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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
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STUDY GROUP ON FRANCHISING

Guide to International Franchising

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INTRODUCTION

In recent years franchising has assumed a place of great prominence in the economy of an increasing number of countries. The most famous names of franchising (McDonald's, Holiday Inn, Pronuptia, ComputerLand) have become household words and are to be seen all over the world. This growth is however not limited to large international chains. Thanks to franchising domestic networks are spreading with a rapidity that was unheard of only twenty years ago.

Despite the unprecedented success of franchising there is a wide-spread lack of knowledge of the exact nature of this way of doing business, as well as of the legal and practical issues that should be dealt with by any entrepreneur who is contemplating making use of the franchising vehicle. This lack of knowledge is common not only in the developing world, but also in industrialised nations in which franchising has been present for some time.

Conscious of the very real benefits of franchising, of its potential to act as a stimulus for economic growth and the creation of jobs, the *International Institute for the Unification of Private Law (Unidroit)* has decided to publish a *Guide to International Master Franchise Arrangements*. The purpose of the *Guide* is to spread knowledge with a view to providing all those who deal with franchising, whether they be franchise operators, lawyers, judges, arbitrators or scholars, with a tool for the better understanding of the possibilities it offers.

Although master franchising was selected as the main focus of the *Guide* by reason of its being the method most commonly used in international franchising, a brief description of the other principal methods used in both domestic and international franchising is also provided. It is hoped that by offering an introduction to readers not familiar with this form of business, the *Guide* will be of use to operators, franchise lawyers and others active on both the international and the domestic scenes. It must however be stressed that the principal purpose of the *Guide* is to assist parties in negotiating and drawing up international master franchise agreements by identifying the legal issues involved in those agreements, discussing possible approaches to the issues and, where appropriate, suggesting solutions which parties may wish to consider for their agreements. By furnishing adequate information the *Guide* aims to contribute to place the parties on a level where a lack of knowledge would otherwise place one of them at a disadvantage.

The *Unidroit Guide to International Master Franchise Arrangements* is the first publication of its kind issued by Unidroit. An example of the so-called "soft law" approach to the harmonisation of law, it confirms the intention of the organisation to differentiate its activities and to move away from the traditional approach of the preparation and adoption of prescriptive legal norms in the form of international conventions.

In the course of its seventy-year history the Institute has concentrated mainly on the preparation of international conventions, which is the traditional expression of international co-operation between States. It is however convinced that also non-binding instruments have an important role to play in the harmonisation of private law.

There are a variety of ways in which to harmonise law: through the preparation of international conventions, for instance, or through the adoption of uniform laws, model laws or guidelines. Not all subjects can be dealt with in the same manner. Some will be more suitable for an international convention whereas others are best dealt with in guidelines or even in a legal guide. To be effective the instrument chosen has to be suited to the subject at hand.

The most obvious reason for the introduction of legislation is the need to come to terms with problems that have arisen in practice. In the case of franchising, these problems will in a majority of cases relate to what are often seen as abuses on the part of the franchisor. The solutions offered will therefore involve attempts to redress the balance between the parties to an agreement where the necessary balance either does not exist or has been distorted. Although a certain imbalance may be justified in view of the different obligations of the parties to the agreement,ⁱ this imbalance

may at times be excessive and may be sanctioned in the actual provisions of the agreement itself. Examples of such provisions are those which provide for too stringent a control by the franchisor of the activity of the sub-franchisor or franchisee, for the retention of excessively extensive rights on the part of the franchisor to terminate the agreement, or for inadequate rights of the other party to terminate for breach on the part of the franchisor. Practices which are often considered abusive or unethical include omissions on the part of the franchisor as regards the assistance and the training it has undertaken to provide its franchisees or the sub-franchisor with.

It is true that when abuses are considered for the purposes of legislation, the abuses taken into consideration are normally those imputable to the franchisor and not to the franchisee. The reason for this is clearly the assumption that the franchisor is the stronger party and will therefore be in a position to impose its terms and conditions on the franchisee. Abuses on the part of the franchisee are on the other hand seen as taking the form of breaches of contract which it will be possible to deal with accordingly.

It was concern caused by instances of what might be considered abuse on the part of the franchisor that in 1985 occasioned a proposal on the part of the Canadian member of the Governing Council of the Institute that Unidroit consider the preparation of uniform rules on franchising. A first, preparatory stage of the project involved the preparation of reports analysing the phenomenon as such, the information gathered by means of a survey conducted by the circulating of a questionnaire to Governments, professional circles and recognised experts in franchising and examining the provisions used in franchise agreements, as well as the monitoring of both national and international developments in the field.

At its 72nd session in June 1993 the Governing Council of the Institute decided that the time had come for a *Study Group on Franchising* to be set up. The terms of reference of the Study Group as defined by the Governing Council were to examine different aspects of franchising and in particular disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of master franchise agreements on sub-franchise agreements. The Study Group was also requested to make proposals to the Council regarding any other aspects of franchising that might lend themselves to further action by the Institute and, as soon as practicably possible, indicate the form of any instrument or instruments which might be envisaged.

As concerns domestic franchising, the Study Group concentrated on the question of disclosure, examining also the experience of countries that have, or have attempted, some form of regulation in this area, the role of franchise associations and the importance of the codes of ethics adopted by those associations. The Study Group did not reach any final conclusion as regards domestic franchising and decided that it would come back to it at a later stage. It consequently recommended that for the time being consideration of any action on domestic franchising be postponed.

In relation to international franchising the Study Group focused its attention on master franchise agreements. It considered in particular the nature of the relationship between the master franchise agreement and the sub-franchise agreements, applicable law and jurisdiction, the settlement of disputes, problems associated with the three-tier nature of the relationship between franchisor, sub-franchisor and sub-franchisees, particularly in relation to termination, and disclosure.

The findings of the Groupⁱⁱ led to the conclusion that none of the areas which had been discussed would lend itself to being dealt with by means of an international convention. This was clearly the conclusion to be drawn from the discussion on how the agreements were concluded and on what information was requested and provided. Considering the great variety of franchise agreements and the different options open to parties entering into franchise agreements, as well as the fact that in international franchising questions such as the term of the master franchise agreement in relation to the development term could be approached in very many different ways and the resulting agreement still be a properly drafted agreement, it appeared that it would be almost impossible to treat such questions by means of an international convention as

the consequence would be to tie the hands of the parties by suggesting that the issue at hand ought to be dealt with in one specific way only, and this would be of little service to the business community.

Furthermore, although nothing would actually prevent the elaboration of an international convention, the proposed subject-matters would require a considerable number of mandatory provisions. The stringent nature of international conventions would moreover not permit adaptations that a State might consider to be an essential condition for its adoption of the convention. The combination of the mandatory nature of the provisions and the binding nature of the convention would not augur well for the adoption of a convention by the different nations of the world. The utility of such an instrument might therefore seriously be questioned.

A review of the different options available as regards the instrument to be adopted, it was concluded that a uniform law would not be more suitable than an international convention and might indeed often be considered to present the same drawbacks.

A more feasible instrument might in this case be a model law. A major advantage of model laws is their flexibility, which permits the legislators that turn to them for inspiration to make the modifications that they consider to be imperative. It is therefore possible for the experts entrusted with the preparation of a model law to include in it a number of provisions that they deem to be the most appropriate solutions to the problems addressed by the provisions, even if it would have been impossible for some States to accept these provisions had the final instrument been a convention. The price to pay for this greater flexibility is of course less uniformity, as a number of provisions will differ from country to country. While the possibility of adopting a model law might be considered for domestic franchising, it was however felt that it would be less suitable for international franchising, in particular considering the methods normally adopted in cross-border franchising.

Of importance in the spectrum of voluntary regulations are Codes of Ethics or Best Practices. Codes of Ethics are however by their nature adopted by the profession concerned and are in most cases drawn up by the national association of the profession, or, internationally, by the federation of national associations. It was therefore considered not to be appropriate for an international organisation such as Unidroit to proceed with the drafting of an international Code of Ethics. Furthermore, while these Codes constitute an important attempt to introduce ethical standards among the members of the professional associations concerned, their effectiveness is disputed.

Another type of instrument that was briefly considered as a possible option for preparation by the Unidroit Study Group was that of the model contract. The majority of the Group however did not feel that such an instrument would be suitable for master franchising. Furthermore, the *International Chamber of Commerce* in Paris was preparing a model franchising contract for international, direct unit franchises and it was preferable to await the outcome of that exercise before proceeding with a similar one. The Study Group therefore decided to exclude the model contract from the options open for consideration.

Whereas a binding instrument such as an international convention was considered to be inappropriate, there emerged in the course of the meeting a general consensus on the opportuneness, and indeed on the desirability, of preparing a legal guide to international franchising, and in particular to master franchise arrangements. It was however suggested that any such guide should be drafted on the assumption, and stating the fact, that parties should use legal counsel and that therefore matters of a general nature would not be dealt with in the guide.

The Group felt that the guide approach would present several advantages for a subject such as franchising. In the first place it could illustrate the problems that might arise in connection with issues that had already been regulated in one way or another by national legislation, but which were of particular importance in the context of franchising (such as intellectual and industrial property). It could also illustrate the advantages and disadvantages of the different options open to operators and alert readers to the different traps that they might find on their

path. This would clearly not be possible if an instrument such as an international convention were opted for. Furthermore, a guide could be prepared in a relatively short period of time, which was not the case for an instrument such as a convention which would require a totally different procedure. A guide could be launched on the market upon completion and could consequently be immediately available to operators, whereas an international convention would require adoption by a sufficient number of States for it to enter into force, followed by the preparation of implementing legislation, all of which might take a long time. If the purpose of the international instrument to be adopted was to reach out quickly to the franchising community, then an instrument such as a guide was the most appropriate. The Group consequently recommended to the Governing Council of Unidroit that work on a legal guide to master franchise arrangements be initiated.

The Governing Council of the Institute endorsed this recommendation at its 74th session in 1995 and requested that work on the legal guide advance as rapidly as possible. This Guide is the outcome of the labours of the Study Group.

CHAPTER 1

FUNDAMENTAL CONCEPTS AND ELEMENTS

A. MASTER FRANCHISE AGREEMENTS AND OTHER COMMERCIAL VEHICLES

There is no doubt that master franchise agreements are the type of agreement most common in international franchising. The realisation of this fact brought the Unidroit Study Group to recommend, and the Governing Council of Unidroit to endorse the commendation, that master franchise arrangements should be the form of franchising to be primarily dealt with in this Guide.

I. MASTER FRANCHISE AGREEMENTS

In master franchise agreements the franchisor grants another person, the sub-franchisor (often also called the "master franchisee") the exclusive right within a certain territory (such as a country) to open franchise outlets itself and/or to grant franchises to sub-franchisees.¹ The sub-franchisor in other words acts as franchisor in the foreign country. The sub-franchisor pays the franchisor financial compensation for this right. This compensation often takes the form of an entrance fee and/or royalties constituting a percentage of the income the sub-franchisor receives from the sub-franchised outlets. The form of financial compensation, and the relative importance of the component parts of this compensation, will vary from country to country and from franchise to franchise.² It should be noted that the use of master franchise agreements is not limited to international franchising and that they may also be used in the domestic franchising context.

In master franchise arrangements essentially two agreements are involved: an international agreement between the franchisor and the sub-franchisor (the master franchise agreement), and a national franchise agreement between the sub-franchisor and each of the sub-franchisees (the sub-franchise agreement). There is generally speaking no direct relationship between the franchisor and the sub-franchisees, although in some countries intellectual property legislation will make a direct link necessary for matters concerning those particular rights.³ The franchisor transmits all its rights and duties to the sub-franchisor, who will be in charge of the enforcement of the sub-franchise agreements and of the general development and working of the network in the country or territory it has been given the right to develop. It is the duty of the sub-franchisor to intervene if a sub-franchisee does not fulfil its obligations, the franchisor will normally not be able to do so. All the franchisor will be able to do is to sue the sub-franchisor for non-performance if it does not fulfil its obligation to enforce the sub-franchise agreements as laid down in the master franchise agreement.⁴

(a) *Advantages and Disadvantages of Master Franchising*

As is the case with any other business technique, master franchising has both advantages and disadvantages for the parties involved.

(1) **Advantages for the Franchisor**

For the franchisor, the advantages include the possibility to expand its network without investing as much as would be necessary if it were setting up the operation itself, although the investment required, in both staffing and financial terms, may turn out to be more substantial than many franchisors estimate before they enter into the agreement. Furthermore, the country of the franchisor and that of the sub-franchisor will in all likelihood differ considerably as to culture,

¹ See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

² See Chapter 4 "Financial Matters".

³ See Chapter 10 "Intellectual Property".

⁴ There are however franchisors who reserve the right to intervene against defaulting sub-franchisees - see Chapter 2, *cit.*

customs and traditions, legislation, language and religion, not to speak of social and economic organisation. It is therefore of considerable advantage for the franchisor to be able to rely on a partner who will be familiar with the country concerned, who will know how the local bureaucracy works, what is necessary to fulfil all the legal requirements that will enable the franchise system to obtain the necessary permits and who will be able to advise the franchisor on the modifications that must be made to the system to adapt it to the local cultural requirements. Furthermore, the geographic distance between the country of the franchisor and that in which it intends to expand its network might be such that it would be extremely difficult for the franchisor to control the performance of the unit operators and to all intents and purposes impossible for it to enforce the terms of the unit agreements. The contribution of a local sub-franchisor, who is able to step into the franchisor's shoes in the country concerned, is therefore essential. The franchisor will be required to provide the sub-franchisor with adequate training and assistance, but thereafter the sub-franchisor will to a large extent be on its own in running the operation. The part played by the franchisor will be minimal when compared with that of the sub-franchisor.

(2) Advantages for the Sub-Franchisor

A major advantage of franchising in general is the fact that the franchisee has the benefit of investing in a well-known and tested business concept. To a certain extent this is true also as regards master franchising, although how well-known a particular franchise system is in the country of the sub-franchisor will vary considerably. The most famous franchises are known in a large number of countries all over the world. Others are less well-known, or are known in fewer countries, but are solid franchises that have every chance of success. For the sub-franchisor they are therefore well worth investing in, even if a considerable investment in time and effort will be needed to make the system known. The technical know-how that accompanies a franchise might also be of considerable interest to a sub-franchisor. It should however be noted, that sub-franchisors are often large corporations with substantial funds and technical know-how of their own. Sub-franchisors in fact need to be large as the amount of investment that they will be required to make to develop the network will be of major importance. Cases have been known in which the sub-franchisor was larger than the franchisor. The relations between the parties are more evenly balanced in such instances.

(3) Disadvantages for the Franchisor

The three main areas with which franchisors have expressed dissatisfaction are the lack of control of the franchisor over the franchise system, the problems associated with the terminating of the master franchise agreement and the splitting of fees.

(i) Lack of control of Franchisor over Franchise System

By entrusting the establishment, supervision and control of its franchise system and its trade marks to a sub-franchisor, the franchisor has to a large extent handed over the control of its franchise system, including its trade marks, to the sub-franchisor. This lack of control on the part of the franchisor is a direct result of the fact that typically there is no direct contractual relationship between the franchisor and the sub-franchisees. The franchisor is thus obliged to rely on the sub-franchisor to enforce the sub-franchise agreements and to ensure that its rights, such as intellectual and industrial property rights, are not infringed upon. The franchisor may as a result be unable to end misuse of the franchise system, or non-performance of the sub-franchise agreement, by sub-franchisees. Where the sub-franchisor is unable or unwilling to act the franchisor's only recourse is consequently to terminate the master franchise agreement. This is not always a realistic option. Even in those situations where direct contractual relationships are exceptionally created between the franchisor and the sub-franchisees, as, for example, where the franchisor is made a party to the sub-franchise agreement, the termination of a master franchise is usually not a practical alternative for most franchisors. Although being a party to the sub-franchise agreement might permit the franchisor to take action where the sub-franchisor does not, this is a solution that is usually avoided by franchisors as it might defeat the whole purpose of master franchising by making the franchisor directly responsible to the sub-franchisees. Legally the franchisor has the right to enforce the provisions of the master franchise agreement that require the sub-franchisor to properly establish, supervise and control the franchise system and the trade marks. It is however a right that is most difficult to enforce from a practical point of view. Although a

carefully structured arrangement between the franchisor, sub-franchisor and sub-franchisees and carefully prepared master and sub-franchise agreements can alleviate the problems of loss of control, the nature of master franchising makes it impossible to avoid these problems entirely.

(ii) Problems with Terminating Master Franchise Agreements

The nature of master franchising is such that it is difficult for a franchisor to enforce its rights to terminate a master franchise agreement. The consequence could be the franchisor continuing in an unprofitable and undesirable business relationship with its sub-franchisor. The difficulties involved in terminating master franchise agreements relate in particular to the impact of such a termination on sub-franchisees. Although the sub-franchisees are not parties to the master franchise agreement, the rights granted by the sub-franchise agreements are derived from the master franchise agreement and their fate is therefore dependent upon the master franchise agreement. The inability to provide for acceptable solutions to the effects of termination, especially as regards sub-franchisees, is one of the most important defects of the master franchise arrangement.

(iii) Splitting of Fees

The financial return of the franchisor is likely to be considerably lower in master franchising than in direct unit franchising and area development arrangements. This will to some extent be offset by the fewer costs incurred by the franchisor. A feature of master franchising is the splitting of the initial franchise fees and the continuing royalty fees between the franchisor and sub-franchisor. This may give rise to the question whether the revenue from these fees is sufficient for both the franchisor and the sub-franchisor. Although typically the fees are split in a proportion that favours the sub-franchisor, the doubt nevertheless remains whether the revenue left in the hands of the sub-franchisor is sufficient to support the type of organisation that a sub-franchisor is required to build in order to ensure the proper establishment and supervision of the franchise network. The question is just as relevant for franchisors who typically receive the smaller portion of the fees paid by the sub-franchisees. This has led franchisors to question whether the revenue they receive is sufficient compensation for their continuing efforts to provide support to the sub-franchisor and for the inherent risks involved in international franchising. In the past many franchisors assumed that, once the master franchise agreement had been entered into and the sub-franchisor had been properly trained in all aspects of the franchise system, the sub-franchisor would be solely responsible for the network, without the franchisor having to intervene. What experience has shown over the years, is that the continued involvement of the franchisor in the foreign country is essential to ensure the viability of the franchise system. Senior management of the franchisor may be required to spend lengthy periods of time in the foreign country with the consequence that the continuing costs of supporting the franchise system in the foreign country remain significant. The royalties that will be earned by a franchisor in the initial three to five year period during which the franchise system is being established may therefore not compensate it for its continued efforts in assisting the sub-franchisor in establishing the franchise system in the foreign country.

The disadvantages described above are at the basis of a certain dissatisfaction with master franchising that is increasingly being felt by franchisors and that has led franchisors to consider other options for international expansion, in particular area development agreements.

(4) Disadvantages for the Sub-Franchisor

If the franchisor feels that it does not have sufficient control over the franchise system, the sub-franchisor might instead feel that it has retained too much. This will in particular be true in relation to the modifications that a sub-franchisor feels to be essential to ensure the success of the franchise system in its territory or country and that a franchisor might be unwilling to introduce as they would represent a departure from the franchise system it has developed and that has proved to be a success in its country of origin.

A number of questions that arise in connection with the agreement coming to an end may also cause dissatisfaction with the master franchise system, in particular questions of ownership of improvements to the system.⁵

⁵ See Chapter 12 "System Changes".

Again, the need to divide the revenue of the system with the franchisor might prove irksome to sub-franchisors who have expended time, effort and financial resources to develop the network.

The disadvantages of master franchising for sub-franchisors also include the fact that there is no assurance that the master franchise agreement will always be renewed, even if realistically it would be very difficult and expensive for the franchisor to put an end to the relationship.

II. FRANCHISE AGREEMENTS AND OTHER AGREEMENTS

Franchise agreements contain numerous elements that may lead them to be equated with other types of agreement, particularly in countries where there is no legislation that specifically regulates franchising. Legislation adopted specifically for commercial agents, instalment sales or standard form contracts has, for example, been applied by analogy to franchise agreements by courts in a number of countries. In reality, however, although franchise agreements are often equated with agency, distribution or licence agreements, and although elements of these types of agreement are present in franchising, there are substantial differences between them.

a) Commercial Agency Agreements

The concept of agency is not a uniform concept. A number of differences exist between the legal systems, in particular between those of the common law and civil law traditions, but also between the systems within the civil law families. For the purposes of this Guide only what is known as “commercial agency” will be considered.

The figure of the commercial agent was developed in the civil law tradition and was introduced into the law of the European Communities by the *European Council Directive 86/653 of 18 December, 1986, on the Co-ordination of the laws of the Member States relating to self-employed commercial agents*.⁶ The civil law concept is in essence summarised in this directive, according to which a commercial agent is a self-employed intermediary who has continuing authority to negotiate the sale or the purchase of goods on behalf of another person (the principal), or to negotiate and conclude such transactions on behalf of and in the name of that principal.⁷

Although the figure of the commercial agent has now been introduced into the European common law systems by the European Directive, traditionally in the common law agency is understood in a much broader sense. It is in fact defined as “the fiduciary relationship which exists between two persons, one of whom expressly or impliedly consents that the other should act on his behalf, and the other of whom similarly consents so to act or so acts”.⁸ As is the case in the civil law systems, it is accepted that the agent can create a direct legal relationship between the principal and the third party. The authority given to the agent may be a general authority by which the agent has unrestricted power to act, or may be a special authority which is limited to one or two specific acts.

It should perhaps be observed that, despite the unifying force of the European Directive, considerable differences still exist in this field between the national legal systems.

In franchising on the other hand, the franchisor and the franchisee are two independent businesspersons who invest and risk their own funds. Franchisor and franchisee are not liable for each other’s acts or omissions. Franchise agreements in fact often contain a provision expressly providing that the franchisee is not the franchisor’s agent and does not have the power to bind the franchisor. The independence of the franchisor and the franchisee is often made clear also to customers by means of a sign placed in the outlet indicating that that place of business is a franchise and is not owned by the franchisor.

⁶ OJ EEC L 382/17 of 31 December 1986. This Directive lays down a general duty of good faith of the agent and the principal in their dealings with each other and by considers questions relating to the remuneration of the agent and to the conclusion and termination of the contract.

⁷ Cf. Article 1(2).

⁸ See *Bowstead on Agency*, 15th ed., London, 1985, p. 1; cf. *Restatement (2nd) Agency*, § 1(1).

b) *Distribution Agreements*

Differences between national legal systems exist also as regards what are known as distribution agreements or *concessions*. In essence, however, a distribution agreement is one whereby a manufacturer or supplier of goods grants a distributor the right to resell or supply those goods. The distributor is wholly independently owned and financed and buys the products from the supplier by whom it has been granted the distribution rights. In some jurisdictions these distribution rights may be granted also for the supplying of services. In others, the distribution agreement is considered to incorporate the distributor into the manufacturer's or supplier's sales organisation.

Distribution agreements may be either exclusive or general. If they are general, the distributor may carry a range of products in respect of which it has a distribution agreement, it may even have competing or conflicting product lines. Exclusive distribution arrangements, on the other hand, normally grant the distributor the exclusive right to sell the products in a specified area.

In franchise agreements there is instead in most cases an exclusivity clause which provides that the franchisee is to market only the products of the franchisor. The vendor and purchaser relationship may also be present in a franchise agreement, but would in most cases be merely a feature of the broader agreement. Furthermore, although a number of features of franchise and distribution agreements may be similar, such as the laying down of specific obligations as regards exclusive purchase requirements, prohibitions to sell competing products, territorial exclusivity, or the distribution of the goods (the organising of the sales, the purchase and maintenance of a stock and the assistance offered to clients), the way they are to be performed in the different arrangements might differ considerably. A clear distinction between franchise and distribution agreements is also to be found in the fundamental elements of the training and assistance provided by the franchisor and of the control exercised by the franchisor over the operation of the franchisee.

c) *Licence Agreements*

A licence may be defined as a contractual arrangement pursuant to which a party (licensor) grants another party (licensee) the right to use the licensor's patents, know-how and/or trademarks in connection with the manufacturing and/or distribution of a certain product. This clearly also forms part of the franchise arrangement which, however, has additional characteristics. It should be noted that although there are certain differences between the licences granted for the different categories of intellectual and industrial property, the main characteristics are the same.

