors Know About The Countries In Which They Plan To Franchise?

Experienced international franchising professionals repeat an admonition to new international franchisors; plan where you want to go rather than going to the first country in which an apparently good prospect requests franchise rights.

According to Jim Hartenstein, International President of Little Caesar’s Pizza, the process of selecting the right countries for international franchising begins with discarding inappropriate countries, based upon the franchisor’s current needs and other macro-economic factors.⁴ For example, franchisors should first eliminate countries where they are barred from doing business. U.S. franchisors must avoid franchising in countries that are on the U.S. government’s boycott list or list of countries with which U.S. residents must not deal, such as Cuba, North Korea and Syria. Moreover, U.S. franchisors may not do business with franchisees or owners who are on the U.S. Treasury Department’s Office of Foreign Assets Control (OFAC) list of terrorists or terrorist’s supporting organizations.

Franchisors should then examine factors that present a high risk, low likely reward environment. Unstable economies, war, domestic turbulence, rampant inflation, high unemployment, very high tax rates, and exchange controls or restrictions on the collection of royalties are some of the factors that should quickly disqualify a country from consideration by new international franchisors. Corruption, trade barriers, other supply chain challenges, advertising, labeling, and import restrictions may disqualify other countries for newer international franchisors. The time required to open new

³ By “domestic franchisees,” we mean franchisees residing within the same country as the franchisor’s principal office.

⁴ Zwisler, Hartenstein, Simon & Nakajima, *supra* note 2.

franchised businesses and concerns about the enforceability of intellectual property protection rights or contract claims should also be of concern to all Franchise Parties.⁵

We recall Goldilocks's declarations, "This one is too hard. This is too soft. This is just right." Franchisors will be most successful when their planning identifies those countries and Franchisee Parties that seem "just right" before they invest significant efforts in a new transaction. A list of resources for use in selecting the right international market may be found at Attachment A.

Of all the countries and markets in the world, franchisors will want to target countries for growth that are most likely to give them:

1. the greatest relative opportunity for profit;
2. in the shortest time;
3. for the lowest investment; and
4. with the least risk.

International franchise professionals refer to countries that meet these as "First Tier" countries.⁶ First Tier countries are determined by evaluating key factors in countries the franchisor is considering for expansion, and eliminating from consideration countries that do not qualify. Ongoing evaluations of countries will cause the First Tier to change over time.⁷

1.4 Why Is Early Legal Advice Essential To The Evaluation Process?

Wise franchisors involve international franchise counsel in the process of developing their growth strategies. The obvious reasons for this often are overlooked by budget-conscious, but shortsighted, franchisors. Legal, intellectual property (IP), and tax issues often have a considerable effect on the time, costs, and viability of a franchise project. Waiting until a franchise candidate has been identified and a letter of intent (LOI) has been negotiated to perform this analysis can result in costly mistakes.

⁵ Although much of this discussion focuses upon Franchisors, international franchisees must be concerned that unanticipated costs and delays imposed on their Franchisors will dampen their ardor for the franchisees' markets and lead to a withdrawal of some vital support. Franchise Parties generally seek a win-win, but when barriers to winning for Franchisors are too intense, they may lose enthusiasm for making further investments in a franchisee's market.

⁶ Many franchisors are approached by offers to purchase franchises for various regions, including the Middle East or Central America.

⁷ Because of the complexities of successfully implementing franchising strategies in multi-country territories, as well as the often-unanticipated costs of entering each new country and supporting franchisees in each country in a region, we focus here on single countries only. We will discuss issues associated with granting franchise rights to a single Franchise Party for multiple countries in Section 1.22.

Although they may be “nonbinding”, LOI’s express the understanding of the parties about issues, including franchising strategy, e.g. master franchise or area development franchise, fees, territory, development schedule, renewal and options rights. The resources required, time needed to accomplish these goals and the effect of the law chosen to govern these issues require an understanding of the legal and related cost aspects of the decisions. Without the benefit of analysis of international franchise counsel, Franchise Parties may either prematurely lock themselves into unwise terms or be forced to walk away from a relationship that could have been productive if unrealistic commitments had not been memorialized in an LOI.⁸

Guidance from franchise counsel about the parameters of franchising and related laws will help the Franchise Parties understand the cost and time required to complete a franchise transaction, and to launch the first franchised business in a new country. For instance, in several countries with franchise registration laws, agreements are executed before registration applications are filed. Examples of countries that employ this approach include China, Korea, and Mexico. Unless international franchise counsel has identified all information and certifications needed to complete a registration, and has prepared agreements, FDDs, and translations before a franchise agreement is executed, months may pass before fees may be paid from the country. In the United States and South Korea, on the other hand, because registration is required before franchise agreements become effective, Franchise Parties will need to know that the franchisor has filed all documents and applications required for registration before a franchise agreement is signed. They will also need to be able to estimate the time required to complete the registrations for purposes of budgeting and development schedules. Franchise laws in Australia, South Korea, and China, among others, also require ongoing reporting requirements to franchisees.⁹

1.5 How Much Is This Going To Cost?

A lawyer who has not repeatedly heard this question has not been practicing law very long. However, the frequency of the question does not make the answer any easier for most of us. Because Franchise Parties reasonably demand estimates so that they can analyze the risks and rewards of proposed transactions, we offer guidelines below to assist everyone associated with an international franchise transaction to rationally approach the expense question. One of the first considerations in a franchisor’s analysis of a potential new market is research to determine the likely transaction costs and adaption costs Franchise Parties will incur.¹⁰

⁸ See *infra* Section 1.11(discussing LOIs).

⁹ In countries, such as the United States, thirteen states require Franchisors to have obtained a registration of their franchises before they may lawfully offer franchises there.

¹⁰ See Carl Zwisler & Kate Nilan, Budgeting for Successful International Master Franchising, Presentation at the Franchise Expo South (Jan. 11–13, 2013) (illustrating the range of issues which Franchisors must address when considering using a master franchising strategy to enter a new market).

1.6 What Are Transaction Costs?

Transaction costs are the marginal costs a Franchise Party incurs before a franchise agreement is executed for a new international market. For franchisors, transactions costs include costs associated with trademark and other IP registration and protection, drafting and translating agreements, legal memoranda, local counsel, franchise registrations, translations of operations manuals, training programs, recruiting costs, brokerage/consultant fees, travel expenses, franchisee due diligence, market research, accounting expenses, the costs of preparing franchise disclosure documents (FDDs), and legal fees associated with preparing and negotiating an LOI and final agreements, among other things.

Franchisors will need to consult with international tax advisors to evaluate optimal strategies for generating cash flow and minimizing the franchisor's (and sometimes, the franchisees') tax liability. They will need advice and strategies to deal with withholding taxes and government restrictions over remitting franchise fees and royalties to the franchisor's headquarters. These expenses will vary, depending upon the country and the particular transaction.

A franchisor embarking on its first international franchise transactions will also incur expenses that are properly capitalized, such as developing form international documents, recruiting websites, consulting services to develop an international franchising plan, fees for preliminary market research, trademark searches in projected target countries, international operations manuals, and training programs and expenses associated with reorienting the company to service franchisees globally. Before pursuing international franchising, a franchisor should either have at least one employee with international franchising experience to lead the effort, or retain an international franchising consultant.¹¹

Prospective international franchisees will also incur transaction costs, including travel to the franchisor's headquarters and visits to other franchisees, legal expenses associated with negotiating franchise agreements and evaluating the lawfulness of the agreements, and legal issues associated with operating the franchise. Prospective franchisees may incur the costs of dealing with marketing and other business consultants used to evaluate prospects for the franchised business in the market. They will also often incur expenses relating to market research and the preparation of business plans to satisfy themselves, their investors, and their franchisors of the likely viability of the franchise in their territories. Prospective international franchisees should also expect to incur some expenses associated with performing due diligence on the franchisor and how well the franchise has performed in the franchisor's domestic market and in other foreign markets.

¹¹ See Mark Hero, Robert Stidham & Carl Zwisler, Use of Brokers, Franchise Sales Networks and Consultants in International Franchising, Presentation at the International Franchise Association/International Bar Association 2013 Annual Joint Conference (May 7–8, 2013).

1.7 What Are Adaptation Costs?

Rarely will a franchise concept cross national borders without facing the need to adapt to local cultural, business and legal issues. Both Franchise Parties share an interest in quickly identifying the adaptation needs. While being sensitive to the need to adapt, most franchisors will want to focus on the core elements of the franchise concept which dare not be modified, lest the franchise lose its customer appeal and opportunity for further growth.

Preparation for adaptation will often begin as a prospective franchisee and a franchisor independently prepare their respective business plans, either before or soon after the execution of an LOI. Intensive adaptation efforts begin after the franchise agreement is signed and the franchisee prepares to open its pilot business.¹² The adaptation will potentially affect every aspect of doing business in the franchisee's country.

The adaption process is comprehensive, and includes identifying and procuring licenses to open the business; translation of manuals and training materials; translation of advertising programs and materials (which will likely require adaptation beyond translation); arranging for sources of supply for the furniture, fixtures, equipment, and inventory needed to operate the franchised business; adapting software and POS systems to local needs; arranging for bank and government agency approvals needed to pay franchise fees; and modification of products or services to accommodate local practices and tastes. Master franchisees in countries with franchise disclosure or registration laws will also need to prepare for compliance with those laws.

1.8 Which Expansion Strategy Is Best?

Franchisors that have only embarked upon domestic franchising typically rely upon direct franchising strategies for growth. Unit franchising, area development franchising, and area representative (AR) franchising are common approaches used for domestic growth. In each of these approaches, the franchisor has contractual privity with each franchisee, and the franchisor is paid directly by each franchisee.¹³

In contrast, U.S. franchisors that embark on international franchising are estimated to use master franchising at least 80% of the time. Master franchising is a three-party strategy issue wherein the franchisor contracts with a master franchisee, and the master

¹² A "pilot business" or "pilot unit" is one or more franchised outlets used to demonstrate the viability and adaptability of the franchise concept in a new market. Its success is crucial to further expansion of the concept in the market. Pilot units are usually owned by the franchisee or by an affiliate that it controls.

¹³ Although AR franchising involves an independent contractor/franchisee in the relationship with a unit franchisee—the franchisor pays the AR a portion of initial and ongoing fees collected from franchisees in a territory for recruiting and supporting the franchisees—the AR has no contract with unit franchisees it recruits or serves and does not collect fees from franchisees. Because AR franchising would require payments to cross national borders twice (once when the franchisee pays the franchisor and a second time when the franchisor pays the AR), it is rarely used in international franchising.

franchisee contracts with unit/subfranchisees. The franchisor has no contract with the unit/subfranchisees. Master franchising tends to be used less frequently when the franchises offered involve relatively complex operating standards and when the franchisees' territory is contiguous to the franchisor's home country.¹⁴

Area development franchising accounts for the vast majority of the remaining international franchise relationships established by U.S. franchisors. In area development franchising, an area developer is granted a territory, within which it must open and operate franchised businesses at a rate set by a development schedule. The parties execute two agreements: an area development agreement that defines an initial fee, the size of the territory and a development schedule, and a unit franchise agreement that is executed before each new franchised outlet is opened. Area development franchising only involves two parties. Area developers do not subfranchise.

Other methods of international expansion include use of branches owned by the franchisor or its affiliates, direct unit franchises, mergers and acquisitions, and joint ventures. Expansion via branch offices and joint ventures typically subjects franchisors to the obligation to comply with all laws, including taxes imposed by the host countries. Moreover, the financial statements of these operations must generally be reported on a consolidated basis with those of the franchisor or its affiliates, adding to the cost of doing business.

Because each joint venture is unique, joint venture agreements are not generally based upon a template or form agreement to the same extent that a form franchise agreement would be. Thus, the legal and accounting costs and time required to draft, negotiate and establish joint ventures are generally greater than are the marginal costs of preparing and negotiating franchise agreements.

Unless the nature of a franchised business is such that the returns from a single location are quite substantial, or unless the number of franchised units of a particular brand that a company could establish in a country are few, the transaction and adaptation costs of unit franchising into foreign markets is generally not warranted by the anticipated returns.

1.9 Which Legal Documents Are Required For International Franchising?

Among the most significant initial costs of international franchising are franchise documents that are used. Franchisors will typically need to develop, or to adapt from previous international transactions the legal documents described in Table 1:

Franchisors will incur the cost of preparing these documents, then modifying them to address the requirements of laws and business practices in the franchisee's country, as

¹⁴ For a review of the benefits and detriments of the various international franchising formats, see Carl Zwisler, *Selecting a Format for International Franchising*, in INTERNATIONAL FRANCHISING: A PRACTITIONER'S GUIDE 27–58 (Marco Hero, ed. 2010).

well as the cost of negotiating them. Often the documents must be translated into the local language. Filing and/or franchise registration costs are also sometimes incurred.

As this table illustrates, the legal component of transaction costs of a master franchising program will be higher than for either an area development or unit franchise program.

Table 1	
Legal Documents Used In International Franchising	
1.	Letter of Intent
2.	Unit Franchise Program <ul style="list-style-type: none"> a. International Unit Franchise Agreement b. International FDD*
3.	Area Development Program <ul style="list-style-type: none"> a. International Area Development Agreement b. International Unit Franchise Agreement c. FDD¹⁵
4.	Master Franchise Program <ul style="list-style-type: none"> a. Master Franchise Agreement b. Unit/Subfranchise Agreement, Master Franchise Version c. Area Development Agreement, Master Franchise Version¹⁶ d. Master Franchise FDD e. Unit/Subfranchise FDD¹⁷
<u>Other Documents Sometimes Required</u>	
1.	Trademark License or Registered User Agreements. These are often filed with the trademark office and/or with a central bank.
2.	Short form franchise agreements, used for filing in some countries.

¹⁵ FDD's may be required by law or may be used even if not required.

¹⁶ Not every master franchise program will also allow the master franchisee to grant area development rights.

¹⁷ If required by law, the Unit/Subfranchise FDD is usually required of the master franchisee. Many franchisors opt to prepare this document. See *infra* Section 1.15.

1.10 How Does The Choice Of Franchising Strategy Affect The Cost And Viability Of An International Franchising Transaction?

Franchisors and prospective international franchisees are often attracted to the concept of master franchising. Through a master franchise, the franchisee party becomes the “franchisor” in its territory, entering into franchise agreements with unit/subfranchisees and collecting fees directly from them. Prospective international master franchisees find it appealing to “own” a franchise brand in their country, and to be the de facto franchisor there. Franchisors are drawn to the advantage of not needing to invest heavily in the development of a new market, and of being able to rely upon the local knowledge, business skills, and contacts of a master franchisee. Franchisors are also attracted to the benefit of a master franchisee undertaking full responsibility for recruiting franchisees, and for training, servicing and supporting them. Franchisors anticipate little or no liability for unit/subfranchisees’ claims and a low investment in the territory relative to the anticipated benefits. Unfortunately, both the investment required and the potential liability for claims are sometimes greatly under estimated.

Unlike master franchising, area development franchising is frequently used by franchisors in their domestic markets. Most companies new to international franchising are familiar with it. Although the area development agreements used domestically will usually require modification, when used internationally the basic concept is familiar to most franchisors.

Although the pricing of international territorial or development rights may differ somewhat from the approach used domestically, the royalties and ongoing fees franchisors charge internationally and at home tend to be similar. All such fees are paid directly to the franchisor or to its designee (subject to withholding taxes). Because each outlet operates pursuant to a franchise agreement between the franchisor and developer/franchisee, contractual privity exists and the franchisor retains the right to exercise contractual control over the operator of each outlet.

