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**THE IMPOSSIBLE DREAM:
CONTROLLING YOUR
INTERNATIONAL FRANCHISE SYSTEM**

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Table of Contents

I.	INTRODUCTION	1
II.	DUE DILIGENCE ON KEY BUSINESS AND LEGAL ISSUES	1
	A. Business Due Diligence	2
	B. Legal Due Diligence	3
	C. Enforcing the Franchise Agreement	5
III.	STRUCTURE ISSUES TO CONSIDER	6
	A. Master Franchising	7
	B. Direct Unit Franchising	8
	C. Development Arrangements	8
	D. Joint Venture Franchising	9
	E. Acquisition	9
	F. Area Representative	10
	G. Global Concerns	10
IV.	INTELLECTUAL PROPERTY ISSUES	10
	A. Trademark Protection	12
	B. Domain Names	12
	C. Copyright	13
	D. Goodwill	13
	E. Know-how/Trade Secrets	13
V.	SECURITY ISSUES	14
VI.	KEY CONTRACTUAL PROVISIONS FOR CONTROL	15
	A. Payment	15
	B. Development Obligations	16
	C. Distribution Controls	17
	D. Competition Law Controls	18
	E. Covenants against Competition Controls	19

F.	Execution Formalities	20
G.	Inspection and Reporting	21
H.	Default and Termination	22
I.	Consequences of Termination	22
J.	Transfer Restriction Controls	23
	1. Mechanism to Impose Transfer Restrictions	23
	2. Content of Transfer Restrictions	24
	3. Enforcement of Transfer Restrictions	24
	4. Other Situations	24
VII.	OTHER PRACTICAL TIPS	25
	A. Working on the relationship	25
	B. Verifying Compliance	26
	C. Providing Incentives to Comply	26
	D. Exploring Practical Enforcement Measures	27
VIII.	CONCLUSION	28

I. INTRODUCTION

Franchise systems stand or fall on the reputation of their brands and the quality and consistency of their product and service offerings. As a result of this, more than for any other business model, it is critical that franchisors understand whether their franchisees are complying with their franchise system standards and that they enforce compliance, especially when going international. This is often not as easy as it sounds.

This paper provides an overview of some of the additional difficulties a franchisor will face in “controlling” franchisees and their franchise systems outside its home jurisdiction. We do not cover all things a franchisor should consider before deciding to “go international” or all of the due diligence in which it should engage. We highlight the research that prudent franchisors will undertake for each new market and some protective measures that may assist a franchisor’s ability to enforce its franchise agreement. We consider contractual provisions that may provide both “carrots” and “sticks” for enforcement and we list a number of practical tips that may assist a franchisor considering international expansion.

Franchising internationally can require more strategic and creative thinking and flexibility than franchising domestically. Franchisors cannot assume that they can simply transplant their domestic franchises overseas and manage them as they would at home. The tyranny of distance, time zones, cultural differences, market differences, unfamiliar business environments, and fewer opportunities to communicate combine to magnify the difficulty for the franchisor. These translate into increased risks and, usually, decreased control. It is important for a franchisor to ask itself whether prospective franchisees truly understand what is required of them and the benefits of following the franchisor’s systems to the letter, with appropriate adaption made to local markets in consultation with the franchisor. If franchisees do not have a clear understanding at the outset of what will be required, the franchisor will have little prospect of "controlling" them as time goes on.

From a pure risk-management perspective, this suggests that franchisors should put more resources into dealing with their international franchisees than with their domestic franchisees, which, of course, is not the objective, in most cases. Franchisors are entrepreneurs and will inevitably take business risks, but they need to know what they are getting into.

Managing these increased risks is a challenge for all franchisors. Ensuring that their franchise agreements can be legally enforced in the relevant jurisdictions is part of the solution, but establishing creative and practical methods of controlling international franchisees can be equally important.

II. DUE DILIGENCE ON KEY BUSINESS AND LEGAL ISSUES

Franchisors should invest significant time and resources in investigating new markets, even if they locate a local master franchisee, area developer, or joint venture partner who will be primarily responsible for local compliance issues.

Franchisors who assume that their franchise agreements should have the same provisions and be equally enforceable everywhere may be in for a nasty and expensive surprise. Franchisors who leave assessment of the local viability of their products and systems entirely to the local master, developer, or partner gamble with their brands. If the franchisee gets this wrong, the brand could be seriously damaged.

Initial due diligence on the business and legal environment in the countries in question is essential. Importantly, if a franchise agreement is to cover more than one

jurisdiction, the due diligence should cover each of them, not just the home jurisdiction of the franchisee. This issue is often overlooked or ignored.

Understanding what is necessary to establish the franchisor's system locally is important. Equally as important is thinking through what might happen if the relationship sours. How can the franchisor enforce its agreement and secure its brand? Does it have an exit strategy that will work in the jurisdiction in question?

A. Business Due Diligence

It is tempting for a franchisor to leave much of the business due diligence to its in-country franchisee. However, if its product or service cannot be lawfully sold in the country or would offend local morés, the franchisor runs the risk of looking unprofessional and doing significant and lasting damage to its brand.

The key areas for initial business due diligence on any new market should, at a minimum, include:

- **Legality of product.** Can the product or service legally be sold in the jurisdiction?¹ Are locally prescribed or recognized business hours more restricted than in the franchisor's home jurisdiction? Do religious holidays or practices affect trading?²
- **Content or composition of product or service.** The product may require significant and costly modification to make it locally compliant or culturally acceptable. For example, many jurisdictions regulate whether a product can be sold as a particular food. If the product does not meet these requirements, it may have to be re-named or re-designed. Local labeling requirements may be impractical or may require the franchisor to divulge confidential information. Certifying food preparation methods may be desirable, even if not required, for religious or cultural reasons.³ Services may need to be modified to comply with religious customs or restrictions.⁴
- **Import costs.** There may be tariffs or other local taxes or duties imposed on the import or sale of products that make them uneconomical.
- **Industry regulation.** There may be industry-specific regulations that could introduce additional costs or impractical requirements.
- **Suitability of offering.** Even if the franchisor's product or service can be sold legally in the market, it may be entirely unsuitable for that market. The name of the brand may translate poorly or the product or its trade dress, such as its color, may be culturally insensitive or simply unpopular.
- **Local costs.** Assumptions the franchisor makes as to what is practical and affordable may be quite different. Employment or real estate costs may lead to a significantly higher cost of sales. Franchise systems relying heavily on local supply chains may not find suitable, affordable suppliers. The provision of rebates to local or off-shore suppliers may be prohibited.

¹ For example, pork products and alcoholic beverages cannot be sold in Kuwait.

² In some Muslim countries, food and drink cannot be served in the daytime during Ramadan.

³ Such as Halal certification for restaurants in Indonesia or Malaysia.

⁴ For example, hotels in Israel need to modify some services on the Sabbath, such as the operation of swimming pools and health clubs.

- **Jurisdictional risks.** Even if the franchisor's product is lawful and suitable for a particular market, the market itself may carry significant risks, such as political instability or the threat of civil disturbance or terrorism.
- **Payments.** Most importantly to the foreign franchisor, do local exchange control and/or tax laws prohibit or restrict payments the franchisor would expect to receive from the local franchisee or require payments to be made in local currency?

While it is also important to conduct due diligence on the prospective franchisee, this is a topic in itself and beyond the scope of this paper.⁵

B. Legal Due Diligence

Local laws can affect the viability of a franchise system and the franchisor's ability to control the franchisee in a variety of ways. Some due diligence on legal issues should be carried out before a draft franchise agreement is provided to potential franchisees.

If the franchisee's brand cannot be used in the jurisdiction, there may be little point in proceeding with the franchise offer. Permitting foreign franchisees to operate under different brands involves additional cost and may defeat the objective of enhancing the franchisor's brand internationally.

Initial legal issues that should be checked with local counsel include:

- **Trademarks.** Whether the key trademarks have been registered and are available. Although some franchise systems have launched under different brands in one or more foreign markets,⁶ doing so is messy and expensive, and builds goodwill for a brand in which the franchisor has no long-term interest. Whether the franchisor's trademark must be registered before it is licensed to a third party to avoid breaching local law.
- **Disclosure or registration.** Whether local laws require any form of disclosure or other step(s) to be taken by the franchisor before the franchise is advertised, before speaking to or meeting with a prospective franchisee, before signing a binding or non-binding letter of intent or accepting any payment.⁷ Whether local franchise laws require a regulatory filing or approval before a franchise agreement can be offered or executed.⁸
- **Mandatory franchise law or technology transfer provisions.** Jurisdictions that have franchise laws often require that certain matters be included in franchise agreements, some of which go to the fundamental elements of the franchise offering, others to the form of the franchise agreement. These include a prescribed minimum term of agreement,⁹ a

⁵ On this topic, see Michael Santa Maria, Jane Woods La Franchi and Penny Ward, *Due Diligence on Prospective Foreign Franchisees*, in INTERNATIONAL FRANCHISE ASSOCIATION, IFA 38TH ANNUAL LEGAL SYMPOSIUM (2005).

⁶ For example, in Australia, many BURGER KING stores are known as HUNGRY JACK'S and, in the UK, KWIK KOPY is called KALL KWIK.