Licence agreements may be exclusive or non-exclusive. In non-exclusive licences the licensee is granted the right to use the licensor's invention, know-how or trademarks but has no exclusive right to do so. The licensor therefore retains the possibility to use the intellectual or industrial property itself, as well as to grant licenses to other licensees. If the licence is exclusive, the licensor undertakes not to grant a similar licence to others and possibly also not to use the intellectual or industrial property itself. An exclusive licence may be granted for a specific territory, for example a particular country, or may be more general in character.

In essence the difference between a licence and a franchise is that a licensor controls the manner in which the licensee uses the licensor's patents, know-how and/or trademarks, but has no control over the business format or the manner in which the licensee carries on its business, whereas a franchisor exercises detailed control over the manner in which the franchisee operates its outlet.

d) *Transfer of Technology Agreements*

Franchising is often found to be covered by the all-embracing transfer of technology provisions applicable in some jurisdictions. Transfer of technology agreements are in effect a form of licence agreement, under the terms of which a licensee is granted the right to establish a

manufacturing facility to produce a product using the licensor's technology. Here again, the licensor does not retain any control over the way in which the licensee conducts its business. Despite this considerable difference, and despite the other characteristics of franchising, transfer of technology laws are often formulated in such a broad manner that franchising is brought within their ambit.

III. *METHODS TO FRANCHISE INTERNATIONALLY*

There are essentially two main ways to franchise internationally: directly or through master franchise arrangements⁹. Joint ventures are also used in international franchising, but mainly as a means to solve problems of financing. They are therefore not used alone, but in conjunction with area development agreements or master franchise agreements in particular.

a) *Direct franchising*

Direct franchising includes traditional unit franchising and franchising by means of area development agreements.

(1) **Unit Franchising**

In unit franchising the franchisor itself grants franchises to individual franchisees in the foreign country. In this case there is an international agreement to which the franchisor and the franchisee are parties. This form of franchising is not used frequently in international franchising, unless it is between countries that are geographically and culturally close to each other.

(2) **Area Development Agreements**

In the case of area development agreements the developer is given the right to open a multiple number of outlets in accordance with a predetermined schedule and within a given area. The franchisor and the developer will enter into a unit agreement for every unit that the developer opens. In this case there is a framework development agreement and a number of unit agreements, all between the franchisor and the developer. Under the unit agreements the developer is a normal franchisee with the same rights and obligations as any other franchisee. Development agreements, which until recently were not common in international franchising, are now receiving increased prominence in countries that are geographically distant from the country of the franchisor. In an international context this form of agreement presents specific problems that do not necessarily exist within a national context. These include the substantial financing that is required to create a network. To be able to open several units in accordance with a predetermined schedule the developer must have considerable financial means. Furthermore, the developer must be in a position to protect the rights it has been granted, such as the intellectual and industrial property rights, and must be able to operate the units in conformity with the requirements of the agreement. The consequence is that if the arrangement is unsatisfactory, it is very expensive for the franchisor, or for another prospective developer, to take over the network. Unrealistic development schedules are also liable to cause problems, although this is not an issue that is limited to international franchising or indeed to area development agreements.

b) *Franchising by Means of a Joint Venture*

Joint ventures are often used as a means to solve the financing problems of the local partner. What normally happens in these cases is that the franchisor and a local partner create a joint venture which typically takes the form of a corporation, but which may also take the form of a partnership or trust. This joint venture then enters into a master franchise agreement with the franchisor, becomes a sub-franchisor and proceeds to open franchise outlets and to grant sub-franchises in the same way as a normal sub-franchisor. Alternatively, the joint venture may enter into a development agreement with the franchisor and thus become a developer. Whether or not a franchisor elects to participate in a joint venture in connection with the grant of a franchise is a managerial, a use of capital, decision which in some cases will be dictated by the laws of the country concerned.

⁹ For a general description of master franchise arrangements, see above, page 7 ff.

One of the most important advantages to be gained by using the joint venture in franchising is the financial contribution that the franchisor is able to make to the operation as a whole. By creating a joint venture together with a local partner the franchisor is able to inject funds into a separate body which will then be able to take on the role of sub-franchisor and so to develop the network. It is a system that is particularly suitable in countries where funding is scarce, but where other pre-conditions necessary to the growth of franchising are present (small businesses or people with savings that they are in a position to invest in a sub-franchise, for example). The existence of adequate financing is often a major stumbling block for the development of franchising. The funds necessary for franchising, and for master franchising, are considerable even if not as substantial as those necessary for the development of a company-owned network. A contribution by the franchisor may therefore be of decisive importance. A joint venture permits the franchisor to make this contribution without creating links that are so close that the franchisor's independence from the local operation is threatened.

c) *The Use of a Branch or Subsidiary*

Whatever the method a franchisor chooses to develop the franchise system, whether direct franchising or master franchising, in combination or not in combination with a joint venture, it will need to consider whether or not, as a corporate entity, it will engage in the franchising activity directly from its head office or from a branch, or whether it will do so by means of a subsidiary. It should perhaps be recalled that a subsidiary is a separate legal entity whereas a branch is not. Whether the franchisor decides to set up a branch office or a subsidiary will often depend upon tax and general management considerations. In either case the body concerned, subsidiary or branch office, acts as franchisor for the purpose of granting franchises. The agreement between the branch or subsidiary and the franchisee will in this case be a domestic agreement subject to the local legislation.

IV. *OTHER FORMS OF INTERNATIONAL FRANCHISE ARRANGEMENTS*

Master franchise and development agreements may to all intents and purposes be considered the classic methods used by franchisors for international expansion. It should, however, be recognised that these methods may not be appropriate in every situation and that other methods of distribution may be better suited under certain circumstances. Example of such other methods include "bare bones" license agreements, scaled down versions of a master franchise agreements, "hybrid franchise/license" agreements, area representation agreements or even distribution agreements.

a) *"Bare-bones" license agreement*

As franchisors seek to establish their franchise systems in countries where franchising is relatively unknown, or in countries where the business culture or business morality is significantly different from that which exists in their own countries, they might soon come to the conclusion that the classic methods used in international expansion are either inadequate or inappropriate in the circumstances. In this case the franchisor's interests may best be served by taking a realistic approach and by opting for a "bare bones" license agreement.

Generally speaking, a "bare bones" license agreement is a limited license agreement by which the franchisor grants the franchisee/licensee a license (that may or may not be exclusive) to use the franchise system, and in some circumstances the trade marks, in the foreign country. Apart from the initial training to be provided to the franchisee/licensee, the franchisor will not be required to provide any additional training or assistance and will, to all intents and purposes, be free of any additional obligations. The franchisor will thus not be expected to supervise the franchisee/licensee and its use of the franchise system and many of the control mechanisms governing the manner in which the franchisee is to use the franchise system that are normally included in any form of franchise agreement would be significantly reduced. Moreover, as the franchisor might not be able to obtain accurate reporting on sales, the agreement might provide for the payment of a specific monthly fee, as opposed to a percentage of sales, for each franchise location in operation. In other circumstances the "bare bones" license agreement might provide for the payment of an escalating

monthly fee that is independent not only of sales, but also of the number of franchise outlets that are in operation. In this case no reporting requirements would be included in such an agreement.

b) Scaled Down Version of a Master Franchise Agreement

The circumstances of a particular business, or the circumstances in which a particular business will be required to operate, might be such that although master franchising would be the most appropriate vehicle for international expansion, a complete master franchise agreement would not be suitable. In such cases a “scaled down” version of a master franchise agreement might be opted for, in which many of the typical obligations imposed on a sub-franchisor, and many of the rights available to a franchisor under a normal master franchise agreement, would be excluded. Which rights and obligations are excluded will depend on the circumstances of the case.

c) Hybrid Franchise/License Agreement

For many manufacturers who are, for the first time, seriously contemplating exporting their products to overseas markets the methods traditionally used to distribute internationally may not be appropriate. Where, for example, the nature of the product is such that the manufacturer considers that the only effective way to sell the product is with the assistance of dealers trained in the use of the product and/or who must sell the product from specifically designated locations where all or a significant portion of the premises are allocated to the sale of that product, or through specific channels of distribution, the interest of such a manufacturer may best be served by appointing a single franchisee/licensee under a hybrid form of franchise/license agreement. This single franchisee/licensee will then sub-franchise/sub-license dealers or other similar entities to sell the products from designated retail outlets or through specific channels of distribution. Alternatively, the franchisee/licensee may be authorised to manufacture the product in the foreign country and to sell the product through sub-franchisees/sub-licensees in the described manner.

A hybrid franchise/license agreement will typically take the form of a traditional patent, know-how or trade mark license under which the franchisee/licensee will be required to distribute the product by means of a business format stipulated by the manufacturer/franchisor/licensor.

d) Area Representation Agreements

Although area representation agreements are sometimes used in international franchising, it must be stressed that they are not franchise agreements but are rather more in the nature of agency or commercial representation agreements. Under this type of arrangement the franchisor will typically grant a third party, the area representative, the right to solicit prospective franchisees as well as to provide certain specific services on behalf of the franchisor to existing franchisees within an exclusive territory. These services will normally cover both the establishment and the continued operation of the franchise outlets.

Area representation arrangements are sometimes treated as a variation of master franchising in which the franchisor receives the same benefits as in master franchising while at the same time avoiding certain of the problems associated with it, namely the handing over of the control of the franchise system and trademarks to the sub-franchisor and the issues that arise in connection with the termination of the master franchise agreement. It should be observed that since area representatives traditionally do not make the same investment as sub-franchisors and do not develop the same goodwill as would a sub-franchisor under a master franchise arrangement, the franchisor cannot expect the area representative to have the same qualities as a sub-franchisor. Rather than being an alternative to master franchising, area representation arrangements are typically associated with direct franchising, in that it is the franchisor, and not the area representative, who maintains a direct contractual relationship with the franchisee. The area representative merely seeks out prospective franchisees, interviews them and makes a recommendation as to their suitability to the franchisor. Area representatives may assume some of the supervisory functions of the franchisor, such as for example training and monitoring the manner in which the franchise system and trademarks are being used by the franchisee, but also in this case the area representative is merely acting as a representative of the franchisor.

B. EXPANDING INTERNATIONALLY: SELECTING THE APPROPRIATE VEHICLE AND NEGOTIATING THE AGREEMENT

I. FACTORS TO CONSIDER WHEN DETERMINING THE MOST APPROPRIATE VEHICLE

An entrepreneur who has decided to expand abroad must determine which commercial vehicle is the most appropriate for its type of business and for the achieving of its objectives. Similarly, the prospective local partner of an entrepreneur must evaluate the type of business it is able to set up as well as the type of relationship it wishes to establish with the foreign partner. A number of factors might be of relevance in this evaluation, some of which are objective factors, such as the market, cultural considerations and the legal environment, other of which are subjective, such as the nature of the business itself, the economic conditions of the parties, their experience, how they intend to divide the responsibility and the revenue, and the control the foreign partner wishes to exercise over the operation of the local partner. Most of the factors considered below are of relevance to both parties, even if each of them will consider the factors from its own perspective.

a) Objective Factors

(1) The Market

Of fundamental importance in the choice of a vehicle is the condition of the market that the system is intending to enter. The factors that should be considered include the type of economy prevailing in the host country, as the approach adopted could be radically different depending on whether the economy of the host country is an open economy without substantial government control, an open economy with significant government control (such as the right to approve the relationship and its terms), a newly industrialised economy, a centrally-planned economy, a newly opened economy where market forces are still evolving, or an emerging economy in a developing country. Other economic factors include the host country's prevailing inflation and interest rates, the ease with which the local partner can finance its investment, the possible role of banks and other financial institutions in the negotiations for, and operation of, a franchise, and the availability of alternative sources of know-how and well-known marks that may make the franchisor's system less of a unique commodity.

It should perhaps be recalled that in franchising it is common for the franchisor to provide a market study analysing the local market and the potential development of the franchise in that particular market. In an international situation the possibility of a franchisor providing such a study for a foreign country is considerably reduced. The franchisor may have to rely on its local partner to provide such an assessment.

The general attitude of the local authorities is also of importance. The interest of a system under which fees and royalties should be exported is, for example, considerably reduced if the local authorities introduce currency restrictions.

(2) Cultural Considerations

An assessment of the vehicle to adopt will also include a number of cultural considerations. If, for example, there is no entrepreneurial tradition in the host country, then a vehicle that permits the foreign entrepreneur to exercise greater control over the operations, that ensures that the local operators are adequately trained and therefore able to function effectively, might be the one most suitable.

Cultural considerations are perhaps most important when the decision to enter the market of a particular country is taken. Whether or not a particular product or service, a particular trademark or trade name, or a particular way of operating, is acceptable in a country will often depend on local traditions, on religious customs and on the local legislation.

(3) The Legal Environment

The legal environment in the host country is of considerable importance in determining what vehicle is the most appropriate. For franchising to function there must be a general legislation on commercial contracts, an adequate company law, sufficient notions of joint ventures, intellectual property legislation and an effective enforcement of the rights guaranteed by this legislation.

If the existence of certain legislation is a pre-condition for the effective functioning of franchising, there are other legal factors that may determine whether or not franchising is appropriate. These include, for example, any registration requirements, the need to submit the agreement to a government authority for approval, the existence of restrictive currency control regulations, import and/or export quotas and tax regulations, including any possible double-taxation agreements. The effects of the above legislation might be considerable. For a contract to be approved it might be necessary to amend it in order to make it conform to the applicable requirements. These amendments might radically change the nature of the relationship, which as a result may no longer be satisfactory to the parties. If this is the case, it might be advisable for the parties to consider resorting to another commercial vehicle.

b) Subjective Factors

(1) The Nature of the Business

Of fundamental importance in the selection of the most appropriate vehicle is the nature of the business itself. Not all business techniques are suitable for all businesses at all times. An evaluation of what is suitable must therefore be made for each single case. Franchising is a business technique that has spread to a vast number of different fields of activity, from hotel keeping to fast food to accountancy services. It is therefore easy to assume that franchising will always be suitable. This is however not the case. In certain instances, for example, the parent company will need to exercise a stringent control over the outlet in the host country, with the consequence that it would be better to opt for a wholly-owned subsidiary. In other instances the local partner will not accept to submit to strict control by the parent company as to the running of the business, perhaps because the nature of the business is such that the local partner needs to be able to exercise greater control, also to permit it to react quickly to a changing local market, in which case a distributorship might be preferable. In a number of businesses an exact conformity of interior decorating among all outlets might, for example, not be necessary, in which case, again, a distributorship might be preferable.

In determining whether or not franchising is the most appropriate vehicle for a particular business, a number of factors should be assessed. First and foremost the business concept must be tested. It must in other words have proved to be successful in practice. It should furthermore be distinctive both in its public image and in the system and methods it adopts and it should be capable of being passed on successfully to others. The financial aspects are also of fundamental importance. The financial returns from the operation of the franchised unit must therefore be sufficient to enable the franchisee to obtain a reasonable return on the assets employed in the business, to enable it to earn a reasonable income and to enable it to pay the franchisor a reasonable fee for the services the latter supplies. The income generated by the franchisor from the operation of the franchise must in turn be sufficient to cover the franchisor's overhead costs and to permit it to earn a reasonable profit.

(2) Economic Circumstances Affecting the Choice of a Vehicle

Which vehicle is selected will to a large extent depend upon the financial situation of the parties. Franchising is a form of business that requires less investment on the part of the franchisor than the setting up of a traditional business in a foreign country. It is in the nature of franchising that most of the investment in the host country is made by the sub-franchisor, the area developer or the franchisee, depending upon which type of franchising is opted for. This does not, however, mean that the franchisor does not have to make a substantial financial investment. Training must be provided for, an efficiently functioning structure for servicing and assistance to sub-franchisors and franchisees must be in place, adequate staffing to support the foreign sub-franchisors or franchisees *in loco* must be hired, the expenses involved in the registration of, for example, intellectual and industrial property rights must be faced. The means must therefore be substantial, both those of the franchisor and those of the sub-franchisor or developer, who are

those who actually have to set up and operate the network. It is clear that a certain cost is associated with each business technique. An evaluation must therefore be made by the parties with a view to determining which technique is the most effective in economic terms.

(3) The Experience of the Parties

The experience of the parties is of importance in a number of respects. If the parent company is considered first, it may be observed that there is a considerable difference between running a chain of wholly-owned outlets and running a network of outlets by means of a master franchise arrangement. If the prospective franchisor has no experience in franchising, it is probably advisable for it to proceed step by step, beginning with it opening its own pilot operations before proceeding to franchise internationally. Furthermore, international franchising by means of a master franchise arrangement is different from franchising by means of an area development agreement or direct unit franchising. If a franchisor has no experience in master franchising, it is advisable for it to acquire this experience in its own country before attempting to use master franchising abroad.

Previous experience with franchising is less important for the prospective sub-franchisor than for the franchisor. It is after all the franchisor who is supposed to provide the training for the sub-franchisor to learn the business, the manuals describing in detail the methods to adopt in the running of the business as well as the continued assistance. In the case of master franchising or area development franchising it would however be important for the prospective sub-franchisor or developer to have business experience, as the running of networks of businesses, particularly as large as master franchise or area development networks, requires ability and professional knowledge. If the prospective sub-franchisor or developer does not have the necessary experience, it is advisable for it to consider adopting another business technique.

Any contract is the natural reflection of the relative bargaining strengths of the parties. What each of the parties is able to obtain from the other will therefore to a large extent depend upon the ability of the parties in negotiating and on the assets they are able to use in the bargaining process. Such assets may also be personal, such as the knowledge and experience of a prospective sub-franchisor in negotiating and implementing international transactions, or in the solving of legal and economic problems.

(4) The Division of Responsibilities and Revenue

The division of responsibilities, and consequently the division of revenue, between the parties will differ from one form of business to another. Within franchising itself, this division will differ from one method of franchising to another. It is in the nature of master franchising that the responsibility of a sub-franchisor will be considerable: it is the sub-franchisor who is responsible for the development of the network, for providing training and assistance to the sub-franchisees and for supervising and enforcing the intellectual and industrial property rights of the franchisor. In the case of direct unit franchising the responsibility of the franchisee will be considerably less: it will not have any responsibility for a network, nor will it have to enforce the intellectual and industrial property rights of the franchisor. In all likelihood it will only be required to inform the franchisor of possible infringements. Similarly, the responsibility of an agent is different from that of a distributor, which again differs from that of a licensee.

The difference in responsibility will also be reflected in the revenue of each of the parties. The more responsibility a party has, the more revenue it is likely to retain. In the case of master franchising, the sub-franchisor must have sufficient revenue to be able to perform its obligations while at the same time permitting it to make a profit. The franchisor must however retain a sufficient revenue flow to account for its unique role in the relationship. Any decision on the vehicle to adopt will also reflect any shifts in responsibility and in the collection of revenue.

(5) Control

An important factor in deciding the most appropriate vehicle for a given situation is the degree of control exercised by the foreign partner over the local partner. In franchising that control

is greater than in licensing or in distributorships. Furthermore, within franchising the degree of control will vary depending on the form of franchising adopted. The control is the most stringent when the direct involvement on the part of the franchisor is the greatest. The control on the part of the franchisor will therefore be the least in master franchise arrangements, as it is in these that there is the least involvement on the part of the franchisor, even if a certain amount of control will always remain. What is acceptable to the two parties will depend on a number of factors, including such subjective factors as personality. A stringent control might, for example, not be acceptable to a person of independent nature who may instead be best able to perform when required to take independent initiatives. A balance between the interests of the two parties must be created also in this respect.

(6) The Risk Factor

Risk is an inherent part of any business and the assessment of the risk involved in the contemplated transaction involves attempting to evaluate the uncertain. One of the reasons for the popularity of franchising is the fact that the statistical information available for unit franchising indicates that the failure rate of franchised businesses is substantially lower than that of other, more traditional forms of business. The uncertainty involved in business would therefore appear to be considerably reduced. It must however be stressed that while this is true of mature franchise systems, in which the concept has been tested and proved, the situation is different for young franchise systems. In these, the risk of failure may in fact be greater than that of traditional businesses. A certain caution is therefore called for in the selection of a franchise, in particular in an international situation. The following remarks refer to mature franchise systems.

In franchising the risk is reduced for franchisors to the extent that they are not using their own capital to develop the system, but the franchisee's. In the case of franchisees the risk is reduced because the business concept they are investing in is proven and accepted by consumers. A sharing of the risk involved between the franchisor and the sub-franchisor, who is the party in the best position to evaluate the risks of the host country, is often provided for in the contract or in the arrangements made.

Most of the risk factors involved are not unique to franchising. There are, however, a number of them that may be considered to be of particular relevance to this form of business. While it is true that risk is lowered because the franchise uses a method which is tested and which has proved to be successful, it is also true that the rigid requirement of observance of the franchisor's blue-print might prevent the sub-franchisor from introducing changes to the system that are essential to ensuring that the franchise is successful in that particular country. Furthermore, the rigidity of these requirements might unduly delay the introduction of modifications which have become necessary due to changes in circumstances. Specific terms of franchise agreements, such as the exclusivities that might be granted, are also to be included among the risk factors, as although they might offer certain guarantees at the beginning of the relationship, they might subsequently prevent the sub-franchisor from adopting a more convenient alternative, for example in the provision of goods, than what is offered by the franchisor.

(i) Risk Factors to be considered by the Franchisor

In order to reduce uncertainty the franchisor will need to consider all the factors that might constitute an element of risk. In case of international franchising such risk factors may be grouped into two major categories: external and internal.

(aa) *External Risk Factors*

Examples of external factors are expected economic developments, the possibility of trade embargoes and the fact that the necessary raw materials are found to be insufficient in quantity or quality. Most of the external factors are beyond the control of the franchisor, but the risk derived from these factors may be reduced by the gathering of more detailed information and by ensuring that the information that already is available is reliable.

First and foremost the political situation in the prospective country must be considered. The stability of the political system may be considered to constitute a guarantee for a stable socio-economic situation and this is fundamental for the establishing of a favourable commercial climate. If the economic climate is good, and there are sound business reasons for the franchisor to develop internationally, then it is advisable for the franchisor to have a reliable feasibility study prepared covering:

- ◆ the legal environment;
- ◆ the situation of the market;
- ◆ local customs, culture, habits and possible difficulties associated with language;
- ◆ geographical distances and the communication systems, both local and international;
- ◆ the possible ways of selecting the right partners (including local counsel);
- ◆ the conditions under which it would be possible to train a sub-franchisor and the sub-franchisees of the sub-franchisor; and
- ◆ the possible ways of sharing the unavoidable risk.

(bb) *Internal Risk Factors*

Internal factors include the organisational arrangements of the domestic operation of the franchisor and the financial and human resources available to it. If, for instance, a franchisor operates by using direct unit-by-unit franchising, it might be inappropriate for that franchisor to consider foreign operations by means of master franchise arrangements, as it has no experience in managing such three-tier systems. If the franchisor's system does not already have a unit able to handle the administration, training and control necessary in a master franchise arrangement, and which is also able to adapt its structure to the needs of the host country or countries, the franchisor will need to devote additional financial resources to the establishing of such a unit. The risk is that if such factors are not taken into account, the international activities will create a heavy drain on the financial and staff resources of the franchisor, thereby harming the domestic operations of the franchisor and ultimately also jeopardising its international activities.

(ii) Risk Factors to be considered by the Sub-Franchisor

To a certain extent the risk factors a sub-franchisor must evaluate are a mirror image of those a franchisor needs to consider. Thus, it is not only the franchisor who must consider the political climate of the host country, but also the sub-franchisor: if the climate is hostile it will not only be the franchisor who will make a bad investment, it will also be the sub-franchisor. In addition, the sub-franchisor might have to face the prospect of paying penalties to the franchisor for non-compliance with the development schedule. If there is a trade embargo that effectively prevents the importation of raw materials that are needed for the franchise, the sub-franchisor will either have to resort to alternative sources of supply, or resign itself to finding that the network will not be able to provide goods or services that fit the specifications of the franchisor as to quality and maybe quantity. In the latter case the sub-franchisor would be open to claims from both the franchisor for not respecting the terms of their agreement and from the sub-franchisees who are no longer in a position to provide customers with the quality goods or services that these expect.