Franchisors and master franchisees share the fees paid by unit/subfranchisees to the master franchisee. The portion of fees charged by master franchisees that is shared between the franchisor and the master franchisee is NOT subject to a rule of thumb analysis.¹⁸ Because all three parties to a master franchise relationship must generate at least a market rate profit for the relationship to succeed, franchisors must model their expenses of supporting master franchises and their unit/subfranchisees and efficiently allocate duties for servicing unit/subfranchisees between the franchisor and the master franchisee. Franchisors must know what their costs will be before determining what fee to charge a master franchisee. If the projected income from fees, based upon the projected number of franchised outlets and the amount of fees the master franchisee can charge unit/sub-franchisees is projected to be inadequate to generate enough profit

¹⁸ In addition to standard fees, such as royalties, initial fees and transfer fees, master franchisees may be required to pay fees to their franchisees on commissions, license fees, rent and other income generated from the master franchise relationship. These fees should be included in the calculation of returns available to the Franchise Parties.

for both the franchisor and the master franchisee, a different strategy may be needed.¹⁹ Those costs are likely to vary from country to country and from transaction to transaction. In some markets, returns from master franchising may be inadequate to warrant a franchisor's use of a master franchising strategy.²⁰

International area development agreements often differ from those used in a franchisor's domestic market. Because of the relative proximity of the franchisor to franchised outlets, some franchisors may provide direct support to area developers' franchised outlets in the same way they would support individual unit franchisees. With distances greater and legal and cultural issues resulting in modified operating requirements in foreign markets, franchisors often assign duties to international area developers that resemble the duties assigned to international master franchisees.

Indeed, the training and expectations of area developers during the launching of a franchising program in a new country may not differ dramatically from those of master franchisees. For instance, in the area development context, after establishing one or a few pilot outlets, franchisors will "train the trainers" employed by the area developer and charge the developer with duties such as site selection, development and coordination of local advertising programs, adaptation of manuals, establishing relationships with suppliers, and training new managers and employees.

After a master franchisee has opened the agreed number of pilot units, the franchisor usually trains the master franchisee in the skills needed to be a franchisor, using a formal classroom training at the franchisor's headquarters, as well as on-the-job assistance in the master franchisee's territory. This is an added expense for the franchisor, but it should result in the master franchisee successfully recruiting and establishing unit/subfranchisees.²¹ Thus, the franchisor's duties in the initial stages of adapting the concept in a master franchise relationship are generally greater than in an area development relationship, and the fees received from the operation of franchised outlets in return are lower until a critical mass of unit/subfranchisees has been established in the master franchisee's territory.²²

¹⁹ Because franchisors and master franchisees may derive income from supplying products or services to unit/subfranchisees or their customers, profitability analysis should consider the income as well as franchise fee income.

²⁰ Kay Ainsley, Kevin Derella, John Dring & Carl Zwisler, Budgeting and Planning for International Expansion, Presentation at the International Franchise Association 2010 Annual Convention (Feb. 5–8, 2010) (program materials are available at <http://www.franchise.org/international-program-materials>).

²¹ Inability of master franchisees to recruit unit/subfranchisees has been identified as the major problem master franchisees confronted. See, e.g., Arturs Kalnins, *Biting Off More Than They Can Chew: Unfulfilled Development Commitments in International Master Franchising Ventures*, CHR REPORTS, Oct. 1, 2005.

²² From the first 5 units established in an area development franchise, franchisor's will typically receive 100% of their standard initial franchise fees (which may be divided between area development and initial franchise fees) and 100% of their standard royalty fees, e.g. 6%. If a master franchise concept is used, the franchisor will receive a fraction of the initial franchise

Simply restated, a master franchise approach is likely to adversely affect a franchisor's cash flow during the early stages of a franchise relationship when compared to the use of an area development approach, unless the initial fee charged for a master franchise is sufficiently greater than the fee charged to area developers (assuming the same development requirements). From a franchisor's perspective, in the initial stage of its development, master franchising's costs are higher and returns are lower than in area development franchising. Master franchising makes the most sense if the resources that might be used by an area developer to open its own units are leveraged through a franchise program which facilitates a faster growth of many more units than the area developer could establish with the same resources.

If transaction and adaptation costs are high relative to the anticipated return from using a franchising strategy, alternatives should be considered. If profit potential of a transaction is inadequate for either Franchise Party, it is in the best interest of both to pass up the deal. Whereas transaction and adaptation costs of entering into a direct single unit franchise agreement may be the same as for entering into a direct multi-unit transaction, the returns from a successful multi-unit deal will be much greater and will usually be much more likely to warrant the expected transaction and adaptation expenses.²³

1.11 What Is The Best Reason To Use A Master Franchising Strategy?

Only one reason really exists for selecting master franchising over other growth strategies: the opportunity for the fastest form of expansion of the brand in a new territory, (other than the acquisition and conversion of a competing brand to the franchisor's brand). If the franchising concept is properly used, master franchisees can grow a franchise brand in a market using the leverage of franchising much more quickly than they could by investing the same capital into developing and operating their own outlets, or by acquiring or converting a competitor. Just as companies use franchising to grow their brands in their home markets, the idea of master franchisees using the same strategy, as taught by the franchisor, to develop the franchisor's brand in a new market makes intuitive sense. Master franchising is merely an extension of the franchising concepts most companies successfully employ before turning to international franchising.

fee for each unit, e.g. 30% and a fraction of the standard royalty, which could range between 1–3% of the unit/subfranchisee's gross sales.

²³ Notwithstanding that truism, many franchisors have reacted to entreaties from prospects in island nations or countries with small populations because of the applicant's demonstrated interest in becoming a franchisee. In the authors' experience, the cost of servicing these small markets sometimes results in infrequent visits to the franchisees' locations and only a modicum of remote support.

1.12 What Changes To Agreements, Manuals And Training Programs Are Needed For Master Franchising?

Master franchising is premised upon a sharing of the responsibilities for recruiting, training and supporting unit/subfranchisees, and upon a sharing of the revenue stream from unit/subfranchisees. Whereas most franchisors embarking upon international franchising already have development agreements or are fairly conversant with how they work, most novice international franchisors are unfamiliar with the details of what is required to successfully use international master franchising as a growth strategy. Franchisors electing to use master franchising may need to prepare a master franchise agreement, and to modify their domestic unit franchise agreements to reflect which of the articulated services in the unit franchise agreement the franchisor and the master franchisee will, respectively, provide to the unit/subfranchisees. Domestic area development agreements also need to be amended if they are to be used with a master franchise agreement.

The sophistication of the franchisor and its international franchising counsel will determine how quickly and costly the international document drafting process will be accomplished. Misunderstanding the time and cost required to properly draft the documents that are needed for an international franchise transaction can be problematic for a transaction. Franchisors are universally in a hurry to have documents available once they have an international prospect, but they are also reluctant to incur the expenses of preparing documents until that point.

Ideally, the franchisor and international franchise counsel will have reviewed and discussed the issues raised in this article before even a tentative international transaction is ready to be memorialized in writing. Assuming that has happened, the franchisor will instruct international franchise counsel to prepare an area development franchise program or a master franchise program. If laws of the country in which the franchisee is located do not require a FDD, the franchisor must decide whether to use a generic international FDD. If the franchisor will use a master franchise program, it must also decide whether it will prepare both a master franchise FDD (MFDD) and a unit/subfranchise FDD (UFDD) for the master franchisee's adaptation and use to sell unit franchises. Novice international franchisors will need to invest significant time in making the decisions required to prepare a master franchise program and MFDD, because these documents have different requirements from domestic unit franchise agreements.

If the franchisor elects a master franchising strategy, a full panoply of issues must be addressed, relating to the economic benefits of the agreement between the parties, enforcement, supply, development schedules, end of relationship issues, franchise sales policies and procedures and (if applicable) franchise law compliance issues. What is often not adequately considered is the time required to integrate terminology

used in the master, unit, and area agreements, especially if international counsel was not the drafter of the domestic franchise agreements.²⁴

Because the master franchisee usually fulfills most, if not all, of the duties to franchisees that are specified in unit/subfranchise agreements that the franchisor would fulfill in a direct, domestic agreement, a thorough review and revision of the franchisor's domestic franchise documents will be required to prepare the international documents. Of course, the agreements used in the master franchise program must all be consistent in terminology and in their expression of obligations, especially for the master franchisee. Because franchisors generally give up virtually all direct control over individual franchisees' operations, the details required in master franchise agreements are extensive and nuanced.

If a franchisor has elected to use an area development agreement, it may require modification to address the issues described in Section 1.9.1 above. It will also need to be internationalized, e.g. modified to deal with law, venue, currency, withholding tax, payment approvals and other common issues. Domestic area development agreements may need modification to address development schedule issues, including when the schedule begins after the pilot outlet has been launched, default remedies, and renegotiation during the term and at the end of an initial term.

Franchisors should also prepare a form letter of intent (LOI, sometimes called a memorandum of understanding or MOU) for use in capturing key business terms of a proposed international franchise relationship. LOIs are typically nonbinding, in the sense that the parties are not required to conclude a formal agreement, however confidentiality, exclusivity, and a few other provisions may be binding upon the parties. Franchisors often require the payment of a deposit as a condition of their signing a LOI. The execution of an LOI and payment of a deposit, where permitted by applicable law, signals the serious intention of the parties and marks the stage at which serious due diligence, business plans and contract negotiations begin. Deposits may be refundable in whole or in part, and are usually agreed to be applied to the initial fee that will be paid for the franchise.

Although they are nonbinding, LOIs establish the expectations of the parties and usually establish parameters for negotiations of the franchise agreements. It would be unusual for the size of the territory, the number of units to be developed, the initial fee or formula for establishing it and the term of the franchise agreement specified in an LOI to change during further negotiations.

²⁴ The review of domestic documents performed by international franchise counsel when modifying them for international use frequently reveals language that should be changed, added to or removed from both the domestic and international agreements. The authors have found that estimating time and cost of adapting domestic agreements to international agreements can be problematic. More often than not, the time and related cost of preparing international agreements are less if international franchise counsel creates its own form of franchise agreements for use and adaptation internationally.

Franchisors must also be concerned about national franchise laws that require the delivery of an FDD or registration and delivery of an FDD before accepting a deposit, or even signing an agreement related to the acquisition of a franchise. They should also consider the conditions required to remit money from the country across national borders. Exchange controls, central bank approvals, trademark license registrations, tax laws may affect the ability to collect payments.

1.13 How Should A Franchisor Budget And Plan For International Expansion?

The complete answer to that question requires much more space than can be allocated to it in this article.²⁵ The most important challenge is budgeting and planning, a process that ideally focuses franchisors on an analysis of every key aspect of how a franchise business will operate in another country.²⁶

One critical first step is to create a chart of accounts that identifies each expense category that both the franchisor and the master franchisee are likely to incur.²⁷ In the planning process, once the tasks and expense items are identified, the franchisor must decide which of the tasks and expenses (or which proportion of the expenses) are to be borne by each of the Franchise Parties. Whereas, in direct franchising, all costs of recruiting, training, and supporting franchisees are the sole responsibility of the franchisor, franchisors and international master franchisees share obligations to support unit/subfranchisees in the proportion that is established in the relevant master franchise and unit/subfranchise agreements. Once a franchisor decides to assign responsibilities to a foreign master franchisee, it must take care to confirm that the appropriate allocation is reflected in both the master franchise and unit/subfranchise agreement, and that it has training programs, master franchise manuals, and personnel devoted to supporting its master franchisees. Franchisors should then determine whether they will be able to charge fees in the target country that are the same as or higher than fees the franchisor charges in its home market. This would normally be done by examining fees charged by competing franchisors and master franchisees in the country. Then based upon the allocation of costs it has prepared, determine what portion of the initial and ongoing fees will be received by the franchisor and the master franchisees. Both Franchise Parties must then determine whether they will receive enough income from a target number of franchisees to operate profitably.

A franchisor should then look at the development prospects for the target market, identifying the number of units that must be successfully established over the

²⁵ See generally CARL ZWISLER, MASTER FRANCHISING: SELECTING, NEGOTIATING, AND OPERATING A MASTER FRANCHISE (CCH ed., 1999).

²⁶ See Ainsley, Derella, Dring & Zwisler, *supra* note 19; John Dring & Carl Zwisler, Creating Profitable Fee Structure for International Franchises, Presentation at the 2008 International Franchise Association International Symposium (Nov. 5–6, 2008).

²⁷ For an outline of these expenses, see Yoshino Nakajima & Carl Zwisler, Budgeting For Successful International Master Franchising, Presentation at the International Franchise Expo (Apr. 10, 2010).

implementation period—i.e., the time within which the franchisor, and possibly the master franchisee, will both break even on their initial investments. If the size or the demographics of the territory, or the financial or development capacity of the master franchisee, are not likely to lead to (after tax) profitability during the implementation period, either a master franchising strategy will not work, or the franchisor must determine whether competitive factors will allow fees charged for the franchise in other markets to be increased to allow for the requisite profits.²⁸

1.14 How Should A Prospective International Master Franchisee Budget And Plan?

A prospective international franchisee will generally bear a much greater burden of due diligence than a prospective franchisee from a market in which the franchisor's business is already operating. Whereas franchisees in markets in which the brand already operates outlets can ascertain the acceptance of the brand and take advantage of adaptations of the brand that have already been made, prospective franchisees in a new market must rely upon their own due diligence and verify assumptions that have been made by the franchisor about doing business in the market.

Franchisors that deliver FDDs to their prospects make their due diligence process much easier, but an FDD is no guaranty of market demand, the existence of a cost effective supply chain or that timely and expensive regulatory obstacles will not be met as a new brand is introduced into the country. Prospective international franchisees should also recognize that estimates of the initial investment required to establish the first franchised business prepared by the franchisor are typically not based on experience in the candidate's country. Thus, they should attempt to independently verify each component of the estimate. Similarly, estimates of sales or profits will not be based upon actual experience in the country, so the risk of relying upon them is high.

Prospects should consider retaining consultants or accountants with industry experience to help them to develop their business plans and evaluate estimates provided by the franchisor. This should be done before an international franchise agreement is executed.

Although the results may vary considerably, if a prospect gathers as much information as is possible about the franchisor's and its franchisees' operating experience in other countries, it will be better able to evaluate operating issues, expenses and key performance indicators that are relevant to how the business will probably operate in its country.