⁷ Countries having disclosure laws in Europe include Belgium, France, Italy, Romania, Spain, and Sweden; in the Asia Pacific, these include Australia, China, Japan, Indonesia, Malaysia, South Korea, Vietnam and Taiwan; and, in the Americas, Brazil, Canada, Mexico and the U.S. For more information, see ABA FORUM ON FRANCHISING, INTERNATIONAL FRANCHISE SALES LAWS (Andrew P. Loewinger & Michael K. Lindsey eds., 2006 & Supp. 2009).

⁸ Such as Malaysia and Mexico.

⁹ Such as Malaysia.

mandatory “cooling-off” period,¹⁰ obligatory dispute resolution provisions,¹¹ and a requirement that the agreement be written in the local language¹² or that it have a local governing law. Due diligence on this issue should not be limited to jurisdictions having franchise laws, as “technology transfer” agreements and trademark licenses are sometimes required to be registered or to include mandatory provisions.¹³

- **Franchise structure.** Whether the proposed franchise structure would breach any local laws, such as those related to pyramid selling, or, for local law reasons, the franchise and trademark license should be separated.¹⁴
- **Local presence.** Whether the jurisdiction requires the franchisor to establish a local subsidiary or branch, or to operate its own outlet for a period before it engages in franchising.¹⁵ Whether foreign investment or foreign ownership laws might restrict the franchisor from establishing or investing locally or stepping in to take over leases and assets and operate outlets if the franchisee is in breach or on termination.
- **Travel restrictions.** Whether visas will be available in the franchisor’s country for the franchisee’s personnel to visit and in the franchisee’s country for the franchisor’s personnel.
- **Compensation.** Whether any local laws relating to termination or non-renewal of agencies, distributorships, or franchises would require the franchisor to compensate the franchisee at the end of the franchise relationship. Whether local law would restrict the ability of the franchisor to recover damages for a breach of the agreement by the franchisee, and how the damages would be calculated.
- **Conduct laws.** Whether local franchise laws, unfair contracts, or other laws or equitable principles would affect the franchisor’s ability to enforce its franchise agreement in accordance with its terms and, if so, whether the application of these laws can be modified or excluded.¹⁶

Advice from local counsel should be sought on the changes that are necessary for or desirable to the franchisor’s franchise agreement for use in the jurisdiction. Changes will inevitably be required, even if the governing law is to remain that of the franchisor’s home jurisdiction. This is because local statutes and public policy will often apply, regardless of the choice of law.

While it may be tempting from a cost perspective to limit the role of local counsel to advising on changes that are compulsory, local counsel can provide valuable advice regarding provisions of a franchisor’s agreement that may be difficult to enforce locally for a variety of reasons and should be able to suggest alternatives that are more likely to be enforced.

¹⁰ Such as Australia.

¹¹ *Id.*

¹² Such as Vietnam.

¹³ Such as the technology transfer laws in the Philippines and trademark laws in Thailand.

¹⁴ In India, trademark licenses having royalties over a certain level require government approval, but no approval is required for franchise fees.

¹⁵ China had such a requirement and Vietnam still does.

¹⁶ Such as a duty of good faith implied as a matter of contract, rather than imposed by local statute.

Franchisors may wish to consider whether local law may be more generous to the franchisor than the law of the franchisor's home jurisdiction. For example, many jurisdictions may permit a higher degree of control over a franchisee than in the U.S., without a franchisor running the risk of being found vicariously liable for the acts of the franchisee. This possibility of additional control, or at least the right to direct the "time, method, and manner" of performance, may be particularly useful internationally.

Areas that commonly require "localizing" in franchise agreements include:

- Provisions relating to antitrust issues, such as relating to exclusive supply arrangements, pricing issues, exclusive territories, and marketing restrictions.
- Restraints of trade and confidentiality provisions, as local courts may not have the ability to "blue pencil," or scale back, these provisions if they are found to be too broad; in the case of a post-term restraint, they may simply be unenforceable.
- Privacy or data protection provisions, including ensuring that franchisees can pass customer data to the franchisor, if required.
- The scope and content of the trademark license, the need for any registration of the franchisee's use of the trademark, and the right or inability of the franchisee to commence infringement proceedings on behalf of the trademark owner.
- Limitation of liability provisions.
- Tax provisions, including structuring payments in light of local tax laws and practice.
- Copyright, to ensure that ownership of all translations, localizations, and improvements made by or for franchisees to system materials are owned by the franchisor.
- Termination provisions, including dealing with any sub-franchisees after termination and whether exercising a termination right would waive any rights to damages relating to the termination.
- Liquidated damages provisions, which may need to be restructured to avoid being unenforceable as a penalty, and provisions requiring the payment of interest, which may be prohibited by local law.
- Preliminary relief, such as injunctions, where local law may not otherwise allow these without the agreement of the parties.

C. Enforcing the Franchise Agreement

Whether a franchisor can control its foreign franchisees may come down to the enforcement provisions of the franchise agreement. The choice of whether to litigate or arbitrate, the choice of venue, and the choice of rules and laws under which any arbitration may occur will be critical.

If a franchisor proposes to rely on litigation to enforce the agreement and the home countries of the franchisor and the franchisee are not parties to the New York Convention on

the Enforcement of Arbitral Awards,¹⁷ the franchisor should question the practicalities of litigating in its home jurisdiction.

If arbitration is to be chosen, the franchisor should consider which arbitral body¹⁸ is likely to be the most practical, fair, unbiased, and cost-efficient, given the jurisdictions involved. It should also consider the number of arbitrators, the language and governing laws of the arbitration, and the assignment of responsibility for the costs of the arbitration and for each party's legal costs.

Although franchisors are understandably reluctant to choose a forum other than their own, enforcement ultimately means enforcement against the franchisee's assets, wherever they are located, and the ability to obtain enforceable orders against the franchisee to prevent infringing conduct. Unless a franchisee's home jurisdiction is unfriendly to franchisors or to the franchisor's home jurisdiction, the franchisee's jurisdiction should not be ruled out as an appropriate venue.

Similar issues arise in relation to the choice of law. In reality, a franchisor is far more likely to wish to sue its franchisee than the reverse. As a result, the dispute resolution provisions should be considered, on a case-by-case basis, bearing in mind the most efficient way to obtain a binding and enforceable judgment in the franchisee's home jurisdiction.

Importantly, before signing a franchise agreement, a franchisor has to understand whether there are any local requirements regarding execution or registration of the franchise agreement that may affect its enforceability. These are discussed further below.

Due diligence on enforcement should not be limited to the period before the agreement is signed. Local laws affecting termination, and the interpretation of those laws, will change over time. It may be critical to investigate these with local counsel before taking any enforcement steps, even if the franchisor's home jurisdiction is the governing law of the contract. Franchisors cannot assume that a power written into a franchise agreement that may be enforceable at signing will remain enforceable over time, or that it will be enforceable in all circumstances. Franchisors and their counsel who fail to take local advice on their ability to enforce and the consequences of enforcing do so at their peril.

Although all litigation is risky, litigation in an international context inflates the risk. Franchisors should pick their battles carefully, ensuring that they only pursue litigation in which their prospects of success are good. A failed attempt to enforce a franchise agreement internationally may suggest to the franchisor's other international franchisees that the likelihood or prospect of enforcement in their jurisdictions is remote. The franchisor's objectives may, in some cases, be met if the franchisor obtains a court order requiring a franchisee to comply with its franchise agreement or a court declaration that the franchisee has been in breach, which may be easier for the franchisor to obtain than an order confirming the effectiveness of a termination.

III. STRUCTURE ISSUES TO CONSIDER

The franchisor has a number of choices of structures for international expansion. Each structure contains its own set of issues, challenges, and advantages. The structure for any expansion into a new market is an important factor in determining a franchisor's eventual success. However, no single vehicle is ideal for every international expansion. When choosing an international expansion structure, there are a number of key considerations that must be addressed, such as control, resources, unique characteristics of the local market,

¹⁷ www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html.

¹⁸ Such as the American Arbitration Association, International Chamber of Commerce, or London Court of International Arbitration.

local legal barriers, training, available human resources, and the challenge of creating and maintaining local distribution networks.

There are a number of methods a business can use to develop international operations and build a global brand, including the following:

A. Master Franchising

Master franchising is a popular expansion structure in the international arena. The term “master franchising” is used to describe an array of relationships and arrangements, including sales agencies, multi-unit agreements with no sub-franchising rights, and arrangements by which the franchisor grants the master franchisee exclusive rights for the development of the system within the territory, including the right to sub-franchise.

However, in a classic master franchise structure, the franchisor grants a master franchisee the right to offer units to sub-franchisees. Depending on the size of territory and whether exclusivity is provided, the responsibility for developing the system in the new territory, including distribution networks and training programs, rests with the master franchisee, rather than the franchisor. As a result, this approach requires fewer resources and significantly less capital investment by the franchisor. Additionally, the local master franchisee will likely be more familiar with its own market than the franchisor, which will benefit from the master franchisee’s knowledge and contacts.