The elements listed above as important for franchisors to consider in a feasibility study are relevant also to sub-franchisors, even if sub-franchisors will consider them from a different point of view. The legal environment is important as it will determine the obligations of the sub-franchisor in, for example, registering the enterprise and in protecting the intellectual and industrial property. If the sub-franchisor does not comply with the legal requirements it may face a claim from the franchisor, in addition to risking its investment. Clearly, an evaluation of the market is essential for the sub-franchisor before it decides to launch into the franchise it is considering entering. This is closely linked to the local customs, culture and habits, as the viability of the product or service might well depend on these factors. Geographic distance and the

communication systems are important for the servicing of the franchise network and therefore for the evaluation of what the sub-franchisor is able to offer sub-franchisees in terms of assistance and the providing of goods or materials.

II. THE SELECTION OF A SUB-FRANCHISOR

The selection of the right partner is of essence and involves a considerable risk for franchisors. The master franchise relationship is one which is to last over time, it involves considerable investment on the part of both franchisor and sub-franchisor, often considerably more than first estimated, and it would be both difficult and expensive to dismantle the system. Selecting the wrong partner could therefore have devastating effects in terms of the possible discrediting of the franchise system and of the loss of investment.

Factors of relevance for the selection of a sub-franchisor include the business experience of the prospective sub-franchisor, the managerial qualities and capabilities of the sub-franchisor or of the managers of the sub-franchisor if the latter is a corporate body, the knowledge of the sub-franchisor as regards such matters as the bureaucratic requirements and official bodies of the host country, the financial soundness of the sub-franchisor, the knowledge of the sub-franchisor of the targeted market and consequently the acumen of the sub-franchisor as regards the modifications to the system that are essential or would be desirable.

The functions to be performed by a sub-franchisor are essentially the same as those performed by a franchisor, in view of the fact that sub-franchisors generally take the place of the franchisor in the licensed territory. These functions include:

- ◆ the identification of suitable sub-franchisees;
- ◆ the appointment and training of the sub-franchisees;
- ◆ the offering of assistance to sub-franchisees in the selection and approval of sites for franchised units;
- ◆ the arranging, as needed, of available supplies and services for unit franchisees;
- ◆ the co-ordination of advertising efforts;
- ◆ the policing of the system within the territory to ensure that each and every sub-franchisee complies with its obligations, to maintain uniformity among the unit operations and to identify possible infringements of the system's intellectual properties in the territory; and
- ◆ the collection of royalties and other payments from unit franchisees.

The personal attributes necessary to a suitable sub-franchisor therefore include initiative (although it should not be so independent that it will wish to break away from the system), management skills, the capacity to recognise the qualities of others and to motivate them, a commitment to the franchise system and in general a willingness to operate for the promotion of the network. Experience in business and a general knowledge of local conditions, customs and laws are furthermore of considerable importance in a sub-franchisor.

III. THE SELECTION OF A FRANCHISE BY A PROSPECTIVE SUB-FRANCHISOR

A prospective sub-franchisor will need to make a careful assessment of the investment that it is required to make, in terms of:

- ◆ the fees and royalties that the franchisor will charge;
- ◆ the hiring or acquiring of premises;
- ◆ the fitting and decoration of the premises;
- ◆ staffing requirements (salaries but also training and any permits or taxes that might be charged for foreign employees);

- ◆ the cost of the actual running of the operation, including the servicing of sub-franchisees with all that that might involve; and
- ◆ any additional costs involved in the setting up of a pilot operation.

A certain amount of training and assistance will be necessary no matter how sophisticated an entrepreneur the sub-franchisor is. The sub-franchisor is after all to run a system in conformity with the specifications of the franchisor and to all intents and purposes this system will be new to it. The risk is that the training and assistance provided by the franchisor will prove to be insufficient, with the result that the capability of the sub-franchisor to manage the system and to furnish adequate assistance to sub-franchisees will be impaired. This risk is the greatest in countries which are considered at risk by the franchisor: if the franchisor fears that the returns from that franchise will be practically non-existent in the future and feels that the chances of success are so tenuous as not to justify the investment that would be required for proper training and servicing, the chances are that the sub-franchisor will be charged a high entrance fee, out of all proportion with the rights it acquires and the services it receives.

The selection of the right partner is extremely important for sub-franchisors: a sub-franchisor must be in a position to evaluate the general soundness of the franchisor, its efficiency and the assistance that it is prepared to offer. If the franchisor does not provide the training and assistance that the sub-franchisor is entitled to expect, or does not perform certain duties, such as for example the registration of the intellectual and/or industrial property with the appropriate authorities, or if the franchisor is not financially sound and goes bankrupt, the sub-franchisor will risk its investment. Of considerable importance is also the experience that the franchisor has with international business, with international franchising in particular, and with master franchise arrangements as opposed to other forms of franchising.

For the sub-franchisor to be able to make a correct evaluation of the franchise, of the franchisor's solidity, of the assistance provided by the franchisor and of the franchisor's relations with, and behaviour towards, the members of its network, sub-franchisors and franchisees alike, it is necessary for the sub-franchisor to make the effort to check the information it has received on the franchisor and the franchisor's history. In this connection contact with other sub-franchisors and franchisees, exchanges of views with reference to their experience, is essential. All too often a lack of due diligence in this respect has led to mistakes being made with consequent loss of the investments made.

Internal factors are important also for the sub-franchisor, as a mistaken evaluation of the capability of, for example, its own staff, may create problems for the servicing of the network. It is essential for the sub-franchisor to make a serious and as correct an evaluation as possible of the means at its disposal, of the effectiveness with which it will be able to use them, and of the financial implications involved.

IV. NEGOTIATING INTERNATIONAL AGREEMENTS

Unit franchise agreements are at times equated with contracts of adhesion as franchisors tend to use standard agreements throughout their systems. The situation is different with master franchise agreements which are normally negotiated extensively. This should come as no surprise, considering that the subject-matter of a master franchise agreement is the granting of franchise rights for a larger area, at times for a whole country or even for more than one country. Unless the country of the franchisor and that of the sub-franchisor are geographically and culturally close to each other, the national differences in terms of language, culture, traditions, religion, law, and economic and social development will be such as to make modifications to the franchise system imperative if it is to be successful in the country of the sub-franchisor. A standard contract that has been tailor-made for use in one country is therefore unlikely to be suitable for another country. The importance of the negotiation process, in the course of which all the necessary modifications are agreed upon, is therefore considerably enhanced in the case of master franchise agreements, particularly in that of international master franchise arrangements.

The negotiations between the franchisor and the sub-franchisor are important also with a view to foreseeing possible future developments to the system. To the greatest extent possible changes to the system should be foreseen from the beginning and a procedure for the introduction of the necessary changes provided for.

In this context the disclosure of information should be considered. Closely linked with the duty of good faith, or good faith and fair dealing, is the duty, moral or imposed by statute, to provide the other party with information. In the case of franchising it is pre-contractual disclosure that is of particular importance. This involves the franchisor supplying the prospective franchisee with information that will permit it to have at its disposal all the elements necessary to evaluate the franchise it is proposing to acquire. This duty is regulated in a number of countries, although with a varying amount of detail.¹⁰

The disclosure of information is of the utmost importance in the building of trust between the parties and for the creation of a mutually beneficial relationship. The disclosure should therefore be mutual, even the statutes and regulations that exist only consider disclosure on the part of the franchisor and not of the sub-franchisor or sub-franchisees. Furthermore, for the benefit of the relationship it would be preferable if the disclosure continued also during the life of the contract. It should perhaps be noted that a duty to inform might in some jurisdictions be considered to be covered by the general principle of good faith and fair dealing.

Whether or not the pre-contractual disclosure, that is the disclosure of information prior to the conclusion of the contract, is as important in a master franchise relationship as in a sub-franchise relationship or a simple unit franchise relationship is disputed. The *European Code of Ethics for Franchising* adopted by the European Franchise Federation, which obliges the franchisor to give the franchisee “full and adequate written disclosure of all information material to the franchise relationship” in order to allow the potential franchisee “to enter into any binding document with full knowledge”, indicates that it is not, stating that the Code of Ethics “shall not apply to the relationship between the franchisor and its master franchisees”. The justification for this is to be found in the normally extensive business experience and the financial background of the sub-franchisor, who usually is a business person or a business entity, as this experience will place it on the same negotiation level as the franchisor. In many cases the sub-franchisor is, or belongs to, a substantially larger economic unit than the franchisor itself. In the case of master franchising it may therefore be assumed that the parties have performed their pre-contractual obligations with the diligence required in any international business transaction. In the course of the negotiations it is nevertheless normal for a franchisor to reply to any questions that a prospective sub-franchisor might have and to furnish the required information. In this connection it should not be forgotten that a franchisor would be bound by any mandatory disclosure laws that might exist in the country concerned as these will usually apply also to master franchise relationships.

V. DRAFTING INTERNATIONAL AGREEMENTS

The master franchise relationship is often regulated by a number of documents in addition to the main master franchise agreement. These may include a manual for the sub-franchisor, an operations manual that the sub-franchisor is to provide the sub-franchisees with regarding the operation of the unit, reports and records to be furnished to the sub-franchisee, advertising guidelines, separate agreements regarding the intellectual property and licence agreements.¹¹ In a number of countries these and similar issues are dealt with in the framework of the main master franchise agreement whereas in others they will instead form the subject-matter of one or more separate agreements. The technique adopted will to a large extent depend upon the drafting techniques traditional in the country or countries concerned.

Practical considerations would appear to dictate that agreements should be drafted in the style and language of the country in which they are to be executed, as that is the country in which any disputes are likely to arise and in which they are to be decided. In most instances this will be

¹⁰ See Annex 3 to this Guide.

¹¹ For a number of collateral agreements, see Chapter 19 “Ancillary Documents”.

the country of the sub-franchisor. It is however not uncommon for franchisors to be reluctant to accept that their contracts may differ depending on the country in which they are operating. Franchisors will often prefer that with which they are familiar, be it the language of the agreements, the format in which the agreements are couched or the law that is to apply to them.¹² This is understandable, considering that franchisors operating internationally will often be active in a number of different countries and that their contracts would therefore need to be written in a considerable number of different languages and styles. This would naturally make it difficult for the franchisor and the franchisor's lawyers to maintain control over the operations. Regrettably, they do not always realise the considerable number of problems that they might run into if they insist on applying their own law, language and contract format.

One option is to adopt different approaches for the master franchise agreement and the sub-franchise agreements. In this case the master franchise agreement will conform more strictly to what the franchisor considers to be essential in terms of language, applicable law and drafting technique, whereas the sub-franchise agreements, which after all are contracts between the sub-franchisor and the sub-franchisees, will instead conform to local requirements. It should however be pointed out that there is no clear-cut solution and that the situation in each country should be examined with the assistance of local counsel.

a) *Language of the Agreement and of the Other Documents*

In a majority of international master franchise relationships the language of the franchisor's country is different from that of the country of the sub-franchisor and sub-franchisees. The language of the agreements, as well as of any collateral documents, is therefore a critical and often sensitive issue.

In a number of countries it is even a point of law, as agreements must be in the local language to be valid. At the very least, a translation of the agreement into the local language must be annexed to the original agreement which is in the language of the franchisor. This is especially important in countries in which agreements must be registered with the public authorities, as registration may not be possible if the agreement is not in the local language. In such cases it may be advisable for the parties to agree on which language should be authoritative in case of controversy, as there may be linguistic discrepancies between the two versions. It should however be borne in mind that the courts of the country of the sub-franchisor may not be able, or permitted, to take the version in the foreign language into consideration in reaching its decision.

It may appear to be logical or normal for sub-franchisors, or for the officers of the sub-franchisor where the sub-franchisor is a corporate body, to be able to understand the language of the franchisor, particularly if it is one of the main languages used in international trade relations. This is however not necessarily the case. Nor, if the sub-franchisor or its officers speak the language of the franchisor, is it possible to assume that they will understand everything that is written in a detailed manual or that there will be no misunderstandings. It is therefore good business practice to furnish all the documentation, including the manuals, also in the language of the sub-franchisor, so as to avoid misunderstandings or allegations of misrepresentation.

The language requirements applicable to collateral agreements will vary depending on the country and the type of agreement. Thus, for instance, any licence agreements for intellectual property rights may need to be in the local language as they will in most instances have to be registered with the appropriate offices.

Manuals are documents that in most countries do not need to be deposited or registered with any government authority. The situation might therefore be different, although a number of considerations need to be made in this connection. A first consideration is that there may be more than one manual: a manual for the sub-franchisor, containing all the instructions and information that the sub-franchisor needs to know to be able to act in place and on behalf of the franchisor in its country or area, and secondly the manual that the sub-franchisor will supply sub-franchisees with, detailing all that is necessary for the running of the single outlets. Of these

¹² The question of the law applicable to the agreement is examined at greater length in Chapter 17.

two different types of manual the second is by far the more common. A vast majority of franchise systems have manuals for the franchisees or sub-franchisees, but only few franchisors supply sub-franchisors with a manual.

If it is advisable for the franchisor to provide the sub-franchisor with a manual in the language of the sub-franchisor, it is essential for the franchisor and/or sub-franchisor to provide sub-franchisees with a manual in the local language. Sub-franchisees cannot be expected to have a sufficient knowledge of the language of the franchisor for a manual to be provided only in that language. Furthermore, it might be necessary to vary the contents of the manual to take local requirements into account. A close collaboration between the franchisor and the sub-franchisor, who is best placed to determine the modifications that must be made to the manual to conform to local requirements, is therefore essential. Questions of copyright (who is to own the copyright to the modified manual) and of costs (who should pay for the translation and also for publishing or duplication) are best determined in the agreement between the franchisor and the sub-franchisor.

Changes in signage, menus, labelling, or advertising may be necessary in some markets but not in others as a result of differences in language. It is also often necessary to translate and adapt the trademarks to the local market.

Other questions to be determined in relation to language are the language in which any submissions to the franchisor should be made, for example proposals for advertising, or progress reports and reports on the franchisees in the territory.

b) Drafting Technique

The style in which contracts are drafted varies from family of legal systems to family of legal systems, sometimes even between countries within a family of legal systems, as a result of the specific requirements of each. These requirements are often the result of the historical development of the legal system concerned. Thus, the legal systems that for example are derived from, or inspired by, Roman law will have requirements that are different from those that are derived from the English common law. These differences are reflected in the manner in which the national legislation is drafted, but also in the drafting of all legal acts.

A common observation is that contracts in common law countries are longer and more detailed than those drafted in civil law countries. This observation is accurate, even if the reasons for this difference are not always reflected upon. In general, the length and detail of the contracts is related to the way in which the legislation is drafted and to the procedure adopted by the courts in adjudicating disputes.

(1) Civil Law Legal Systems

A number of different legal systems are normally grouped together under the term "civil law legal systems". These include the legal systems that are the descendants of Roman law, such as the French, Italian and Spanish legal systems and the legal systems that have drawn inspiration from them, for example Latin American and a number of North African legal systems; the Germanic systems that are derived from German law (Germany, Austria, Switzerland) and the legal systems inspired by them, such as the Japanese and the East European systems before the advent of Socialism, and also the Scandinavian legal systems which, however, constitute a separate grouping.

With the exception of the Scandinavian legal systems, a characteristic of the legal systems of the civil law tradition is the systematic codification of different areas of law (civil law, commercial law or criminal law). The result is a body of law which is organised in a systematic manner and which often contains a detailed regulation of a number of subject-matters that in other legal systems are left to the determination of the parties. A number of these provisions are mandatory and may therefore not be derogated from, whereas others are non-mandatory, with the result that their subject-matter may be determined and regulated by the parties. The codes, or special legislation, will cover general contract law, including the formation, interpretation, assignment,

non-performance and termination of contracts, as well as a certain number of special contracts, although which are covered will vary from country to country.

As a large number of issues are regulated by the legislative instruments, there is less need for the contracts to enter into great detail except where the parties feel that a certain amount of detail is necessary or desirable. This may particularly be the case where the parties want to give a precise indication of their agreed will to courts which may analyse the agreement in the future. This may be of considerable importance as the courts will in some jurisdictions have the power to interpret the contracts and to modify the terms of the agreement if these terms are considered unfair. Furthermore, if an item that is dealt with in the non-mandatory provisions of the codes is not provided for more specifically in the contract, the terms that are in codes will apply. Clearly, the mandatory provisions of the codes will always apply no matter what the contracts say.

The fact that detailed provisions are laid down in statutes or codes makes it unnecessary for the contracts to go into great detail. In fact, to do so might lead to confusion and to the risk that a large number of provisions run counter to the statutory or codified law and therefore are invalid. In general terms it might be said that it would be unwise to follow the more detailed common law model for a contract that is to be applied in a civil law jurisdiction and vice versa.

(2) The Common Law Legal Systems

What first strikes a lawyer from a civil law legal system when confronted with a contract from a common law jurisdiction is its length. The great detail with which provisions are drafted is unheard of in civil law jurisdictions. The reason for this great detail is to be found in the strict adherence of courts to the word of the statutes. This created a need for the contracts to be extremely detailed so as to cover every possible contingency. Lawyers therefore try to imagine every potential conflict that might arise in the future and draft their contracts accordingly.

c) *Drafting Alternatives*

A number of different drafting alternatives are possible. Which is the most suitable will depend on the jurisdiction in which the contract is to be implemented. The main alternatives are firstly, a comprehensive contract in the common law style, covering every possible condition and event; secondly a written document containing references to other documents, such as accessory agreements or general conditions of trade; and thirdly a short contract with reference to the applicable legislation. The second and third options might of course be combined, in that it is possible to have a contract that refers to both legislation and accessory agreements or other documentation.

These alternatives are available for the contract as a whole, but also for specific terms thereof such as the arbitration clause. This clause might be written with a certain amount of detail, or may be extremely short, referring simply to the type of arbitration to be resorted to in case of dispute (for example, ICC arbitration).

VI. INTERNATIONALISING THE FRANCHISE SYSTEM

A franchise system that is expanding into one or more foreign countries will in most cases need to be modified before it enters the foreign market, as it will be necessary for it to adapt to the local conditions of the host country. The franchise agreement and the ancillary documents will consequently also need to be adapted by the franchisor to cover the local requirements of the host country. Among the factors to be considered in this connection are the following:

- (a) the language of the documentation and of the agreement,¹³
- (b) currency issues: where the franchisor and the sub-franchisor or franchisee use different currencies, the agreement should specify the currency in which payments are to be made.

¹³ See the discussion on language above, page 30 ff.

Special provisions may furthermore be required in cases in which the host country has currency restriction laws in place;¹⁴

- (c) technology transfer laws: a number of countries have legislation regulating the transfer of technology, in accordance with which the approval of the authorities must be obtained prior to the use of foreign

¹⁴ See Chapter 4.

technology or know-how in the country;¹⁵

- (d) competition laws: antitrust, or competition, laws often affect practices that are inherent in many franchise systems, such as exclusive dealing arrangements, tying arrangements, price fixing and covenants not to compete. It may therefore be necessary to adapt the franchise agreement to ensure that it does not fall under the applicable competition law;¹⁶
- (e) tax issues: payments made to a franchisor, including the payment of initial franchise fees, royalty fees and, in some cases, advertising fees, are typically subject to income and withholding tax under the tax laws of most countries. Under these laws, payments to the franchisor are subject to an income tax calculated as a specified percentage of such payments and the tax must be withheld by the payor and remitted to the national taxing authorities. Many countries have double taxation treaties that reduce the withholding rate or eliminate such taxes altogether. A reduction of the taxes to a minimum will usually require a sophisticated analysis of tax credits, tax treaties and of the sources of the franchisor's income;¹⁷
- (f) trademark considerations: a number of countries require use for protection to be granted trademarks. In order to satisfy this requirement some of these countries will require that any licensed use of a trademark or service mark be recorded with the trademark authorities in the form of a registered user agreement. It is also necessary for the franchisor to consider the advisability of adapting its trademarks and signage to the local market;¹⁸
- (g) cultural differences: many franchise systems adapt to differences in the cultures or tastes of different countries by developing country-specific products, flavours, or formulations;
- (h) supply arrangements: the supply arrangements made by a franchisor in its own country may not be suitable for markets located at a great distance from the franchisor's country. In the international franchise agreement adequate provision must therefore be made to ensure that a constant supply of approved products is available to distant franchisees;¹⁹ and
- (i) dispute resolution: while a purely domestic franchise relationship will in most cases not give rise to questions of choice of law and jurisdiction, this is not the case in an international relationship. Franchisors with foreign operations will in fact need to give special attention to choice of law and jurisdiction in their agreements. In doing so, they will need to consider whether the countries of the parties are signatories to any relevant convention or treaty.²⁰

VII. SUBSEQUENT CHANGES

Franchise agreements, particularly master franchise agreements, are normally intended to last for several years. It will therefore be necessary to introduce adaptations of and modifications to the system in the course of the life of the relationship.²¹

In a three-tier franchise system the sub-franchisor will be the party principally responsible for ensuring that the necessary modifications are implemented by the sub-franchisees. In that context, the agreement and manual are likely to be the primary instruments through which change will be effected, as the sub-franchisor may not be in a position to offer inducements, to provide financial assistance, or to make concessions to the franchisee in exchange for the introduction of the modifications.

Whether or not a proposed modification is considered to be reasonable or even feasible will in part be conditioned by the cost of introducing the proposed modification. The extent to which

¹⁵ See Annex 3.

¹⁶ See Annex 3.

¹⁷ See Chapter 4.

¹⁸ See Chapter 10.

¹⁹ See Chapter 9.

²⁰ See Chapter 17.

²¹ See Chapter 12 "System Changes".

the cost of introducing a proposed modification is substantially different in countries other than the franchisor's own country may have an influence on the decision as to whether to implement the modification throughout the system world-wide and, if so, on the time schedule and on the allocation of responsibility for the actual implementation of the changes. Franchisors often try out changes in their countries of origin before imposing them on franchisees in other countries. In many cases the market in other countries may not be ripe for the change, as when, for example, local suppliers are not able to comply with new product specifications.

Many changes introduced in a domestic franchise network might not be feasible in a foreign setting. A franchisor that, for example, begins to distribute its products through alternate channels of distribution such as supermarkets, or that permits its franchisees to sell at satellite locations from carts or kiosks, may not be prepared or equipped to implement the same changes in its overseas operations.

CHAPTER 2

NATURE AND EXTENT OF RIGHTS GRANTED AND RELATIONSHIP OF THE PARTIES

A successful franchise system enables the affiliated franchisees to use a proven business method for the delivery of a product or service. This business method is an assembly of largely intangible assets developed and arranged by the franchisor in accordance with a formula or pattern often referred to as the “franchise system”. A franchisee gains access to this assembly of assets by obtaining the right to use it from the franchisor. The granting of rights is the cornerstone of the relationship between the franchisor and the franchisee. In master franchising a clause granting rights will be necessary in both the master franchise agreement and the sub-franchise agreements. The characteristics of these clauses are fundamentally similar, even if the master franchise agreement will, in addition to specifying the rights that the sub-franchisor is granted, delimit the rights that the sub-franchisor is authorised to grant the sub-franchisees.

The granting of rights is not a one-time transaction, but rather the beginning of a long-term relationship between the parties. The clause granting the right to use the franchise system delimits the sub-franchisor’s authority and constitutes the foundation on which the other provisions of the agreement build. Without the grant of rights the other provisions have no meaning, as their role is to establish in greater detail the terms of the relationship outlined in the grant of rights. The grant of rights is thus often considered to be subject to, or modified by, all the other terms and conditions of the franchise agreement.

In essence, the grant provision of the franchise agreement creates a licence. The sub-franchisor is licensed to use the specified assets of the franchisor, such as trademarks, know-how and intangibles, as well as to expand the franchise system in the manner and within the limits provided for in the grant clause and in the other provisions of the agreement. The rights that are granted are limited. The grant provision typically defines:

- ◆ what assets are licensed to the sub-franchisor;
- ◆ the purpose for which the licensed assets may be used;
- ◆ the geographic territory within which those assets may be used;
- ◆ when and/or how long the sub-franchisor may use those assets; and
- ◆ the degree of exclusivity given to the sub-franchisor (i.e. the extent to which others are restricted or barred from using the licensed assets in the same manner and territory).