1.15 How Should A Prospective Master Franchisee Evaluate A Foreign Franchise Candidate?

International candidates for master franchises and their lawyers face challenges when evaluating a foreign franchisor's capabilities and systems. Even countries with laws that

²⁸ All revenue sources should be evaluated, not just unit fees charged to franchisees.

require FDDs to be presented to prospective master franchisees do not require disclosures of much of the information needed to evaluate a master franchising program. So what can the lawyer advise his franchisee candidate to do? Table 2 contains practical steps that a prospective master franchisee's counsel can recommend:

Table 2	
1.	Obtain the contact information for present and former international master franchisees and area developers so that they can be contacted to gauge their satisfaction with the franchisor's franchising program.
2.	Prepare questions for delivery to the franchisor and other master franchisees and area developers to obtain the critical information. U.S. FDD Item 11 questions provide a helpful outline of the information a prospect needs to understand about the support services and training a franchisor will offer to its master franchisees. In most of the world, no FDD is required, and most franchisors do not prepare their own FDDs, so unless a franchisor volunteers other ways of delivering information about its programs, asking questions is the only way a prospective master franchisee can obtain the information. If the franchisor does business in a country that requires the use of an FDD, the prospect should request one and review it with its franchise lawyer, keeping in mind that much information in a foreign country's FDD may not describe the international franchising program.
3.	Determine who from the franchisor's organization will be available to assist the master franchisee to launch its franchise recruiting, site selection, and support functions; how long those people will be in the master franchisee's territory; and whether they will actually participate in the franchise recruiting process.
4.	Determine when the master franchising component of the training will be provided. Most international franchisors now offer operational training to master franchisees before they open their pilot units in their territories. Then, once the agreement dictates or the Franchise Parties agree that franchisee recruiting is about to begin, franchisors offer master franchise training.
5.	In countries with franchise disclosure laws, master franchisees will need to prepare, deliver, and sometimes register franchise documents as a condition of offering franchises. Confirm the franchisor's role in preparing, reviewing, approving, and filing franchise documents in the master franchise territory. If the franchisor's financial statements or information about an advertising fund that the franchisor operates for the benefit of the territory is required to meet disclosure or registration obligations under franchise laws in the territory, confirm through the master franchise agreement or otherwise that the franchisor is committed to meeting those obligations.
6.	Understand the process for procuring consent to modifications to the franchise system and franchise operations manual that the master franchisee will need to make to adapt the franchise program to the master franchise territory. Who will

Table 2	
	prepare the changes? Who will translate them into the appropriate languages? Who will own copyrights on the manuals? Who will review and approve the changes? Within what amount of time must they be approved?
7.	Determine the extent to which the franchisor will be involved in the operation of advertising programs and advertising funds in the master franchise territory. Will funds be paid to the franchisor and then returned to reimburse expenses in the territory (not recommended because payments will cross borders twice and be subject to associated expenses and taxes each time), or will the franchisor operate the fund for the benefit of franchisees in the territory? If the latter is the approach, what influence will the master franchisee have over the marketing efforts and expenditures?
8.	Request to see the franchisor's business plan and market research related to doing business in the territory. Most franchisors will ask master franchise candidates to prepare their own business plans and use them to evaluate the candidate and the country, and they may be reluctant before a LOI and nondisclosure agreement is executed to share their own business plans. Do the plans seem realistic based upon the way business is conducted in the territory? If the plans are unclear about how the franchised business will be supplied with furniture, fixtures, equipment, inventory, and supplies, what process is proposed for meeting those needs? How can one determine whether the cost of obtaining these items will not upset cost assumptions in the business plan?
9.	Especially when dealing with less experienced international franchisors, evaluate the grand opening promotion plans for the pilot unit. Foreign franchise brands are generally unknown in a new country and the efforts required to generate initial patronage may cost significantly more than the grand opening of the 400th store in the franchisor's domestic market.
10.	Confirm the franchisor's commitment to international franchising. This can be done by determining the resources allocated to the projects, the existence of a dedicated international staff, and business plans that show budgets for expenses. If you are able to obtain international budgets, focus on whether the anticipated returns from international investments are unduly optimistic.

1.16 How Should Franchisors Prepare To Answer The Questions Of Prospective Master Franchisees?

Because the questions presented in 1.14 are natural for savvy prospective master franchisees to ask, franchisors should be prepared in advance to address them. One best practice is to prepare an international FDD that can be used in countries lacking specific franchise disclosure requirements. Candidates who read and use an international FDD will be better informed than otherwise, use of an international FDD

would seem to result in a shortened evaluation and negotiation period and the elimination of misunderstandings after an agreement is executed.

1.17 Why Are Master Franchise And Modified Operating Manuals Needed?

Just as virtually all franchisors have developed operations manuals to explain to franchisees and their staffs the procedures for opening and operating a franchised business, franchisors that adopt master franchising as their expansion strategy should prepare master franchise manuals that explain how master franchisees are to fulfill their duties as master franchisees. Lawyers drafting master franchise agreements will generally require the master franchisee to operate the master franchise business as directed in the “master franchise manual.” This approach is used to create flexibility and confidentiality in operating procedures.

Although franchisors have typically operated multiple outlets before they begin franchising, and can prepare their franchise operations manuals based upon how they have learned to successfully operate their businesses, most franchisors grant their first master franchise agreement having no experience with international master franchising. Thus, they will need to either hire or retain someone with the appropriate experience to create the master franchise manual. This is a cost of master franchising that is often overlooked.

The unit franchise operations manuals used by franchisors in their home markets typically require modifications to address different ways of doing business in a different country. They also require modification to clarify the role of the franchisor and of the master franchisee in supporting unit/subfranchisees. These manuals usually must be translated into the vernacular of the territory, which can be a considerable additional expense.

Although master franchise agreements often require master franchisees to adapt manuals to their markets and to bear responsibility for translating them, franchisors need to approve the adaptations and to satisfy themselves that translations are true to the franchisor’s intentions. This is another cost.

Manuals used by international area developers will also need modification.

1.18 What Additional Training Programs Are Needed When Expanding Using International Franchising?

Training is a core element of virtually every franchising program. Franchisees expect to be trained in how to operate the franchised business, or in how to adapt their pre-existing operating procedures (if they are affiliation or conversion franchisees) to the franchise brand’s policies and procedures. Because of their importance, franchisors’ training obligations are often required to be detailed in FDDs.²⁹

²⁹ See, e.g., FTC Franchise Rule 16 C.F.R. 436.5(k)(7) (2014).

Most franchisors have developed a training manual that provides detailed instruction in how to operate a franchised business that training is usually embodied in a formal curriculum and involves a variety of training materials. It is usually conducted in a classroom, at the franchisor's headquarters, and in the field, often at the franchisee's location.

When an international master franchise is granted, the initial training program and materials usually need to be modified to reflect how business is done in the foreign territory. Materials may ultimately require translation. Much, if not all of training related to operating a franchised outlet will be assumed by the master franchisee. The franchisor will want to establish means to make sure that the essence of its program is retained by the master franchisee or the area developer.

An entirely new training program must usually be established to teach a master franchisee how to act as a franchisor in its territory. This type of training and support is important to the success of master franchisees, especially those that lack previous franchising experience. Creating the programs will require some time and investment. Most franchisors can explain how they approach franchising in their home countries, but they may not have documented each of the processes they follow in their day to day activities, at least in a way that is easily usable by a new master franchisee in a new country.

For budgeting purposes, franchisors should consider expenses related to creating training materials and manuals, the duration and location of the classroom component of the training, how many of the master franchisee's team should attend the training, the nature of follow up training in the master franchisee's territory, and ongoing training to help master franchisees improve their businesses. Some experienced international professionals recommend sending the franchisors employed or retained international sales head to the master franchise territory to help with initial franchise recruiting and/or franchise expos.

1.19 How Much Control Do Franchisors Need Over International Master Franchise Relationships?

Many franchise lawyers have drafted master franchise agreements that are relatively detailed in describing development schedules, territories, fee splits, advertising approval, initial and ongoing training obligations of the franchisor, termination standards, but not much else. Some franchise lawyers terminate their drafting of international master franchise agreements with an authorization of the master franchisee to prepare its own unit/subfranchise agreements for use in the territory, which are "subject to the franchisor's approval."

The rationale for this approach includes:

1. The master franchisee and its lawyers understand franchising in the territory and applicable laws and they are in a much better position to

prepare the agreements than are lawyers for the franchisor in a different country.

2. The master franchisee will need to be able to sell franchisees on the benefits of the agreement, as well as live with the agreements and enforce them.
3. So long as the master franchisee complies with the master franchise agreement, what difference does it make what unit franchise agreements require? After all, if a problem exists with a franchise agreement, the master's job is to deal with it.
4. Preparing a unit/subfranchise agreement is just another expense that a Franchise Party must pay. Rather than pay the franchisor's lawyers to draft it, and then negotiate it with the master franchisee candidate, let the master franchisee incur the expense.
5. The need for a good unit/subfranchise agreement ultimately falls upon the master franchisee, so let the master franchisee deal with it.

Others, including the authors, favor requiring master franchisees to use unit/subfranchise agreements that have been prepared by the franchisor's international franchise counsel. Their rationale is:

1. Even if the master franchisee's counsel prepares the agreements, their experience and understanding of the nuances of international master franchising is not knowable in advance of entering into negotiations with a master franchisee candidate.
2. Drafting a unit/subfranchise agreement which is consistent with a master franchise agreement requires considerable time and expense. Although a franchisor can reserve the right to review the master franchisee's draft of the unit/subfranchise agreement, the time and cost required to reach an acceptable agreement, following a review, are significant. Moreover, if the same form of unit/subfranchise agreement is to be used in other territories, the franchisor will potentially incur a similar expense for every transaction.
3. More than half of the obligations placed upon a master franchisee arise from the unit/subfranchise agreement. In the especially critical end-of-term and end-of-relationship issues that can arise in a master franchise agreement, the unit/subfranchise agreement must fit like a hand in a glove into the contours of the relationship described in the master franchise agreement.
4. Issues relating to; how unit/subfranchise agreements are enforced if the master franchisee shirks its duty; how to protect the franchisor's intellectual property if it is misused by the franchisee; the relationship

of the franchisor to the franchisee and their relative rights and duties during and after the term of the master franchise agreement, including during defaults by the master franchisee, are best dealt with in unit/subfranchise agreements. A franchisor cannot afford to not have those issues properly addressed in its unit/subfranchise agreements, and retaining experienced international franchise counsel to draft those agreements is the only way to make sure that those objectives are accomplished.

Many international franchise lawyers advise their clients to not authorize any changes to unit/subfranchise agreements once the Franchise Parties have agreed upon them. Moreover, they advise conditioning the effectiveness of a unit/subfranchise upon the franchisor's written approval of any changes that may have been negotiated in a unit/subfranchise agreement.

1.20 Why Are Development Schedules A Problem?

Neither party to a multi-unit franchise agreement would execute it if it did not reasonably expect that the development goals specified in the agreement would be timely met. Franchisors select territories and prospective franchisees based upon their relative capability to generate profits at a level represented in the plans and agreements that they execute.

Multi-unit franchisees invest in international franchise agreements, anticipating that the fees they invest in acquiring the franchise and in adapting it to their market will be soon recouped through the successful operation of the number of outlets they agree to develop in their agreements. Their investors and financiers expect the minimum agreed growth.

So, when the growth rate falls behind expectations, neither of the Franchise Parties is usually happy, and either is likely to demand to renegotiate or end the agreement. When a development schedule default exists, the franchisee generally faces the risk of termination of rights in which it has made a substantial investment. Although well-structured area development and master franchise agreements contain several development schedule default remedies (See Table 3), none of them will usually allow either the franchisor or the franchisee to meet their revenue projections, over the Term of the international franchise agreement.

The remedies established for development schedule defaults can be valuable under certain circumstances for either party. Franchisors usually reserve the right to:

Table 3	
Development Schedule Default Remedies	
1.	Terminate the area development agreement, but not franchise agreements granted pursuant to it, unless the developer is in violation of them. This may orphan franchise units that were constructed in anticipation of scale economies

Table 3

	<p>expected to arise from a large number of units generating purchasing power for supplies, inventory and advertising. The infrastructure established by an area developer to support the scheduled number of units may not be supportable by the units already open, which may lead to closing of the operating units.</p>
2.	<p>Eliminate territorial exclusivity. This may seem benign, but in international development agreements, area developers, especially in the retail and food service sectors, usually establish centralized services and offices which are designed to support all units. Area developers may be responsible for training store managers, site selection, implementing advertising programs in the territory, and fulfilling other functions that franchisors typically perform for unit franchisees in their domestic markets. New individual franchisees may be unwilling or unable to fulfill these functions for themselves, and the franchisor may find that doing so itself would not be cost effective. New area developers may be reluctant to establish similar facilities and functions in a territory where another developer continues to operate multiple units.</p>
3.	<p>Eliminate a portion of the developer's exclusive territory. This may work if the remaining territory is large enough to support the developer and further expansion. However, if the developer has opened units at locations throughout the territory before the development agreement is terminated, the subdivision of the territory may leave one or more of the original developer's units in a new developer's territory.</p>
4.	<p>Require payment of an "imputed royalty." This is designed to approximate the royalty fees the franchisor would have collected if the developer had been in compliance with its development schedule. Although this remedy may work in the short term and help the franchisor to achieve its short term income expectations, developers will rarely put up with such payments for long. The net result will be a resort to one of the other remedies.</p>
5.	<p>Require payment of an extension fee. This is paid as a condition of obtaining an extension of time to meet the development schedule. This can work when an area developer really does intend to catch up, but after the agreed number of extensions has expired, the parties will revert to another remedy.</p>
6.	<p>Require payment of liquidated damages. The development agreement would require the developer to pay an approximation of lost future profits when the development agreement is terminated because of a development schedule default. Developers generally will try to avoid this type of commitment.</p>
7.	<p>Include an option for the franchisor or its designee, which could be a successor developer to purchase the area developer's business, including some or all of the developer's individual franchised units, upon termination of the development agreement.</p>

Table 3

8. Terminate the development agreement and all unit franchise agreements.

Evaluating the growth potential of a territory and the capacity of a franchisee to maximize that growth potential is much more of an art than a science. While the planning process should include serious consideration of the development potential of any franchise territory under consideration, franchise agreements which adopt “development potential” as the standard for a franchisee to retain its franchise rights usually end in default. Franchise Parties both often become enamored of the growth potential in a new territory, and become excited about the opportunity. The franchisor’s development staff reports the size of the potential deal, and his or her superiors become excited. Prospective master franchisees and area developers tell their partners about how great the franchise is and how it could be an amazing success. The franchise lawyer plugs numbers into a development schedule without understanding the rationale that underlies them, but feels confident in having drafted remedies for any potential default, and, ideally, a methodology for resetting the development schedules during and at the end of the term.

Then, a default occurs.

Rather than using aspirational development goals that are unlikely to be met, the Franchise Parties should consider establishing development goals that express the minimum development the two agree is needed to warrant their investment in the transaction. If those goals are not met, either side would, therefore, agree termination of the agreement is appropriate unless the default is reasonably capable of being cured very soon. Because a development schedule would a minimum requirement, it would not preclude much faster growth if the franchisee can accomplish it. Further, because initial fees are often correlated with the initial development commitment of the franchisee, a lower minimum initial fee may preserve some of its capital for more direct investment in development in the territory.

Although careful drafting and planning will not avoid all development agreement defaults, it may avoid many. Overly aggressive development schedules frequently lead to defaults. So do schedules which do not allow sufficient time for a new developer to adapt a pilot unit to a new market, and to make it profitable. Franchise Parties generally agree that the sooner they can get more units operating, the sooner their mutual income generation goals will be met. However, if the first unit is not operating successfully before additional expansion is underway, the focus may be removed from what is needed to make the core business profitable. Establishing a flexible date to begin the development schedule is one way to deal with this issue. It can be keyed to the date when the pilot unit meets certain benchmarks, or it can be the earlier of the time the benchmarks are met, or a fixed time. This flexibility may be seen as defeating the purpose of a development schedule. However, if the first units are not profitable, the business plan is probably doomed anyway.

A second approach may aid in using the reduced territory described in remedy 3 in table 3. If, in addition to designating a territory and schedule, the schedule designates areas within the territory where initial units must be developed, reducing the territory size may be easier.

Another approach to reducing chances of development schedule defaults is to grant an area developer or master franchisee a smaller territory and a lower number of units to be developed than the franchisee had requested. The franchisor can grant the developer or master franchisee an option for a fee that is payable when the option is exercised, to acquire adjacent territory which was part of the initial request within an agreed time, provided that the development schedule in the initial territory has been timely satisfied. That may reduce the initial investment of the area developer, and reduce the risk that a large territory will be underdeveloped.

1.21 Why Do Franchisors Grant Territories Rights That Won't Be Developed?

In their domestic markets, experienced franchisors usually define territories that are strategically suited to the ability of their franchisees to develop profitable businesses within them. For some reason, an international franchising offer evokes very different responses from franchisors. Novice international franchisors often entertain proposals to grant large countries, or regions comprised of several countries, to a single franchisee without reviewing a business plan, and without identifying the resources the franchisee candidate has available to develop a territory to its potential.

Prospective international franchisees typically request a master franchise or area development territory that is at least contiguous with the borders of their country, if not with the borders of surrounding countries. They seek both the prestige of being the brand's representative in their countries, and the opportunity to be the exclusive beneficiary of the investment they make in the costs of adapting the brand to the territory. Franchisors that have not adequately evaluated the market may not appreciate its development potential. Sometimes the territory size is a default decision by a franchisor that has no present intention to expand into a particular market for years, and sees only an upside for granting large territory that might be developed.

Some executives of international franchisors that are approaching a sale or a public offering may feel the existence of an agreement with an aggressive development schedule regardless of the probability that the development schedules will be met is worth much more than worrying about possible future growth opportunities. Or franchise executives may be willing to ignore otherwise rational standards for the sake of being able to claim to peers that the franchisor is "a multinational company with a footprint in many countries."