Master franchise arrangements do, however, have some disadvantages. While the structure is useful for spreading costs of administration, training, and support, much depends on the quality of the master franchisee. There is so much riding on the qualities, resources, and relationships of the master franchisee that a wrong choice can wreak havoc on a franchisor in the market for years. Finding the right master franchisee can be time-consuming and expensive. The best master franchisees may also demand a better return on investment than ones of lesser quality. Additionally, the existence of the master franchisee, as an additional layer between the franchisor and the unit franchise operator, can make it much harder for the franchisor to control the system closely.

While it is tempting to choose a single master franchisee for an entire country or region, because of the challenges outlined above, sometimes it is better to divide the territory into smaller chunks and have several master franchisees. Canada, for example, functions commercially more like four countries than one. Few master franchisees have done a superior job of fully developing a franchise system throughout Canada. In some countries, one master franchisee may not be able to manage the entire territory. Granting the whole of the European Union or the Middle East to one master franchisee may result in strong development in only parts of those territories, leaving other valuable opportunities unrealized.

It is important to set clear growth (and unit maintenance) targets for the master franchisee. On the other hand, most targets in master franchise arrangements are not met.¹⁹ Consider using multi-tiered growth incentives and giving rewards for good performance, while suspending certain rights (e.g., exclusivity) for failing to meet goals. In an ideal world, the franchisor might develop targets by testing the market through an initial direct franchise arrangement. However, that rarely happens, so the franchisor is left to study the market in other ways to determine the unit levels that can and should be attained. Master franchisees are very often required to own and operate one or more stores in order to familiarize themselves with the business and maintain their awareness of changes in the marketplace.

¹⁹ Arturs Kalnins, *Biting Off More than They Can Chew: Unfulfilled Development Commitments in International Master Franchising Ventures*, 5.12 CHR Reports 1, 8 (2005).

An important issue in structuring a master franchise agreement is the nature and content of the unit franchise agreements to be granted by the master franchisee. On the one hand, the franchisor will want to have continuity and the comfort that comes from requiring the use by the master franchisee of the form of unit agreement used in the franchisor's home jurisdiction. The master franchisee will want to have some flexibility to adapt the pro-forma agreement for local customs, circumstances, and laws. The master franchisee may also wish to have some flexibility to vary the standard agreement for special deals and situations. Translation of the pro-forma agreement into a local language may also be required by law or local market forces. Who does that translation, its cost, and its accuracy are some issues that need to be addressed. In the final analysis, there usually has to be a workable balance between the needs of the franchisor and the master franchisee.

The question also arises as to whether the franchisor should be a party to the unit franchise agreements to better enable it to take over the local network and enforce unit franchise agreements. This approach always carries with it at least a modicum of contractual risk. Alternatively and, it is suggested, at a minimum, the master agreement should contain a provision allowing the franchisor, at its option, to take an immediate assignment of all unit franchise agreements upon or before termination of the master franchise agreement. To close the loop, it should be required that the unit franchise agreements contain provisions permitting the master franchisee to assign the unit franchise agreements without any consent from or notice to the unit franchisees. An alternative approach would be a provision in the unit franchise agreements appointing the franchisor the agent of the master franchisee for the purposes of enforcing the terms of the unit franchise agreement or effecting any assignment.

B. Direct Unit Franchising

If the franchisor is familiar with the foreign market and capable of providing the support, it may opt to franchise directly to unit franchisees, taking responsibility for recruiting, training, and supporting a franchise network through long-distance control from the headquarters, a subsidiary office in the target country, or an appointed agent. This structure maximizes control by the franchisor and minimizes certain risks, but can result in slower growth and will often require a higher level of financial commitment and allocation of management resources.

Single-unit franchisees, who tend to be smaller and less sophisticated independent owner/operators, generally require greater levels of support than would a more sophisticated multiple-unit franchisee. This may also mean that the foreign franchisor will need to purchase or find local advice and contacts by itself, and to establish its own local distribution networks. Navigating the local market can be onerous and challenging.

C. Development Arrangements

Multi-unit franchises, area development arrangements, and territorial development arrangements are some of the names applied to situations where a single franchisee is given the right to open two or more franchises in a given territory. Sometimes, a franchisee will acquire multiple units by evolution, as the franchisee grows and prospers. Sometimes, franchisees acquire multiple units by operation of rights of first refusal originally granted to the franchisee for additional units within areas contiguous to the franchisee's original territory. Often, rights of first refusal are granted by the franchisor as inducements to sell franchises. A cautious approach should always be taken when considering whether to grant to one franchisee the right to open multiple franchise units in a system. Multi-unit franchisees are usually financially stronger and more sophisticated businesspeople. This can be an advantage in good times and a disadvantage when trouble arises, because such a franchisee can be a more formidable adversary and a more demanding "customer" than

single-unit franchisees. Area or territorial development arrangements will be most advantageous where the area or territorial franchisee has extensive knowledge and connections in a market that is more distant from the markets in which the franchisor is already present.

The agreements that support such arrangements need to be carefully constructed. Some important considerations are:

- The territory should be no larger than is manageable by the franchisee.
- There should be clear and appropriate performance criteria that must be met by the franchisee to maintain exclusivity in the territory.
- There should be cross-termination provisions among the agreements for each unit.
- The support commitments of the franchisor should be appropriately adjusted, given the greater resources and responsibilities of a territorial franchisee.

D. Joint Venture Franchising

Joint venture franchising occurs when the franchisor takes an equity position or a partnership role in the franchisee entity. Joint venture franchising can be used with virtually any franchise vehicle, from unit franchises to master franchises. Joint venture franchising has two distinct levels of contractual relationship. At the franchisee level, the franchisor will want to have a shareholders' agreement, partnership agreement, or joint venture agreement in place. In addition, the franchisor will want to have its customary franchise documentation in place between itself, as franchisor, and the franchisee entity in which it has an interest. The reasons for creating a joint venture structure include:

- The franchisor's desire for greater control/influence over the franchisee entity.
- The franchisee's need for temporary or permanent capital from the franchisor.
- The franchisor's desire for a greater return from the operations of its franchisees.

Under a joint venture, the franchisor shares ownership of an operating entity with a local partner. In practice, this type of arrangement does not change the system; rather, it allocates ownership and risk in a unique manner. It can be used to take advantage of the foreign partner's local knowledge, and to gain business or tax advantages in markets where locals are accorded preferential treatment. It can also provide a source of capital, although it is more usual for the franchisor to provide the resources and its local partner to offer expertise. Because the franchisor is working on a more equal basis with its partner, it may have more control over the system than under a master franchise arrangement. However, it will likely also have more responsibility for developing the system in the territory, i.e., establishing distribution networks, franchise sales, training programs, etc., due to its higher level of involvement.

E. Acquisition

The acquisition of a competitive business can be one of the quickest ways to expand a franchise system internationally. The target company may be another franchisor or a multi-unit business that is capable of being converted into a franchise network. While the rewards in this type of expansion strategy are great, the challenges and risks are even greater. Such acquisitions raise issues of territorial exclusivity and encroachment, re-branding, changes in

business culture, and management transition. The franchise issues are overlaid on top of the usual and customary issues of any business acquisition.

F. Area Representative

Another alternative may be to enter into an area representative arrangement, under which the franchisor grants rights to a local entity to market franchises, and train and support franchisees on behalf of the franchisor. The area representative is often rewarded with a share of ongoing royalties, front-end franchise fees, renewal fees, etc. This is more of an agency or broker arrangement than a franchise structure and, if structured properly, can itself avoid the application of franchise disclosure laws. However, like single-unit franchising, the franchisor often ends up dealing with unit franchisees directly, despite the presence of the representative. Thus, it may not offer significant advantages over other structures.

G. Global Concerns

The following are important matters to keep in mind in deciding upon the best structure:

- **Taxes.** Different structures have different tax implications. It is important to determine as an initial matter whether the franchisor will be a North American entity or a local subsidiary or joint venture. Consider the nature of any payments being made and how taxes will affect the revenue stream, at both the target level and the home level. Be very aware of local tax laws, and consider whether it is possible or advisable to use special purpose entities. Understand that certain tax treaties may result in withholding taxes.
- **Franchise, agency, and other legal regulation.** Some structures may be limited by local laws, or impelled by them. For example, creating a joint venture can get around otherwise onerous local ownership requirements. Be prepared for administrative red tape, especially in less commercially developed markets.
- **Relationship issues.** The franchisor should determine the degree of control it will require over the system, and be realistic about what to expect under different structures.
- **Resource issues.** The quality and quantity of human resources needed will be different for different structures. Ultimately, resource issues often determine the structure. These include the capital resources available for expansion. Where these are limited, a master franchise arrangement may be the only practical possibility. Likewise, consider what it will take to deal with the physical distance between markets. The costs of travel, sending corporate materials, translation, and possibly a branch office can be extremely high.

IV. INTELLECTUAL PROPERTY ISSUES

Intellectual property rights, such as trademarks, copyright, and patents, are some of the most valuable assets of a franchise system. Increasingly, with the growth of the Internet and global communications, North American brands have value in other countries long before the products and services are available there. Certainly, if a franchise brand is successful in North American countries, the marketing of the franchises in the system will be that much easier in other countries. In fact, it is arguable that the first point of investigation

before entering a foreign market should be with respect to the availability of the system trademarks for use in that market and the ability to protect and grow the brand there. Franchisors that wish to expand their horizons beyond North America, by offering their products or services through franchisees in foreign markets, must consider the selection of their trademark carefully, as the same mark can be received differently by foreign consumers and intellectual property offices.