The statement of grant of rights thus provides the principal definition of the relationship between the franchisor and the sub-franchisor. All other aspects of the franchise agreement add detail and focus to the definition of the relationship, often by reference to the rights that have been granted.

A. WHAT IS GRANTED

The grant simply licenses the sub-franchisor to use the intangible assets that comprise the method of doing business being franchised in the manner specified in the agreement. Each of the licensed assets may be classified under one of two basic categories of intellectual property: that which identifies the franchise (trademarks, for instance), or know-how.

Most franchise systems adopt the business format approach, which involves virtually all aspects of doing business that might be important to the success of the franchise. In this type of franchising both franchisor and sub-franchisor have an interest in clearly identifying which assets are being licensed to the sub-franchisor.

The franchisor will typically provide a sub-franchisor with a trademark licence and with know-how concerning the business.²² Depending on the nature of the franchise, the know-how transferred will normally include marketing methods, product formulations, product preparation and delivery techniques, purchasing procedures, sanitation methods, quality standards and control, training, inventory management, record keeping, design of facilities and the like. The know-how thus represents the ensemble of experience gained by the franchisor in the course of its activity as entrepreneur and as franchisor. It is this experience that that the franchisor has used to develop procedures and methods that are effective for its type of business. The single elements of the know-how may not be unique, what is unique is instead the manner in which the different elements are combined and used. The single elements of this commercial know-how are therefore not protected, nor is it possible to protect them as they are freely accessible to all. It is only where the know-how is secret that it is possible to protect it and to proceed against anyone who has acquired the know-how by illegitimate means.

In a majority of franchise systems most of the know-how, while perhaps unique in its configuration or in the way in which it is used, is not secret and may therefore generally be legally copied by others who are not licensed, including sub-franchisors whose licence has expired. It nevertheless acquires great value by having been developed into a system which is identified by the distinguishing trademarks and by other proprietary assets. This value is further enhanced by the increasing number of uniform franchised units which contribute to the creation of the strong image and goodwill associated with a franchise system, particularly if it is large.

The grant of franchise rights may be compared with a package deal, in that it normally includes a licence to use all the know-how, both proprietary and non-proprietary. This avoids any doubt as to whether the sub-franchisor is gaining access to all the rights that are understood as forming part of the franchise.

For convenience, the parties will often include the know-how and the identifying characteristics under two basic definitions in the franchise agreement: the system and trademarks. The system includes all aspects of the business system that the franchisor has set up, including all the know-how that comprises the franchised business method and all the identifying characteristics. The trademarks are the words and symbols that identify the franchise system and distinguish it from others.

I. SYSTEM

The definition of the system will usually briefly describe the know-how and other important characteristics that comprise the franchised system. These may include:

- ◆ a description of the nature of the business, including the methods, procedures and techniques of operation, quality assurance techniques, distinctive and standardised designs for products, premises or facilities;
- ◆ a reference to the know-how that comprises the system;
- ◆ a reference to the trademarks, logos, trade names, trade dress and other identifying characteristics of the system;
- ◆ key aspects of the business method that make it unique: this will usually include an operations manual which gives detailed instructions on the proper operation of the franchise; management techniques such as inventory controls, record keeping, personnel practices and purchasing; characteristics of the products; marketing or advertising methods; as well as whatever other aspects of the business are considered to form part of the system that the sub-franchisor is called upon to develop; and
- ◆ the know-how and goodwill of the name, as well as a description of the uniform and attractive public image that all franchised units are required to reflect.

²² See Chapters 10 "Intellectual Property" and 11 "Know-How and Trade Secrets".

II. TRADEMARKS

In addition to the ensemble of know-how, one or more recognisable characteristics will normally identify the franchise system and distinguish it from other businesses. These characteristics normally include one or more distinctive trademarks. They may also include the design of the product or service offered and the unique overall trade dress or appearance of the business as it is being operated. These characteristics are clearly visible to customers and others outside the system.

The identifying characteristics are often proprietary, with the consequence that others may be barred from using them by law. For example, only the franchisor and its licensees may use the trademarks in jurisdictions where the marks have been registered. As the registrations are renewable indefinitely, the trademarks will usually become the most important assets of the system. This is especially true considering that customers and the general public will be more familiar with the trademarks than with any other part of the franchised business. The importance of the trademarks, which identify and protect the system, is such that it is very common to define them separately in contracts. The trademarks that are to be licensed are often identified by listing the trademarks and their registration numbers or the applications for the relevant country or countries. Such a listing may be attached to the franchise agreement as a separate document. Alternatively, trademarks may simply be defined as whatever distinguishing trademarks, symbols, designs or logos are used to identify the franchise system. In any event, any definition must be flexible in order to include trademarks that may be developed in the future.²³

Once it has defined what constitutes the system and the trademarks, the grant clause will simply grant a licence to the sub-franchisor to use the system and the trademarks to develop franchised units in accordance with the terms of the agreement.

B. HOW THE LICENSED ASSETS MAY BE USED

The way in which the sub-franchisor may employ the system is specified in the other terms of the grant clause. There are three basic alternatives: (1) the sub-franchisor may be given the right to develop and operate its own franchised units using the system; (2) the sub-franchisor may be given the right to sub-licence others to use the system; or (3) the sub-franchisor may be licensed to engage in both of these activities.

When master franchise agreements grant the sub-franchisor the right to develop and operate its own franchise units, it is common to require that a separate unit franchise agreement be concluded between the franchisor and the sub-franchisor for each of these units. This enables the operation of each unit to be governed by that separate unit agreement in the same way as any other unit in the network. The master franchise agreement will in this case be able to focus on the sub-franchisor's role as sub-franchisor, without it having to include clauses that relate to the opening and operation of the single units. The separate nature of the unit agreements will furthermore permit the units to operate without much interruption should the master franchise agreement come to an end. It should be noted that the grant of trademark rights may be limited in the master franchise agreement to rights that are necessary for the sub-franchisor to perform its functions as sub-franchisor, namely the granting of trademark sub-licences to the sub-franchisees and the right to use the trademarks in connection with the recruitment, appointment and supervision of sub-franchisees.

A disadvantage of requiring separate unit franchise agreements is that each unit agreement is an international agreement and will therefore be subject to any regulations and requirements that apply to international licence agreements in the country concerned. Compliance with such regulations and requirements is often time-consuming and expensive. On the other hand, separate unit franchise agreements can provide sub-franchisors with a flexibility and independence that will enable them to operate much more efficiently in the area they are to

²³ See Chapter 10.

develop. Whether or not a separate unit franchise agreement should be required must be decided on a case-by-case basis.

C. WHERE THE RIGHTS MAY BE EMPLOYED

The geographic territory in which the sub-franchisor may engage in the franchised business is defined in the grant clause. The sub-franchisor is generally granted the right itself to develop units throughout an entire geographic area, as well as to sub-franchise.

The size of the territory is frequently an issue of much discussion and negotiation between the franchisor and the sub-franchisor. The sub-franchisor will often want a large territory, as a large territory will logically enable it to open more franchised units than will a smaller territory. On the other hand, the franchisor has an interest in limiting the size of the territory to that which can realistically be developed and managed by the sub-franchisor. If the territory is too large, parts of the territory will not be developed because the sub-franchisor will not have the personnel or resources necessary to develop them properly.

The sub-franchisor often insists on a territory that is larger than its current resources can support, as it wishes to be able to capitalise on the success of its experiences in the future. This desire is often tempered by the franchisor's expectation of a large initial up-front payment for the expanded territory. In addition to capital, the development of a territory requires personnel with certain skills and abilities. The franchisor will furthermore wish to be assured that the sub-franchisor *inter alia* has the competence, necessary language skills, cultural and business insights and business connections to develop the entire territory. The successful operation of a franchised business, which is a largely homogeneous system of products and business methods, will depend on the awareness of the developers of the language, consumer patterns and business practices that are part of the culture of a given community. A franchisor must have sufficient awareness of these factors to adapt its business to them. It may, for example, not make sense to grant a German sub-franchisor rights to a territory that includes not only Germany, but also parts of other neighbouring countries because of language and other cultural differences. It may not even make sense for a sub-franchisor in Beijing to be granted territorial rights to Shanghai, even though both cities are in China, because of the significant language and cultural differences that exist between these two cities.

Thus, it is generally in the interest of both franchisor and sub-franchisor to delimit the boundaries of the territory of the franchise, in terms of size and cultural requirements, in such a manner that the sub-franchisor, given its resources and commitment, can reasonably be expected to develop it during the term of the franchise agreement.

A number of solutions are possible to address the competing interests of the franchisor and the sub-franchisor regarding the size of the territory. It is possible for the franchisor to grant the sub-franchisor contingent rights to other territories in addition to the initial territory; to permit the sub-franchisor to expand its territory if certain conditions are satisfied, or to give the sub-franchisor a right of first refusal when the development of additional territories is considered. It should be noted that when these rights are given, they substantially limit the franchisor's possibilities to permit qualified and interested third parties to develop the additional territory. The importance and implications of this restriction however vary greatly from franchise to franchise.

Although the territory granted is identified in the grant clause, other clauses may determine whether the territory as initially defined will remain unvaried throughout the term of the agreement. The sub-franchisor may for example be required to open sub-franchised units at a certain pace in order to be allowed to maintain its rights to the initial territory granted. The agreement may provide for a reduction in the size of the territory for which the sub-franchisor has authority if that pace of development is not kept. Conversely, there may be a provision which grants the sub-franchisor an expanded territory if certain development objectives are met.

D. EXCLUSIVITY V. NON-EXCLUSIVITY

For the sub-franchisor to be able to determine the exact extent of the rights it is being granted, it is important for it to be aware of any exclusions from, or limitations of, those rights. It is in the section of the master franchise agreement that lists the rights granted to the sub-franchisor that any indications of such exclusions or limitations are normally to be found.

In this connection it is particularly important for the sub-franchisor to be aware of any limitations regarding the use of the trademarks or the franchise system, as these form the essence of the franchise. Furthermore, if the sub-franchisor is granted any type of territorial protection, it is important for the conditions of such protection to be clearly set out. It might moreover be useful if the agreement were to deal expressly with those rights that often become a point of contention. These include:

- ◆ the right to incorporate new trademarks and logos into the system;
- ◆ the right to use and license the marks to others for different uses;
- ◆ the right to modify the business format, operating procedures and standards;
- ◆ the right to sell trademarked products through alternative channels of distribution; and
- ◆ the right to establish or operate additional or different distribution systems.

A master franchise agreement that expressly permits the franchisor to implement such changes is more likely than a more generally formulated agreement to withstand the argument that such modifications violate good faith and fair dealing and other similar duties that might be imposed by law. The possible relevance and effects of legislation relating to unfair contract terms, unequal bargaining power and unfair competition should also be considered in this connection. The franchisor might further wish to exercise care so as to ensure that an express indication of certain reserved rights is not taken to imply that other rights that are covered by the general reservation of rights are excluded.

The grant clause will specify the extent to which the rights granted to the sub-franchisor are to be considered exclusive. Exclusivity is basically a monopoly on franchising rights in a given geographic area. In an exclusive agreement, a sub-franchisor is granted the exclusive right to establish franchises and/or to sub-franchise in a given territory. There are three basic categories of other persons who might be granted the right to use some or all of the licensed assets in the licensed territory: the franchisor itself; other sub-franchisors or unit franchisees; and other persons who might be authorised to use some of the licensed assets in the territory, but not as part of a franchised business (for example the shop around the corner). The sub-franchisor may be granted exclusive rights to the territory in that the franchisor agrees not to authorise any other person to use any of the licensed assets in that territory.

The flexibility afforded by franchising provides the franchisor with numerous options for developing a given area. The franchisor will at times reserve the right to establish its own units in the territory even if it agrees to exclude third persons from using the licensed assets.

The franchisor may furthermore reserve the right to sell certain products associated with the franchise system through third persons who are not operating within the franchise system: a certain product may, for example, be offered through retail outlets not identified with, or part of, the franchise system. Many products that are fundamental to the business of franchised units may thus be sold in other points of distribution within the territory, such as supermarkets, or by means such as catalogue sales. The franchisor may want to increase its market penetration by providing for product distribution by these, and many other, alternative means. This may cause problems for the sub-franchisor and sub-franchisees, in that while the total quantity of franchised products sold in the given territory might increase, the sales made through the franchised units may actually be reduced as a result of the alternative methods.

There is obviously potential for conflict between franchisor and sub-franchisor as a result. One solution is for the sub-franchisor to be granted the right to distribute the products through all distribution channels in the franchised territory. Another is for the franchisor and sub-franchisor to form a joint venture and then to share in the alternative distribution activities and benefits. In any event, the possibility to distribute products outside the franchised system is best specifically addressed, as a typical grant clause will not include such important rights.

It is common for the sub-franchisor to request an exclusive right to use the licensed assets in the territory granted, as it wishes to have the assurance that its commitment of resources to the development of the franchised system will not be undercut by similar efforts on the part of others. This perspective will in most cases be shared by the franchisors, who will be willing to grant exclusive rights to the sub-franchisor in order to foster the greatest possible commitment on its part.

If the rights granted to the sub-franchisor are to be wholly or partially exclusive, it is advisable to define exactly what “exclusive” means in the context of the particular grant, so as to avoid later misunderstandings.

E. THE THREE-TIERED RELATIONSHIP OF MASTER FRANCHISE ARRANGEMENTS

The granting of rights is further complicated by the realities of master franchise arrangements. Master franchising is often classified as a tripartite relationship between the franchisor, the sub-franchisor and the sub-franchisee. Strictly speaking, however, with the exception of certain specific cases, master franchising is not so much a tripartite as a three-tier relationship, although for ease of reference it is often referred to as tripartite.

As indicated above,²⁴ the typical master franchise arrangement used in international franchising is between two parties, namely the franchisor and the sub-franchisor. This agreement expressly allows, and usually requires, the sub-franchisor to enter into sub-franchise agreements with sub-franchisees for the establishment and operation of individual units of the franchised business. At the time of their transaction the two parties to the master franchise agreement therefore anticipate that the actual operation of the franchised units will be conducted not by the sub-franchisor, but rather by the sub-franchisees pursuant to separate sub-franchise agreements concluded between the sub-franchisor and each of the sub-franchisees. Indeed, it is not uncommon for the master franchise agreement to expressly prohibit the sub-franchisor from operating units itself (except perhaps through an affiliated company).²⁵

As the master franchise agreement typically is only between the franchisor and the sub-franchisor and the sub-franchise agreements are usually solely between the sub-franchisor and the sub-franchisees, there is no direct contractual relationship between the franchisor and the sub-franchisee. The sub-franchisor therefore acts as the local facilitator of the international franchise transaction under which the sub-franchisee establishes and operates franchised units using the franchisor’s trademarks and other intellectual property.

The three-tier nature of the relationship between franchisor, sub-franchisor and sub-franchisee acknowledged by the master franchise agreement raises a number of issues, many of which are inherent in the relationship itself. Others arise as a result of express provisions in the master franchise agreement.

The scope of the rights granted to the sub-franchisor under the master franchise agreement will naturally affect the rights and obligations of the sub-franchisor and sub-franchisee under the sub-franchise agreement. The sub-franchisor cannot grant the sub-franchisees more extensive rights than those it has acquired under the master franchise agreement. Specific prohibitions

²⁴ See Chapter 1 “Fundamental Concepts and Elements”.

²⁵ See the discussion on pilot units in Chapter 5 “Obligations of the Franchisor”.

contained in the master franchise agreement may furthermore be echoed in the sub-franchise agreement.

It is common for the master franchise agreement to impose an obligation on the sub-franchisor to include specific provisions in the individual sub-franchise agreements on matters of particular importance to the franchisor. Franchisors may thus require that their standard domestic franchise agreements and system standards serve as the basic elements in the sub-franchise relationship in the foreign country. Under the typical international master franchise agreement, the franchisor will provide the sub-franchisor with copies of its domestic franchise agreement and systems standards manual. The sub-franchisor will be required to convert the franchise agreement into a form sub-franchise agreement that is appropriate for its sub-franchisees, to make sure that the documents meet local legal requirements, to modify the documents so as to make them consistent with local custom and to translate them into the local language.

The master franchise agreement may also provide that the franchisor's prior consent or approval must be obtained regarding various matters relating to the sub-franchisor's relationship with its sub-franchisees, to the terms of each sub-franchise agreement and/or relating to the sub-franchisees' operation of the local sub-franchised units. The master franchise agreement may for example require that the sub-franchisor obtain the franchisor's approval of each prospective sub-franchisee and of each transfer of the sub-franchised business to a new sub-franchisee. The master franchise agreement may further require the franchisor's approval of the terms of each sub-franchise agreement, especially if there are deviations from the standard form agreement previously approved by the franchisor. The sub-franchisee's site selection, site plans and drawings and mark usage are other areas for which the master franchise agreement may require the franchisor's approval. It may however not be practical for the franchisor to control these aspects of a sub-franchise in another country, even if it does control such matters in the case of its domestic franchisees. This may be due to the administrative costs, time delays and/or cultural differences involved. In all likelihood it will be more practical for the franchisor to delegate these approval responsibilities to the sub-franchisor. If, however, the franchisor does not wish to grant full discretion to the sub-franchisor in this regard, it may in the master franchise agreement establish minimum criteria to be used by the sub-franchisor. Alternatively, the franchisor may retain responsibility for the approval process, but provide in the master franchise agreement that it may delegate such responsibility to the sub-franchisor in writing once the sub-franchisor has demonstrated its ability to exercise such discretion to the satisfaction of the franchisor. If the franchisor insists on retaining approval responsibility for some matters relating to the sub-franchised business, the franchisor and sub-franchisor should establish the procedures of the approval process in such a manner that the sub-franchised business is not unduly hampered. It may, for example, be appropriate if certain matters submitted to the franchisor for approval are deemed to have been approved if the franchisor does not object within a certain specified period of time after submission.

Expiration or termination of the master franchise agreement will affect the sub-franchise relationship. The duration of sub-franchise agreements is at times made to coincide with that of the master franchise agreement. Thus, if the master franchise agreement terminates or expires for any reason, all the related sub-franchise agreements will likewise terminate or expire. It may however be appropriate for the sub-franchise agreements to continue in effect despite the termination of the master franchise agreement. Numerous international master franchise agreements will therefore require that sub-franchise agreement to provide that if the master franchise agreement terminates, the franchisor will succeed to the interests of the sub-franchisor under the sub-franchise agreements. These master franchise agreements also typically require each sub-franchisee, at the time it concludes the sub-franchise agreement, to provide a legally binding acknowledgement to the effect that if the rights of the sub-franchisor are transferred to the franchisor, then the franchisor is entitled to exercise and enforce all such rights without the consent of, or reference to, the sub-franchisor.

The three-tier nature of the master franchise agreement may give rise to conflicts of interest between the franchisor and the sub-franchisor regarding development requirements, unless this question is properly addressed. If the master franchise agreement imposes unrealistic

requirements on the sub-franchisor in relation to, for example, the deadlines for the opening and continued operation of franchised units, the sub-franchisor may be tempted to grant sub-franchises to unqualified sub-franchisees, to approve ill-conceived locations, or to fail to terminate non-performing sub-franchisees solely for the purpose of complying with the development schedule. This would damage the franchisor by unnaturally inflating business failure data for the territory when the unqualified sub-franchisees or improperly located units eventually fail, or by harming the franchisor's marks and goodwill by the continued operation of units that do not comply with system standards. A realistic development schedule should therefore be carefully established so as to reduce these potential conflicts to a minimum.

Master franchise agreements will usually require the sub-franchisor to comply with all regulatory requirements applicable to the offering and sale of franchises in the host country. The sub-franchisor is thus typically required to prepare and distribute materials offering the franchise to prospective sub-franchisees and to register with the appropriate government authorities, when necessary. The sub-franchisor may in addition be required to indemnify the franchisor for any liability resulting from the sub-franchisor's failure to comply with such regulatory requirements.

It is not uncommon for the franchisor to provide its sub-franchisor with computer software and to require the sub-franchisor to duplicate and sub-licence the software to each sub-franchisee.

The master franchise agreement may require the sub-franchisor to grant franchises to prospective sub-franchisees located and qualified by the franchisor. If development requirements are imposed on the sub-franchisor, then the master franchise agreement should indicate whether sub-franchisees located by the franchisor are to be added to those located by the sub-franchisor and whether all units thus opened should be understood as forming part of the number required by the development schedule.

International master franchise agreements typically require the sub-franchisor to submit periodic reports on the operation of the sub-franchised units to the franchisor. In order to permit the sub-franchisor to comply with the deadlines for the submission of such reports, it is important that the sub-franchise agreements require the sub-franchisees to submit all the necessary information to the sub-franchisor sufficiently in advance of the deadline.

If a franchisor intends to benefit from certain provisions in the sub-franchise agreements, it should consider requiring that it be expressly recognised as a third party beneficiary under the agreements, if this is permissible under the applicable law. The express recognition in the sub-franchise agreements of the franchisor's status as a third party beneficiary may be appropriate with regard to the sub-franchisees' use of the franchisor's intellectual property and confidential information. Similarly, the indemnification provisions in the sub-franchise agreements are often drafted so as to expressly include the franchisor as a beneficiary of the indemnity. The insurance provisions may also require the franchisor to be named as an additional insured in the sub-franchisee's insurance policies.²⁶

G. DIRECT CONTRACTUAL RELATIONS

As noted above, under the typical master franchise arrangement there is no direct contractual relationship between a franchisor and a sub-franchisee. There may however be situations in which such a direct relationship is necessary, and others in which it is desirable, as the advantages of such an arrangement outweigh the disadvantages in that particular case.

The laws of some jurisdictions may not offer sufficient protection to franchisors who transfer technology or other intellectual property under the standard master franchise agreement, unless

²⁶ See Chapter 14 "Liabilities, Indemnification and Insurance".

there is a direct contractual relationship between the franchisor as the owner of the intellectual property and the sub-franchisee as the user. Other jurisdictions do not recognise the sub-licensing of intellectual property rights, which is a key element in the master franchise arrangement. In these jurisdictions the franchisor will usually insist on having a direct contractual relationship with the sub-franchisees for that particular purpose.

A direct contractual relationship between the franchisor and the sub-franchisees may be desirable even when it is not necessary for the protection of the franchisor's intellectual property, as this would result in the franchisor's increased ability to control the sub-franchisees and to directly enforce the provisions of the sub-franchise agreements without the involvement of the sub-franchisor. This may be especially important in jurisdictions that do not recognise a third party beneficiary's right to enforce a contract for its benefit. Direct contractual relationships may also have the result that the franchisor will to some extent be involved in local operational matters and that it will provide some support and assistance directly to the sub-franchisees. It should however be pointed out that the consequences of direct contractual relationships may also include the endangering of the independent status of the parties and consequently an increased risk of legal liability for the franchisor, both as to claims by sub-franchisees for non-performance and as to local legal matters affecting the sub-franchised businesses. As long as the franchisor, the sub-franchisor and the sub-franchisee are clearly independent, there is little question of any of them answering for the acts or omissions of the others.

The most common reason for the creation of direct contractual relations between the franchisor and the sub-franchisee in the master franchise context is for the protection of intellectual property rights. There are two commonly used methods by which these direct contractual relationships are created under a master franchise agreement. Firstly, the parties may combine the master franchise agreement and the sub-franchise agreement into a single, tripartite franchise agreement between the franchisor, the sub-franchisor and the sub-franchisee, under which the franchisor grants the sub-franchisor the right to sell and service the sub-franchises, the sub-franchisor sells a sub-franchise to the sub-franchisee and the franchisor directly licences the sub-franchisee to use the intellectual property concerned. In this case a separate tripartite agreement will be necessary for each sub-franchise granted. Secondly, a more common solution is for the franchisor and the sub-franchisee to enter into a licence agreement in which the franchisor grants the sub-franchisee a licence to use the intellectual property in connection with the operation of the sub-franchised business. This licence agreement is separate from the master franchise agreement between the franchisor and the sub-franchisor and from the sub-franchise agreement between the sub-franchisor and the sub-franchisee. In this case the sub-franchisee is required to execute the licence agreement as a condition to entering into the sub-franchise agreement with the sub-franchisor and both agreements typically include cross-default provisions. Even in jurisdictions where a separate licence agreement is not initially needed, franchisors will often include an express provision in the master franchise agreement reserving the right to enter into direct licence agreements with the sub-franchisees if the franchisor determines that the lack of direct contractual relations presents a risk to its intellectual property. The master franchise agreement should in this case further require that, if the franchisor chooses to exercise such rights, the sub-franchisors will modify the sub-franchise agreements to delete the relevant provisions affecting the intellectual property so that the sub-franchisees' intellectual property rights are governed solely by the separate licence agreement.