If a franchisor has needlessly granted territories which were unlikely to be timely developed, the franchisor may find that its future growth opportunities are stifled. Franchisors may be approached by well-qualified candidates who could significantly grow the brand in underdeveloped or undeveloped territories already granted. But they

may fear that pursuing the leads will embroil them in litigation, even if the existing franchisees have clearly failed to meet development goals. Concern for this eventuality leads more mature franchisors to focus on achieving operational and development economies within granted territories.

1.22 What Added Transaction Costs Are In Multi-Country Territories?

Franchisors' concerns about transactional costs are frequently overlooked in the early stages of the negotiation of multi-country territories. Before consulting with international franchise counsel, franchisors may offer multi-country territories to a party, set a closing date for thirty or fewer days from the date of an LOI, and then realize that obtaining the advice needed to draft different documents for seven countries within that time is virtually impossible for their international franchise lawyers. They overlook the need to research laws and draft agreements to comply with all the laws in each country, regardless of its size (and in some countries, to deal with different regulations in different political jurisdictions within the countries.)

Franchisors may also overlook the different business cultures among different contiguous countries. Prospective area developers and unit/subfranchisees from a master franchisee's neighboring countries may be reluctant to deal with a foreign master franchisee. The master franchisee may not have an experience doing business in other countries within its multi-country territory. The net result can be that the parties have negotiated an agreement to set the basis for a future dispute, rather than to actually expand the franchise brand.

1.23 How Can International Franchise Agreements Be Structured To Anticipate Fee And Operational Changes In The Franchise Program?

When drafting, franchise lawyers generally use several approaches to allow for the natural changes that must occur within a franchising program. Franchise agreements grant franchisors broad discretion to make changes in their franchise programs. Franchisors reserve the right to implement changes through the operations manual. Domestic franchise agreements usually require a renewing franchisee or the transferee of a franchisee's franchise to "execute the then current form of franchise agreement."

Unlike domestic franchise agreements, most international franchise agreements are negotiated, often heavily. The process may take weeks or months. Thus, when franchise counsel to an international franchisee reads language creating a duty of his or her client to "execute the then current form" of agreement, the reaction is unfavorable. Why would the parties negotiate terms of the franchise agreements, especially unit franchise agreements, and then agree that the franchisor could completely change them before the second outlet opens?

The response to franchisees' counsel typically ranges from capitulation to the franchisee's counsel, in which case all terms are locked in for ten or twenty years, to agreeing to lock in a few key terms while permitting modification of the rest. International franchisors need the flexibility to introduce changes into their franchise

systems, including franchise agreements, just as much as franchisors do that only operate in a single country.

Is a reasonable compromise available? The most common form of compromise involves defining changes that cannot be made without mutual consent of the Franchise Parties, but allowing the franchisor to make the other changes, provided the franchisee receives timely notice and the changes are generally applicable to all (similarly situated) franchisees. In concept, the parties might agree that no changes will be required that add material costs and obligations to franchisees, or which materially reduce their rights or the duties of the franchisor. In practice application of that concept could subject almost any change to a dispute.

One approach allows the franchisor to require international franchisees to adopt and accept the changes if they are made no more frequently than annually, they apply to franchisees in the franchisor's home territory and are described in that year's FDD (if the franchisor is from a jurisdiction that requires one). This approach allows fees as well as other material terms of franchise agreements to be changed. The franchisor can adopt changes, but it must be able to sell those changes in its own country as a condition of imposing them on foreign franchisees. This usually provides protection for international franchisees against arbitrary changes developed by franchisors.

1.24 Can Franchisors Use Audited Financial Statements From Their Home Countries To Satisfy Franchise Laws In The Franchisee's Country?

Because most of the countries that require the preparation of an FDD require franchisors to include audited financial statements in their FDDs, and because of the time and cost required to prepare an audited financial statement, franchisors must understand whether an audit requirement exists early in their discussions with a prospective franchisee. Will an audit from the franchisor's home country suffice in the candidate's country? Will parent or affiliate or consolidated statements be acceptable? If the franchisor has not previously had an audit, must it have one immediately before offering franchises? If so, how many fiscal years of statements must be audited?

With forty-five years' experience with franchise regulation, the United States has developed comprehensive guidance for franchisors about financial statement requirements. However, many countries with franchise laws have not clarified in either their franchise laws, or in regulations issued pursuant to them, the type of financial statements that are acceptable.³⁰

For a variety of reasons, companies may decide to establish an international franchising affiliate to offer franchises in other countries. Those companies may be shell

³⁰ For example, a foreign franchisor offering franchises in the United States may be required to have three years of financial statements audited using U.S. Generally Acceptable Auditing Standards (not IFRS) to offer franchises. U.S. laws will usually allow a new franchisor which has not previously undergone an audit to phase into the requirements, but few, if any, other country's franchise laws have adopted this approach.

companies which contract with an affiliate that could be the domestic franchisor entity to use its assets and employees to service foreign franchisees.

For planning and budgeting purposes, international franchisors need a full understanding of how a country's audit requirements will affect the cost and timing of a transaction, including the ongoing process of selling franchises in a country, either directly or through master franchisees.

2. Franchisee Training, Support, And Adaptation Challenges In International Franchising

Surveys conducted about problems with international master franchising have identified franchisors' lack of understanding of their franchisee's market and inadequate training as two of the most significant problems in international master franchising.³¹ A lack of understanding of a franchisee's market will always be a challenge, but one that is much easier to overcome in the age of the Internet and increasing international commerce.

When both a franchisor and new franchisee base their business plans and expectations about how a foreign franchise will work in a new market upon misunderstandings of differences between the franchisor's home market and the new franchisee's market, avoidable problems can arise. Differences in consumer preferences, the way consumer needs in the new market are already met, government regulation, labor and employment practices, taxation, duties, work ethic, real estate, logistics and transportation issues can all hamper a quick adaptation of a franchise to a market.

Only through research conducted by both Franchise Parties can they minimize the risk of making costly inaccurate assumptions about the extent of adaptations that will be required in the franchisee's country.

To illustrate issues that can only be identified through research, consider the recent experience of a U.S. franchisor. The franchisor operates a business that offers full day pre-school services to children in the United States in free-standing classrooms. Children arrive early in the morning and stay all day, engaging in classroom activities and recreation throughout the day. When negotiating with a prospect in China, the franchisor learned that all formal education in China for children older than six years is provided by the state. So, the franchisor modified its program in China to offer "educational enhancement" classes in one-hour segments, and adapted it to use bi-lingual English-Chinese language teachers who could teach the children English as they embarked upon leadership training and other skills.

When the same company began discussions with a prospect in Indonesia, it decided that, given the licensing laws there, it would offer a half day program operated as a school. As they developed the adaptations and were preparing to apply for a license to operate a pre-school, a scandal involving an unrelated kindergarten arose, leading to

³¹ See, e.g., John P. Hayes, Fundamentals of Franchising, Presentation at the 2013 International Franchise Conference (Nov. 6–7 2013).

the discovery that nearly 5,000 kindergartens and pre-schools were operating in the country without licenses. As a consequence, all unlicensed schools were compelled to immediately seek licensing, and their applications were given priority over new applications. This has delayed the franchisor's entry plans for at least one year.

Not all industries are regulated in the ways these schools are, but significant adaptations in operating models required by country-specific laws may lead many franchisors to avoid some markets until they have expanded into other countries where adaptation is much easier. However, the example illustrates how laws unrelated to franchising can have an impact on a franchise business model. Although a discussion, the many ways to research a market are outside the scope of this Article, local trade associations and the local franchising association in the prospective franchisee's country can be a great resource for information about operational and regulatory issues.³²

2.1 How Can Franchisors Determine Which Markets Will Be Most Expensive For Adaptation?

Some countries are subject to trade sanctions and boycotts and are, therefore, off limits to companies and residents from the countries that impose them. Some countries are undergoing serious political and economic turmoil, making the risk of doing business there high. Many other countries, however, are not nearly so obviously problematic for foreign franchisors.

For example, countries with predominately Muslim populations that prohibit or highly regulate the importation or consumption of pork products and alcohol may create significant barriers for franchising chains that depend, even in part, upon the sale of such products for the success of their outlets.

The McDonald's and Domino's examples in India illustrate how even companies that feature menu items with beef and pork can adapt successfully to a market where they are not generally consumed, if issues are identified in advance of entering the market and the franchise offering is adapted to address the issues.

A few other examples of adaptations that are required in different markets will further illustrate challenges for international franchisors and franchisees. Obtaining access to the products and services that have made a franchised business successful in its home market may be a challenge in other countries. In some countries products may not be lawfully imported. In others, imports are lawful, but duties are high to protect domestic manufacturers or farmers. Laws may prohibit the use or importation of genetically modified (GMO) agricultural products. Different labels may be required on imported products, which may include printing in local languages, a listing of ingredients, and/or a description of the caloric content in portions offered for consumption.

³² See *infra* Attachment A; see generally *Collateral Issues in Franchising Beyond Registration and Disclosure*, 17 THE FRANCHISE LAWYER no. 2, 2014.

Currencies may not be convertible into U.S. dollars, Euros, or whatever currency the franchisor prefers. In some cases, local currencies may not be sent outside the country. Trademarks, domain names, and copyrights are generally entitled to protection under most countries' laws, but in most countries, the first person to register obtains the right to use the mark, URL, or copyrighted work. Thus, foreign franchisors may find that they and their franchisees are precluded from using their own brands unless they pay the registrants for the rights, or spend time and money in attempts to obtain rights through litigation.

Other legal and cultural influences affect the way franchisors and franchisees may carry on their businesses. Issues like the duration of the typical workday, the number of national or religious holidays when businesses are closed, leasing practices, the availability of financing for franchised businesses, inefficiencies, biases and corruption in the regulatory and judicial process all affect the profitability and time required to attain profitability in a country.

Although most of the obstacles described above may be overcome, the time and cost to do so before actually launching a franchising program in a country may be so great that a transaction is not worth undertaking, or a prospective franchisee moves on to other opportunities.

Fortunately, many resources are available to help franchisors and franchisees to identify the changes required to do business in new countries, and often at a lower cost than ever before. For U.S.-based franchisors, an excellent resource of information about doing business is the Country Guides published by the U.S. Commercial Service (USCS). U.S.-based franchisors may use USCS services to learn about how to do business in a new country and how to identify prospective franchisees. USCS will also perform due diligence investigations on prospective franchisees for a modest fee.³³

Trade ministries in many other countries are also actively involved in supporting international franchising, both as an outbound and inbound benefit for their citizens.³⁴ Many other countries are also promoting this form of cross-border expansion and have programs to provide assistance to international franchisors and franchisees.

³³ Although the quality of service varies from country to country, U.S. Commercial Service (USCS) team leaders over the last two decades have worked diligently to train their country representatives in the nuances of franchising. One of the authors regularly presents training sessions to explain the basics and nuances of international franchising to help the Commercial Services officers excel in providing services to U.S.-based Franchisors. The USCS team is demonstrably committed to supporting U.S. Franchisors in their international efforts and its members regularly attend IFA conventions, and bring delegations to attend the International Franchise Expo.

³⁴ One of the authors has made presentations to groups sponsored by government agencies from Brazil, Canada, Georgia, Iceland, Indonesia, Malaysia, Mexico, OPIC, Pakistan, Singapore, Spain, Tunisia, UAE, and United Kingdom.

3. How Local Laws Affect Profitability?

As discussed in Parts 1 and 2 of this article, entering a new market should only be done after thorough research of that market. The research should aim to understand both the business and legal landscape. International franchise counsel should play a key role in that due diligence so that legal counsel can alert his or her clients to the legal issues they and their franchisees will confront. To perform the requisite legal due diligence, international franchise lawyers need the time and resources to research the issues outlined in this article, as well as, the opportunity to identify, with assistance from local counsel, the country's regulations that apply specifically to the type of business the franchisee will operate. A franchisor's domestic franchise counsel will rarely be able to independently perform the needed research and analysis. So, we must find and rely upon experienced local franchise counsel, industry counsel, and sometimes tax counsel, to help us with the issues our franchisor and franchisee clients will confront. When it comes to the legal due diligence performed in connection with international expansion, the focus of many franchisors is still often limited to the franchise laws of the new market. Franchise law review is a necessary component of legal due diligence, but failure to understand other legal issues and related market realities may cost the franchisor dearly.³⁵ Without a broader legal review, it is hard to judge whether the franchise system is viable in the new market or to understand what modifications may be necessary to the franchise system to make it successful. In this section of the article, we will review various related legal issues that should be taken into consideration when analyzing new market entry. The issues listed are by no means complete, but they are chosen because they can have a significant impact on the success of a franchise system in a new market and can be hard to do anything about if not considered before market entry.

3.1 What Is The Best Way To Begin Legal Due Diligence?

While the focus of this section are areas of law that franchisors may not consider much in their home market, areas of law that a franchisor needs to consider go well beyond what is covered in this article. What areas of law will matter will depend on the specific market the franchisor wishes to enter as well as on the particular industry it is in. For example, a franchisor in the restaurant business will be concerned about many laws that are of little importance to a franchisor of a tax preparation and accounting franchise system. To determine the appropriate scope of legal due diligence one good starting point is to look at the franchisor's home market. What laws impact the franchise system in the home market? What adjustments has the franchisor made to its system in the home market due to the legal environment there? Of course, such an analysis will not provide a complete road map to the legal analysis needed in the new market. Legal issues can be handled very differently in different markets, and even the question of what constitutes a legal issue worth regulating can differ greatly. The discussion below focuses on a few areas of law that would almost always have to be taken into

³⁵ A detailed discussion of the various national franchise laws is beyond the scope of this article. These only address franchise law for the purpose of understanding whether they will apply to a particular transaction.

consideration by a franchisor's international expansion, and especially such areas of law that may have a significant impact on the financial viability of a franchise system in a new market.

3.2 How May National Laws Treat Licenses And Distributorships As Franchises?

International franchise counsel also can often assist franchisors with navigating countless legal issues. Franchise counsel should explain the consequences of granting a franchise in the country under franchise laws, including the duty to obtain franchisee consent to implement franchisees' contractual duties to upgrade franchised premises, the franchisor's duty to pay for upgrades to the premises of the franchised business, the duty to provide accurate information about the proposed market to the franchisee, the duty to disclose laws applicable to the operation of the franchised business, commercial agency laws that could grant rights to exclusive territories following the expiration of a franchise, and laws which prohibit franchisors from imposing restrictions on franchisees' right to sell products over the Internet. International franchise counsel should select experienced local franchise counsel in each country targeted by the franchisor for assistance in evaluating these issues and other potential franchise law and related legal obligations and impediments to doing business in the country.³⁶

There are endless reasons why a franchisor may or may not wish to expand through franchising in a new market: the local franchise laws may be cumbersome; the regulation of other distribution models may be more favorable than franchising a joint venture with an existing competitor may be offered. Whether a company chooses expansion through a franchise model or through a different expansion strategy, understanding the scope of local franchise laws is important.

When analyzing international distribution models, it should be remembered that the franchise definitions used in national franchise law differ from one another. While the exact definition of a franchise in the U.S. may vary from state to state, the definition under the FTC Franchise Rule can be used as guidance for what constitutes a franchise in the U.S.:

Franchise means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing that: (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services or commodities that are identified or associated with the franchisor's trademark; (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of

³⁶ Franchise counsel may obtain cursory insights into these legal issues through the resources at Attachment A.

operation, or provide significant assistance in the franchisee's method of operation; and (3) As a condition of obtaining or commencing operation of the franchise, the franchise makes a required payment or commits to make a required payment to the franchisor or its affiliate.³⁷

While there may be significant differences among the U.S. state franchise laws,³⁸ which may be of importance in individual cases, as a rule they tend to be of minor importance in day-to-day operations for most U.S. franchise systems. Internationally that may not be so, as such differences in franchise definition may affect the entire strategy for a foreign market. For example, in Mexico, there is no required fee element to the franchise definition:

A franchise will exist whenever, in conjunction with the license to use a trademark, granted in writing, technical knowledge is transmitted or technical assistance is furnished in order to enable the licensee to produce or sell goods or render services in a uniform manner and with the operating, commercial and administrative methods established by the holder of the trademark, aimed to maintain the quality, prestige and image of the products or services distinguished by said trademark.³⁹

Thus, structuring to avoid a "franchise fee," for example by only charging a bona fide whole sale price for goods supplied to the foreign "franchisee," would not help a franchisor avoid Mexican franchise law.