Distinctiveness is a basic requirement for registration of a trademark in most countries. However, some countries may permit registration of a mark that may become distinctive when used over a number of years, to create a sufficient reputation and be recognized by consumers. However, marks that are only “capable of being distinctive” are usually more difficult and costly to register, and, for countries that follow British law, may even be put on a separate register.

The following list offers general requirements and suggestions for the selection of an international trademark:

- The name of a company, individual, or firm may be registrable but may be required to be presented in a special or particular manner, and registrations of designations such as “Inc.” or “Co.” may not be allowed.
- Invented words constitute the best trademarks because they are inherently and, therefore, *prima facie* distinctive.²⁰ However, what constitutes an invented term is always a matter of debate between the trademark office and the applicant, and the final determination is a question of fact.
- If a mark is a geographical name, it may not qualify for registration. However, the mere fact that a proposed mark also denotes some location or geographical feature may not cause objection unless it appears that the goods have some connection with the particular place or the applicant is attempting to suggest a connection that does not exist.²¹
- A surname may also be excluded from registration unless the mark is both a rare surname and an ordinary word with a specific meaning that is much more commonly known.
- Words that are clearly laudatory or descriptive do not qualify for registration.
- Pictorial or design marks and graphic designs may be distinctive if they do not reference the character or quality of the goods they identify. Design marks are especially useful in countries with low literacy, where consumers may recognize a device or an image more readily than a word mark.
- Ordinary letters and numbers may not be registrable or will suffer from a very narrow scope of protection, even though it may be common practice among traders to use their company initials.
- Marks must not be offensive to morality.²²
- A mark must not contain a negative connotation within a particular jurisdiction.²³

²⁰ For example EXXON, Spandex, and Kodak,

²¹ For example Bordeaux for wine from that region in France.

²² For example, the OPIUM trademark for perfume was initially considered scandalous but was eventually accepted in most jurisdictions except Hong Kong.

²³ For example, “mist” is acceptable in English markets but means “manure” in German.

The following is a summary of how to protect intellectual property assets in an international franchise project:

A. Trademark Protection

To protect the validity of a trademark, the mark must be licensed in accordance with the trademark license requirements of the particular jurisdiction in which it is used. For example, in Canada, for a valid license to exist and for the goodwill generated by the franchisee to inure exclusively to the benefit of the trademark owner, the owner must have direct or indirect care or control over the character and quality of the wares and services offered in association with the trademark.²⁴ The trademark license itself should provide for these controls and the franchise agreement and/or the trademark license agreement should address issues of liability and indemnity. The protocols set out in the trademark license agreement should be clear and should be practiced. Failure to implement the controls set out in the license, also known as “naked licensing,” can result in the license being found invalid and the marks non-distinctive.²⁵ As mentioned, if a mark is not distinctive with respect to its owner, the owner will lose the exclusive right to its use. Conversely, the owner does not need to have control over the quality of the wares and services associated with the mark in other jurisdictions, such as Egypt, Germany, Hong Kong, Japan, South Africa, and Taiwan.²⁶

For those jurisdictions in which control is required, in the event that a franchisee fails to observe the protocols in the license to the point where the franchisor believes that the validity of the mark is in jeopardy, the franchisor might consider bringing an action to enforce the license and, if the franchisor takes the position that the franchisee is no longer a licensee, a trademark infringement proceeding.²⁷ Typically, in a trademark infringement proceeding, the owner will request a declaration that the mark has been infringed, an injunction to prevent the previous franchisee from continuing to use the mark, and damages or an accounting of profits.

B. Domain Names

It is important to register domain names together with trademarks as part of an overall intellectual property protection program. The possession of a trademark does not give any rights to specific domain names, although a domain name may give rise to trademark rights if it acts as a source indicator.²⁸ Domain names are registered with a registrar accredited by the Internet Corporation for Assigned Names and Numbers and should be registered in the name of the franchisor. The franchisor may then license the use of the domain name to the franchisee, if possible, or work with the franchisee to generate and control the content on the relevant web page. In addition, the contract should contain a specific provision on domain name usage and franchisee websites. The website should, for example, include proper trademark notices and a legal line or statement that identifies the owner of the marks and the fact that they are used under license.

The franchisee will want to operate a local-language website to advertise its business. In most cases, the franchisor will benefit from the publicity generated by such a website, provided the website conforms to the quality standards and general image of the brand. Contracts that prevent franchisees from operating their own websites are, therefore,

²⁴ Trademark Act R.S.C. 1985, c. T-13 at § 50.

²⁵ “Naked licensing” is a term used in U.S. law. A trademark was found invalid for this reason in *Barcamerica International USA Trust v. Tyfield Importers, Inc.*, 289 F.3d 589 (9th Cir. 2002).

²⁶ Kenneth S. Kaplan, Andrew P. Loewinger and Penny J. Ward, *Systems Standards in International Franchising*, in American Bar Association, 28th Annual Forum on Franchising (2005; unpublished).

²⁷ *Id.* Some countries in which this type of action is allowed are Argentina, Australia, China, Germany, Hong Kong, India, Indonesia, Israel, Japan, Korea, Mexico, South Africa, Taiwan, and the United Kingdom.

²⁸ For example, *selloffvacations.com* is both a domain name and a registered trademark in Canada.

unhelpful. It is better to regulate appropriately, in the franchise agreement, the rules that apply to franchisee websites.

C. Copyright

When granting a franchise, a franchisor will typically document its confidential business methods and trade secrets in one or several manuals. Most retailers create store operating manuals and marketing manuals. Other copyright items used in a franchise are marketing materials, shop-design plans, and local-language translations of the manuals.

A number of issues arise in connection with manuals and other copyright items used in a franchise relationship. First, it is important to state clearly who owns the copyright. Normally, ownership will be with the franchisor. Further, the agreement with the franchisee should state that the copyright in any and all additions or improvements to the manuals will vest with the franchisor or will otherwise be assigned to the franchisor, and the franchisee or author should waive any moral rights they may have in such additions. In those jurisdictions where moral rights cannot be waived,²⁹ a specific provision should be included that gives the franchisor complete freedom to alter and distribute or otherwise exploit the improved manual or document. Translations, for example, are a danger area, as the copyright in a translation will vest in the translator unless otherwise agreed.³⁰

Another difficulty in relation to the use of copyrighted material in international franchising is the issue of “localization.” As a rule, there will be certain peculiarities in each territory that will make it necessary to make certain amendments to the manuals. Often, these amendments are suggested by the local partner. As above, it is important to have a strict process in place for approval of local amendments. Otherwise, the local partner will feel free to “improve” the system without asking and may even claim “ownership” of any such improvements. Depending on the nature of the “improvement” made, it may be necessary for the franchisor to offer to pay a reasonable license fee for its use. This applies particularly to patentable improvements.

D. Goodwill

The goodwill of the franchisor needs to be protected and the trademark license should stipulate that the goodwill generated by the franchisee by use of the trademark inures exclusively to the benefit of the trademark owner. The franchisee will benefit from the “goodwill” created by the franchisor. Goodwill is the benefit and advantage of the good name, reputation, and connection of a business.³¹ Often, it is thought that, by protecting the trademark, the goodwill is also protected. However, there are aspects of the goodwill that are not captured by the trademark. These should be addressed separately by stating clearly that the goodwill belongs to the franchisor. Further, any damage done by the franchisee to the “goodwill and reputation” of the business should entitle the franchisor to terminate.

E. Know-how/Trade Secrets

Most franchise systems are based on trade secrets and confidential know-how, rather than patents or registered designs. Sometimes a franchise can be based on a unique product protected by a registered design. For example, the Croc Shoe Shop concept is based not only on a registered trademark but also on a registered design for the “Croc” shoe.³² In industrial services franchises, patented processes are sometimes used. However, 90 percent of all franchise systems rely on know-how and trade secret protection and do not register a

²⁹ For example, in France and China.

³⁰ Babette Märzheuser-Wood., *IP Protection in Franchise Agreements*, In-House Lawyer, July 2008

³¹ *IR Commrs v. Muller and Co's Margarine Ltd.*, [1901] A.C. 217, 223 (H.L.).

³² *Supra* note 30.

patent. Often, the type of know-how used in a franchise is not patentable. It is, therefore, particularly important to contractually protect the confidential know-how of the franchisor.

Traditionally, know-how protection takes one of the following three forms:

- Confidentiality provisions.
- Restrictive covenants.
- Protection based around unfair competition and criminal trade-secret theft law.

It is very important to include a strong confidentiality clause in a franchise agreement. The franchisor needs to define, in no uncertain terms, the elements of its system that it regards as confidential. Otherwise, there is a significant risk that the franchisee will consider some of the business processes as part of its acquired skills. Where this happens, the franchisee will consider itself free to use those skills in a new, competing business.

The granting of a franchise involves the licensing and transfer of many valuable intellectual property rights. It is of extreme importance that the various risks associated with international intellectual property licensing are properly understood and regulated in the contract.