In jurisdictions that do not recognise sub-licensing an alternative to this approach is the appointment of the sub-franchisor as the franchisor's agent for trademark licensing purposes. The sub-franchisor will then perform the services necessary to licence the franchisor's intellectual property to the sub-franchisees on behalf of the franchisor.

The direct relationship between the franchisor and the sub-franchisees may in some cases extend beyond what is necessary for the protection of trademark rights, in that franchisors may at times retain the right to inspect the premises of each sub-franchised unit as well as each unit's accounting books and records. Moreover, the franchisor may in the master franchise agreement retain the right to make periodic inspections of the units and to offer the sub-franchisor (and sub-franchisees) periodic consultations with regard to the operation of the units. The retention of such

rights on the part of the franchisor might be accompanied by the power to sanction non-performing sub-franchisees. The master franchise agreement might furthermore establish that the franchisor will provide services, assistance, products and/or supplies to sub-franchisees. In this case the agreement will authorise the franchisor to suspend provision of such services and assistance and to suspend the sale of such products and supplies to sub-franchisees who do not comply with the sub-franchise agreements.

The advisability of establishing such close relations between the franchisor and the sub-franchisees might be questioned. While the security of the sub-franchisees and of the franchise system might benefit from, might indeed require that, the franchisor is able to take the place of the sub-franchisor if the latter is unable to continue performing its duties and therefore abandons the network, a right of the franchisor to control the operation of the sub-franchised units, and to intervene in case of malfunctioning units, concurrent with that of the sub-franchisor is likely to cause problems. The authority of the sub-franchisor would be undermined and the lines of demarcation of the rights and obligations of the franchisor, sub-franchisor and sub-franchisees blurred. The possibility that the franchisor might be held liable for the acts or omissions of the sub-franchisees would also increase.

H. PROBLEMS WITH SEVERAL SUB-FRANCHISORS IN THE SAME TERRITORY

Although it is uncommon in master franchising, it is also possible for the franchisor to grant more than one master franchise within a certain territory. One of the main advantages of such an approach might be the creation of healthy competitive pressure on each sub-franchisor to fully and rapidly exploit its licence to develop franchised units. That same competitive pressure may however result in major negative consequences of which the franchisor, the sub-franchisor and the sub-franchisees should be aware.

One of these consequences is the fact that this competition may lead sub-franchisors to accept prospective sub-franchisees who are not qualified, especially if there is an unrealistic development schedule.

Another consequence of having more than one sub-franchisor in the same territory is the possibility that the standards of performance of the sub-franchisors may differ. Differences in business experience and resources may result in the assistance and services one sub-franchisor provides to its sub-franchisees differing dramatically from the assistance and services provided by another sub-franchisor. The performance of the sub-franchisees would without doubt be affected by such a state of affairs, with the result that legal claims might be made by the sub-franchisees whose sub-franchisor does not, or cannot, provide the same level of services and assistance as that provided by the other sub-franchisor. Similarly, the different sub-franchisors might apply and enforce the system standards differently, with the consequence that the appearance and operation of the sub-franchised units might be lacking in uniformity, with resulting negative effects on the integrity of the system.

Finally, the benefit of an economy of scale might be reduced or might disappear for both the franchisor and the sub-franchisors where there is more than one sub-franchisor in the same territory. There may for example be duplication in such matters as trademark registration and licensing and marketing. The franchisor will furthermore without doubt incur in additional costs and administrative burdens in dealing with more than one sub-franchisor.

These issues, as well as any others created by such arrangements, must be clearly dealt with in each and every master franchise agreement and sub-franchise agreement if a franchisor, despite the problems that might ensue, nevertheless decides to grant master franchise rights to more than one sub-franchisor in the same territory. The parties should pay particular attention not only to the issues that affect the relationship between the franchisor and sub-franchisor, but also to those that arise between the sub-franchisors and to the consequences for the sub-franchisees.

CHAPTER 3

TERM OF THE AGREEMENT AND CONDITIONS OF RENEWAL

A. LENGTH OF TERM OF AGREEMENT

Lengthy initial terms of duration are common in the case of master franchise agreements. Terms of twenty years are not unknown, nor are options granting the sub-franchisor the right to renew the master franchise agreement for a further term of twenty years. Successive options to renew the agreements for twenty years each may also be provided for. A number of franchisors, however, on the strength of their domestic experience in granting unit franchises, insist on entering into international master franchise agreements for shorter terms, such as five or ten years.

From the franchisor's point of view the standard rationale for short terms, at least for domestic agreements, is that the franchisor must be given the opportunity to update its franchise agreement so as to reflect legal developments, fundamental changes to the franchise system and changes to the financial situation. Regrettably, not all franchisors will always realise the fundamental differences between domestic and international franchising and will therefore attempt to apply their domestic experience to international franchising. This is however not always appropriate and sub-franchisors in international arrangements will be loathe to subject themselves to the uncertainties of what the market place will be dictating in the future.

In a number of countries the maximum or minimum terms of the agreement are fixed by law or by judicial precedent. A limitation in rights must at times be added to this limitation in duration, in that at the end of the term of the agreement it may not always be possible to protect the know-how as it will be deemed to be the property of the sub-franchisor. It should also be pointed out that in a number of countries, especially developing countries, in which approval of the agreements by the competent authorities is required, long-term arrangements might be viewed favourably from the point of view of, for example, the tax concessions that can be made.

B. CONDITIONS OF RENEWAL

The renewal of the term of the master franchise agreement, if renewal is possible, is typically subject to the fulfilment of certain conditions. These conditions include a number or all of the following:

- (a) that the sub-franchisor is not in default of a material obligation at the time of renewal and that the sub-franchisor is not continuously in default of a material obligation during the term of the master franchise agreement, independently of whether or not such default has been cured;
- (b) that the sub-franchisor has paid all amounts due to the franchisor on time throughout the term of the master franchise agreement;
- (c) that the sub-franchisor sign a general release of any claims that it may have against the franchisor; and
- (d) that the sub-franchisor inform the franchisor in the prescribed manner of its intention to renew the agreement within a set period of time prior to the termination of the master franchise agreement.

A condition for the renewal of the agreement will often be that the franchisee accept the franchise agreement of the franchisor that is current at the time of renewal. Franchisors basing themselves on their domestic experience may therefore insist that the term of the master franchise

be of short duration. In such circumstances the sub-franchisor will be given the right to renew the agreement for an additional term or terms, provided that it accept the franchisor's then current form of international master franchise agreement. In an international situation, however, the agreement current at the time of renewal will almost by definition not be the current agreement being offered in that territory, but will be what is offered somewhere else in the world. Furthermore, rights are granted to sub-franchisees on the basis of the first contract and this makes it difficult to adopt another agreement in case of renewal. While there are considerable advantages in requiring that the agreement current at the time of renewal be adopted in terms of maintaining the uniformity of a franchise system, there are nonetheless difficulties in an international context. There are furthermore situations in which certain provisions are sure to remain unchanged, such as those relating to the royalty or the territory. What is increasingly common internationally is the giving of guarantees that certain fundamental items will not be changed under any circumstances.

The question of the same agreement being renewed as against the adoption of the agreement current at the time of renewal is one which is of particular importance in some jurisdictions, such as for example the European Communities, where know-how must be granted for there to be a franchise and where this know-how must be secret. After ten or twenty years the question arises whether the know-how can still be considered to be secret and therefore, under certain competition law conceptions, whether the arrangement can still be considered to be franchising.

Requiring the sub-franchisor to accept the master franchise agreement current at the time of renewal also in the case of international franchise agreements is however liable to create certain problems. The unit franchise agreements entered into by the sub-franchisor with its sub-franchisees are dependent on the master franchise agreement. Any modifications of the master franchise agreement will therefore impact on existing unit franchise agreements. Moreover, the considerable investment that is required of the sub-franchisor in establishing the franchise system would argue against applying shorter terms to master franchise agreements. International master franchise agreements are furthermore typically negotiated, with the consequence that it might not be realistic to require that the sub-franchisor upon renewal enter into the franchisor's then current form of international master franchise agreement.

Another reason for adopting lengthy terms for master franchise agreements is the fact that central to the master franchise arrangement is the granting of sub-franchising rights to the sub-franchisor. Insofar as the expiration of the term of the master franchise agreement may result in the termination of the sub-franchise agreements, expiration will impact directly not only on the relationship between the franchisor and the sub-franchisor, but also on the future of all sub-franchisees, none of whom is a party to the master franchise agreement. It should also be pointed out that it is generally accepted good practice for an adequately long term to be granted so as to enable the sub-franchisor to get a return on its investment and to stimulate the sub-franchisor to develop the territory properly.

It should be observed that there are jurisdictions in which the fact that a definite term is not indicated in the agreement may have the effect that the agreement is considered to be one of indefinite duration. This may also be the case if the provision dealing with the term of the agreement is badly drafted.

Other conditions that are sometimes provided for include an obligation on the part of the sub-franchisor to pay a renewal master franchise fee that may be a specific sum or may be based on a formula, and an obligation on the part of the sub-franchisor to require all of the sub-franchisees to maintain, renovate and remodel the individual franchise premises they operate. Although these conditions are sometimes included in the master franchise agreement, a number of them, for example the obligation referring to maintenance and renovations, are best left to each individual unit sub-franchise agreement.

C. EFFECTS OF EXPIRATION OF THE TERM OF THE AGREEMENT

In the case where the effect of the expiration of the term of the master franchise agreement on the unit sub-franchise agreements is not dealt with in the master franchise agreement or the unit sub-franchise agreement, it would probably be true in many jurisdictions that each individual unit sub-franchise agreement would automatically terminate. In this case each sub-franchisee would be required to cease using the franchise system and trademarks and to remove any decorations or indications identifying the premises in which the franchise outlet is situated as belonging to the franchise network. The sub-franchisee would probably also be forced to comply with non-competition covenants. The repercussions of the failure to deal with the effects of termination of the master franchise agreement on the unit franchise agreements would therefore be extremely serious, not only for the franchisor, but also for each sub-franchisee.

The only practical alternative in dealing with the effects of termination on sub-franchise agreements would appear to be to provide for the assignment by the sub-franchisor to the franchisor of all of the sub-franchisor's rights, title and interest in and to each unit sub-franchise agreement.

The practical difficulties associated with the enforcement of such an assignment has made it necessary to provide for appropriate mechanisms. It is therefore not unusual to include in the master franchise agreement an obligation on the part of the sub-franchisor to provide the franchisor with a power of attorney authorising it to execute all such assignments of unit sub-franchise agreements for, and on behalf of, the sub-franchisor, should the sub-franchisor fail to do so. Alternatively, the franchisor may require from the sub-franchisor an undated assignment of each unit sub-franchise agreement as and when each agreement is entered into. This assignment would be held by the franchisor in safekeeping until the expiration of the term of the master franchise agreement. In the event, however, that the master franchise agreement were terminated, the franchisor would be authorised to date the assignment and to make use of it to effect the assignment from the sub-franchisor to itself. Whether or not the enforcement of either provision would be upheld by the courts of a particular jurisdiction is an important question with regard to which the prudent franchisor will seek counsel within each relevant jurisdiction.

In addition to the master franchise agreement containing an assignment provision, each individual unit franchise agreement should contain an acknowledgement by the sub-franchisee that when the term of the master franchise agreement has expired, the right, title and interest of the sub-franchisor in the unit franchise agreement will be assigned to the franchisor. In certain jurisdictions the unit franchise agreement should therefore include an acknowledgement by the sub-franchisee that the franchisor is a third party beneficiary of such rights. In other jurisdictions it might in certain cases be appropriate to make the validity and effect of each unit sub-franchise agreement conditional upon the intervention of the franchisor in the agreement. Such intervention is advisable in jurisdictions where trademarks can only be licensed by the owner or where a person must expressly accept the stipulations made in its favour in order to be able to exercise any rights granted by such stipulations. This is the case, for example, in certain civil law jurisdictions. It should, however, be pointed out that a procedure such as the one described might be difficult to implement in the context of international franchising, even if it might be the most effective way to protect the rights of the franchisor in a number of jurisdictions.

Another question of considerable importance when the effects of the expiration of the term are considered and provided for, is whether or not the sub-franchisor should be entitled to financial compensation by the franchisor if the end of the agreement results in the assignment of the unit sub-franchise agreements to the franchisor. It should be noted that authorities in some jurisdictions might question the validity of such assignments in the absence of financial compensation in one form or another. In such jurisdictions it would therefore be advisable for provision to be made for payment in one form or another by the franchisor to the sub-franchisor following such assignments, so as to avoid the risk of such assignments being declared null and void.

Of considerable importance in this context is also whether the franchisor should be obliged to accept the assignment of the sub-franchisor's rights under each unit sub-franchise agreement, whether the franchisor should be allowed to choose the units to be assigned to it, or whether the franchisor should merely be granted an option to obtain such assignments.

To the extent that the franchisor is obliged to accept such assignments following the expiration of the term of the master franchise agreement, it will be required to assume a role that it may not be equipped to assume, namely that of franchisor in a foreign country in which it will not have the benefit of an established organisation to support its activities. Moreover, it may very well be assuming obligations that have been incurred by the sub-franchisor vis-à-vis its sub-franchisees. Thus, if the sub-franchisor has entered into an agreement with a sub-franchisee waiving its rights to receive royalties, the franchisor will be bound by such an agreement notwithstanding the fact that it may not be aware of it. To the extent that the sub-franchisor is in default with respect to one of its obligations under a sub-franchise agreement, the franchisor who has assumed the rights and obligations of the sub-franchisor under that agreement might very well be faced with a law-suit. While it might be true that the franchisor would have recourse against the sub-franchisor in the circumstances, in most instances such a recourse may prove to be illusory.

The drafting of the provisions of the master franchise agreement that relate to the effects of the expiration of its term therefore requires careful consideration by both franchisor and sub-franchisor and must be dealt with in detail. The impact of such provisions should also be dealt with in each unit sub-franchise agreement.

Considering the risk of automatic termination of the sub-franchise agreement in case of termination, or expiration of the term, of the master franchise agreement, it is in the interest of the sub-franchisee to obtain an undertaking by the franchisor to the effect that, should such an event occur, it will enter into a franchise agreement directly with the sub-franchisee, at least for the unexpired portion of the sub-franchise agreement. In this manner the sub-franchisee will not lose its right to continue to operate as a franchisee. Whether or not this is an option that realistically is available to sub-franchisees in the context of most international arrangements is however uncertain.

Another problem associated with short term international master franchise agreements is the gradual loss of motivation on the part of the sub-franchisor as the expiration of the term of the master franchise agreement draws nearer.

An example of the foregoing may be that of a master franchise agreement with a term of ten years. In the last few years, as the expiration of the term draws nearer, the sub-franchisor may lose any motivation to comply with the development schedule, despite the fact that it may still be required to establish a certain number of franchise outlets per year. The sub-franchisor will however only reap the benefit of the unit sub-franchise agreements entered into during such later years up until the expiration of the term of the master franchise agreement, regardless of the term of such unit franchise agreements.

It is nonetheless not to be recommended that the development schedule remain inoperative during the latter part of the term of the master franchise agreement, as franchisors will wish to encourage the establishment of franchise outlets throughout the term. It would therefore appear to be fair and equitable to provide that, notwithstanding the expiration of the term, certain portions of the master franchise agreement will remain in force solely with respect to franchise outlets for which unit agreements have been entered into prior to such expiration and that the sub-franchisor will lose its right to develop additional franchise outlets under the master franchise agreement. This would permit the franchisor to itself establish, or to franchise others to establish, new outlets within the territory concerned.

Each franchise outlet existing at the date of expiration of the term of the master franchise agreement would in other words continue to be serviced by the sub-franchisor for the remainder of the term of the unit franchise agreement. In this case the sub-franchisor would continue to receive the royalties and other payments due to it until the expiration of the term of each unit sub-franchise agreement. Assuming that a unit sub-franchise agreement, the term of which is ten years, is entered into by the sub-franchisor during the last year of the term of the master franchise agreement, an arrangement such as the one described would have as a consequence that certain provisions of the master franchise agreement would remain in force for a period of ten years beyond the expiration of its term. It should be noted that in certain jurisdictions this type of provision is helpful in gaining the acceptance of master franchise agreements by government authorities and agencies authorised to review their acceptability.

In a number of countries a valid reason for having the term coincide with the last of the sub-franchise agreements to expire is to be seen in the post-term non-competition clauses, in that, depending on the circumstances of the case, it might be desirable from the franchisor's point of view to have the non-competition clauses start to run from the extended period of time and not from the expiration of the term of the agreement.

D. NEGOTIATIONS FOR RENEWAL OF THE AGREEMENT

The remark that customs vary from country to country and from region to region may be considered commonplace, but it is nevertheless true. It is therefore important to remember that what is considered a good custom in a particular cultural setting may not be appropriate in another. This applies also to the type of provisions that are included in agreements, not the least to those relating to the negotiations for the renewal of the agreement.

CHAPTER 4

FINANCIAL MATTERS

A. WHAT PROVIDES INCOME?

The ultimate controlling factor of income is the difference between the cost and selling price of the products and/or services that are sold or provided by the franchise system. This provides a margin that has to be shared between all the levels in the system according to their respective contributions and costs.

In the final analysis the financial resources that provide income to franchisor, sub-franchisor and sub-franchisees must flow from the sales and profits generated by the franchised units. Franchise fees, whichever way they are to be calculated, can only be paid if the franchised units are successful. If the profitability of these units would not be sufficient in the market in which the operation is to be established, the question immediately arises of whether the franchise operator would be able to succeed in that market place without substantial restructuring, or even whether it would succeed at all. It cannot be assumed that margins and profitability will necessarily be the same in each and every market, particularly in view of the large number of potential variable factors that are involved, such as, for example, product costs, rental and other costs, competitive products and services that affect the pricing structure.

B. THE SOURCES OF INCOME AVAILABLE TO SUB-FRANCHISORS

There are two levels to consider in reviewing sources of income in master franchising transactions. The first level is that between the franchisor and the sub-franchisor, the second is that between the sub-franchisor and the sub-franchisees.

The ability of the sub-franchisor to make payments to the franchisor will depend upon the income it is able to generate from its sub-franchisees. It must be remembered that the franchise fees and the other payments that the sub-franchisees will make to the sub-franchisor will provide the sub-franchisor with its gross income. It is out of this gross income that the sub-franchisor will be required to finance its activities as a “franchisor” of the system in its country, to make its payments to the franchisor and to earn a sufficient profit to justify its investment and labours.

A sub-franchisor will be able to obtain its income from the following sources:

I. INITIAL AND CONTINUING FEES

- (i) by charging sub-franchisees an initial fee on entering into the franchise agreement. This fee may be presented to the sub-franchisee in a number of different ways:
 - ◆ it may be a fee for joining the franchised network;
 - ◆ it may be charged as a mark up on the price for the provision of goods and/or services by the sub-franchisor when the sub-franchisee establishes its business. In the early days of a franchise system these initial fee payments provide a significant proportion of a franchisor’s income. This proportion is gradually reduced as the network grows and as the continuing franchise fees paid by an increasing number of franchisees produces a significant flow of income. This occurs because the volume of initial fees is related to the number of outlets that are opened and as the network grows the rate at which outlets are opened tends to slow down;
- (ii) by receiving on-going income from the sub-franchisee’s activities:

- ◆ by making a profit on the sale to the sub-franchisee of the products that are sold by the sub-franchisee in the course of its business or that are used in the provision of services to its customers;
- ◆ by charging a continuing franchise fee (often called a royalty) which is calculated as a percentage of the gross income of the sub-franchisee, such as, for example, five percent of the sub-franchisee's gross income. These percentages vary widely depending on the range and nature of the services that the sub-franchisor provides to its sub-franchisees. It should be observed that although there may be some royalty element in these continuing fees, it is not correct to describe them as royalties as they invariably are paid in return for services. Royalties are instead normally regarded as passive income for the use of a property right, for instance for the use of copyright material or trademarks. In view of the fact that payment of royalties is likely to be treated differently by tax authorities from payments for services, this source of income needs to be carefully considered and dealt with appropriately in the contractual documents;
- ◆ in some franchise systems the continuing franchise fees may be lump sum payments, such as a fixed amount in the local currency, regardless of the sub-franchisee's gross income. For the sub-franchisee the advantage of such arrangements is that it knows the precise amount it must pay the sub-franchisor each month (or other relevant period) in respect of continuing franchise fees. The disadvantage is that in the initial period when the sub-franchisee is seeking to establish its business, the fixed fee may represent too large a percentage of its income. From the sub-franchisor's point of view the disadvantages are that the fixed fee is not protected from inflation and that the sub-franchisor might therefore have to continue to provide the range of services for which it has contracted with a dwindling value to its revenue flow. Furthermore, its income will not increase as sub-franchisees become more successful and increase their gross incomes and it would find it difficult to expand and improve the range of services that it provides.

(iii) If the franchise is a product based franchise, the franchisor may:

- ◆ manufacture the products to be sold by the sub-franchisees;
- ◆ have the products manufactured under its trade marks by a third party; or
- ◆ secure product supplies for the network from other sources.

Income may be generated in two possible ways when products are involved: by product mark ups and as payments from producers or suppliers in the form of rebates, discounts or commissions.

I. PRODUCT MARK UPS

Mark ups may be defined as an increase in the sales price of the products which is made by adding overhead expenses and a certain margin of profit to the costs. The franchisor, whether manufacturer or wholesaler, may thus "mark up" the products to provide an income. The sub-franchisor will in turn mark up the price at which it sells the products to the sub-franchisees and the sub-franchisees may mark up the product for resale to the consumer, so as to provide the necessary gross margins that are the foundation of the sub-franchisee's profitable activities. It is the possibility of variation in the mark ups made by the franchisor and the sub-franchisor which can have an impact on the financial capabilities of the sub-franchisee. It is therefore necessary to ensure that the sub-franchisee is protected against unreasonable price increases that would affect its ability to operate with sufficient profitability to meet all its commitments and to earn enough for itself. It should be stressed that no sub-franchisor and/or franchisor can succeed if the sub-franchisees are not sufficiently successful.

II. PAYMENTS FROM PRODUCERS OR SUPPLIERS

A franchisor may not be able to manufacture the products that it has designed or of which it has determined the specifications. It may therefore licence a manufacturer to produce the products that will be supplied to the sub-franchisors and through them to the sub-franchisees. It is not uncommon for the manufacturer to pay a licence fee to the franchisor for the right to manufacture these products.

Manufacturers and suppliers may also pay over-riders or retrospective rebates. These are volume related discounts that are to be paid when agreed volume purchase levels are reached. It is a method of providing a benefit for bulk purchasing and the issue that may arise is who should have a right to these discounts. There are franchisors and sub-franchisors who would claim this right, but sub-franchisees would also contend that these benefits should be made available to the sub-franchisees, as it would be their efforts in aggregate in achieving sales which would give rise to the payments.

In addition to offering these benefits, manufacturers and suppliers will sometimes contribute to advertising, marketing and promotional activities, both nationally and at the different points of sale.ⁱⁱⁱ

The situation is somewhat different in the case of service franchises, as this involvement in product supply, with its capacity to generate income, would not be available to the same degree, although there might be some products that need to be supplied in the course of the provision of the service.

C. THE SOURCES OF INCOME OF THE FRANCHISOR.

I. INITIAL FRANCHISE FEES

One of the most difficult issues that arises in the negotiation of a master franchise agreement is the determination of how much the franchisor should be paid for the grant of the rights, for the licence to use the know-how and for the assistance given to the sub-franchisor to enable it to set up its business in the host country.