Similarly, companies that knowingly operate as franchisors sometimes find that they will be regulated in some countries under commercial agency laws.

3.2.1 Commercial Agency Laws

Even if a franchisor is able to avoid foreign franchise laws, it may still be subject to regulation of its distribution or franchise agreement that, with respect to the termination

³⁷ FTC Franchise Rule 16 C.F.R § 436.1 (2014).

³⁸ For example, the New York franchise disclosure law does not require the franchisee to both pay a fee and have its business associated with the franchisor's trademark. Instead, it is enough that the agreement between franchisor and franchisee satisfies only one of the New York state equivalents of the second and third prongs of the federal test. N.Y. GEN BUS. LAW § 681(3) (McKinney 2015). Another example is Minnesota, which instead of requiring the franchisor to have the right to control the franchisee's method of operation requires that the franchisor and franchisee have "a community of interest in the marketing of goods or services." MINN. STAT. § 80C.01 Subd. 4 (2015).

³⁹ Translation of Ley de Proteccion a la Propiedad Industrial [LPPI] [Law on Industrial Property], Diario Oficial [DO] June 27, 1991, Art. 142. Notably, there are also no statutory exemptions or exclusions for large franchisees or franchisors, or other exceptions common in the U.S.

of the agreement is akin to U.S. franchise relationship laws. Dealer protection laws or commercial agency laws often focus on protecting against unfair termination and nonrenewal of commercial agency agreements.⁴⁰ Their scope needs to be reviewed country-by-country, but generally they are intended to protect independent sales agents, but they are sometimes interpreted to govern distributorships and franchises. Commercial agency laws are usually considered mandatory law on the basis of public policy which means they may not be waived by contract. In addition to prohibiting termination of agreements except for good cause commercial agency laws often provide for indemnification of the dealer upon termination. These laws frequently contain an indemnification requirement requiring the supplier/franchisor to pay former franchisees several years' profits. Thus, failure to understand such laws can be very costly to franchisors.

Commercial agency laws are regulated through a European Union Directive,⁴¹ and are common in South and Central American countries, and the Middle East. With respect to several Latin American countries, the Dominican Republic-Central American Free Trade Agreement (CAFTA-DR) has resulted in waivers of commercial agency laws that would have applied between businesses from the signatory countries but for the free trade agreement.⁴² Even if relying on CAFTA-DR, companies still need to make sure they are familiar with local laws and follow the necessary formalities. For example, in El Salvador the provisions of the Commerce Code that affect the rights of commercial agents and distributors would still be applicable even in an agreement with a party from another CAFTA-DR signatory country, unless the agreement between the parties expressly waives applicability of the applicable Commerce Code sections.⁴³

Many franchise arrangements may not be considered "commercial agencies" under commercial agency laws and the existence of such laws may be of little consequence to the Franchise Parties. However, where such laws exist the franchisor should take care to investigate their scope. The scope of the laws can differ significantly between different countries, and often the interpretation of the laws may go beyond a strict interpretation of the statutory language.

Avoiding commercial agency laws usually requires an analysis of the intended agreement by local counsel. In some instances, application of the laws can be avoided by choosing an international arbitration clause. Where the law cannot be avoided altogether, it may be possible to alleviate its impact by establishing objective criteria for termination. For example, setting minimum sales quotas or other objectively measurable goals can help to prove that there is good cause for termination. Likewise,

⁴⁰ For a more thorough review of commercial agency laws, see Cherry J. Hearn, Michael E. Santa Maria & Herbert S. Wolfson, *International Agency Laws: Ignorance Is Not Bliss*, Presentation at the International Franchise Association 2014 Annual Legal Symposium (May 4–6, 2014).

⁴¹ Directive 86/653 ECE, the Commercial Agents Directive.

⁴² The U.S., the Dominican Republic, Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua are the CAFTA-DR parties. Nonsignatories are still subject to these laws.

⁴³ See Annex 11.13 of DR-CAFTA.

entering into short term agreements without automatic renewal terms may be another option if the commercial agency law termination provisions do not extend to a right to renew. These types of solutions, however, can be tenuous and should be reviewed and decided on together with local counsel.

3.3 How Can Franchisors Protect Their Intellectual Property In International Transactions?

Protection of franchisors' intellectual property is essential to any international transaction. When entering a foreign market, franchisors must understand what protection local law offer and how they may have to adjust their practices to protect these crucial assets. IP concerns are central to why international franchisors should equip themselves with qualified counsel. Franchisors should only expand into countries where their intellectual property is or can be readily protected. Franchise counsel with international trademark expertise will help with franchisors to determine whether their trademark and other IP are protectable; perform searches to determine prior uses or registrations of their franchisor–client's trademarks; advise the franchisors to search the Internet to determine whether others may be using URL's that include the franchisor's trademarks; and counsel franchisors about how to protect copyrights, trade secrets, and patents that may be relevant to the franchisor's business model. International franchise/IP counsel will work with local counsel to register trademarks, domain names, copyrights, and other protectable IP interests.

The cost of acquiring or challenging another registrant's or user's right to use the franchisor's trademarks can be quite expensive, and may be a reason not to pursue a particular market.

The franchisor should be certain to research the availability of, and then register its trademarks and its domain names in a new market, unless someone else has already registered them. This right should not be delegated to a master franchise or any other third party. In some markets, a registered trademark may be a prerequisite for franchising,⁴⁴ but with or without such statutory requirements, it is just a good practice to register one's most important asset. In other countries, the trademark registration requirements may be indirect, for example, in China where a trademark registration is a prerequisite for international remittance of royalties.

Another important aspect of trademark registration that franchisors need to understand is whether the new market follows the U.S. approach to trademark rights: the first-to-use approach, or if adheres to the first-to-file approach. While many countries apply the first-to-use approach, there are also many large markets that do not. Notably, China is a first-to-file jurisdiction, as are many Middle Eastern countries and some in Europe (i.e.

⁴⁴ *E.g.*, both Malaysia and Indonesia require a franchisor to register its trademarks, and in Mexico a trademark application must be on file. Malaysia: Sec. 24 of the Malaysian Franchise Act 1998; Indonesia: Minister of Trade Regulation NO. 53/M-DAG/PER/8/2012, art. 2(1); and Mexico: Ley de Protección a la Propiedad Industrial, art. 142, Diario Oficial de la Federación, June 27 1991.

Spain, Germany and France). If the new market is a first-to-file country, the franchisor must be especially careful and ensure that it promptly registers its trademark to avoid speculative registrations by third parties.

3.3.1 Copyright Protection – Translations, Modifications and New Materials

Most countries have adopted the Berne Convention for the Protection of Literary and Artistic Works (“Berne Convention”).⁴⁵ Under the Berne Convention, each signatory must grant foreigners the same copyright protection as it grants its own nationals. This provides some level of comfort with respect to the manuals, training materials, advertising materials and other original documents that a franchisor provides to the master franchisee, but does not obviate the need to understand what is required locally to obtain copyright protection.

International copyright issues often go beyond just the franchisor’s original language materials. For example, it is common that a master franchisee in a foreign market will be required by the master franchise agreement to translate both the operations manual and marketing materials to their local language. The Berne Convention requires signatories to permit the original copyright owner to retain the right to authorize translations, but once translated the translated work may be considered an original work in which the translator has some rights.

Further, almost every franchise system will require some customization of materials to fit the culture and tastes of the new market. As the franchise system develops in the local market, an area developer or the master franchisee will likely develop additional marketing and advertising collateral. The question of copyrights in modified or independently developed materials may also create an issue for franchisors.

The issues raised by translations, modifications, and development of new materials raise both non-legal and legal issues for a franchisor. Non-legal issues include the accuracy of the translation. How does the franchisor know that the translation is correct and conveys the spirit and meaning of the original text? Having a trusted partner who can review materials is key. This could be an employee of the franchisor who speaks the local language, or a trusted translator, or for legal documents, local counsel.

The primary legal aspect of translations, modifications and development of new materials is the ownership of such materials, and independent of local laws on the subject should be addressed in the agreement between the Franchise Parties. Even if the franchisor is presumably claiming copyright and ownership of its material in the original language, a franchise agreement should address who owns the materials that the area developer or master franchisee may be preparing. This should include direct

⁴⁵ 828 U.N.T.S. 221. The Berne Convention can also be found at <https://treaties.un.org/pages/UNTSONline.aspx?id=1>. As of the date of this paper, 168 countries are signatories to the convention.

translations of the materials the franchisor may have provided, as well as modifications to them and independently developed materials.

It is important that the agreement between the Franchise Parties is explicit in what is covered: the franchisor should usually be the owner of both the manual and any additions, improvements and local adjustments, as well as any translations; and the master franchisee should waive all rights, including moral rights in the works (if possible). If a franchisee hires a person to prepare translations, the translator should normally be requested to sign an agreement that the translation is prepared as a “work for hire,” and that all rights to the translation are owned by the franchisor. If local law would vest such rights in the master franchisee or the translator, the franchise agreement may have to specify that the rights will be assigned to the franchisor. In some countries, moral rights cannot be waived⁴⁶ and then it is important to grant the franchisor the unlimited right to alter, use and to sublicense the revised manual and materials.

3.4 How Do Real Estate Laws Affect International Franchising?

The availability and cost of real estate is a very important component of any franchise system with brick and mortar locations. Finding suitable sites can be an issue in some developed markets, but can be especially problematic in developing countries where there may be little real estate that meets the franchisor’s expectations. Both real estate availability and cost need to play an important role in the assessment of a new market by a franchisor. For one, if there is limited inventory, it will affect the likely speed of establishment in the market as it will be difficult to find good locations. Assuming a simple supply and demand model applies, the more limited the inventory, the higher the price will be, thus affecting the franchisee’s bottom line. If franchisees must settle for secondary locations, it is possible that the profitability of the franchisee will suffer, hurting the franchisee directly, and usually indirectly hurting the franchisor’s royalty stream. Poor locations may also have a negative impact on brand perception in the market, leading to bigger issues than isolated underperforming stores.

Where real estate is available and reasonably priced, it may be difficult for prospective franchisees to obtain. Financing may not be as easily available as it is in the franchisor’s home country. Even in developed countries, it cannot be assumed that the master franchisee and its franchisees will have access to capital in the same way as in other markets. Often, franchisees must contribute a significantly higher percentage of the project costs out of existing funds before a bank will be willing to make a loan. In some European markets franchisees may need to hold a 30% to 50% equity interest to qualify for a loan.⁴⁷ However, many other countries have government agencies and banks with

⁴⁶ See, e.g., the French Code de la propriété intellectuelle, J.O. 1 (July 1992). The scope of moral rights differ between countries, but can include rights such as the creator’s right to receive credit for the work, the right to control how the work is used, and also the right to receive royalties.

⁴⁷ Stephane Teasdale & Marco Hero, *How to Prepare a Franchise System for Expansion to Europe*, 2009 A.B.A. ANN. F. ON FRANCHISING.

programs targeted for use by franchisees, assisting small business owners in getting loans, but it cannot be assumed that the availability of financing, or the cost of financing, will be the same as in the franchisor's home country.

Lack of access to the financial markets will affect the franchisee in many ways. For example, it may affect the development schedule and as a consequence the speed by which a royalty stream out of the market can be established. Likewise, if financing is more costly in the target market, the Franchise Parties will have to take that into consideration when considering when projecting their returns in the market.

Concerns about real estate do not end when its available and reasonably priced. From a legal perspective, a fundamental issue is how much control the franchisor wants to retain, or have its master franchisee retain over franchisee locations. The Franchise Parties must ensure that local real estate laws will enable the parties to enforce their agreement as intended. For example, are options to take over a lease upon termination of a franchise agreement enforceable? How do franchisees' statutory rights to renew leases impact post-term covenants not to compete? And if the franchisor wishes to take over leases itself, does local law permit foreign entities as tenants? In some countries, such as Indonesia, a foreign entity may not even be legally able to lease real estate or operate a retail business.

Local laws and practices will also affect the term of franchise leases. However, even if a franchisor may lawfully lease or own a sublease property in another country, counsel should advise it about:

1. the tax consequences of owning a real estate property interest;
 2. the laws that regulate landlord-tenant relationships; and
 3. whether it otherwise makes sense to attempt to operate locations in the country following a default.
- 3.5 How Do Labor And Employment Laws Affect International Franchising?

Compared to the generally employer-friendly employment and labor laws in the U.S., laws in other countries are often much more focused on protecting employees. It is important for a franchisor to ensure that the relationship between it and a master franchisee or area developer is not later construed as an employment relationship. Joint employer issues are a hot topic in the U.S. right now, but other countries face similar issues. For example, in Spain, a franchisee's employees could be considered employees of the franchisor under two different theories: an "illegal transfer of employees" theory under the Spanish Workers Statute,⁴⁸ and franchisor and franchisee

⁴⁸ Article 43 of the Workers' Statute, Royal Legislative Decree 1/1995 of March 24, 1995, Estatuto de los Trabajadores.

could also be considered a “company group with labor effects” under the Spanish Commerce Code⁴⁹.

It is also important for a franchisor to understand how the local labor laws may affect the relationship between the franchisee and its employees and consider whether the franchise system may need to be adjusted to better fit the employer-employee relationship in the foreign market. For example, at-will employment is a concept more or less unique to the U.S. In other countries, terminating an employee is often similar to the process of terminating a franchisee in a U.S. state with a relationship statute, or to terminating a commercial agent under foreign commercial agency laws: tricky at best, impossible in the worst case. A franchise model that has high employee turn-over included in its model may need to rethink some of its model to better fit a market with lower turn-over (and thus often a more well-trained and well-compensated work force that may expect something else out of a position that is considered an entry level position in the U.S.). Understanding the roles that unions play in the labor market is another important factor. In some countries, the degree of unionization is significantly higher than in other countries and may impact the structure of the franchise system.

3.6 Are Security Agreements and Guarantees Enforceable Under Local Law?

It is common in both domestic and cross-border franchise agreements to require the owners of a franchisee or master franchisee to guarantee performance of the agreement. If a guarantee is secured by significant assets, it can be an effective tool to ensure performance. Especially in international franchising, a franchisee's owners are often wealthy, and a guarantee can be particularly useful, to the extent it is enforceable. To ensure enforceability, franchisors should consult with local counsel about local guarantee laws. Such laws can affect both the substance and form of a guarantee.

In some countries, it may be difficult to enforce a personal guarantee and franchisors may then prefer other alternatives for securing performance of their franchise agreements. One alternative is a letter of credit (“LOC”).⁵⁰ A standby LOC is also frequently used where the franchisor is concerned about the financial strength of the international franchisee parties or the ability to enforce a judgment in the country where the franchisee's owner and its assets are located. Usually, a LOC is issued by a bank in the franchisee's market and confirmed by a bank in the franchisor's home country. The franchisor can draw on the letter of credit upon the terms set forth in the letter itself.

⁴⁹ Article 42.1 of the Commerce Code, Royal Decree, August 22, 1885. *Codigo de Comercio*.

⁵⁰ A letter of credit involves fees and must be very clearly drafted to ensure that the franchisor can draw on it as needed. International franchisees will usually insist upon an independent third party confirming the existence of a breach before a franchisor may draw on a LOC.