V. SECURITY ISSUES

Many franchisors use performance and financial guarantees in the hope of ensuring that the obligations of a franchise agreement will be satisfied if the franchisee does not perform. Guarantees can be an effective means to deter a franchisee's violation of a franchise agreement and encourage cooperation. Personal guarantees are typically requested in international transactions because often international franchisees are owned by individuals with significant assets available for execution of a judgment. Corporate guarantees are also viable options for a franchisor, but they present their own unique issues. In general, a franchisor must ensure that all applicable corporate consents and formalities have been followed by the franchisee. Finally, regardless of whether a personal or corporate guarantee is used, the effectiveness of any guarantee will depend upon how difficult it is to execute on the assets supporting the guarantee.

Apart from any structuring issues related to guarantees, depending on the jurisdiction, there may be drafting requirements and execution formalities to observe. Observing these requirements may assist the franchisor in defending any challenge that the guarantee is a contract of adhesion, is unconscionable or is not authentic.

Most jurisdictions will enforce a guarantee if it complies with local drafting or execution requirements, so franchisors should consult with local counsel to ensure the guarantee meets all the local requirements.

One-sided or oppressive clauses in adhesion contracts can be void where an entity or individual renounces rights or waives personal notifications.³³ To avoid this issue, a franchisor may draft an express acknowledgment in its guarantee that the document has been negotiated by the parties. In addition, in the event of a dispute, the franchisor should retain evidence of changes made during those negotiations. Because a guarantor's waiver of demands and notices could amount to a one-sided contract of adhesion, franchisors frequently limit such notices to renewal or extensions of the guarantee or to notices regarding modifications and amendments of financial obligations.

Typically, a guarantee will state that the franchisor need not pursue all remedies

³³ Such as provided for in the Antitrust Act of Panama.

against the franchisee before proceeding against the guarantor. However, in Indonesia, for example, the courts will not enforce a guarantee, unless the primary debtor (in this case the franchisee) has exhausted its own assets. Although this provision may be waived in certain instances, an Indonesian court may invalidate the waiver and determine that the guarantor is not financial liable. In China, personal and corporate guarantees are rarely used. The government (whose approval is required for a guarantee to be enforced) discourages them and they are difficult to enforce.

In countries where a personal guarantee may be difficult to enforce (or if there is a concern that there will be few assets left to satisfy a judgment if the franchise fails) a franchisor could obtain a letter of credit or a bank guarantee in an amount adequate to protect a franchisor's interest. A letter of credit is generally the franchisor's most efficient and secure option for protecting its interests. The letter of credit is typically issued by a bank in the franchisee's home country and confirmed by a bank of the franchisor's choosing (the "confirming bank"). A franchisor can draw on the letter of credit by submitting to the confirming bank an affidavit or other required documentation with instructions to make payment to the franchisor in a specified amount (up to the full amount of the letter of credit).

In general, bank guarantees are less desirable than letters of credit. Bank guarantees require the franchisor to exhaust its remedies against the primary obligor before the issuing bank will honor the bank guarantee.

In the case of both letters of credit and bank guarantees, banks usually require significant deposits and fees.

VI KEY CONTRACTUAL PROVISIONS FOR CONTROL

It is essential that the franchisor consider carefully the provisions in an international franchise agreement that will assist its control of the system. Some of the key provisions that will affect control are discussed below:

A. Payment

Generally, in international transactions, the initial fee for franchise rights is calculated in one of two ways. It is either a fixed fee or a fee based on a quota or on performance. A fixed fee may be payable upon execution of the franchise agreement or on a periodic basis during the term of the agreement. Quota fees may be payable upon reaching certain gross sales levels or upon the sale of individual sub-franchisee or franchisee-operated units. Alternatively, a minimum sustaining quota fee may be charged for the franchisee to retain its exclusivity or any franchise rights under the agreement. Often, sustaining quota fees are calculated on an annual basis.

Because franchisors frequently underestimate costs to expand their systems overseas, some franchisors control their costs by requiring their franchisees to reimburse the franchisor's expenses in developing products and services or the franchise system itself for target markets. Examples of reimbursed expenses include:

- All expenses incurred in connection with the conversion of the franchisor's packaging, signage and advertising materials to the target country.
- All expenses incurred related to governmental reviews and approvals.
- All expenses incurred by the franchisor in connection with training the franchisee and its staff, communications expenses, translation and other development costs for the operations manual and other franchise system materials, and legal and

other professional costs and expenses incurred in connection with the development of the franchise documentation.

Reimbursement of the franchisor's expenses may occur upon execution of the agreement or after a test period or some other initial period of the agreement, such as when a prescribed number of units are opened in the target country. Alternatively, it could occur throughout the entire term.

For those fees incurred by the franchisor for the development of individual franchisee locations, the franchise agreement may provide for payment to the franchisor of fees for a specific number of initial outlets or additional outlets. The fee could be expressed on a fixed amount basis, a per unit basis or on some formula basis. Continuing fees are often expressed as a royalty, computed as a constant or variable percentage of gross sales or revenues of the franchisee. They may also be expressed on a fixed fee basis for each unit developed. The agreement could also provide for minimum periodic fees, which are usually calculated on a quarterly or annual basis.

All definitions of gross or net sales will frequently provide for certain exclusions from revenue subject to fees, including refunds, discounts, taxes and other similar non-profit items to the franchisee. The international franchise agreement may also stipulate that the fees will be subject to an inflation factor or adjustment based on an objective published cost of living or other index, particularly in countries with high inflation records.

The agreement must stipulate the mechanics for payment of fees, including the frequency of payment, interest on late payments and the methods of payment, as well as the possibility of payment to a designated bank account of a franchisor in the target country. Where withholding taxes are due on fees paid to the franchisor from the target country, the fees may be written to break up or stipulate specific components as allocable to certain services that may not be subject to withholding tax. This may include technical assistance services, training, rights to know-how, license of the franchisor's trademarks, site selection, inspection and consultation fees.

B. Development Obligations

The franchisee in an international franchise agreement is typically provided certain development rights and obligations. These rights are frequently defined in terms of a specific number of units that the franchisee, its affiliates or its sub-franchisees are obligated to own and operate.

The agreement also provides for a development schedule that specifies a minimum number of units to be opened and operated during a development period (usually expressed on an annual basis); a cumulative number of units that must be opened and in operation at the end of each development period; a provision dealing with any destroyed, closed or terminated outlets; and the ability of the franchisee to accumulate units developed beyond any quota requirements.

In countries or territories with multiple political, geographic or economic regions, development obligations may be expressed in terms of these specific territories, rather than being expressed on a broader target country basis.

The franchisee is typically required to own and operate one or more franchised units. Regardless of the specific numerical requirements, a specific form of agreement should be executed for each unit. **[Explain why; in addition, this sentence would seem to fit better later in the paragraph.]** The agreement may stipulate that the franchisee is required to open and operate a certain number of units itself or own and operate units for a minimum

period of time before being granted the right to sub-franchise. In some instances, the franchisee's right to continue to sub-franchise is also subject to its ability to own and operate a specified number of units during the term of the agreement.

For those agreements permitting or requiring sub-franchisee units, the franchisor may wish to have certain information provided to it prior to approval of such units or even the sub-franchisees themselves. The franchisor may specify certain site selection criteria and certain franchisee selection criteria as threshold criteria rather than having to approve each unit and each sub-franchisee. Alternatively, the franchisor may provide for the right to approve each site either during an initial period or throughout the entire term of the agreement.

If the franchisee fails to comply with its development obligations, there are a number of alternative potential responses. The most severe would be to terminate the agreement in its entirety. As a less severe consequence, the franchisee's development rights may be terminated. The franchisee would continue to service existing sub-franchisees and may be given the right to continue to develop on a right of first refusal basis. Alternatively, its exclusivity may be terminated, which would allow the franchisee to continue to develop in competition with the franchisor or another franchisee appointed by the franchisor. The franchisor would not, however, be able to grant exclusive development rights in the territory to the newly appointed franchisee.

The franchisee's failure to comply with its development obligations could also result in the surrender of part of the territory for which exclusive rights were granted. This would allow the franchisor to develop the territory itself or to enter into a new franchise or other agreement with a different franchisee.

International franchise agreements frequently provide for a test period to be stipulated in allowing for the development of one or more pilot units before the rights granted by the franchise agreement itself become operative. It is necessary to define the scope and timeframe for operation of the pilot unit(s), including the number and types of units to be established, the right of the franchisor to inspect the pilot units and operating results, the threshold levels of performance to be attained by the pilot units and the criteria for continuing operation of the pilot units. If the franchisee determines not to continue following the pilot period, or the performance criteria are not satisfied to allow the franchise agreement to be implemented, the test period agreement may provide for an additional fee or liquidated damages. If the franchisee does not continue with the franchise agreement following development of the test outlet, the franchisor may wish to have a right to acquire the pilot unit, or the franchisee may be permitted to continue operation of the pilot unit subject to appropriate de-identification procedures.

C. Distribution Controls

Master franchisees typically have resources to establish their own distribution networks within the target country. They often desire to distribute inventory and equipment to their sub-franchisees to retain control of the distribution network and the corresponding revenue stream. Nevertheless, a franchisor may want to retain responsibility for the distribution network, especially when the franchise system involves the sale of a large number of proprietary items, or if the franchisor maintains or intends to establish local distribution centers close to the target market. Retaining responsibility for the distribution system allows the franchisor to maintain some degree of control over the operation of the franchise system in the local market. In light of these potentially conflicting interests between the franchisor and the franchisee, many franchise systems offer a compromise, in which the master franchisee assumes responsibility for the distribution of locally procured products and the franchisor retains control over distribution of proprietary goods.