The expectations of some franchisors are so high that would-be sub-franchisors are frightened off. There are instances in which unrealistic figures have been agreed only to create problems for both parties when it became apparent that the sub-franchisor could not make money either at all or sufficiently quickly to justify the high initial cost. This results in a breakdown of the relationship or in the re-negotiation of the financial provisions. It is sensible to make the effort to agree on a realistic financial structure in the initial negotiations.

Tax considerations and legal issues come into play when the decision about the structuring of the fees is taken. Some of the payments may be regarded as capital and others as revenue for tax purposes and their separate identification may assist in dealings with the tax authorities.

There are a number of factors that may be taken into account when the calculation of a proper and equitable level of initial franchise fees to be paid to the franchisor is made. The degree of importance to be attached to each will differ from country to country, depending upon the practices and structure to be found in each. These factors are:

- ◆ the actual cost to the franchisor of dealing with the sub-franchisor: training, offering assistance in the setting up of the sub-franchisor's business and working to prove that the concept works within the host country;
- ◆ the cost and time it would take the sub-franchisor to acquire the requisite know-how and skills to operate and franchise a similar business in its territory;
- ◆ the value of the territory as estimated by the franchisor: franchisors tend to calculate the value of a territory by comparing the population numbers with a similar sized area in their

own country and what they may have achieved in initial franchise fees for that area. There is a difference that must be taken into account in making this comparison, as in many countries (but not all) the franchisor's name will be less well known and there will be no guarantee that the franchisor's concept and system will operate to the same level of effectiveness. There is therefore the risk that such comparisons by franchisors may not produce realistic and economically sound results;

- ◆ the estimated total amount of initial franchise fees that could be charged by the sub-franchisor to its sub-franchisees in the host country. The initial franchise fee to be charged may for example be US\$ 5,000 and the territory may be considered capable of sustaining 200 franchised outlets. This would produce a total pool available of US\$1,000,000. However, a sub-franchisor will be incurring expenses that need to be set off against these fees to assess the full benefit;
- ◆ the fact that the franchisor has developed a system in its own country and has been proved successful has a value, as it should, with pilot testing and specific variations that may be advisable, be capable of swiftly producing an effective business system within the host country.

Franchisors based in countries where high initial fees are charged to franchisees tend to have much higher expectations as to the value of the territory and the estimated total amount of initial franchise fees and may therefore ask for more than may be realistic in the territory concerned.

There are no hard and fast rules on how to arrive at what the right amount to be paid is. The factors referred to are all relevant and it is the sub-franchisor who must be careful not to over-pay as it is the sub-franchisor who will be in the best position to make a realistic evaluation of the financial possibilities of the system in the territory it has been given the right to develop.

There are many innovative ways in which to structure the fees. Local laws must carefully be considered as they very often have an impact on levels of payment, indeed they may in fact govern the basis upon which payment is made. In countries where there are exchange controls the administering authority may determine the level of payments that it considers to be appropriate regardless of the bargain reached by the parties. This may require that the initial fee is justified by specifying each of the separate elements that make up the fee, so that the nature of the payments is clearly identifiable. This may be particularly important in cases where payments for goods and services receive a more favourable treatment. In some countries the intellectual property laws may also have an influence on the intervals at which the fees should be paid as well as on the amounts that may be charged for the exploitation of intellectual property rights. Furthermore, both exchange control and intellectual property laws may have an influence on the level of continuing fees where payments have to be made to a foreign franchisor.

In addition to initial fees, franchisors in most cases expect to be paid a continuing franchise fee for the use of their name and system and the provision of ongoing support services. The level of the fees will have to reflect the cost of providing these ongoing support services.

II. CONTINUING FRANCHISE FEES

Franchisors who charge their franchisees in domestic operations a fee amounting to five or six per cent of their revenue will at times propose a three or four per cent continuing fee (or royalty) from a sub-franchisor. That sub-franchisor may not be able to charge its sub-franchisees more than five or six per cent, which is a percentage that might be extremely attractive if the sub-franchisor has no obligation to share its income with the franchisor, but if the sub-franchisor is required to pay the franchisor three or four per cent of the revenues of its sub-franchisees (which is equal to sixty per cent or more of its own revenue) the proposition is doomed to failure. The sub-franchisor has to generate sufficient income to operate its business profitably after paying the continuing franchise fees to the franchisor. In many cases it is difficult to justify the payment of more than between ten and twenty per cent of the sub-franchisor's income from the continuing franchise fees it receives from its sub-franchisees. Every prospective sub-franchisor should

prepare a business plan; in many cases the franchisor will be prepared to provide an input. It is essential for the sub-franchisor carefully to prepare cash-flow and profit forecasts as part of its business plan so that it is in a position fully to appreciate the impact on its profitability of the payment of continuing franchise fees.

There are franchisors who supply products to sub-franchisors for onward sale to sub-franchisees. These sub-franchisees will charge a mark up on the sale of the products to the consumers. In a significant number of cases there will also be a continuing franchise fee to pay in addition to the product mark up. There is nothing inherently wrong with mark ups. Manufacturers and wholesalers charge on this basis, otherwise they would not make a profit. In many instances the franchisor and/or the sub-franchisor have the role of manufacturer and/or wholesaler.

In addition to determining that a certain percentage of the revenue of the sub-franchisees should constitute a continuing fee, there are other methods of calculating fees that may be agreed in particular cases. These include:

- ◆ fees related to numbers of products sold;
- ◆ fees calculated as a percentage of purchases as opposed to sales;
- ◆ fixed fees;
- ◆ sliding scales where, for example, there is a charge of X% up to a certain level and thereafter an increasing or decreasing percentage;
- ◆ a fixed minimum fee coupled with fees based upon a percentage of gross income;

and

- ◆ a fixed maximum fee above which the continuing fees will not rise.

D. PROBLEMS CAUSED BY PRODUCT SALES WITH “MARK UPS”

There may be special arrangements made in respect of visits by the franchisor to the country. There may be a provision in the contract requiring the franchisor to make one or more visits a year which may be included in the fees paid. Agreement may also be reached on who bears the cost of such visits or the cost may be shared.

In those countries where there are high levels of import duties the impact of these duties can be exaggerated when the total gross price (including the “mark up”) is subjected to them. This may have the effect of removing any competitive advantage that the products might otherwise enjoy with respect to price.

It is important to emphasise that there are no precise guidelines laying down what fees should be. All fees are negotiated. The different methods referred to are usually the result of a conscious seeking of a solution to the legal, fiscal and financial issues that arise, as well as of the relative bargaining power of the parties to the negotiations.

E. CALCULATION OF PAYMENTS AND PROCEDURES

The method adopted for the actual making of the payment of continuing fees should be in line with the way in which the sub-franchisor deals with its sub-franchisees. If, for example, the sub-franchisees pay their fees by the tenth day of every month, an obligation placed on the sub-franchisor to make payments at the same time and in respect of the same period would be impossible for it to meet. Despite this obvious point provisions of this nature are frequently encountered in contracts. A sub-franchisor will need the time to collect the information and the funds to enable it to make the required reports and accounting to the franchisor. The payment

periods and accounting periods at both levels must take this essentially practical issue into account.

Another issue that frequently arises is whether the sub-franchisor should be obliged to pay franchise fees to the franchisor even if it has not been paid by its sub-franchisees. This is an issue for negotiation between the parties, but the franchisor may be reluctant to share the sub-franchisor's credit risks. It is usual for a provision to be included in the contract requiring the sub-franchisor to ensure that sub-franchisees observe and perform the terms of sub-franchise agreements. The existence of such a provision would mean that failure on the part of the sub-franchisor to collect fees and financial reports would be a breach of contract. Although the inclusion of such a provision might seem unduly harsh on the sub-franchisor, the importance for the whole network of the sub-franchisors properly supervising their sub-franchisees and ensuring that they fulfil their obligations cannot be stressed too much. It is only if all the members of the network observe the required standards, for example as regards the quality of the product or service that they offer, that the reputation of the whole network is maintained. In financial terms, a defaulting and non-paying sub-franchisee will invariably not only not be paying fees, but will probably not be submitting returns of sales, which in turn will make it impossible to know what should be remitted. It is therefore important to deal with these issues in the agreement.

Allowance must be made for delays in the banking system, as payments sometimes take an inordinate time to travel from bank A in country X to bank B in country Y. Despite the existence of electronic systems that provide instant transfers, banks cannot be relied upon to use the fastest method of transmission of funds and the agreement should specify the method to be used. Some franchisors open a bank account within the territory concerned so as to enable them to receive payment promptly.

The franchisor will invariably stipulate the currency in which payment is to be made. Franchisors usually prefer payment in their own currency, although a third currency will sometimes be agreed upon. It is necessary to establish in the agreement a date for conversion and it is also sensible to identify which bank's quoted rate will be used for conversion on the date of payment and who should bear the cost of the conversion. The agreement should also establish the alternative action to be taken if the currency conversion cannot take place as a result of exchange controls. In view of the long-term nature of master franchise agreements, provisions are often inserted into the agreement to allow for the possibility that exchange controls may be introduced in the future. A drastic solution which is at times envisaged in agreements is a reservation of the right to terminate on the part of the franchisor if currency restrictions are imposed and payments cannot be made. Where exchange control permission is required it should be ascertained whether the franchisor or sub-franchisor has the responsibility to make the application. In any event both parties should agree to co-operate in any application that is to be made.

F. FISCAL CONSIDERATIONS

The agreement should deal with the way in which payments will be treated and characterised for tax purposes in both the franchisor's country and the host country. It is by no means certain that the initial fee will be regarded as free of withholding tax by the taxation authorities of the country of payment. The franchisor could therefore find that the initial fee is subject to withholding tax. Furthermore, the definition of royalty payments should be examined. Any double taxation treaty should be taken into consideration to ensure that the franchisor may if it so wishes receive payments free of withholding tax. The agreement should enable the franchisor to obtain the benefit of any double taxation treaty by the provision of evidence of payment in the host country in such form as may be necessary to enable the relief to be claimed. Franchisees should seek to avoid liability for payment of tax more than once in respect of the same payment. Another risk that the franchisor may run is that the payment of franchise fees may be considered by the law of the host country as the carrying on of business by the franchisor in that country.

Some franchisors insert what are known as “grossing-up” provisions in their contracts. These provide that if tax is deductible, effectively it has to be borne by the sub-franchisor who must increase its payment to the franchisor so that the franchisor receives net the amount it would have received had there been no tax deduction. The effect of such provisions is to increase the level of fees payable by the sub-franchisor as it is effectively paying the franchisor’s tax liability on the payments that are remitted to it. This cost is not recoverable from the franchise network. The sub-franchisor should check its projections and cash-flow forecasts if it feels obliged to accept such a provision, so as to ensure that the additional burden does not make the financial proposition unacceptable.

Finally, it should be noted that the laws of some countries will impose a withholding tax on advertising fees paid by a sub-franchisor to a foreign franchisor. In such cases the franchisor will experience no serious consequences when, as often occurs, the laws of the country in which the franchisor is receiving such remittances provide for a foreign tax credit for the amount of the foreign withholding. There will only be a problem if the franchisor is not able to obtain a tax credit in its country. If it is unable to do so the effect will be to reduce the funds available for advertising expenditure.

A further issue arises when funds paid into the regional advertising fund in one year are not spent until the following year. In view of the above, and in anticipation of problems that may arise in, for example, the case of creditors losing claims against the franchisor, it is important for the parties to state explicitly to whom the funds belong.

CHAPTER 5

OBLIGATIONS OF THE FRANCHISOR

Master franchise agreements must list the obligations of the franchisor. Whether they contain a short list of a few basic obligations or a detailed enumeration of all conceivable duties that a franchisor might undertake will depend on the commercial maturity of the system, on contract drafting style and on the bargaining power of the parties. Local customs and laws will also be of relevance in this connection. Parties should avoid using a wording that is so vague that it is not possible to understand what exactly the duties of the franchisor are, or to make long lists in an attempt to be exhaustive, as this might give rise to hopes that realistically the franchisor will not be able to meet. There is a natural tension between the parties, on the one hand in relation to the extent of the franchisor's obligations and the corresponding rights of the sub-franchisor and on the other hand in relation to the sub-franchisor's obligations and the corresponding rights of the franchisor. A franchisor very naturally considers its system unique and wishes it to be used and applied with as little change as possible in the host country. The franchisor also has a natural tendency to believe that all the elements of its system are self-evident and that its manual and training courses are so well prepared that the sub-franchisor will not need all that much help to adopt and use the system properly in the host country. The sub-franchisor on the other hand just as naturally wishes to have as much freedom as possible to adapt the system to the conditions of the host country. It also very understandably wishes to receive a substantial amount of initial and ongoing assistance from the franchisor. These contrasting interests have to be balanced in the course of the negotiations between the parties.

It is evident that the franchisor cannot give the sub-franchisor unlimited freedom with respect to the adaptation of the system, as no cross-border, or even world-wide, franchise system can be developed or exist without a high degree of homogeneity and corporate identity. Nevertheless, the main responsibility for the adaptation of the system normally falls to the sub-franchisor, the point at issue being the degree of control that the franchisor must, or wishes to, exercise on the measures of adaptation to be taken. It is evident that any sub-franchisor will need the assistance of the franchisor when it introduces the new franchise concept in the host country. Here again, the point at issue will be the degree of involvement of the franchisor. All these issues are closely linked to financial issues. The adaptation of the system by the sub-franchisor, as well as the initial and ongoing assistance provided by the franchisor, require considerable resources, both in terms of personnel and in terms of finance. The level of initial, ongoing and other fees will therefore to a large extent depend on whether the tasks and obligations are allocated to one party or the other. Conversely, the level of fees that a franchisor wishes to obtain will depend on, among other factors, the number and extent of the obligations that it is itself prepared to accept and to fulfil.

It is a question of style and structure whether franchisor's obligations are dealt with in only one clause of the agreement, whether they are listed briefly in one clause which then refers to other more detailed provisions, or whether they are dealt with partly in the agreement and partly in annexes to the agreement, in the operations manual(s) or in other ancillary documents. In a number of jurisdictions there may be mandatory rules on contract forms that require that all the obligations of the parties be set out in the contract document itself and be personally signed by them. In such cases it is not possible to refer to unsigned ancillary documents.

The obligations of the franchisor may in general terms be divided into initial and ongoing obligations. The parties should carefully consider each of the points mentioned hereafter with a view to deciding whether, and the extent to which, it is appropriate to treat and to include them in the master franchise agreement.

A. DUTIES OF INFORMATION

I. INITIAL INFORMATION

Once the master franchise agreement has been signed, the franchisor should provide the sub-franchisor with all information that will permit it to adapt the foreign franchise system to the conditions of the local market and to start the business. In particular, the franchisor should provide the information that the sub-franchisor is to transmit to its potential sub-franchisees, either to comply with legal requirements or for business reasons. It is evident that it is in the best interest of the franchise system, and of the franchisor, that the sub-franchisor is provided with all the information it needs to start and to run the master franchise operation successfully in the host country. The information that concerns the franchise system and its functioning is usually transmitted by means of initial training²⁷ and operations manuals.²⁸

Other information that the sub-franchisor usually needs, and the provision of which some agreement might expressly indicate as being a duty of the franchisor, includes:

- ◆ the technical characteristics or chemical composition of products that are to be imported into the host country and that may have to be adapted, or the importation or use of which may require authorisation by the local authorities; and
- ◆ the information on the economic and legal conditions of the local market that the franchisor will often have gathered before entering into negotiations with the sub-franchisor.

II. ONGOING INFORMATION

The agreement will normally include an ongoing obligation of the franchisor to regularly provide the sub-franchisor with information on events in the (possibly world-wide) network, as well as on developments of, and improvements to, the system that are of importance to the sub-franchisor. Such ongoing information is usually provided in the form of an updating of the manuals, to include improvements that are made to the know-how, or whenever changes to the system are introduced.²⁹

The possibility of setting up permanent means of communication, electronic means included, between the franchisor and the sub-franchisor should be considered, as should the possibility of setting up advisory councils of sub-franchisors.

B. TRAINING

The proper training of the sub-franchisor and the sub-franchisees is a fundamental condition for the success of any franchise operation. The franchisor's training obligations are often dealt with in a separate section of the agreement, a distinction usually being drawn between initial training and ongoing training.

I. INITIAL TRAINING

The initial training and the studying of the manuals should permit the sub-franchisor to learn all the elements of the franchise system (the franchisor's know-how)³⁰ and thereby enable the sub-franchisor to run a franchise unit, at least as a pilot operation. More importantly, the initial training should give the sub-franchisor all the basic elements necessary for the establishment and administration of a franchise network, including what is required for the

²⁷ See Section B "Training", below.

²⁸ See Section C "Manuals" below.

²⁹ See Chapter 12 "System Changes".

³⁰ See Chapter 11 "Know-How and Trade Secrets".

marketing and sale of the sub-franchise units and the actual running of the network, i.e. all that is necessary for it to be able to act as “franchisor” in its own country. In the relatively short period of time of the initial training the sub-franchisor will not be able to learn all the skills that the franchisor has developed and that are the result of the experience of many years. It would therefore be advisable for this know-how to be written down in a “sub-franchisor’s manual”.³¹ The initial training should also enable the sub-franchisor to train its future sub-franchisees. Where appropriate, the franchisor should furthermore teach specific skills, such as for example the use of a particular computer software or the handling of sophisticated machines.

Training may be provided to the sub-franchisor personally, to delegated managers or to other representatives of the sub-franchisor responsible for the actual running of the master franchise operation.

The initial training of the sub-franchisor, and subsequently of the sub-franchisees, is a fundamental condition for the successful operation of a franchise network. Its importance should therefore be reflected in the master franchise agreement. The franchisor should clearly indicate how long this training will last, where it will take place and in what language it will be conducted, as well as what its component parts will be. The contract should state clearly who is to bear the costs involved: in most cases the initial training will be covered by the initial franchise fee, but the cost of travel, accommodation and other expenses related to the training are usually to be borne by the sub-franchisor. In view of the fact that the initial training is the basis for the future activities of the sub-franchisor, it is advisable for the franchisor to ensure that language barriers do not obstruct the success of the training.

II. ONGOING TRAINING

It is also advisable for additional training programmes for the sub-franchisor and/or its representatives to be held regularly in the course of the relationship. The purpose of such ongoing training programmes is to keep the sub-franchisor up to date with developments of, and improvements to, the franchise system. As these additional training programmes in most instances are held on the premises of the franchisor, they permit a regular contact between the employees of the franchisor and the sub-franchisors and their management. The master franchise agreement should clearly state the length of the ongoing training programmes, what they involve and the financial commitments of each of the parties.

Depending on the nature of the franchise involved, it may be in the best interest of the franchise network if the franchisor were to offer optional supplementary training programmes, so as to ensure a regular flow of information and continuous communication between the franchisor and the sub-franchisors.

III. CONSEQUENCES OF UNSUCCESSFUL TRAINING

It is possible that the franchisor during the initial or ongoing training programme realises that a person following the training course, a sub-franchisor or a delegated representative, is unsuitable for the tasks he or she is being trained for and will therefore in the opinion of the franchisor not be successful in completing the training programme. In this case the wise course might be to dismiss the trainee and possibly even to terminate the contractual relationship, particularly if the person concerned is a sub-franchisor. A franchisor who wishes to have the possibility to take such a decision must make it clear in the agreement itself. In this connection the possibility of a partial or full reimbursement of the fees paid for the training, and/or even of the initial franchise fee, might be considered. A franchisor would understandably find it difficult to renounce a sub-franchisor that it has found after what in most instances is a long search and a sub-franchisor would find it even more difficult to give up the hopes it has placed in the franchise. It may however be wise for both parties to end the relationship at this early stage, as this may save both of them from much greater disappointments and also possibly from substantial financial losses in the future.

³¹ See Section C below.

C. MANUALS

I. FRANCHISE UNIT MANUALS AND SUB-FRANCHISOR MANUALS

In most franchise systems, especially in business format franchise arrangements, the know-how and other intellectual property rights are all embodied in the manuals that are provided by the franchisor to the sub-franchisor. These manuals also illustrate in detail the manner in which the franchisor's trademarks are to be used and in which the franchise system is to be implemented.

The manuals will typically deal with every aspect of the franchise system. Most master franchise agreements will therefore impose a specific obligation on the sub-franchisor to fully comply with all requirements and instructions specified in the manuals. They will also contain a further provision to the effect that all of the provisions of the manuals are to be deemed to form part of the master franchise agreement as if the manuals had actually been incorporated into the agreement itself. It is therefore usually one of the franchisor's principal obligations to hand over a copy of the manuals to the sub-franchisor upon or soon after executing the master franchise agreement. It is usually also appropriate to provide the sub-franchisor with an opportunity to examine the contents of the manuals prior to executing the agreement. Courts in certain jurisdictions may otherwise conclude that the sub-franchisor is not bound by the provisions of a document with which it was not familiar prior to the execution of the agreement.

In most cases the manuals that are provided by the franchisor will refer to the management of the unit franchises and will describe in great detail the workings of each and every aspect of the franchise system. In the case of master franchising, however, the sub-franchisor does not only operate as a franchisee, it also operates as a franchisor *vis-à-vis* its sub-franchisees. The sub-franchisor must therefore be provided with all the information that it requires to operate as a franchisor. The means adopted by franchisors to provide sub-franchisors with this information include the provision of a manual which details the duties and obligations that are to be assumed by the sub-franchisor in its capacity as "franchisor" under each unit sub-franchise agreement and the nature of the relationship between a franchisor and a franchisee.

As the manuals contain all the know-how associated with the franchisor's system and the franchisor will need to protect its know-how, it is recommended that the manuals remain the property of the franchisor and only be "lent" by the franchisor to the sub-franchisor, as opposed to being "provided". If the manuals are only lent, the sub-franchisor will be required to return all copies of the manuals to the franchisor when the agreement comes to an end and will not be able to retain any copies thereof.

II. ADAPTATIONS AND CONSTANT CHANGES

The laws, language, tastes, customs and culture of the foreign country into which the franchisor intends to introduce its franchise system will in most cases differ considerably from those of its country of origin. The franchise system will consequently require adaptation to conform to local conditions and the manuals must reflect the adaptations made. Although it is recommended, especially in international franchising, that the franchisor encourage the sub-franchisor to suggest such changes and adaptations in order to improve the chances of success of the franchise system in the host country, the franchisor must consider the degree of control that it will ultimately exercise in connection with any changes to, and adaptations of, the franchise system that are proposed by the sub-franchisor and should require that such changes are made only under the following circumstances and subject to the following conditions:

- (a) changes and adaptations should be made only when they are required by clear differences between, for example, the customs, cultures, habits and tastes of consumers in the host country and those of consumers in the franchisor's country. They should not be made merely as a result of a desire of the sub-franchisor to improve the franchise system;

- (b) prior written approval on the part of the franchisor should be required for the implementation of any change. This approval should not be unreasonably withheld. Any changes to the franchise system that would individually or collectively result in a fundamental change, or that would have a generally negative impact on the operation of the franchise system in a neighbouring country, should be subject to the prior approval of the franchisor. The granting or refusal of approval should be at the absolute discretion of the franchisor;
- (c) the sub-franchisor might be permitted to make any changes that are required to comply with the laws of the host country without the prior consent of the franchisor. The franchisor should nevertheless be advised of such changes prior to their implementation;
- (d) all permitted changes to the franchise system should be reflected in the manuals; and
- (e) all changes to the franchise system, whether initiated by the franchisor or the sub-franchisor, as well as any know-how associated with such changes, should be acknowledged by the sub-franchisor as being the sole and exclusive property of the franchisor and as being a constituent part of the system that is being franchised. If such an acknowledgement concerns an improvement made by the sub-franchisor, it may be viewed in some jurisdictions as constituting a grant back license.³² It may therefore be illegal under local law. Under such circumstances it is usual to include a provision by which the sub-franchisor grants the franchisor a perpetual, world-wide, royalty free license which permits the franchisor to use improvements initiated by the sub-franchisor as well as to sub-license their use to other sub-franchisees of the sub-franchisor.