3.7 How Do Antitrust Laws And Trade Secret Protection Schemes Affect International Franchising?

Most developed countries have some form of competition or antitrust laws. The scope of these laws differs and understanding their scope may require significant changes to an international franchising program. For example, these antitrust laws may limit the Franchise Parties' ability to freely contract regarding exclusive supplier arrangements, resale price restrictions, geographic restrictions on internet use, and covenants against competition.

One such example is the European Community Treaty on the Functioning of the European Community, Article 101, which applies throughout the EU and prohibits contract terms and behavior that would restrict competition within the EU. Franchise agreements typically will fall within the scope of Article 101, though when drafted properly they may be exempted under the Vertical Restraints Block Exemption (the "Block Exemption").⁵¹ For the Block Exemption to apply, neither the franchisor, nor the franchisee can have a market share above 30%. Because of the consequences of falling outside the scope of the Block Exemption franchisors should take care to ensure that their master franchise and franchise agreements used in the EU countries fit within the restrictions of the Block Exemption, if they satisfy the market share threshold.

Notwithstanding the Block Exemption, the European Court of Justice held in *Expedia Inc. v. Autorité de la Concurrence and others*, case C-266/11, 2012, that if an agreement has an "anti-competitive object – it will be presumed to have an anti-competitive effect on the market.

Some of Block Exemption restrictions may be surprising to U.S. franchisors, as they affect provisions that are commonly included in U.S. franchise agreements. For example, the Block Exemption limits a franchisor's rights to set exclusive territories, and also limits the franchisor's right to prohibit franchisees from selling online.⁵² It also includes other types of restrictions, such limiting the franchisors to set minimum prices and setting prices in special promotions that franchisees have to participate in.

In other countries, even though the types of restrictions that are listed above may not be expressly prohibited by local antitrust laws, franchise agreements may be interpreted as

⁵¹ Comm'n Reg. No. 330/2010, O.J. L102, 23.4.2010.

⁵² With respect to exclusive territories and online sales the Block Exemption distinguishes between active and passive sales. A franchisor may limit active sales outside of a defined territory or online, but not passive sales. "Active" sales are those in which the franchisee is taking a purposeful, active step to obtain a customer. "Passive" sales are those resulting from unsolicited inquiries from consumers. For a further discussion of the Block Exemption, see for example John H. Pratt, *The New Vertical Agreements Block Exemption Regulation*, 13 THE FRANCHISE LAWYER, no. 2, 2010, and Jeffrey A. Brimer, Alison C. McElroy & John H. Pratt, *Going International: What Additional Restraints Will You Face?*, 2011 A.B.A. ANN. F. ON FRANCHISING.

adhesion contracts, and as such, franchisors have to be aware of the potential limitations on their ability to enforce their agreements as written.⁵³

In their negotiations, franchisors and prospective master franchisees always focus upon the fees the master franchisee will charge to its subfranchisees and the portion of the revenue from those fees that will be shared by the Franchise Parties. National antitrust laws may play an important role in determining whether a franchisor may set the initial franchise fees, royalty fees and other fees master franchisees may charge. Setting the fees a master franchisee must charge may be viewed no differently than setting the prices that a franchisee must charge for its products and services. Both may constitute unlawful vertical price fixing under some laws. Depending upon the country, setting these fees may be lawful, subject to a rule of reason analysis or per se unlawful.

If a franchisor is concerned about either the fairness of the fees a master franchisee will charge if it has complete discretion to set them, or if it is concerned that creative master franchisees may find workarounds to minimize the fee income that must be shared with the franchisor, at least one strategy is available. If the franchisor prefers the master franchisee to charge a 6% royalty fee, and if the franchisor is entitled to receive one half of the royalty fee collected by the master franchisee, the master franchise agreement may be written to require the master franchisee to pay the franchisor the higher of 3% of the unit/subfranchisee's gross sales, or 50% of the royalty fee charged by the master franchisee. That will assure the franchisor of its share of the fees its budgets are based upon, and allow it to benefit from any higher fees a master franchisee may charge.

Even if franchising is not regulated in a country, covenants against competition in international franchise agreements will usually be regulated. Understanding the scope of such laws and their effects on the Franchise Parties' agreement may affect the exit strategy for a franchisee. The general criteria for enforceability of restrictive covenants are much the same throughout the world: they must be reasonable with respect to the types of activities that are restricted, their geographic scope, and their duration. What is reasonable; however, may be viewed very differently in different countries, depending on their general view of restrictive covenants. There may also be additional conditions on restrictive covenants, both in-term and post-term. For example, in China and Germany, a post-term covenant to compete may entitle a master franchisee to compensation.⁵⁴ Similarly, in Mexico, the right to work is a constitutional right, and post-term covenants may be hard to enforce.⁵⁵ While the applicability of some local laws may be avoided through choosing the franchisor's home country law as governing law, antitrust laws, including those addressing restrictive covenants usually fall into a

⁵³ *E.g.*, the Unfair Contract Terms Act of 1977 of the United Kingdom; the Unfair Contract Terms Act of 1997 of Thailand. Other countries also occasionally question whether franchise agreements are adhesion contracts. See, e.g., Swedish Supreme Court case *Lars L v Acard Sverige AB*, NJA 1992 s 290 in which the court analyzed whether an arbitration clause in a franchise agreement could be disregarded on the ground that it would be considered an adhesion contract.

⁵⁴ Section 90a German Commercial Code.

⁵⁵ Article 5, Mexican Constitution.

country's mandatory laws. These types of provisions cannot be waived by adopting another country's law as the governing law of one's contract and the country's law will usually be upheld on public policy or public order grounds.⁵⁶

3.8 What Obstacles To Collecting Agreed Upon Fees May Arise In International Franchising?

Tax regimes in different countries vary, but in most countries, income derived within the country's borders is taxed, whether or not the entity earning the income is domiciled there. As it is undeniably harder for a tax authority to collect from taxpayers located abroad than those located within its own country, most countries impose withholding taxes on revenue generated in the country by foreign entities. For franchisors, royalty payments and similar fees will usually be subject to withholding. Withholding rates may range from 0%, usually based upon a double taxation treaty, to 35%.⁵⁷

To increase its net return, a franchisor may want to consider whether a gross up provision in their international master franchise agreements would be helpful. A gross up provision requires the master franchisee or developer to pay over to the franchisor the full amount of the royalty or fee that the withholding tax applies to as if such tax was not being levied. For this to happen, in practice, the master franchisee or developer pays more than the actual royalty or other fee that the withholding tax applies to. For example, if the royalty was \$100 and the withholding rate was 10%, the master franchisee would have to pay approximately \$111 for the franchisor to receive \$100 after the withholding tax has been deducted. The calculation shows clearly why international franchisees tend to be opposed to gross up provisions – the effective royalty rate just went up by 11% over the negotiated rate in the example. For the same reason, franchisors should not disregard the effect of gross up provisions and should consider alternative solutions, if possible. Where such provisions result in the master franchisee or area developer paying significantly more in fees it reduces the attractiveness of the franchise. With the additional tax burden, will the franchisee's return on investment still be sufficient? A compromise may result in the franchisee paying taxes on fees that exceed an agreed rate.

Before agreeing to fees in a LOI, Franchise Parties should have explored the effects of various taxes and possible tax avoidance and tax minimization strategies. Part of that analysis should include an evaluation of the extent to which foreign withholding tax payments may be credited against tax due in the franchisor's home country.

To minimize the effects of withholding taxes, the Franchise Parties may want to look closely at the various fees and payments flowing between the parties and examine the tax regulations with a mindset towards minimizing the fees under the agreement that

⁵⁶ Philip F. Zeidman, *With the Best of Intentions: Observations on the International Regulation of Franchising*, 19 STAN. J.L. BUS. & FIN. 237, 265 (2014).

⁵⁷ See *United States Income Tax Treaties*, IRS.GOV, <http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties--A-to-Z> (last visited Apr. 10, 2015).

are subject to withholding taxes and maximizing those that avoid such treatment under the tax laws. By way of example, withholding taxes in Colombia are 33% on royalties, 10% on technical assistance services, technical services and consulting services, and 26.4% on software licenses.⁵⁸ Clearly, if the parties can classify the payment stream from the franchisee to the franchisor as payment for technical services, withholding taxes will decrease significantly. This is only an example of the effect classification of payments could have on the economics of an international franchise agreement. Franchise Parties should always consult with their tax advisors to make sure the best strategy is adopted. Gross up provisions are not be permitted in all countries.⁵⁹

Another tax-related concern is whether the franchisor's activities in the new market create a permanent establishment, thereby exposing the franchisor to income tax liability in that market. In most international franchise arrangements, a franchisor's presence in the new market is too limited to create a permanent establishment. However, to the extent that a franchisor has employees in market, has an office there, establishes a bank account there or holds an interest in real estate or in the franchisee, it needs to make sure it understands the tax consequences of its choices.

3.8.1 Exchange Controls

Exchange controls are rules and regulations that restrict or prohibit payments from one country to another. While most developed countries today do not limit or restrict cross-border payments of royalties and similar payments (except by imposing withholding taxes), these types of rules are still common in many developing countries. Local franchise counsel should be asked to explain these restrictions. The degree and type of restrictions vary among different countries.⁶⁰ For a franchisor, it is important to understand how these exchange controls will affect payments from a franchisee before any significant time is spent in negotiations with a prospective franchisee. For example, frequent payments may be inconvenient if all cross-border payments are subject to exchange controls. In that instance, the parties may be better off structuring monthly or even quarterly payments. On the other hand, if the exchange controls only apply to transfers above a certain amount it may be beneficial to the parties to require more frequent payments to the extent the payments would then be below the threshold level. For most markets, the exchange controls will at the most amount to a hassle, but in some countries, such as Venezuela, there are significant administrative steps that will slow down the payment process significantly and may affect the financial model due to statutorily set exchange rates.⁶¹

⁵⁸ Pablo Hooper, Jane W. LaFranchi & Erik B. Wulff, *Franchising in Latin America*, 2010 A.B.A. ANN. F. ON FRANCHISING.

⁵⁹ *E.g.*, in the Philippines and in Ukraine.

⁶⁰ See *infra* Attachment A (Currency Conversion Restrictions).

⁶¹ Pursuant to the Venezuelan Law on the Currency Exchange Regime and on Currency Exchange Violations was published in Special Official Gazette No. 6.126 of February 19, 2014 currency exchange transactions are permitted, but the administrative steps involved make this a complex process. For commentary on the new system, see P.G., *A Fistful of*

4. How Should Franchise Parties Evaluate The Feasibility And Cost Of Supplying Franchisees?

4.1 Supply Chain Issues

Depending on the type of business and industry sector a franchise system is in, it may be more or less dependent on the availability of specific products. Restaurant franchise systems and retail franchise systems such as clothing stores, hardware stores and similar businesses rely heavily on the availability of specific goods. But many predominantly service-based franchise systems may also be dependent on the availability of some special products. This dependence may present difficulties even within the franchisor's home market, but internationally, supply chain issues can often become the most troublesome part of a franchise system's growth.

The key concerns surrounding the availability of the "secret sauce" or products that are necessary for the operation of franchised locations focus on the issues of brand consistency and cost. These concerns can be distilled down into some more specific issues that franchisors frequently encounter when looking at product availability and evaluation of the necessary supply chain: (i) cultural and local preferences and tastes; (ii) availability of the products or acceptable substitutes in the local market; (iii) evaluation of local suppliers; and (iv) barriers to importing the products from abroad.

4.2 Product Adaptation To Local Preferences

How the product offering of a franchise system must be adapted to fit local tastes and cultural norms is a question that could fill many books. For the purposes of this article, suffice it to say that, the degree of customization will vary greatly between different systems and countries. The most talked about adaptations are in the restaurant industry where, predominantly for religious reasons, certain meats must be taken off the menu, or products need to be manufactured or cooked in particular ways.⁶² However, any retail franchisor will likely confirm that local preferences go significantly beyond what foods are customarily eaten, and local customs will affect the product offerings of most businesses. A retailer of any goods will have to determine what the appropriate price point is for its products and if the typical quality maintained is sufficient, or maybe

Dollars, or Perhaps Not, ECONOMIST (Apr. 1, 2014 3:52 PM), <http://www.economist.com/blogs/americasview/2014/04/venezuelas-byzantine-exchange-rate-system>.

⁶² McDonald's is one company that has found a way to adapt its menu to India's large Hindu population. Known as a hamburger restaurant that prominently features various forms of beef burgers, franchisees of McDonald's Indian restaurants do not offer beef burgers, but rather focus on veggie burgers, chicken, and fish sandwiches. Of course, the Hindu abstinence from beef is well-known to most westerners, and McDonald's did not enter the market there until 1997, decades after it had begun taking on other international markets. Domino's Pizza also entered the Indian market in 1996 and modified its offering of pizza toppings. Readers from Domino's home in the U.S. may find the Indian menu's offering of "non-vegetarian pizzas" to be a significant contrast to the U.S. menu. www.dominos.co.in/menu.

unnecessarily high, for the local market. There are also many changes that may be required due to local customs and consumer product safety rules. For example, for electronics of every sort, voltage and plugs as well as safety features may have to be adjusted; for chemicals the composition may be different either due to regulation or consumer tastes; and for food products, permitted additives differ.

4.3 Product Availability And Evaluation Of Local Suppliers

Once the Franchise Parties have agreed upon what the local franchisees' product offering should be, the bigger issue will be how to get those products to market.

Finding the right suppliers to supply the franchisees in foreign markets can be a challenging prospect. Usually, this obligation is placed on the franchisee, subject to use of the franchisor's criteria in selecting their suppliers and products. These criteria should cover the same type of issues as the franchisor considers domestically: quality, consistency and social responsibility/ethics standards. To some degree, the analysis of those criteria is no different than in the franchisor's home market, but it is also important to understand how relationships between suppliers and their customers work in the local market. A franchisor should try to understand if there are other factors that may impact a franchisee's choice of suppliers. In some cultures, it may be acceptable for suppliers to pay a "commission" to their customers upon receipt of a large contract. In other countries, such as the U.S., some of those types of payments may be unlawful bribes.⁶³ These types of practices may have an impact on the franchisor both from an FCPA perspective, but also from a financial perspective. If the supplier overcharges franchisees or starts supplying sub-par products to franchisees, it is likely to impact the profitability of franchisees and in the extension the other Franchise Parties.

Depending on the importance to the brand of the specific product being sourced, it may make sense for the franchisor to retain more control over the sourcing. Brands that are well-known and that generate media interest should consider retaining control over the franchisee's suppliers. In those circumstances, the evaluation of a supplier may need to be more thorough than what the franchisor would engage in for domestic suppliers. Once approved, the level of control and supervision by the franchisor will exercise over those suppliers will likely be more limited than in a domestic scenario. The food safety issues experienced by some QSR concepts in China during 2014 are instructive in this regard.⁶⁴

While there are obvious risks involved in allowing an area developer or master franchise to exercise control over the supply chain in its country, from a cost perspective it may be

⁶³ See, e.g., Robinson-Patman Act, 15 U.S.C. § 13(c) (2012) (when lawful franchisor may choose to levy a fee on such commissions).

⁶⁴ See, e.g., Associated Press, *McDonald's to Increase Oversight of Chinese Suppliers*, N.Y. TIMES, Sept. 2, 2014, http://www.nytimes.com/2014/09/03/business/mcdonalds-to-increase-oversight-of-chinese-suppliers.html?_r=0 (regarding a Chinese meat supplier selling expired meat products to McDonald's and other QSRs).

the best option. Franchisors should balance their need for control over the supply chain and the need for products to strictly comply with brand standards, against the cost and administrative complexities of importation. As will be discussed below, the cost of importing products into a local market may substantially exceed product costs and delivery charges.

4.4 Tariff and Non-Tariff Trade Barriers

Trade barriers come in many shapes and forms, including laws, regulations, and government practices. They can be intended to block foreign imports, or may be established to promote local business growth. Other barriers flow from generally applicable local regulations, procedures and administrative practices that make cross-border trade unnecessarily complex.