In preparing to draft provisions related to the selected distribution arrangement, the franchisor should investigate the antitrust and competition laws of the target country, particularly as they relate to distribution and supplier matters. The franchise agreement will need to detail the right of the franchisor to designate approved suppliers or sources of products and services, which may include the franchisor or its affiliates. If not prohibited by law, the agreement may stipulate that some or all of such suppliers may be located outside the target country where local suppliers or sources are not practically available. In all cases where the franchisor is to receive rebates, advertising allowances, concessions or other payments from designated suppliers or sources of products and services, an appropriate disclosure provision should be included in the franchise agreement, again subject to local antitrust or competition laws.

For approved suppliers to be selected by the franchisee, the franchisor will typically provide the franchisee standards for supplier approval, with which standards the franchisee must comply. The franchisor may also provide for a right to limit the number of suppliers, to inspect and monitor the supplier's premises and facilities, to receive samples for testing purposes, and to change or disapprove an approved supplier or source of supply on notice to the franchisee.

If rebates, allowances, concessions or other payments from suppliers to be made available to the franchisor are to be shared with the franchisee and/or its sub-franchisees, or to be added to an advertising or marketing fund, the franchise agreement should be appropriately drafted to detail these arrangements.

Finally, with respect to any goods or supplies sold to or provided by approved suppliers to the franchisee for use in the franchise system in the target country, appropriate restrictions should be placed for in the franchise agreement, subject to the target country's antitrust or competition laws, prohibiting resale outside the target country, directly or indirectly, to prevent grey marketing or unauthorized parallel importation in other foreign countries where another franchisee has already been appointed or where a franchisee may be appointed in the future.

D. Competition Law Controls

Developed countries typically have antitrust, competition, or trade practice laws. In attempting to structure controls and practices for the franchise system, it is important that a franchisor expanding internationally be well-versed in the application of such laws to its franchise practices and franchise documents. For example, laws affecting suggested pricing, misleading advertising, price discrimination, co-operative advertising allowances, telemarketing, tied selling, exclusive dealing, and market restrictions must be reviewed and incorporated into the franchisor's documents as required, as well as into the administration of the franchise system. Franchise counsel cannot assume that foreign competition law will follow the U.S. model. Instead, franchise counsel needs to inquire at the outset about the effect of competition laws in the target country.

Generally, two forms of anti-competitive activities affect franchising and raise issues under competition laws: (i) collusion by two parties that restrict consumers' choices regarding products and services and (ii) abuse of a superior bargaining power that harms another contracting party. Common franchise agreement provisions that may violate competition laws include purchase or exclusive supplier requirements, tying requirements, resale price restrictions, restrictions on the right to contest the trademarks, geographic restrictions on where the franchisee can conduct business, and self-help provisions that enable a franchisor to impose unilateral action upon a breach of the franchise agreement. Although common to U.S. antitrust law, counsel should not assume that the consequences of failure to comply with these laws are the same outside the United States.

For example, the European Community's Article 101 of the Treaty on the Functioning of the European Community³⁴ is one of the most prominent competition laws. It applies to all European Union member nations and prohibits any behavior that restricts competition within the EU. Generally, franchisors are fully subject to Article 101 unless exempted under the Vertical Restraints Block Exemption Regulation. This regulation exempts franchisors from Article 101 compliance if they have less than a 30 percent market share and do not engage in certain enumerated practices, such as resale price maintenance. Under the new Vertical Restraints Regulation and Guidelines that came into force on June 1, 2010, neither the franchisor nor the franchisee may have a market share that exceeds 30 percent for the block exemption to apply.

The EC competition authorities interpret Paragraph 51 of the Guidelines on Vertical Restraints to prohibit franchisors from restricting franchisees from maintaining an independent website or even restricting a franchisee's Internet presence to an interior page or series of interior pages on a franchisor's website. Moreover, a franchisor may not set unreasonable restrictions on a franchisee's use of the Internet under the guise of trademark control.

Apart from the EU, there is a wide variation in the types of antitrust and competition laws that may be applicable to franchising. For example, Argentina's antitrust law may be applicable to franchise agreements, but only where the companies involved have significant revenues in the country and the price/value of the transferred company/assets in Argentina is significant. Other countries, however, including the United Arab Emirates and Kuwait, have very little in terms of competition laws. Parties are generally free to set price controls and implement restrictions or take concerted actions that would often violate U.S. antitrust laws or the competition laws of other countries.

Finally, other countries have laws that limit the enforceability of contracts that are viewed as contracts of adhesion. British and Thai laws particularly apply to provisions that are not negotiated or to provisions perceived to be anti-competitive because of the franchisee's lack of bargaining power. Such provisions include choice of law provisions, dispute resolution provisions, or non-competition clauses.

E. Covenants against Competition Controls

Most franchisors use in-term and post-term covenants not to compete to protect their systems. They are concerned about maintaining the value, identity, and reputation of the franchised business. Analysis of the enforceability of such covenants internationally is similar to a U.S. state-law analysis. Non-compete covenants in foreign jurisdictions will generally be enforceable if they include reasonable limitations as to the time, geographic area, and scope of activity restricted.

In some countries, however, there may be additional restrictions on non-compete provisions. For example, in certain circumstances, EU countries may restrict in-term covenants not to compete to five years (and post-term covenants to one year). In Germany, unless the post-term covenant not to compete is withdrawn before termination, a franchisor may be required to pay the franchisee statutory compensation to enforce a post-termination non-compete covenant, regardless of whether the franchise agreement specifies any compensation and regardless of the reason for termination.

In certain jurisdictions, including Mexico and several regions of Brazil, the right to work is a constitutional right. These countries are highly critical of post-termination covenants against competition, regardless of the perceived harm caused to a franchisor. Unless it is

³⁴ Formerly Article 81 of the Treaty of Rome.

shown that the operation of the competing unit necessarily includes the use of confidential information, it may be difficult to enforce a covenant against competition in these countries, especially if the covenant effectively restricts the franchisee from earning a living.

In summary, the post-term covenant of the franchisee not to compete will require a thorough understanding and application of applicable laws in the target country. It will require appropriate definition of the prohibited activities, the geographical scope of application, the time period for the covenant and the persons to whom the covenant applies, including the franchisee, principals of the franchisee, affiliated and related companies and designated shareholders.

F. Execution Formalities

One of the key foundational elements for a franchisor's assertion of control in a franchise arrangement is ensuring that a valid and enforceable agreement is in place with the franchisee. Often, this begins (or ends) with confirming that the international franchise agreement has been properly executed. Some jurisdictions have complicated execution formalities for franchise agreements whether executed in or outside the applicable jurisdiction. These formalities may include spousal execution, witness execution, notarization, and legalization requirements, or the payment of stamp duties. Notarization can frequently require review or translation in the applicable jurisdiction by a licensed notary, who often is a lawyer and may have substantive comments on the franchise agreement.

Execution formalities for franchise and ancillary agreements differ by country. **[The deleted sentence did not seem to tie in with the following examples.]** For example, under the laws of the People's Republic of China, all documents that are supposed to be presented for governmental approval must be translated into and executed in Chinese; there may also be an English version of the document. Additionally, the legal representative of the PRC franchisee should execute such documents and apply the appropriate enterprise seal. Other Asian countries require the affixation of a chop³⁵ or other form of company seal. Although some of these formalities are not mandatory, in a subsequent challenge to the validity of the agreement, the franchisor can use the chop or notarization as further proof of the validity of the relationship.

In the United Arab Emirates and Kuwait, franchisors should ensure that the franchise agreements are not notarized. Failure to notarize a franchise agreement may effectively block the ability of the franchisee to register the franchise agreement under the Kuwaiti agency law. A franchisor should be particularly sensitive to such laws because they may entitle franchisees to receive certain compensation upon termination or early expiration of the franchise relationship. Similarly, in the UAE, franchise agreements that are notarized and translated into Arabic are more capable of registration under the UAE Commercial Agency Law.³⁶ Also, a franchisor must ensure that any guaranties signed by franchisees in the UAE are notarized and translated into Arabic to be enforceable.

Many Latin American countries require that agreements that are executed abroad be "legalized" either through the nearest country consulate or through the Hague Convention on

³⁵ A "chop" is the colloquial name used to refer to a Chinese seal. China, Japan, Korea, Taiwan, and Vietnam currently use a mixture of seals and hand signatures and, increasingly, electronic signatures.

³⁶ Many countries in the Middle East have agency laws that apply to franchise agreements. The amount of compensation owed to the franchisee varies but is often left to the discretion of the local courts, which typically consider a variety of factors, including (i) the franchisee's actual investment and (ii) a reasonable prediction of future profits. A standard award would be an amount equal to one year's total profits (averaged over four to five years) as well as compensation for the goodwill of the business and any unused inventory.

Apostille.³⁷ The failure to legalize a franchise agreement in El Salvador (or, alternatively, have an *apostille* affixed to the agreement) can render the agreement invalid in that country.