The question of who is to be responsible for translating the manuals, and who should pay for the expenses associated therewith, is a matter of negotiation between the parties to the international master franchise agreement and is best dealt with in the agreement itself.

The franchisor should not be afraid of the sub-franchisor initiating changes and otherwise adapting the franchise system if the foregoing conditions are respected by the sub-franchisor. To permit changes to the franchise system without observing all of the foregoing conditions is however to invite disaster. If, for example, the sub-franchisor retains ownership rights to changes to the franchise system that it has initiated and does not grant the franchisor a license to use this know-how, then the franchisor may not only be unable to prevent the sub-franchisor from making use of such changes after the master franchise agreement has come to an end, it may itself be prevented by the sub-franchisor from continuing to use the modified know-how following the end of the agreement. Similarly, in certain jurisdictions the franchisor may be vulnerable to legal proceedings instituted by the sub-franchisor, unless it is clearly agreed that all such changes are the property of the franchisor. In such proceedings the sub-franchisor might claim a diminution of the continuing royalty or of other remuneration payable to the franchisor on the grounds that what the sub-franchisor initially contracted for is not being used and that part of that which is now being used is the property of the sub-franchisor and not of the franchisor.

What has become increasingly clear in the last few years is that franchisors wishing to export their franchise system to a foreign country must pay greater attention to the cultural and other differences that exist between their own countries and the proposed host countries. Franchisors must of necessity make the necessary investment in time and effort to familiarise themselves with these differences and must ensure that they are reflected in adaptations of their franchise systems. It should be noted that at least in the early stages of development changes to the franchise system should certainly be the result of the joint efforts of franchisor and sub-franchisor.

An even more delicate situation relates to changes to the franchise system that the franchisor wishes the sub-franchisor to adopt for use by its sub-franchisees in the foreign country. In most cases this might very well be a legitimate request on the part of the franchisor who is always endeavouring to improve its franchise system. Notwithstanding the legitimacy of the request,

³² Cf. European Community competition law.

however, the franchisor must recognise that it might be difficult for the sub-franchisor to insist that its sub-franchisees adopt all such changes. Depending on the nature, degree and costs of the proposed changes, the sub-franchisor should furthermore be given the right to test-market them in the foreign country prior to having them implemented and should only be obliged to introduce the changes if the results of the test-marketing prove positive. In addition, the sub-franchisor may be granted certain fixed periods of time within which to implement the changes.

Franchise systems change constantly to keep up with developments. As it is impossible to reflect all operational changes by amending the master franchise agreement, these operational changes are typically reflected in changes made to the manuals. It is thus through the manuals that the franchisor is able to ensure that the sub-franchisor and the sub-franchisees comply with the franchise system. It is however important that all changes to the franchise system are reasonable, or in line with the principle of good faith, both as to the extent of the changes concerned and as to the costs involved in introducing them. The franchisor may otherwise have difficulty in enforcing changes that the sub-franchisor and sub-franchisees could obviously not have foreseen when they signed the master franchise and sub-franchise agreements.

D. ASSISTANCE AND OTHER SERVICES

The most complete information and the best of initial training courses may not be sufficient to place a new sub-franchisor in a position where it is able to offer the new franchise operation a perfect start. It is therefore not uncommon for the franchisor to give initial, and subsequently ongoing, advice on the adaptation of the system to the conditions of the host country, on the setting up of the management and operational structures of the sub-franchisor, on the logistics of the future network, on the planning and setting up of the first pilot operation including, where appropriate, the internal decoration, fittings, equipment, the setting up of stock, the hiring of personnel and the preparation of a “grand opening”.³³

I. INITIAL ASSISTANCE

Up until the opening of the first pilot operation, and possibly for some time beyond that, the franchisor’s management and operational assistance is usually provided by experienced personnel from the franchisor’s headquarters. This initial assistance is normally included in the initial franchise fee and is therefore not paid for separately by the sub-franchisor. It may occur that the franchisor requests reimbursement for the cost of the travel expenses and accommodation of its personnel. The extent and duration of the assistance will largely depend on the amount charged as an initial franchise fee, but the distance in geographic and even cultural terms from the location of the franchisor’s headquarters will also be of relevance in this regard. Conditions may be so different that the franchisor’s staff may be able to offer substantial help only as regards the technical aspects of the implementation of the system, but will be able to offer little as regards other operational issues. On the other hand, where the culturally foreign elements of the franchise system introduce commercial tools that are new to the host country, it might even be crucial that personnel from the franchisor’s headquarters assist in the implementation of those culturally foreign elements.

There is no fixed rule by which the extent of the franchisor’s initial assistance is determined. It is usually the result of lengthy negotiations and mainly depends on the complexity of the franchise system, on the economic environment of the host country, on the business experience of the sub-franchisor and on the extent to which the franchisor wishes to control the adaptation of the franchise system. It will also vary depending on whether the individual system is a service franchise or a product franchise and on whether the contractual goods and equipment are mainly

³³ See also Chapter 8 “Advertising and the Control of the Advertising”.

supplied by the franchisor or are obtained from local sources. As the franchisor usually prescribes standards for the quality of the services and/or the goods, it will usually and to the greatest extent possible provide advice with respect to the sources of supply, at least for goods that are to be imported from abroad. The franchisor will usually also give advice on the ongoing management of the franchise operation, on the handling and hiring of personnel, on book-keeping and reporting, including the forms that should be used, on the sales techniques that should be adopted and on public relations and advertising activities. Important written material on these points is usually contained in the manuals. It is in the long-term interest of the franchisor and of the system that the franchisor give as much initial assistance as it reasonably can afford within the framework of the initial franchise fee. It is however possible for specific services to be provided against additional payments.

II. ONGOING ASSISTANCE

For the whole duration of the agreement the franchisor will usually continue to provide advice and assistance on all management, operational and technical issues. It may be observed that under European competition law “the continuing provision of commercial or technical assistance during the life of the agreement” is a mandatory element of any franchise agreement. In many cases a “hot-line” for the sub-franchisors will be instituted, so as to ensure that any assistance needed is provided quickly and efficiently. In most cases such ongoing advice, whether it is offered by telephone or by correspondence, is not paid for separately, but is instead covered by the ongoing franchise fees.³⁴ Also included in the continuing franchise fees are normally such regular services as the providing of information on events within the network and within the market, the supervising of the development of the sub-franchisor’s business and the organisation of regular, possibly annual, meetings of the sub-franchisors of the system, for example by geographic region. Travel expenses are normally not included.

So as to ensure that quality standards are maintained, the franchisor or its representatives will regularly visit the sub-franchisor and its operations in the host country. Where the franchisor inspects the outlets of the sub-franchisees, these visits could be considered as part of the regular quality/service/safety and cleanliness inspections that the sub-franchisor is normally obliged to make. The findings of these inspections would then be discussed with the sub-franchisor with a view to improving the performance of the members of the network. Such visits would also serve to control the performance of the personnel of the sub-franchisor and to improve the franchisor’s knowledge of the local market.

The sub-franchisor may find it most cost effective to pay for the additional optional services that are provided by the franchisor’s personnel, rather than to consult outside advisers. The franchisor’s personnel will have long-standing and world-wide experience on how to sell franchises, on how to run successful public relations and advertising campaigns, on how to optimise the sale of the franchised goods and services and on how to adapt the system rapidly to changing economic conditions. It may therefore be advisable for the franchisor to make experienced members of its international team available to the sub-franchisor upon request. Where such optional services are offered, the fees and costs involved should be clearly indicated, normally in the annexes to the agreement or in the manuals.

III. ASSISTANCE TO THE SUB-FRANCHISEES

It is unusual, but not excluded, that provision is made in the master franchise agreement for the franchisor to provide direct assistance to the sub-franchisees. Considering that this is in contradiction with the master franchise concept, such assistance should probably be limited to the initial phase or, for short periods, to crisis situations. Where a crisis situation lasts too long, the question will normally arise whether the agreement should be terminated or whether the sub-franchisor’s territory or other exclusive rights should be reduced.³⁵

³⁴ See Chapter 4 “Financial Matters”.

³⁵ See Chapter 15 “Remedies for Non-Performance”.

E. OTHER OBLIGATIONS OF THE FRANCHISOR

I. SUPPLY OF GOODS

The franchisor may undertake to supply goods to the sub-franchisor and the sub-franchisees of the network, not only where it wishes to impose an exclusive purchase obligation in favour of its own or other specific products or of certain specific initial equipment, but also where it wishes to ensure that the goods are of a certain standard. Before the franchisor takes on such a commitment, it should make sure that it will be able to meet the obligations, considering also the distance involved and the import conditions applicable in the host country. Where it does take on such a commitment the sales conditions and any limitations in the franchisor's liability should be clearly stipulated in the agreement.³⁶

II. PROMOTION

The franchisor will usually undertake to promote the franchise network internationally. For this purpose an international advertising fund will in most cases be established, to which all the sub-franchisors will contribute advertising fees. In such cases it is appropriate for the franchisor to accept that a control mechanism be introduced in relation to its use of the funds, although this is a matter that will be negotiated by the parties.³⁷

III. PROTECTION OF TRADEMARKS

Another important obligation of the franchisor is the maintenance and protection of the trademarks and other intellectual property rights, know-how included, that it licenses to the sub-franchisor.³⁸

IV. OTHER SPECIAL OBLIGATIONS

Depending on the peculiarities of the individual franchise system, the franchisor may have, or may take on, further obligations, such as

- ◆ the setting up, maintenance and promotion of a credit card system to be used in its international network (for example in car rental or hotel networks);
- ◆ the setting up and maintenance of a world-wide or regional reservation system (for example in the car rental or hotel business); or
- ◆ the seeking of supply and/or service contracts with government agencies and other public institutions or major customers, with access to supply or service possibilities being offered to the sub-franchisor and its sub-franchisees, possibly against payment of additional fees.

F. REMEDIES FOR NON-PERFORMANCE BY THE FRANCHISOR

Non-performance, or at least the repeated non-performance, by the franchisor of any of the obligations referred to in this chapter may constitute a material breach of the agreement. It is therefore common practice to provide for the termination of the master franchise agreement in the case of a material breach of the agreement by the franchisor. A certain number of conditions will in general accompany such a provision.

³⁶ See Chapters 10 "Intellectual Property", 11 "Know-How and Trade Secrets", 9 "Supply of Equipment and other Products" and 14 "Liabilities, Indemnification and Insurance".

³⁷ For more details, see Chapter 8 "Advertising and the Control of Advertising".

³⁸ See Chapters 10 "Intellectual Property" and 11 "Know-How and Trade Secrets".

The termination of a master franchise agreement will involve considerable practical difficulties and might have dramatic consequences for the sub-franchisees. The agreements will therefore often provide also for less drastic solutions.³⁹

G. RIGHTS OF THE FRANCHISOR

A clear distinction between the rights and obligations of the franchisor is not always possible. Frequently an obligation will contain also a right, or will be conditioned by the other party's fulfilment of its own obligations. There are however obligations that at the one and same time are also rights. Thus, for example, the controlling of the network by the franchisor may be considered an obligation, in that it may be considered to be the duty of the franchisor to safeguard the network's reputation and to ensure that quality standards are maintained, but also a right, in that the franchisor retains the right to control the performance of the sub-franchisor.

There are also other rights that the franchisor might wish to retain over and above the normal rights/obligations specified in the agreement, such as, for example, the right to approve the location of the outlets in the host country, the right to approve prospective sub-franchisees, the right to appoint a director to the Board of Directors of the sub-franchisor or to receive fees directly from the sub-franchisees as opposed to passing through the sub-franchisor and the right to deal directly with the sub-franchisees irrespective of any decision taken by the sub-franchisor. A certain caution should however be exercised, in that rights of this nature might be considered to change the nature of the relationship between the parties, giving rise to the risk of vicarious liability for the franchisor⁴⁰

³⁹ For more details, see Chapter 15 "Remedies for Non-Performance".

⁴⁰ See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

CHAPTER 6

OBLIGATIONS OF THE SUB-FRANCHISOR

The sub-franchisor has responsibilities to both franchisor and sub-franchisees. To the franchisor the sub-franchisor is its “presence” in the host country. To the sub-franchisees the sub-franchisor is their franchisor. As the custodian of the franchisor's trademarks and/or trade name, goodwill, system and other intellectual property rights, the sub-franchisor will be required to undertake many obligations relating to the development and maintenance of a franchise network in the territory concerned.

The sub-franchisor will be required to contribute to ensuring that the franchisor's system can viably be operated in the territory. It will be required to introduce the system into the territory, to develop the franchise network and to provide the full range of the franchisor's services to its sub-franchisees.

The franchisor will invariably impose a number of obligations on the sub-franchisor to ensure the orderly and realistic development of the potential in the territory. There will be detailed obligations relating to the speed at which sub-franchised outlets will be required to be opened. These obligations will normally be specified in what is known as a development schedule.

A development schedule that sets out the projected annual and cumulative rates of growth of the network in the host country is a common feature of master franchise agreements. Without it, the franchisor would not be confident that a commitment exists on the part of the sub-franchisor which would result in what it regards as the proper exploitation of the territory. The development schedule is regarded by franchisors as being of great importance, particularly where exclusive rights are granted, because it protects the franchisor against under-exploitation of the territory. Unless a sub-franchisor is prepared to accept what the franchisor regards as a realistic development schedule for the establishment of operational units, the master franchise route may lose some of its attractions to the franchisor. On the other hand, the sub-franchisor must be satisfied that the development schedule proposed by the franchisor can be achieved within the scope of the resources that it is prepared, or can afford, to commit to the project. These two factors, the number of units and the rate of growth, will normally be the subject of discussion and negotiation.

There are practical difficulties in establishing development schedules. At the time the contract is being negotiated the parties may not have sufficient knowledge to enable them to judge what rate of expansion can be achieved. What is certain is that the franchisor's expectations are likely to be on the high side, while those of the sub-franchisor will be on the low side. Most sub-franchisors prepare a business plan as a part of the process of deciding whether or not to enter into a master franchise agreement. The business plan should include an assessment of the rate of growth that the business is capable of achieving. Otherwise the sub-franchisor will not be able to make a balanced business judgement about whether or not to enter into the agreement and in relation to the level of resources that it would need to commit to the establishment of the business.

In many cases there will be the problem of introducing to the host country an unknown name and an untried system. This will particularly be the case where the sub-franchisor does not feel confident in accepting a commitment to a development schedule that it is uncertain will prove in practice to be fair to both the franchisor and itself. Undoubtedly there is a need for flexibility. When fixing a development schedule, there may be lessons to be learned from reviewing the performance of competitors in the territory concerned. Many franchisors are prepared to accept a realistic minimum development on the basis that the commercial reality is that if the business is successful, it is unlikely that the sub-franchisor would not wish to expand it to the full. It is important for both parties that the sub-franchisor is obliged to expand sufficiently to ensure that

it achieves a critical mass of sub-franchisees that will enable it to make the maximum use of its resources and thereby to arrive at the achievement of effective growth.

In establishing the development schedule there is a factor which, experience shows, may need to be discussed. There are businesses that have production facilities or, as in fast food, preparation and cooking. Over the years some of these have rationalised their approach by centralising some or all of the production or preparation and cooking functions and have established satellite outlets rather than full service operational outlets. This approach is often the result of the need either to use capital more effectively to enable the business to compete, or of the cost of the increasingly technologically based capital equipment requirements that change so rapidly. While it is difficult to foresee what may emerge as the best method of exploitation in the future, the possibility that this factor may arise may need to be considered.

The issues of the viability of the system and the lack of knowledge of the franchisor's name may be approached by having an initial period (also called a trial period) during which the sub-franchisor will be required to establish one or more pilot operations. The purpose of the pilot operations is to ascertain whether the business that is franchised is viable and to judge how successful it may be in the target territory. The performance of the pilot operation will also enable the franchisor's system to be adjusted to take account of the experience obtained. The pilot operation will furthermore assist in the marketing of sub-franchises, as the ability to demonstrate success in operation is a vital sales aid. In some countries the codes of ethics of franchise associations may require pilot operations to be set up. The European Commission Regulation 4087/88 on the application of Article 85(3) of the Treaty to categories of franchise agreements defines the franchisor's know how as "resulting from experience and testing",⁴¹ which is another way of describing the practical experience that pilot operations provide.

The debate about development schedules does not necessarily end when the contract is executed because the agreement may incorporate the right for the sub-franchisor to renew or extend the contract upon its expiration.⁴²

The terms upon which that may occur will undoubtedly involve the establishment of a continuing development schedule of one kind or another. Even if the parties are agreed that full market exploitation has taken place, the sub-franchisor will probably be faced with a demand from the franchisor that what exists must be maintained and that any sub-franchisees who exit the network will be replaced.

If, as may be more likely, full market exploitation has not been achieved, there will have to be a method of establishing what the "new" development schedule will be. The issues at this stage will differ somewhat from the issues that are considered when the initial contract was negotiated. All the then unknown factors will have been resolved:

- ◆ the name will have become known;
- ◆ the system will be working;
- ◆ the scope for the opening of operational units and the speed with which this can be achieved will be known.

The discussions at the renewal/extension stage are more likely to involve

- ◆ what further scope for development exists;
- ◆ over what period that can be achieved;
- ◆ what changes may have taken place in the business and economic climate in the territory;
- ◆ what the sub-franchisor's new business plan shows; and
- ◆ whether there are other factors that should be taken into account.

⁴¹ Article 1(3)(f).

⁴² See Chapter 3 "Term of the Agreement and Conditions of Renewal".

As the sub-franchisor is the custodian of the franchisor's interests and property rights within the territory, the parties may be expected to discuss provisions in the master franchise agreement under which the sub-franchisor would be asked to undertake a number of obligations:

- ◆ to come to an agreement with the franchisor on sub-franchisee qualification criteria to be established and to observe and operate them, so as to ensure that the sub-franchisees are of the right calibre;
- ◆ to train sub-franchisees in accordance with the training courses and procedures laid down by the franchisor. In some cases the franchisor might require the sub-franchisees to attend training courses at its main training centre in its own country;
- ◆ to enter into agreements with sub-franchisees, the terms of which follow the franchisor's standard domestic form but which have been adapted for local use to take into account variations in law and business practice.

Having entered into these agreements the sub-franchisor would be required to ensure that the sub-franchisees comply with their terms. This does not necessarily mean that if a sub-franchisee does not perform its contractual obligations the sub-franchisor should immediately initiate legal proceedings. There are other methods short of legal proceedings that are employed by sub-franchisors when a sub-franchisee is in default in order to persuade the sub-franchisee to comply with its obligations. Depending on the nature of the non-performance, these other methods may include:

- ◇ additional training;
- ◇ enhanced support;
- ◇ persuading the sub-franchisee to improve performance; and
- ◇ an attempt to persuade the sub-franchisee to sell its business so that another can take its place in the network.

These particular contractual provisions need to be drafted in such a way that the sub-franchisor is provided with sufficient scope to handle the network in a flexible manner, while at the same time ensuring that the franchisor's property rights are kept secure;

- ◆ the sub-franchise agreement will inevitably need to impose upon the sub-franchisee a number of financial and reporting obligations. These will include reporting sales figures, so that franchise fees can be calculated and verified, and providing financial information and accounts relating to its business. The payments that will be made to the sub-franchisor and the reports upon which they are calculated will in turn form the basis for the payments by the sub-franchisor to the franchisor. The sub-franchisor will therefore be required to ensure that the sub-franchisees comply with their obligations to provide the required reports and to make prompt payment of their financial commitments. The sub-franchisor will also be required to verify the accuracy of the financial information it receives and of the payments made by the sub-franchisees;⁴³
- ◆ the sub-franchisor will have the prime responsibility in the territory for ensuring that trademark laws are complied with and that the sub-franchisees use the marks in a proper way consistent with legal requirements. The sub-franchisor will also be expected to monitor the market place in the territory so as to identify any possible infringements of the trademarks. The franchisor would normally be expected to take over enforcement proceedings against infringers and to bear the costs of any necessary legal proceedings, with the sub-franchisor and the sub-franchisees undertaking in their respective agreements to provide assistance and evidence that will enable the franchisor to conduct those proceedings effectively. In a number of jurisdictions trademark law might require licensees to be involved in any such proceedings;

⁴³ See Chapter 4 "Financial Matters" for a discussion of who bears the credit risk.

- ◆ many franchisors take an interest in the proper setting up by the sub-franchisor of an administrative and operational infrastructure that will enable it to cope with the establishment, growth and development of the network. It is common to find requirements that the sub-franchisor should only employ in key positions those who have been trained and approved by the franchisor. Some franchisors also specify key posts which the sub-franchisor must create, such as, for example, general manager, operations manager, or finance manager;
- ◆ mention has been made of the need to establish pilot operations to verify the efficacy of the system in the host country. The sub-franchisor will be expected to identify the legal and regulatory requirements that are applicable in the territory for the operation of such a business from the experience gained in the pilot operations. It might be advisable to reflect some of these requirements in amendments to the operations manuals. Furthermore the experience gained in conducting pilot operations will perhaps reinforce the franchisor's views on site location, or may indicate that different local considerations need to be taken into account so that criteria are established that make sense in that particular territory. The experience thus gained will enable the sub-franchisor to provide the right level of advice enhanced by knowledge acquired from experience in supporting the sub-franchisees;
- ◆ there will also be some provision detailing how advertising and promotional activities will be conducted and at whose expense.⁴⁴

All these factors combine to enable the franchisor and the sub-franchisor jointly to place the sub-franchisor in a position to establish an organisation in the host country that resembles that of the franchisor in the country of origin, providing the same range of services and support in that territory as the franchisor provides in its own territory. There is one factor to which little attention is paid, namely that there are very few franchisors operating in the international market place who actually provide their sub-franchisors with manuals on how to conduct themselves as franchisors. The general practice would appear to be to set out the rules in the franchise agreement, to provide the sub-franchisor with training normally of an operational nature and to give guidance in response to questions or on periodic visits by the sub-franchisor to the franchisor's centre of operations or vice versa.

Most franchisors find it administratively essential and cost effective to be able to communicate with their sub-franchisors in the franchisor's language. This means that the franchisor will invariably provide the sub-franchisor with material written in the franchisor's own language which will need to be adapted and translated for use within the territory. It is normally expected that the sub-franchisor should undertake the preparation of translations at its own expense. The franchisor will however need to have the copyright to the translation vested in it, as it would otherwise lose control of its know-how. It is also common to provide that there should be a language of communication in order to avoid confusion. Again, this is invariably the language of the franchisor.

It is understandable that a franchisor with multinational ambitions cannot effectively undertake to have available in its own organisation members of staff who not only have the requisite skills, but are also able to communicate in the many different languages with the sub-franchisors who will be established in the different countries.

As far as the various intellectual property rights of the franchisor other than the trade marks are concerned, in its role of custodian of those rights and interests the sub-franchisor will itself need to undertake to preserve them. Important elements of these intellectual property rights are the know-how and confidential information that the franchisor has to make available to the sub-franchisor and through the sub-franchisor to the sub-franchisees. All franchise systems are based upon the package of know-how that the franchisor has compiled and that represents the way in which the franchised business is to be conducted. Apart from the formal record of such know-how in the franchisor's operations manual, there will be other transmissions of know-how in training, in advice given and in various other communications between franchisor, sub-franchisor and sub-franchisees. In passing on this know-how to the sub-franchisor for the purposes of

⁴⁴ See Chapter 8 "Advertising and the Control of Advertising" for a fuller discussion.

conducting the business, the franchisor will impose upon the sub-franchisor strict obligations to keep the know-how confidential. The sub-franchisor will, however, have to pass the know-how on to the sub-franchisees and will therefore be required to impose obligations on the sub-franchisees requiring them to keep the franchisor's know-how confidential. The sub-franchisor will also be required to enforce any breach of such obligations by the sub-franchisees.

As the owner of the know-how of the franchise system, the franchisor will retain the right to approve the introduction of improvements or modifications to the system, independently of whether these modifications or improvements originate with the sub-franchisor or a sub-franchisee. If the franchisor were not to retain such a right, the uniformity of the system and of the standards of the system would eventually be imperilled.