If a product or a reasonable substitute for it is not available in a local market, or if the franchisor considers a product so important that it wants to exercise close control over the product's source or quality, it may find that the only available option is to import the product from another country. Where the distance is great, there are many challenges to this approach: some are pure logistical. If a shipment is delayed or franchisees in the local market have an unexpected increase in sales, the franchisees' businesses may experience supply shortages. Or, in the event of perishable products, overseas shipment may be either infeasible or be cost-prohibitive. Logistical issues can sometimes be overcome by local warehousing of the important products and similar measures. However, other international supply chain issues will not be as easy to overcome.

Many of these issues arise from measures established to protect local businesses. In most countries, trade barriers are a tool for the government to express policies and, to varying degrees to direct business decisions. In most countries, agricultural production is subsidized. Certain industries are considered to be of strategic, national importance and may not be owned by foreign parties. Such nationalistic tendencies are actively counter-acted by free trade agreements that are intended to aid international trade, but these agreements cover far from all international relationships. The best known free trade agreement has created the European Union. Most countries are signatories to a range of multinational and bilateral trade agreements, but they do not necessarily extend to all trade partners. For example, while both North American Free Trade Agreement (NAFTA) and Dominican Republic-Central American Free Trade Agreement (CAFTA-DR) help with trade relations in North America and Central America, there is currently no free trade agreement between the U.S. and the EU⁶⁵. Without a free trade agreement import and export duties can sometimes increase prices by several hundred percent.⁶⁶ If research reveals the existence of trade barriers between the franchisor's

⁶⁵ The U.S. and the EU are currently negotiating TTIP (the Transatlantic Trade and Investment Partnership) but its conclusion is likely still many years away.

⁶⁶ See, e.g., Edward Cody, *Bush War on Roquefort Raises a Stink in Paris*, WASH. POST, Jan. 29, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/28/AR200901>

home country and the target country, franchisors may be able to establish an affiliate in a country with a trade agreement with the target country and use it to supply key products to franchisees in the larger country.

4.4.1 Tariff Barriers

Tariff barriers are duties imposed on products and are usually intended to limit trade in that product, usually to promote domestic production and employment or to protect consumers, though sometimes they can be purely retaliatory, such as when the U.S. imposed a 300% tariff on Roquefort cheese as a reaction to an EU ban on hormone-treated meat.⁶⁷ The World Trade Organization is working to reduce tariff barriers, and in general tariff barriers are relatively easy to understand and take into account when evaluating supply chain issues.

4.4.2 Non-Tariff Trade Barriers (NTBs)

Less easy to predict and more difficult to counteract are the various non-tariff barriers (“NTBs”) a franchise system may face. These are barriers that do not directly prohibit the importation of goods or prohibit market entry by foreigners, but that set rules and limits with a chilling effect on import and foreign investment. The degree of regulation varies greatly among countries, although developing countries tend to have a higher degree of government intrusion than developed countries. It is, of course, possible to discover many of these issues beforehand through due diligence, but some of the issues are so granular that franchisors will rarely understand such matters if they do not consult the local franchise counsel before negotiating a franchise in a new market or proposing the franchise structure to use there. While some NTBs are franchise specific, many are not. Rather they apply to all imports and foreign investment in a country. NTBs may include for example: (i) import licensing; (ii) local content requirements; (iii) embargoes; (iv) logistics barriers; (v) anti-dumping practices; (vi) tariff classifications; (vii) valuation issues; (viii) non-consistent standards; (ix) packaging and labeling requirements and many other standards, taxes and fees that impact the ability to import goods in a cost efficient manner.

In some instances, NTBs are part of customs rules and regulations and target only imported products. For example, agricultural testing may apply specifically to imported goods. Such rules when only intended to make sure that the products are safe and meet local food regulations are reasonable, but still potentially costly.⁶⁸

Where standards, labeling and content requirements for products differ between local and foreign suppliers in a market, they may have the same effect as customs

2804071.html (action taken by the U.S. government that lead to a temporary 300% import duty on Roquefort cheese).

⁶⁷ Matthew Dalton, *U.S. Drops Tariffs on Roquefort*, WALL ST. J., May 7, 2009, <http://www.wsj.com/articles/SB124163054223492525>

⁶⁸ A completely different issue is that reasonable standards may be rendered unreasonable by slow turn-around times and corruption.

regulations, even though they apply both to imported and domestic products. When the customs rules and regulations, or domestic standards are implemented in a fair way, they usually reflect market standards and the values and expectations of the local population. However, this section is not intended to expound on the virtues of different standards and rules as a reflection of local values, but rather to explain the different types of NTBs that franchisors may have to deal with when requiring Franchise Parties to import products from abroad, and the potential effects such NTBs may have of the Franchise Parties' bottom line.

4.5 Import Licensing

Licensing requirements may apply to the entity that imports products, or to the products themselves. Import licensing, when simple, transparent and predictable, serves a national interest of controlling products that enter a market. Where the applicable rules are widely available and straight-forward in their application, this evaluation is reasonably simple. However, import licensing can also be abused by countries to favor local producers. The requirements for obtaining licenses may be obscure; the procedures may be complex or handling times may be long. When this is the case, the import process becomes uncertain and time consuming for the Franchise Parties.

One example of a country with complex import licensing requirements is Argentina, which has introduced a number of customs and licensing procedures in recent years. Argentina requires a certificate of free circulation from the National Food Institute (Instituto Nacional de Alimentos). Although a food licensing requirement of that kind may not seem odd, U.S. companies have reported that it is used to delay or even deny importation of food products.⁶⁹ In Brazil, importers must register with the Secretariat of Foreign Trade (SECEX), and some products, including beverages, require authorization by specific ministries.⁷⁰ In Ecuador, the Ministry of Agriculture, Livestock and Fisheries relies on Consultative Committees made up of local producers for some import authorizations,⁷¹ which raises questions of the fairness of such committees' deliberations.

4.6 Local Content Requirements

While licensing requirements may be an indirect way of protecting domestic production, in some instances countries do so more directly. For example, Indonesian law requires that franchise systems give priority to domestically produced goods – 80% of the sources of goods and services should be from Indonesia and there are severe restrictions on foreign investment into retail businesses. In Malaysia, foreign investment must be pre-approved by the Committee on Distributive Trade of the Ministry of

⁶⁹ U.S. TRADE REPRESENTATIVE, 2014 NATIONAL TRADE ESTIMATE REPORT ON FOREIGN TRADE BARRIERS 18 (2014).

⁷⁰ *Id.* at 35.

⁷¹ *Id.* at 88.

Domestic Trade, Co-operatives and Consumerism. Like Indonesia, Malaysia prohibits foreign investment in certain retail businesses.

4.7 Valuation Issues

Another potential pitfall in connection with the importation of goods can be the valuation of the imported products. The higher the value of the goods, the higher the base on which tariffs and other fees will be assessed. For example, in Argentina, “reference values” are applied to several thousand products. If a product falls within a category with an established reference value the duties are calculated based on the reference value, even if the good is invoiced at a lower price. There are exceptions from this rule, such as if the importer can show that the agreement between the buyer and seller is at arm’s length.⁷²

4.8 Logistics Barriers

The most common type of legal logistics barrier is the creation of so much paperwork and red tape that importation of goods becomes a time consuming and costly process. One such example is the requirement in Argentina that invoices for goods that are sold at below the “reference value” that Argentine customs agencies have established for the type of product must be validated by the exporting country’s customs agency and also by the Argentine embassy or consulate in that country.⁷³ In Angola, one private laboratory, Bromangol, has a de facto monopoly on food testing.⁷⁴ Another form of logistics barrier is to only permit goods to enter through certain ports into the country, or lengthy clearance times.

Some logistics barriers however, are not imposed by rules and regulations, but rather by circumstances in a local market. For example, where roads and other modes of transportation are poorly developed or of poor quality, both the cost and time of delivering products can be significant. Where product freshness is important, such constraints may even make it impossible to use imported goods. In some parts of the world, Franchise Parties will also have to take into consideration crime – for example the likelihood of trucks being held up.

4.9 Corruption

It would be disingenuous not to at least mention the role of corruption when discussing supply chain issues. With the exception of parts of Europe, North America and Australia, New Zealand (and a few countries in other parts of the world) corruption is involved in business transactions to a greater or lesser extent.⁷⁵ Corruption may range

⁷² *Id.* at 20.

⁷³ *Id.*

⁷⁴ *Id.* at 8.

⁷⁵ For a country-by-country overview of corruption throughout the world, see *Corruption by Country/Territory*, TRANSPARENCY INT’L, <http://www.transparency.org/country> (last visited Apr. 10, 2015).

from small payments that give a party priority consideration in the handling of official matters, to much more significant payments without which a party's matter will not be considered at all. In many countries, customs and import licensing officials are particularly prone to demanding bribes. While in many cases, a small payment may have been the most efficient way of handling a matter, for franchisors from countries with national anti-bribery laws or that have adopted anti-bribery treaties, this is usually not a possible option. The U.S., the Foreign Corrupt Practices Act ("FCPA") prohibits U.S. companies and their employees, U.S. citizens, foreign companies listed on a U.S. stock exchange or required to report to the SEC, and foreign persons while in the U.S., from corruptly paying or giving anything of value to a foreign official in order to obtain or retain business.⁷⁶ U.S. franchisors are by no means alone in having to comply with anti-corruption type restrictions. The U.K. Bribery Act of 2010 is, in some respects, even further reaching than the FCPA. While the FCPA only prohibits bribing public officials, the U.K. Bribery Act prohibits bribing anybody.⁷⁷ It also makes it unlawful to accept a bribe.⁷⁸

There is certainly no one-size-fits-all solution for supply chain issues. Solutions depend on the industry that the franchisor is in, the market that it is entering, the sophistication of the franchisee, the availability of products and experienced suppliers and forwarders in the market, and many other factors. Unfortunately, as with so many other aspects of doing business internationally, the solutions adopted are rarely scalable. The local differences between laws and market conditions will require each market to be evaluated on its own. Even franchisors with significant domestic experience in supply chain issues need to exercise care when taking their franchise programs to new countries. The domestic experience, while beneficial, is likely not sufficient to efficiently handle international supply chain issues. Franchisors may wish to at least start out by using third party providers familiar with the new local market and with the types of supply chain issues that the franchise system is likely to encounter.

5. End Of Franchise Issues

5.1 Why Should International Franchise Agreements Address All End Of Franchise Issues?

End of franchise issues can be troublesome in a franchisor's domestic market. But, those problems can often compound when foreign franchisors must rely upon court systems in their franchisees' territories to enforce contractual rights and post-term covenants. International area developers and master franchisees also face significant potential problems when franchise agreements end. For example, to challenge an unfair termination or nonrenewal, they may be required by their franchise agreements to

⁷⁶ There is an exception for minor "grease payments" that have to be paid for the party to obtain what they are legally entitled to. See 15 U.S.C. § 78dd-2(b). However, the line between a permitted grease payment and a bribe can be treacherous and it is generally advisable to stay away from such payments altogether.

⁷⁷ Section 1 of the U.K. Bribery Act 2010.

⁷⁸ Section 2 of the U.K. Bribery Act 2010.

arbitrate or litigate the issues far from home and far from friendly witnesses, who reside in their territories. They may find that they must dispose of property that was specially built for the franchise, deal with non-compete covenants, handle warehousing and purchase agreements that were established with suppliers, and pay compensation to terminated employees. Area developers and master franchisees that have made an investment in infrastructure in anticipation of expanding to meet development targets will usually need to unwind the entanglements that they have encountered.

Franchisors and their master franchisees confront the most difficult end of franchise issues.⁷⁹

Planning for the end of a franchise relationship is as important for international franchise lawyers as is planning to deal with opening and operational issues. Ultimately, all international franchise relationships will end. The ending of a master franchise relationship usually involves several parties that have become involved with the franchise. The job of Franchise Parties' and their counsel is to anticipate end of franchise issues, and to draft language in their agreements to address them in a workable way.

5.2 Dealing with a Notice of Termination—Master Franchise

5.2.1 How Many Relationships Can Be Affected by the Termination of a Master Franchise?

The termination or nonrenewal of an international master franchise agreement causes both franchisors and master franchisees to confront a series of problems. Franchisees whose only franchising experience is with direct unit franchising are accustomed to dealing with the duty of franchisees to stop holding themselves out as a franchisee and to return all confidential and proprietary materials to the franchisor. Often a post-term non-compete covenant will be implicated. The franchisee must deal with its landlord, suppliers, and employees. Signs must come down and telephone and Internet listings must be changed.

These issues are only the beginning of what master Franchise Parties face at the end of a franchise relationship. Because a master franchisee replicates most of the functions of a franchisor in its territory, it may enter into numerous contractual and business relationships when fulfilling its role. For instance, the master franchisee will accept initial franchise fees, area development fees, and option fees from franchisees for rights

⁷⁹ For a review of several of the legal theories, see Leonard Polsky, Mark Abell, Ruby Asturias & Sun Chang, Post Expiration and Termination Issues in Master Franchising: The Fate of the Unit Franchisees and Other Issues, Presentation at the International Franchise Association/International Bar Association 2014 Annual Joint Conference (May 6–7, 2014). The authors excelled in identifying legal theories to support rights of unit/subfranchisees upon termination of master franchises, but were unable to find decisions which apply the theories. This is unsurprising, given the frequency with which arbitration is used to resolve formal disputes, and the apparent reluctance of Franchise Parties to international agreements to engage in litigation.

that may not have been exercised on the termination date or expiration date of the master franchise agreement. The master franchisee may have received promissory notes from franchisees or payments from franchisees' customers for products or services to be delivered in the future. The master franchisee may be a lessor or sublessor to franchisees. Or, the master franchisee may be a supplier of products to franchisees and may have entered into supply agreements with franchisees, as well as with manufacturers, wholesalers, or other suppliers.

Additionally, the master franchisee may have created and established an advertising fund that it administers in its territory. In connection with that fund, it will have established a bank account, entered into contracts with advertising agencies, made commitments to advertising in media over a period of time, or failed to collect fees from its company-owned units or from some franchisees.

The master franchisee may also have committed to participate in franchise expos and trade shows. The master franchisee may own and host websites and social media sites on which the brand is promoted in the territory. The master franchisee may have loans for which assets of the master franchise business are collateral. The master franchisee has direct contractual relationships with its unit/subfranchisees. This list is not exhaustive.

5.3 What Can Go Wrong When The Notice Of Termination/Nonrenewal Is Delivered?

Franchisors usually end an international master franchise relationship because they are not being paid, because the development schedule is in serious default, because their brand is being damaged by the actions or inactions of the master franchisee, or because the master franchisee is disaffected with the franchise and notifies the franchisor that it wants to end the relationship. The Franchise Parties are frequently hostile to each other, each blaming the other party for the failure of the relationship to meet their original expectations.

Rarely does a termination notice get sent upon the occurrence of the first event of a default of an international master franchise agreement. Problems fester, payments are missed, units are not opened until, ultimately, one of the Franchise Parties acts upon its frustration by sending a termination notice, filing a lawsuit, or both.

Then, the Franchise Parties take inventory of their options and the problem that the end of the relationship will create. How do they address each of the relationships and agreements described above? What contractual rights do the parties have to protect themselves and their relationships?

Common rights of the franchisor are to stop the master franchisee from using its marks or system and to stop the master franchisee from holding itself out as a master franchisee. Master franchisees may be required to turn over websites and telephone listings using the franchisor's trademarks. Past due amounts must be paid to the franchisor. And, at the option of the franchisor, the master franchisee must assign unit/subfranchise agreements in the territory to the franchisor or its designee.