Many countries have certain requirements that must be met if a franchise agreement is signed within such countries' borders. A franchise agreement in Costa Rica should be notarized before a Costa Rican notary and witnessed by two individuals. In Argentina, payment of a stamp tax is required, unless the agreement is to be performed entirely in certain local jurisdictions (for example, the city of Buenos Aires). In Japan, a minimal stamp tax will be imposed if the franchise agreement is executed in Japan. Franchise agreements in India will have to be stamped before execution if signed in India or within three months of execution if signed outside of India. In Germany, franchise agreements that contain preemptive rights relating to the acquisition of real estate property or shares in a GmbH³⁸ must be contained in a notarial deed executed in German before a German notary to be enforceable; a German notary will review and notarize those provisions only if they comply in all regards with German laws.³⁹

G. Inspection and Reporting

A franchisor will typically desire that certain reports concerning performance of the franchises in the target country be submitted to it on a periodic basis. The franchise agreement must therefore prescribe the type and frequency of the required reports. These reports may also include operational reports delineating the number of outlets opened and operating, or under development, the identification of sub-franchisees and locations of all franchised units. Other reports required to be submitted may include statements of revenues from each franchised unit on a periodic basis and other operating statistics and information.

Financial statements will generally also be required to be submitted on a specified periodic basis. It is important to note that the method of financial reporting in some target countries may differ from generally accepted accounting principles in the franchisor's home country. Consequently, conversion of financial statements and reports may be required.

The agreement may specify that reporting obligations be satisfied by electronic means, including e-mail, requiring special computer hardware and software with modem access capability. Special payment terms may also be required in countries where the government has imposed temporary or permanent restrictions on payment. Special payment terms may include payment to a designated bank or other financial institution or intermediary located in the target country, payment by way of tangible property, or drawdowns against deposits lodged in the home country.

Finally, a franchisor will generally require that the franchise agreement provide for inspection rights of the franchisee's and sub-franchisees' outlets, and the right to perform audits of all statements submitted by the franchisee. The audit and inspection rights will include the right to review the books and records of the franchisee and the units operated by it.

³⁷ The Hague Convention Abolishing the Requirement of Legalisation for Foreign Public Documents was signed by the original signatories on October 5, 1961. It specifies the process through which a document issued in one of the signatory countries can be certified for legal purposes in all the other signatory states. Such a certification is called an *apostille*.

³⁸ *Gesellschaft mit beschränkter Haftung* (GmbH) (English: company with limited liability) is a type of legal entity very common in Germany, Austria, Switzerland, and other German-speaking Central European countries.

³⁹ Opinions differ on whether the whole agreement or only the portion of the franchise agreement concerning the preemptive right must be notarized. It may be difficult to find a German notary who will notarize only a portion of the franchise agreement, as opposed to the entire agreement or a significant portion of it. Failure to obtain a notarial deed in relation to rights in real property in Germany may void a franchise agreement in certain circumstances, if it can be proven that the party attempting to void the agreement would not have executed the document had it known the rights to real property were not valid. This could occur despite the presence of a severability clause.

The franchisee may be required to furnish copies of all inspection reports related to outlets operated by the franchisee and sub-franchisees. The parties will generally negotiate whether the right of the franchisor to inspect and perform audits must be subject to prior notice or whether the franchisor will have the right to inspect or perform audits without advance notice.

H. Default and Termination

An international franchise agreement will typically provide a long list of items constituting default of the agreement. While cure periods may be negotiated for any or all events of default, some of the events of default will provide for the right of the franchisor to terminate the agreement immediately.

Typical events of default in an international franchise agreement include breach of representations or warranties by the franchisee; failure of the franchisee to comply with the development schedule or meet target quotas; breach of the agreement; bankruptcy or insolvency; and failure to meet other development obligations.

The agreement may also provide for certain conditions which, if not met, can result in termination. Such conditions may include failure to obtain necessary government registration or approvals, failure to register trademarks in the target country, and implementation of exchange controls that prevent payment of fees to the franchisor in the franchisor's designated currency over a specific period of time. Cure periods will generally be negotiated to allow the franchisee an appropriate period of time to cure those defaults that are capable of being corrected.

Many foreign countries, including Italy, Malaysia, Romania, and Russia, have laws requiring that the termination or non-renewal of a franchise agreement be supported by good cause, or at least that the franchisee be given prior notice of the termination or non-renewal and an opportunity to cure a breach. In most countries, "good cause" for termination will include a franchisee's failure to comply with material provisions of the agreement, including repeated or prolonged failure to make required payments under the agreement, the franchisee's commission of a felony, abandonment, fraud, bankruptcy, or insolvency.

I. Consequences of Termination

The consequences of terminating an international franchise agreement can be complicated, particularly if sub-franchise agreements are involved. An initial consideration is whether the franchisee will have any continuing rights or obligations to operate the franchise system already developed in connection with the franchisee's own outlets and those of sub-franchisees. If a franchisee will be precluded from continued operation, the franchisor may provide for an automatic reassignment of all sub-franchise agreements and a right to purchase all franchisee outlets on a pre-determined formula basis. The franchisor pursuing these options must review the laws in the target country affecting the preparation of conditional assignments to prepare the appropriate assignment language and documents in both the franchise agreement and the individual unit sub-franchise agreements.

If the franchisee will be precluded from further involvement in the franchise system, appropriate covenants also should be provided for with respect to non-competition, non-solicitation, non-use of trade secrets and confidential information, and cessation of all use of proprietary products and trademarks. These provisions will not be significantly different from those typically found in a unit franchise agreement in the franchisor's home country.

Where site selection or locations are critical to the franchise system, the franchise agreement may also provide for conditional rights of assignment of all leases and subleases

entered into by the franchisee. To ensure that such provisions are effective, the franchisor must determine the availability of such provisions under local target-country real estate and leasing laws. The franchisor will also need to review the formal requirements for the preparation of the assignment language and documents.

To avoid problems associated with the termination of a franchise agreement involving sub-franchisees, the franchisor may elect to have the franchise agreement require a defaulting franchisee to sell the franchise agreement and related rights, and assign all sub-franchise agreements, to a qualified third-party purchaser designated by the franchisor. This would allow the franchisor to locate a new franchisee and to assign the system rights to the new franchisee as developed at that time. Such a right will require considerable negotiation with the franchisee to determine the value to be attributed to the assignment.

J. Transfer Restriction Controls

The legal issues affecting transfer restrictions typically fall into three categories: the process or mechanism through which the restrictions are imposed, the substantive content of the restrictions, and the enforcement of the restrictions.

1. Mechanism to Impose Transfer Restrictions

With respect to the mechanism or process for imposing restrictions, transfer restrictions are typically contained in the franchise agreement. Franchisors may seek to incorporate similar restrictions into the franchisee's organizational documents and in the franchisee's share certificates. This places existing shareholders, prospective purchasers, and other interested parties on notice of the existence of the restrictions, at least until the organizational documents and share certificates are changed. Other jurisdictions may require that restrictions and rights of first refusal be formally set forth in notarial deeds or pledge agreements.

Franchisors should consider requiring that restrictions be placed in a franchisee entity's charter documents to limit the ability to transfer to an innocent third party, unless prohibited by local law. In many countries, including Panama, Peru, and Nicaragua, this is the recommended approach. For example, Panamanian corporate law provides that articles of incorporation may include transfer restrictions, but prohibits any absolute prohibition on share transfers. Similarly, in Taiwan, the franchisee's articles of incorporation may not restrict transfer. Further, transfer restrictions in an entity's organizational documents are not customary in Malaysia or Australia. Measures that have been employed successfully in Costa Rica include requiring that the franchisee's shareholders ratify and approve the contract by resolution, specifically highlighting the transfer restrictions, duplicating the restrictions in the franchisee's corporate minute book, and registering a note of the resolution in the shareholders' registry.

Several jurisdictions provide that pre-emptive rights relating to the acquisition of real estate be contained in a notarial deed. Similarly, pre-emptive rights regarding personal property may have to be contained in a pledge agreement. Many Latin American countries, for example, have laws regarding the filing of pledge agreements in the appropriate land or property registries. The benefits of making such filings must be weighed carefully. In Germany, failure to memorialize these pre-emptive rights pursuant to statutory requirements could result in the entire franchise agreement being declared void if a challenge to the pre-emptive rights is made successfully. In other cases, the only considerations are the cost and time of filing the documentation.

2. Content of Transfer Restrictions

With respect to the content of the restrictions, in most jurisdictions, the parties are free to establish procedures for and conditions on the transfer of the franchisee, the franchise agreement, or all or substantially all of the assets of the franchised business. Typically, the only requirement is that such procedures and conditions be reasonable.

Australia codified the right to impose reasonable transfer restrictions. The transfer restrictions will be enforced as long as the conditions are reasonable and any contractually mandated franchisor approval authority is not abused. Statutory circumstances deemed reasonable for the franchisor to withhold its consent include that the transferee fails to meet the franchisor's selection criteria, has outstanding monies due and owing to the franchisor, has breached the franchise agreement and the breach remains in effect, or does not satisfy some other reasonable requirement contained in the franchise agreement.