The other relationships, discussed in Section 5.1.1, often are not addressed. As a result, the franchisor could find itself facing a situation wherein the master franchisee has negotiated a 180-day notice of termination or nonrenewal. During that period, the master franchisee may engage in any of the following:

1. The master franchisee may continue offering and, possibly, entering into new franchise relationships. Even though the franchisor may have the right to approve each new franchisee, franchise agreement, or site, the master franchisee may not comply once the termination notice has been sent.
2. During the franchise sales process, the master franchisee may use FDDs or advertising materials that omit mention of the termination notice, or that otherwise misrepresent the franchise relationship.
3. The master franchisee may collect area development fees, deposits, initial franchise fees, and fail to report them to the franchisor.
4. The master franchisee may make commitments to advertise the franchises, or discontinue all efforts to promote the brand in the territory, missing deadlines to exhibit at major franchise expos or to advertise in annual franchise directories.
5. The master franchisee may terminate further purchases needed to supply franchisees or it may collect and retain rebates that may be owed to franchisees.
6. The master franchisee may send termination notices to franchisees.
7. The master franchisee may notify the media that the franchisor is unethical and that the franchise is a bad investment.
8. As a supplier of products or software, the master franchisee could announce significant price increases and may be able to commit franchisees to pay for the purchases.
9. The master franchisee could notify unit/subfranchisees that the franchisor has terminated its franchise rights in the country and invite them to join with the master franchisee to convert their operations to a new brand developed by the master franchisee.

The “what ifs” are only limited by one’s imagination.

5.4 How Can A Franchisor Protect Itself?

International franchisors usually do not do business in the territory of an international master franchisee and do not have personnel there. Even if they did, how would they know what the master franchisee is doing during the time between delivery of a termination and its effective date, if neither the master franchisee fails to report what it is doing?

Unless the acts are unlawful, such as fraud or theft, what could a franchisor do about them during the termination notice period even if it had knowledge? Would the franchisor be able to demonstrate that it would be irreparably injured by the master franchisee's actions or inactions? Would it be subject to a pre-suit mediation requirement or a duty to pursue claims in arbitration in a different country? If so, it would have to await the appointment of an arbitrator and the receipt of a preliminary award before converting it into an enforceable right in the courts where the master franchisee conducts business. A properly drafted master franchise agreement may help to resolve these challenges. A franchisor can address these myriad concerns by causing its master franchise agreements to include the following:

1. The most obvious first step is to set a very short termination notice period. Because a termination notice is rarely unanticipated, the parties usually have ample opportunity to attempt to work out the disentangling of their relationship. Unless required by law, notices should be delivered without an opportunity to cure, the remaining time spent by the franchisee should be focused on how to disengage from the franchise relationship, than continuing to support and grow the franchise program in the territory.
2. A second step is to have a contractual right or power of attorney giving the franchisor or its designee the right to "step in" and manage the master franchisee's business for the benefit of the master franchisee during the notice period. The issues associated with exercising such a right are considerable, especially if it is contested. However, if the master franchisee also contests the termination and seeks or obtains a preliminary injunction to delay it until a trial on the merits, the right could be an important way to prevent "waste" occurring during the notice period. Also, the existence of a contractual right may create an incentive to accelerate the actual end of the relationship.
3. Another option is to include a term in the master franchise agreement prohibiting the master franchisee from entering into any agreement, lease, or license relating to the master franchisee's business without the franchisor's approval. Approval should be conditioned on the agreement, lease, or license granting the franchisor or its designee the option to assume the master franchisee's rights and duties under the instrument immediately

upon the delivery of a notice of termination or nonrenewal. In addition, the agreements could grant the franchisor or its designee the right to assign, enforce, or terminate the agreements upon the termination or nonrenewal of the master franchise agreement. Those instruments should also authorize the franchisor to notify parties to the instruments of the existence of the termination or nonrenewal notice immediately upon delivery of such notice.

4. The franchisor may prohibit any such agreements, leases, or licenses from being executed, amended, extended, or renewed upon receipt of a notice of termination or nonrenewal without the franchisor's express approval.
5. The master franchise agreement should clearly grant the franchisor the right to communicate directly with franchisees and prospective franchisees at any time during the term of the master franchise agreement and thereafter.
6. The master franchise agreement should grant the franchisor the right to immediately terminate the master franchise agreement if any point-of-sale (POS) or other computer access to the master franchisee's or unit/subfranchisee's business stops for more than 24 hours.
7. The master franchise agreement should require the master franchisee, upon receipt of a notice of default or nonrenewal, to submit for the franchisor's prior approval all advertising, marketing, and promotional contracts with a duration of more than 30 days, which may not be effective without the franchisor's approval.
8. The master franchise agreement should require that all prepayments received by the master franchisee, including option fees, area development fees, deposits, prepaid customer payments, and supplier rebates be retained in a trust account that is independent of the master franchisee's operating account until the payments may be recorded as income under the locally applicable generally accepted accounting standards.
9. All guarantees and security interests acquired by the master franchisee from franchisees' principals, should, by their terms, be made for the benefit of the franchisor and assignable to the franchisor upon its demand.
10. The master franchise agreement should require that the master franchisee's principals, agents, and representatives resign from their positions as officers, directors, or controllers of all advertising funds upon termination of the master franchise agreement.

11. Upon termination or nonrenewal of the master franchise agreement, at the franchisor's option, the master franchisee should be deemed to have assigned to the franchisor and/or its designee all of its rights to bring claims against any unit/subfranchisee or supplier to franchisees.
12. Upon receipt of a notice of default or nonrenewal, the master franchisee should be prohibited from commencing legal action or arbitration against any franchisee and from terminating or refusing to renew a franchise agreement without the franchisor's prior written approval.

5.5 What Problems Do Master Franchisees Face When A Master Franchise Agreement Ends?

Master franchisees typically enter into agreements related to the master franchise business in anticipation of their growing the franchise network in their territories. They are not typically focused upon what might happen to them if the master franchise is terminated or not renewed. What could go wrong?

1. Most master franchise agreements require the master franchisee to enter into franchise agreements directly with unit/subfranchisees and developers. When the master franchise agreement ends and the master franchisee no longer has the right to collect fees from unit/subfranchisees or to receive any other benefits from those agreements. However, unless those agreements expressly state that the master franchisee is no longer liable to unit/subfranchisees and developers following the master franchise agreement's termination, or nonrenewal, the master franchisee may remain liable for the performance of those agreements.
2. Unit/subfranchisees may assert claims for misrepresentation if the master franchisee failed to disclose its knowledge that the master franchise agreement was about to be terminated or that it was in default of its development schedule and that it had not been renegotiated.
3. If the master franchisee has guaranteed leases, or has leased or subleased property to unit/subfranchisees, those agreements usually remain in place following the termination or nonrenewal of the master franchise agreement.
4. If the master franchisee has committed to make purchases of products, advertising, real property, or other services for the benefit of its unit/subfranchisees, absent language in such agreements granting the master franchisee the right to terminate them if its

master franchise agreement ends, the master franchisee has the duty to fulfill its obligations under those agreements.

5. The master franchisee may want to extricate itself from its obligations under its company-owned unit franchise agreements, and to make different investments. However, it may be subject to post-term noncompete covenants, and unable to find a buyer for the units as franchises because of the uncertain status of the franchise brand in the territory.
6. Upon receipt of notice of the master franchisee's termination, unit/subfranchisees may stop making payments, both past due and currently due, thereby exposing the master franchisee to further liability to the franchisor (especially if franchise fees are based upon amounts owed by franchisees, rather than upon amounts collected.)
7. Even if the franchisor or its designee steps in to service unit/subfranchisees in the territory, in the absence of receiving a full release from the franchisor, the master franchisee may still be subject to unit/subfranchisees' claims of nonperformance, or for failure to refund initial franchise fees, option payments, or area development fees the master franchisee had collected and turned over to the franchisor.

5.6 What Language Should A Master Franchise Agreement Contain To Protect A Master Franchisee From Claims Described In Section 5.5?

1. Master franchisees should insist upon language in the master franchise agreement that conditions assignment of franchise agreements, other contracts, leases and licenses, and control of advertising funds to the franchisor upon a release from the franchisor and an agreement to indemnify the master franchisee against all claims of parties to those agreements based upon acts or omissions arising after control is transferred. The master franchisee should seek to further condition the franchisor's rights to obtain assignment of the master franchisee's rights in these instruments upon its obtaining a release for the master franchisee under all personal guarantees the master franchisees' owners have executed as a condition of entering into those agreements.
2. If a franchisor insists upon having step-in rights (described in 5.4.2 above) following the delivery of a notice of termination or nonrenewal, master franchisees should insist that unit/subfranchise agreement should include a covenant that the unit/subfranchisee will not sue the master franchisee for any claims arising during the time the franchisor or its designee operates the master franchisee's

business, and for any claims that arise following the termination of the master, and that it will indemnify the master franchisee against the cost of defending any such claims.

3. The master franchisee should insist upon similar language, to that described in 5.6.2, being placed in any agreements, licenses, and leases with third parties, a master franchisee executes with a supplier whenever the franchisor insists upon the right to assume control over the agreements upon termination or nonrenewal of the master franchise agreement.
4. The master franchisee should insist upon the master franchise agreement giving the master franchisee the option, upon termination or nonrenewal of the master franchise agreement, of selling its company-owned units, warehouses, headquarters, commissaries, fleet, etc. to the franchisor or its designee for fair market value, or otherwise being released from any post-term noncompete covenants. The agreement should also address a time period for exercising the right as well as a method for establishing fair market value.
5. If the master franchisee is required to refund all deposits and fees collected from franchisees for services or products not yet delivered, the master franchisee should insist that the funds be placed in an escrow account or in a trust fund in the territory for the benefit of the payors of those fees, and that the franchisor indemnifies it against claims arising during the time the franchisor or its designee controls the funds.
6. If the franchisor insists upon step-in rights in the case of a notice of default or nonrenewal, the agreement should require the franchisor to indemnify the master franchisee against all claims arising out of its management. It should also specify the extent to which the franchisor may access funds of the master franchisee or make commitments on behalf of the master franchisee beyond what is needed for day to day operation, but in no case, incurring debt without the master franchisee's consent.
7. When a development schedule or other defaults exist under the master franchise agreement, the master franchisee should immediately cure or renegotiate the obligation before closing on the sale of additional unit/subfranchises. Otherwise, the status of the default should be explained in any FDDs used to sell franchises or in acknowledgements in franchise agreements that are being used to sell franchises.

8. The franchisor should agree to assign to the former master franchisee the net proceeds of any claims recovered which were owed to the master franchisee at the time of termination or nonrenewal, less the cost of enforcing the agreement, after all amounts owed to the franchisor and its affiliates have been deducted from the recovery.

5.7 What Happens To Unit/Subfranchisees When A Master Franchise Is Terminated?

The fate of a unit/subfranchisee in a territory formerly subject to a master franchise agreement is often not determined by the terms of a unit/subfranchise agreement or a master franchise agreement. Although the 2014 Multi-unit Franchise Commentary published by the North American Securities Administrators Association (NASAA) requires disclosures in the U.S. about a unit/subfranchisee's rights, no other law really addresses the status of an orphan unit/subfranchisee. According to the Commentary, a master franchisee's FDD "must include a disclosure of the circumstances under which its subfranchise may be canceled, and the effect, if any, that cancellation may have on a subfranchisee's rights to continue to use the franchisor's marks."⁸⁰

The only other regulation to specifically address master franchising is in South Korea, but it does not deal with the issue of an orphaned unit/subfranchisee.

If Franchise Parties can agree on what would happen to unit/subfranchisees when a master franchise agreement ends, they can often draft a roadmap for dealing with the issues. Unfortunately, as the principal drafters of master franchise and unit/subfranchise agreements, franchisors generally do not want to commit to a course of action at the time of the execution of a master franchise agreement. They do not know how many outlets will be operating in the country, the cost of assuming the master franchisee's duties, the availability of a new master franchisee to take over the territory, whether the outlets will be operating profitably, etc., when the master franchise agreement ends. Nor do they know whether, by assuming the contractual obligations of a master franchisee, they will be assuming a significant risk of litigation from unhappy unit/subfranchisees.

Thus, master franchise agreements generally grant franchisors the option to assume the unit/subfranchise agreements when the master franchise agreement ends. Moreover, recognizing the potential effect on the ability of a master franchisee to sell unit/subfranchises, many unit/subfranchise agreements do not include language which would either cause the agreements to terminate automatically upon termination of the master franchise agreement, or grant the master franchisee or the franchisor the option to terminate them.

⁸⁰ NASAA Multi-Unit Commentary, SF 13.0. The Commentary is used by state franchise examiners to interpret U.S. FDD requirements.

Franchisors can draft agreements to provide for assumption of the master franchisee's rights upon termination or nonrenewal of the master franchise agreement. However, they cannot insulate the master franchisee or the franchisor from claims by the master franchisee's former unit/subfranchisees.

A discussion of strategies for dealing with unit/subfranchisees at the end of a master franchise agreement was prepared by Stephane Teasdale and James Susag for the ABA Forum on Franchising in 2013.⁸¹

6. Conclusion

In the foregoing pages, we have identified a seemingly endless list of common mistakes that may arise in the international franchising process. Notwithstanding the existence of common mistakes and problems, we have endeavored to suggest workable approaches for avoiding or mitigating the problems. We are optimistic that our readers will use the information we have provided to avoid many of the problems that we have identified and thereby adopt practices which are more beneficial to all participants in the international franchising process.

* The authors thank Erica Tokar, a Gray Plant Mooty associate, for her significant contribution to the preparation of this article.

⁸¹ Stephane Teasdale & James Susag, *Terminating an International Master Franchisee*, 2013 A.B.A. ANN. F. ON FRANCHISING.

Attachment A

Resources for Selecting the Right International Market

Compiled by Carl Zwisler

- **Commonality of Language and Culture with Franchisor's Home Country**—CIA's *World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/index.html>
- **Corruption**—Transparency International's Corruption Perceptions Index, <http://www.transparency.org/cpi2014/results>
- **Currency Conversion Restrictions**—IMF's Annual Report on Exchange Arrangements and Exchange Restrictions, <http://www.imf.org/external/pubs/nft/2014/areaers/ar2014.pdf>
- **Customs, Duties, Content, Labeling, and Other Import Restrictions**—Export.gov, <http://www.export.gov/%5C/tradeproblems/index.asp>
- **Ease of Doing Business in a Market**—World Bank's *Doing Business*, <http://www.doingbusiness.org/reports/global-reports/doing-business-2015>
- **Franchise Country Ranking**—The EGS GlobalVue™ <http://www.edwardsglobal.com/wp-content/uploads/2011/05/EGS-GlobalVue-1014.pdf>
- **Country Risk**—Euromoney's World Risk Average, <http://www.euromoneycountryrisk.com>
- **Inflation/Deflation**—IMF's World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2014/02/weodata/download.aspx>
- **Laws Regulating Franchising**—
 - Law Business Review, Ltd.'s *The Franchise Law Review* (Edited by Mark Abell), <http://thelawreviews.co.uk/titles/1131/the-franchise-law-review/>
 - Getting the Deal Through, <https://gettingthedealthrough.com>
 - CCH's *Business Franchise Guide* via IntelliConnect, <http://www.intelliconnect.cch.com>
 - *International Comparative Legal Guide to Franchise*, 2015
 - American Bar Association Forum on Franchising's *International Franchise Sales Laws* (Edited by Andrew Loewinger and Michael Lindsay)
 - *International Franchising* (Edited by Dennis Campbell)
 - *International Distribution Institute*, <http://www.idiproject.com>

- **Political And Economic Stability**—World Bank’s World Governance Indicators, <http://info.worldbank.org/governance/wgi/index.aspx#faq>
- International Suppliers
- **Purchasing Power Parity**—*The Economist’s* Big Mac Index, <http://www.economist.com/content/big-mac-index>;
Expatistan Cost of Living Index, www.expatistan.com/cost-of-living
- **Trade Sanctions**—U.S. Department of the Treasury, <http://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx>
- **Withholding Tax Rates and Other Tax Laws, as Adjusted by Tax Treaties**—U.S. Internal Revenue Service, <http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z>

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Prior to joining Greensfelder, Ms. Krakus was an associate with Sonnenschein Nath & Rosenthal LLP. She also practiced in Warsaw, Poland with the Swedish law firm of Magnusson Wahlin.

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