Korea has a similar approach. Although Korean law does not prohibit a franchisor from restricting a franchisee's transfer of assets, if the restrictions are unreasonable and unnecessary for the proper management of the system, or if they amount to an abuse of superior bargaining power by the franchisor, then, similar to Australian law, the restrictions may not be enforced.

It may strengthen the enforceability of a transfer restriction in these jurisdictions (and others) if the franchise agreement contains an acknowledgment by the franchisee that the restrictions are reasonable and necessary for the proper management of the system.

3. Enforcement of Transfer Restrictions

Regardless of the mechanism employed and the content of the transfer restriction, the most frequent obstacle franchisors encounter in enforcing transfer restrictions is preventing an attempted or completed transfer. The inability to obtain injunctive or equitable relief will make it difficult, if not impossible, to prevent an improper transfer of, or encumbrance upon, an interest in the franchisee, the franchise agreement, or the franchisee's assets. Ultimately, the franchisor may need to terminate the franchise agreement, failing which it may find itself with a new, unapproved franchisee.

Some jurisdictions limit relief for the breach of a transfer restriction to either termination of the franchise agreement or damages. In these countries, injunctive or other equitable relief is unavailable or difficult to obtain. In other countries, the power to restrict transfers of shares in a franchisee is limited because of a constitutionally granted right of each person to dispose of his or her property as they so choose. This is the case, for example, in Costa Rica.

In several of the Middle East countries, such as Saudi Arabia, Egypt, and the UAE, it is difficult to obtain injunctive or equitable relief. Courts that are reluctant to grant immediate injunctive relief will often require a full hearing on the merits of the case at issue.

4. Other Situations

Other issues may be triggered when the target jurisdiction has a complex regulatory regime that governs international transactions. In the PRC, for example, if the franchisee forms a joint venture, any attempt to obtain a security interest on the equity of a franchisee entity must be approved by the Ministry of Foreign Trade and Economic Cooperation. In addition, all other investors in the joint venture must consent to the security interest at the time of the pledge and at the time of foreclosure. It is unlikely that a sale in violation of a pledge agreement that has obtained MOFTEC approval will pass muster, because, under

PRC law, any sale or transfer of equity interest in a joint venture must be approved by MOFTEC. Before the execution of any pledge agreement, local PRC counsel caution that parties should verify with the State Administration of Industry and Commerce if the joint venture interest at issue has been encumbered in past.

The practical reality is that it may be difficult to obtain a security interest covering the joint venture's equity from the parties to the joint venture. However, a covenant by the parties to the joint venture not to transfer the joint venture interest does not require any government approval. In addition, such a covenant can be included in the franchise agreement. It is also typically advisable to include, as an event of default in the franchise agreement or pledge agreement, any substantial sale of the joint venture assets and any transfer of a joint venture interest.

VII. OTHER PRACTICAL TIPS

Although the ultimate control of a franchise system and of a franchisee means enforcing the franchise agreement or registering an arbitral award in a court of law, the franchisor should have strategies in place to do all it can to achieve control short of this.

A. Working on the relationship

If the relationship with a franchisee is constructive and communications are open, the parties should be working together to ensure that the franchisee understands what it needs to do to comply with the franchise system and to operate a successful business. An international franchisee's primary motive in joining a franchise system is usually to leverage the franchisor's experience and best practice. In many cases, this objective is more important than the right to use the franchisor's brand, as the brand may be little-known in the franchisee's home country.

Too often, a franchisor's international support team is focused on signing new countries or territories, rather than supporting those already in place. Some foreign franchisees feel loved in the period leading up to signing, but feel neglected thereafter. Distance and time zones mean that the franchisor and its brand will not be constantly visible to the international franchisee, in the same way as it would be, in most cases, to domestic franchisees. As a result, prudent franchisors will introduce strategies to ensure that communication lines with international franchisees remain open and that they are in regular contact.

The franchisor will need to earn the respect of the local franchisee, not just demand it. A franchisor which fails to ask about or understand the franchisee's local market difficulties will not earn that respect or gain that understanding. To enhance business relationships, a sensible franchisor will ensure that its franchisee support staff are briefed on cultural sensitivities and techniques used by businesses in the franchisee's jurisdiction.

Franchisors will have communication tools for their domestic franchisees, but these may be unhelpful or inadequate for franchisees overseas. An intranet, chat rooms, and bulletin boards will assist. Additional focus groups may be useful for foreign franchisees. The franchisor may have to go out of its way to ensure that foreign franchisees are embraced as part of the system, and involved in system recognition programs, at least as much as domestic franchisees.

The franchisor should demonstrate its understanding of the differences in the franchisee's local market. For example, rather than sending the same manual updates and bulletins to all franchisees in its system, it could contact foreign franchisees to review the materials with them and ask if any changes are needed to the updates and about any local issues or concerns they may have as a result. The franchisor should acknowledge and act on

any feedback it receives from its international franchisees regarding local difficulties. If it does not, the franchisee may stop advising the franchisor of its local compliance difficulties, on the basis that there is no point doing so, therefore shutting down a valuable communication channel.

B. Verifying Compliance

Perhaps the greatest challenge faced by franchisors internationally is the increased difficulties they experience in verifying whether the foreign franchisee is complying with the franchise system.

It is important that all franchisees understand that their compliance may be checked at any time, as, without this, combined with distance, language, and cultural differences, the franchisee may be tempted to risk non-compliance.

The reality is that the franchisor will not have employees on the ground and will not visit foreign franchisees as frequently as its domestic franchisees. Once critical mass has been reached, it may help for the franchisor to locate support staff regionally, closer to its international franchisees and outside the franchisor's home jurisdiction. Before this time, it could be useful to engage local or regional consultants who could arrange "mystery shopper" visits and benchmarking. This would not replace the franchisor's formal review processes, but could supplement them.

In some cases, the franchisor may be able to enlist the assistance of the franchisee's customers to provide feedback to it on the franchisee's performance. Customers could be encouraged to provide feedback directly to the franchisor through memberships, clubs, competitions, the use of social media, or the like.

C. Providing Incentives to Comply

Termination is risky, costly, and rarely the preferred option. The prospect of termination is the ultimate incentive to comply, but need not be the only incentive. Not all interim compliance powers will be practical in all circumstances, but the fact that the franchisor has powers it could exercise will provide additional "encouragement" to the franchisee to comply.

Other "carrots" to comply could include:

- **Expanding development rights.** On occasion, franchisors are in a hurry to "cover the map" and sign franchisees for whole countries or even continents. Exclusive rights conditional on compliance with development obligations may not be the answer, as the onus will be on the franchisor to establish a breach to remove or reduce the exclusivity. An alternative approach may be to provide the franchisee with incentives: If it opens more than X complying outlets in a particular city, state, province, or country within Y period, it will have the first right of refusal over additional territory.
- **Exclusivity.** Again, rather than the onus being on the franchisor to establish a breach, before it can remove rights from a franchisee, the franchisee could be granted initial exclusivity for a limited time. After this period, the franchisee could be granted an additional exclusivity period, but if and only if the franchisee has been complying with the franchise agreement, the system, and all development obligations.

- **Royalty structure.** In some cases, a two-tier royalty structure can be useful, with the franchisee paying a lower amount if it is complying, or at least is providing all required reporting as and when due.
- **Suspension.** While not always practical, it can be a powerful tool for the franchisor to have the right to remove a franchisee's access to a central reservation system, or to the franchise system's website; the right to open new stores or to sub-franchise; or the right to new products, until the non-compliance has been cured.

D. Exploring Practical Enforcement Measures

Before a franchisor takes steps to enforce an international franchise agreement, it should ensure that it is in a position to preserve the franchise system in the country, if that is its objective. In preparation for this, it should ensure that it has contact details and copies of arrangements with key local suppliers and landlords, and contact details of all sub-franchisees, together with copies of their agreements. Without this information, it will be difficult for the franchisor to preserve its system locally.

In some cases, it may be useful for the franchisor to have a right to step in and operate the franchisee's local outlets or to enforce local sub-franchise agreements. Stepping in without understanding the local environment is dangerous, but not impossible, and the fact that the franchisor has the right to do so may provide another incentive to comply.

Enforcing sub-franchise agreements on the master franchisee's behalf is again theoretically possible, but can be problematic. Issues include whether the franchisor will do so as the master franchisee's agent and whether it will take an assignment of the sub-franchise agreements from the master franchisee.

Requiring the franchisee and its staff to undergo additional training to cure compliance issues can be a useful power, as long as it is clear that the franchisor's costs of this additional training and of any additional inspections are to be met by the franchisee.

VIII. CONCLUSION

Is it a fanciful dream that the franchisor can control its international franchise systems? That depends on what level of control is deemed acceptable and what approaches are taken in expanding the system into foreign jurisdictions. Absolute control is absolutely unattainable, but a commercially reasonable level of control should be the more realistic target. Success in this area depends on good planning, thorough due diligence, and careful franchisee selection. It also requires the right documentation, the establishment of solid intellectual property rights, and the implementation of workable security safeguards.

Additionally, having sufficient human and financial resources to monitor developments in the foreign market closely and acting quickly when necessary will provide the franchisor with a greater degree of control over the system. Leadership and good communications, while not strictly "controls," serve to enhance whatever control mechanisms are available to the franchisor.

Finally, perseverance and patience will be important allies of the successful international franchisor.