It may therefore be said that the sub-franchisor, from the point of view of both franchisor and sub-franchisees, is the effective franchisor for the system in the territory. The franchisor will expect the sub-franchisor to run the system as it would itself and the sub-franchisees will expect that the sub-franchisor behaves towards them as a responsible franchisor. Indeed if the sub-franchisor operates effectively, the sub-franchisees would not regard anyone else as being the franchisor.

CHAPTER 7

THE UNIT SUB-FRANCHISE AGREEMENT

International master franchise arrangements are normally not executed in the form of a three-party agreement. The three-tier structure is usually achieved by two separate agreements: the master franchise agreement between the franchisor and the sub-franchisor and the sub-franchise agreement between the sub-franchisor and the sub-franchisee.⁴⁵ It is thus the sub-franchisor who selects the sub-franchisees and who enters into a sub-franchise agreement with each of them. The point at issue in this connection is the extent to which the franchisor is able to influence, or even to control, the selection of the sub-franchisees and the drafting of the sub-franchise agreements.

It is characteristic of franchising that the franchisor, by means of the sub-franchisor and the sub-franchisees, intends to achieve a reproduction in the host country of a concept that has proved to be successful in its home country. It is natural for the franchisor to want these reproductions to be as close to the original as possible. A method to achieve this is to impose an obligation on the sub-franchisor to use standard sub-franchise agreements that are more or less identical with the standard form unit franchise agreement used by the franchisor in its own country, even if translated into the language of the host country. In many instances, however, it is neither possible nor appropriate for legal, economic, cultural or other reasons to use a version of the franchisor's standard form unit agreement that has merely been translated. Even if the franchisor must, or will, allow more or less substantial modifications to be made to its standard agreement, and adaptations to be made to its system, it cannot, and usually will not, allow only the trademark and/or trade dress to remain identical with that of the original system. It is therefore necessary for the franchisor to have a certain control over the drafting of the sub-franchise agreements, the only question being the extent of this control.

To achieve its objectives a franchisor basically has two options:

- ◆ the franchisor may impose its usual standard franchise agreement on the sub-franchisor and require compliance with all its stipulations unless they are in contradiction with mandatory laws or cultural customs of the host country, with the sub-franchisor essentially being responsible only for the translation of the agreement and of the annexed documents, or
- ◆ the franchisor may provide a basic structure for the contract, including a number of mandatory provisions, but leave the actual drafting of the standard form sub-franchise agreement to the sub-franchisor.

There are no fixed rules on when and how either of these methods should be used. This will depend on a number of factors:

- ◆ the maturity of the system and the experience of the franchisor;
- ◆ the business experience and financial solidity of the sub-franchisor;
- ◆ the complexity of the system;
- ◆ the trust of the franchisor in the ability of the sub-franchisor;
- ◆ the distance in geographic, cultural, economic and legal terms between the country of the franchisor and the host country; and
- ◆ the level of knowledge of franchising that exists in the host country in general and within its legal community in particular.

⁴⁵ See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

All these factors have to be taken into account when the appropriate drafting method is chosen and when the tasks are divided between the franchisor and the sub-franchisor.

A. FIRST OPTION: COMPLIANCE WITH THE STIPULATIONS OF A PRESCRIBED STANDARD FORM CONTRACT

Many franchisors prefer the terms of the standard form that is to be used in the host country to be exactly the same as those of the standard form agreement they have provided, which usually is the one they normally use in their own countries. In such cases the sub-franchisor will as a rule be placed under an obligation to translate the foreign model agreement into the local language at its own expense. In order to attain compliance with the original model agreement, the franchisor will commonly add the following obligations:

- ◆ any alterations or amendments that the sub-franchisor wishes to make must be approved by the franchisor;
- ◆ the sub-franchisor may not start to use the translated version without the franchisor's prior written approval;
- ◆ the sub-franchisor must warrant that it will not alter or amend the translated version that has been agreed upon without prior consultation with, and written consent of, the franchisor;
- ◆ the sub-franchisor must warrant that each of its future sub-franchisees will execute the standard form sub-franchise agreement agreed upon;
- ◆ the sub-franchisor must warrant that the sub-franchisees will operate in full compliance with their sub-franchise agreement and that it will enforce compliance with the terms of the sub-franchise agreements, including by legal action where appropriate or necessary; and
- ◆ the sub-franchisor must warrant that all its sub-franchisees meet the then current admission criteria with respect to
 - ◇ personal qualifications,
 - ◇ related business experience, and
 - ◇ financial solidity.

A franchisor who chooses this option should consider:

- ◆ that the mere imposition of a translated version of the original unit franchise agreement may contravene mandatory legal rules and/or commercial and/or cultural customs of the host country;
- ◆ that it should therefore show flexibility with respect to the sub-franchisor's requests for adaptation of the sub-franchise agreement. This does not mean that the sub-franchisor should be entirely free to adapt the sub-franchise agreement and subsequently to modify the adapted agreement without the consent of the franchisor. The sub-franchisor should provide information justifying the adaptations or modifications it proposes with a view to ensuring that the agreement conforms to the laws, customs and commercial practices of the host country;
- ◆ that negotiations in which the sub-franchisor has to struggle to obtain the franchisor's consent for each and every modification it considers to be necessary or appropriate in order to meet the local requirements will very soon lead to a confrontational relationship, that this does not augur well for the collaboration between the parties and that it also considerably increases the initial legal costs of both parties; and
- ◆ that the criteria for the admission of sub-franchisees that the franchisor applies in its country of origin may not be appropriate in the host country and that their unaltered

application might therefore be of considerable hindrance to the development of the franchise system. If the franchisor wishes to impose certain admission criteria on the sub-franchisor, then these should be reasonable, appropriate for the system and for the host country, as well as acceptable to the sub-franchisor.⁴⁶

In addition to approving the individual sub-franchise agreements, franchisors may sometimes wish to approve each prospective sub-franchisee in a foreign country and in some cases this may be feasible. In most cases, however, the franchisor will probably not be in a position to exercise these rights. Approval procedures of this nature may in fact be an obstacle to the dynamic development of a system in the host country. They may also involve an unwelcome risk of liability for the franchisor. This does not exclude the franchisor for control purposes receiving copies of all sub-franchise agreements executed, but the franchisor should consider whether, under the applicable law, such a procedure could create a risk of liability.

When the tasks are divided between the parties, these should bear in mind the reason for which the franchisor has decided to expand its system via master franchising. The main reason is invariably that the franchisor could not, or did not want to, invest its own financial means or use its own personnel in this foreign market and decided to leave this to a sub-franchisor. As it is the sub-franchisor who bears the main financial risk for the development of the system in the host country, it would also appear to be reasonable to transfer responsibility to the sub-franchisor at all possible levels, therefore also for the drafting of the sub-franchise agreements.

B. SECOND OPTION: PRESCRIPTION OF A SPECIFIC STRUCTURE INCLUDING SOME MANDATORY PROVISIONS

The second option may in many cases be the more appropriate one. It is less rigid and thus gives the sub-franchisor more liberty to establish a standard form of agreement for practical use in the host country. In this case the franchisor may prescribe a specific structure which it considers reasonable and a number of mandatory provisions that it considers necessary to transmit the system, to protect its know-how and intellectual property rights and also to ensure the uniformity of the franchise network.

The franchisor may require the following issues to be included or dealt with in the sub-franchisor's standard sub-franchise agreement:

- ◆ a general description of the franchise system in a preamble;
- ◆ the precise scope of the rights granted;
- ◆ a description of the territory for which the agreement applies (where applicable);
- ◆ lists of the sub-franchisor's and the sub-franchisee's rights and obligations;
- ◆ training provisions (initial and ongoing), including the extent and component parts of the training;
- ◆ the supervision of sub-franchisees in general and quality control in particular;
- ◆ the exchange of experience and the organisation of meetings of sub-franchisees, other means of ongoing communication, possibly the setting up of a council of sub-franchisees;
- ◆ the protection and control of the use of the trademarks, know-how and other intellectual property rights;
- ◆ the implementation of system changes;
- ◆ franchise fees (initial and/or ongoing);
- ◆ reporting rules, payment rules and control rights;
- ◆ compliance with local laws, the provisions of the franchise agreement and the manual(s);
- ◆ (minimum) insurance rules, indemnity;
- ◆ promotion, advertising issues;
- ◆ confidentiality, non-competition covenants (including post-term);
- ◆ assignment rules (including assignment to the franchisor);

⁴⁶ See Chapter 6 "Obligations of the Sub-Franchisor".

- ◆ non-performance of the agreement by the franchisee and possibly by the sub-franchisor;
- ◆ duration, renewal and termination of the agreement; and
- ◆ jurisdiction issues (arbitration, mediation, conciliation).

The relative liberty of the sub-franchisor does not exclude that the franchisor may provide in the master franchise agreement that:

- ◆ it wishes to approve the final version of the standard sub-franchise agreement;
- ◆ the sub-franchisor should not deviate from or amend the approved standard sub-franchise agreement without prior consultation with, or possibly the written consent of, the franchisor;
- ◆ each sub-franchisee should sign a standard sub-franchise agreement before starting to operate a unit; and that
- ◆ it should receive a copy of each signed sub-franchise agreement, not in order to approve it, but simply for the record.

The franchisor may prescribe the use, and possibly even the specific wording, of certain key provisions, such as

- ◆ strict rules governing the mandatory use of the trademarks, know-how and other intellectual property rights, including rules on how to supply services, on how to prepare or manufacture the goods and on other quality standards;
- ◆ rules concerning the use of advertising material if supplied by the franchisor;
- ◆ provisions concerning the ownership of the manual(s) (including ownership of the translation into the local language), the confidentiality of all component parts of the franchise system and provisions relating to the enforcement of these provisions; and
- ◆ compliance of the sub-franchisees with all applicable laws, regulations and other requirements of the authorities in the host country, in particular with labour and tax laws.

The sub-franchise agreements must contain a provision on what will occur when the master franchise agreement comes to an end as a result of the expiration of its term or because it is terminated. The franchisor may require the automatic termination of all the sub-franchise agreements that the sub-franchisor has concluded in either of these cases and the sub-franchisor should warrant such an automatic termination. The franchisor should further decide whether in such a case the sub-franchise agreement should be automatically assigned to it, or whether it should be granted an option to select the sub-franchisees it wishes to continue relations with. The franchisor will usually prefer the last of these alternatives.⁴⁷ Whatever the choice of the franchisor, or whatever it can agree upon with the sub-franchisor, the standard form sub-franchise agreement must clearly reflect the solution adopted. It goes without saying that both parties to the master franchise agreement should carefully consider whether the solution adopted is viable under local conditions.

C. COMPLIANCE OF THE SUB-FRANCHISE AGREEMENT WITH THE LAWS OF THE HOST COUNTRY

It is evident that the franchisor would never be able to force a sub-franchisor to draft and use a sub-franchise agreement that in any way infringes the laws and regulations of the host country, including legislation of international origin, or that would cause the sub-franchisees to break such laws. As the franchisor usually is not sufficiently familiar with the laws of the host country, it falls upon the sub-franchisor to clearly and openly indicate which clauses of the

⁴⁷ See Chapters 15 “Remedies for Non-Performance” and 16 “The End of the Relationship and its Consequences”.

standard form sub-franchise agreement proposed by the franchisor in its view infringe local laws and to discuss possible alternatives with the franchisor. A reasonable franchisor should be open to such a discussion, considering that it in fact should require the sub-franchisor to ensure that the standard form sub-franchise agreement complies with all local laws. This does not mean that the sub-franchisor should take advantage of this situation to do away with all the clauses of the agreement that it does not like. It should respect the franchisor's objective, and right, to safeguard the licensed system's identity also by contractual means. Both parties should base their negotiations on the common objective of facilitating the expansion of the network in the host country by means of a standard form sub-franchise agreement which is appropriate in the local legal and social circumstances, while at the same time maintaining the overall identity of the network. This could mean that the franchisor will insist on imposing specific "mandatory" contract clauses in some countries while accepting less rigid contractual arrangements in others.

D. ENFORCEMENT OF THE SUB-FRANCHISE AGREEMENTS

It is one thing to impose a specific contract form on a sub-franchisor at the beginning of a relationship, but it is quite another to ensure its permanent use and enforcement over the years. The greater the distance between the franchisor's headquarters and the sub-franchisor's territory, the more the franchisor has to rely on the trustworthiness of the sub-franchisor to fulfil its contractual obligation to enforce the obligations of the sub-franchisees under the sub-franchise agreements.

The franchisor will therefore in the first place require the sub-franchisor to closely supervise the compliance of the sub-franchisees with the terms of the sub-franchise agreement, in particular in relation to the use of the trademarks and other intellectual property rights, the proper use of the know-how and the adherence to the quality standards of the system. As the franchisor's realistic possibilities of control are limited, it is also entitled to request in the master franchise agreement that the sub-franchisor warrant the performance of its supervisory duties as well as the compliance of the sub-franchisees with the sub-franchise agreements.

The sub-franchisor will normally also be obliged to ensure that non-performance of the sub-franchise agreements may be effectively remedied by recourse to the means provided for in the sub-franchise agreement and in the host country's legal system, in case of necessity by termination of the sub-franchise agreement.

Not every single instance of non-performance of a sub-franchise agreement can be considered a material breach of the master franchise agreement. Where, however, the non-performance harms the system, particularly where it is an event that has occurred more than once and that has not been remedied despite the fact that an appropriate period of time has been given for this purpose, then it may be considered to constitute a material breach of the master franchise agreement.

As a franchisor will in general hesitate to terminate a master franchise agreement, it may have recourse to other remedies. It may, for example, claim monetary compensation from the sub-franchisor, which the latter might in turn claim from those of its sub-franchisees who have not performed the sub-franchise agreements. Probably only in very serious cases of non-performance or breach of sub-franchise agreements will the franchisor terminate the master franchise agreement.

Sub-franchisees are however not alone in not performing the sub-franchise agreements. It may well happen that a sub-franchisor (usually for lack of funds) does not properly perform its duties under the sub-franchise agreements. If, in such cases, the sub-franchisees start to enforce their contractual rights, stop paying the royalties or simply conduct business outside the franchise system, the sub-franchisor's network might quickly fall apart. As this would damage the franchisor's reputation in general and not only in that particular country, it would appear to be advisable for the franchisor to oblige its sub-franchisors to give all their sub-franchisees the

address of the franchisor so that they may address their complaints directly to the franchisor. It would be in the best interest of the network as a whole for the franchisor to take the complaints of its sub-franchisees seriously and to make every effort to ensure that its sub-franchisor complies with the sub-franchise agreements.

E. COMMUNICATION WITH AND SYSTEM IMPROVEMENTS BY SUB-FRANCHISEES

Improvements to the system are made or proposed not only by the franchisor and the sub-franchisor, but also by the sub-franchisees.⁴⁸ They are close to the consumers and they are therefore the first to realise what improvements might be required by the market. They will therefore usually submit suggestions and requests to which the sub-franchisor and the franchisor should respond. It is for this reason that the franchisor would be well advised to oblige its sub-franchisors to institute permanent communication procedures and to entertain an intense exchange of views and experiences with its sub-franchisees, as well as to organise regular meetings of the sub-franchisees of the network. The sub-franchisor should encourage its sub-franchisees to come forward with proposals for improvement, but it should also ensure that they do not implement them without the prior approval of the franchisor. It will fall upon the sub-franchisor to obtain this prior approval. The sub-franchise agreement should provide rules on how improvements made by sub-franchisees are to be integrated into the franchise system. Needless to say, these rules must comply with the legislation of the country concerned and the solutions will therefore differ from country to country. The options open are that such improvements are either entirely transferred to the franchisor (with or without compensation), or that they are licensed to the sub-franchisor or to the franchisor, with or without exclusivity being granted but with ownership being retained by the sub-franchisee. Permitting the sub-franchisees to retain the ownership of the improvements they have devised and which are introduced into the entire franchise system will encourage sub-franchisees to come forward with their ideas. The offering of appropriate compensation or the instituting of a system for the rewarding of such initiatives would also be an incentive.⁴⁹

F. CHOICE OF FORUM AND CHOICE OF LAW

The franchisor will usually not influence the sub-franchisor's policy in relation to the choice of forum clause for the sub-franchise agreements. The sub-franchisor's freedom in making such a choice may however be limited by local legislation.

The franchisor may nevertheless have an interest in not publicising any litigation concerning its system and might therefore prefer to keep any controversies out of the State courts. It is however not evident that the franchisor can, or indeed should, oblige its sub-franchisors in every country to prescribe the use of arbitration in their sub-franchise agreements. Franchisor and sub-franchisor should come to an agreement on the most appropriate dispute resolution method in the case at hand after having considered all the different possibilities, mediation included. In countries where franchising is a relatively unknown business method and where State courts may have difficulties in dealing with franchise issues, arbitration might be the better alternative, if it is available at a reasonable cost and if arbitral awards can be easily enforced.

Choice of law is usually not an issue for sub-franchise agreements, as these are generally concluded between parties operating on the same national territory. There are however cases in which a sub-franchisor has sub-franchisees in several countries, or in several states of a federal State, and that these have at least partially different legislations. This situation resembles that of a franchisor with sub-franchisors in different countries. When a sub-franchisor selects the law that it proposes should apply, it might therefore take into consideration the same elements as a franchisor in an international situation.⁵⁰ It is in any event advisable to adjust the choice of law and choice of forum to the situation.

⁴⁸ See Chapter 12 "System Changes".

⁴⁹ See Chapter 12.

⁵⁰ See Chapter 17 "Applicable Law and Dispute Resolution".

CHAPTER 8

ADVERTISING AND THE CONTROL OF ADVERTISING

It comes as no surprise that advertising plays a major role in ensuring the success of a franchise system. In this, franchising is no different from other, more traditional forms of business. For international franchising, as for other businesses, a fundamental problem is that, with the exception of systems with famous trademarks, the goodwill and public image of the system must be built up from scratch. This may of course to some degree be the case also in purely domestic franchising, especially in large countries where a franchised operation may not be well-known in all regions of the country, but it is far more likely in cross-border franchising.

In this connection the value and importance of advertising and promotion cannot be doubted. Franchisors and franchisees therefore share an interest in maintaining a degree of standardisation of advertising and promotional programmes. This is equally important in both the domestic and in the international contexts, in the latter of which, however, advertising does raise an additional set of issues. The most immediate set of issues that arise in the international context are likely to relate to the process of “building up from scratch”. With respect to the creation of consumer awareness where little or none existed before, the franchisor and sub-franchisor must come to a clear understanding as to who will bear the burden of doing so, in terms of human as well as financial resources. A prospective sub-franchisor should normally be prepared to accept the obligation to introduce the franchise into the country, unless the franchisor has indicated that it is prepared to do so. The franchisor might not be willing to do so as the cost of doing so might far exceed any benefit that the franchisor could derive from the country.

The main objectives in controlling the manner in which a franchise system is advertised abroad are first, the global standardisation of the franchise image projected to prospective customers and second, the protection in other countries of the proprietary marks used in the franchise system. A third objective should also be recognised, namely the avoidance, to the maximum degree possible, of false or misleading advertising. While this is commonly accepted as a legitimate goal in domestic franchising, it has to date been considered less often in the international context. This is certain to change in the future. In addition, it is likely that the franchisor will be less familiar than the sub-franchisor with the legal and cultural environments of the sub-franchisor’s country and the issues that may arise in connection therewith. This usually leads to an obligation being imposed upon the sub-franchisor to police the activities of the sub-franchisees in this regard.

In striving to standardise the image of the system that is projected to prospective customers, sub-franchisors and sub-franchisees seek to preserve and cultivate the goodwill of the franchise system with the public, as well as to structure the system in such a manner that similar advertising rights are granted, and similar advertising obligations are imposed, wherever the system is developed. When they protect their proprietary marks in foreign markets, franchisors will need to protect their proprietary rights also as regards the translation of the marks into the local language. The inclusion in international franchise agreements of provisions such as the ones described below may be of assistance in achieving these objectives.

A. APPROVAL AND USE OF ADVERTISING MATERIALS

Of importance in determining the extent to which the franchisor will control the manner in which the system is advertised abroad, is whether the franchisor will itself provide all the advertising materials used by the sub-franchisor and the sub-franchisees, whether it will instead merely approve all the advertising materials used by them, or whether it will provide guidelines or

standards that they will be required to follow in developing their own local advertising materials. While many franchisors would prefer to retain absolute control over the advertising of their franchisees, in the first place by supplying all advertising materials and thereafter by monitoring their use by the franchisees, most franchisors find this option too cumbersome to be practical in cross-border franchising. Sub-franchisees will moreover resist such stringent control on the part of the franchisor. In practice a majority of franchisors and sub-franchisors will agree on either the franchisor approving the advertising materials, or the franchisor providing guidelines or standards that the sub-franchisors are expected to follow in developing their own local advertising materials.

I. APPROVING ALL MATERIALS

If the franchisor is to approve all the advertising materials used by the sub-franchisors, a decision will need to be taken as to whether the franchisor should have pre-approval rights or post-approval rights. In the case of pre-approval rights the sub-franchisors will be required to submit all the advertising materials they develop to the franchisor for approval prior to their use. Any such material will be subject to review and to renewed approval by the franchisor at specified intervals. Alternatively, a franchisor may require that foreign sub-franchisors submit all the advertising materials they develop within a certain period of time after they begin to use such materials. This latter type of requirement is normally accompanied by a provision in the agreement that permits the franchisor to reject any submitted materials and that requires sub-franchisors to cease using any disapproved materials immediately. In either case, submissions are ordinarily made in both the local language and in the language of the franchisor.

II. PROVIDING ADVERTISING GUIDELINES OR STANDARDS

A franchisor who provides guidelines or standards to assist foreign sub-franchisors in developing their own advertising materials has several issues to consider. These issues include:

- ◆ how the guidelines or standards are to be identified (for example described in the international franchise agreement or in the operations manual of the system);
- ◆ whether the sub-franchisors will be required to prepare periodic marketing plans;
- ◆ if sub-franchisors are required to prepare marketing plans, whether such plans must be submitted to the franchisor; and
- ◆ if sub-franchisors are required to submit marketing plans, whether the franchisor must approve the plan, or whether the franchisor and the franchisee will simply discuss the plans together.

In addition the parties should bear in mind that, while marketing plans will normally indicate the objectives that the parties hope to meet, only very rarely are these objectives fully achieved. Prudent franchisors and sub-franchisors draft provisions on advertising that provide for the possibility that marketing plans may not be met and that identify a means by which the general success or failure of a marketing plan can be measured.

III. MASTER FRANCHISING CONTRASTED

The methods described above of controlling advertising in other countries differ substantially from the manner in which franchisors manage advertising in the case of master franchising. In master franchising the parties tend to delegate to the sub-franchisor a large number of the responsibilities of the franchisor also as regards advertising, but franchisors retain control by deciding at a general level how international advertising should be conducted.

B. TRANSLATIONS

A second major decision that should be taken in the initial stages of a franchise system's expansion abroad concerns the manner in which the advertising materials will be translated into the foreign language. The parties need to decide whether the franchisor will translate the

advertising materials into the local language before providing them to sub-franchisors, or whether the franchisor will provide its sub-franchisors with advertising materials in its own language and then require the sub-franchisors to have the materials translated. If the sub-franchisors are required to provide for the translation of the materials, a decision should be taken as to who should pay for the translations.

Franchisors often prefer to provide sub-franchisors with translated advertising and promotional materials, as those who require the sub-franchisors to provide for the translation of the materials run the substantial risk of losing proprietary rights to such translations in the country concerned.

Franchisors who require sub-franchisors to translate materials should also require them to submit such translations for final approval, either prior to, or concurrent with, their actual use of the materials. In this way the franchisors will retain some influence over the manner in which publicity for the system appears in translation abroad. In order to protect their rights to such translated materials, franchisors should also require sub-franchisors, as well as any sub-contractors to whom the sub-franchisors have entrusted the translations, to execute agreements granting all proprietary rights in the translations to the franchisor. An agreement to this effect should be concluded prior to the translation of the materials.

Finally, franchisors should consider whether they want their trademarks to be translated into the local language for use in the advertising materials that is to be used in that territory. Franchisors who elect to translate their trademarks will in all likelihood retain ownership rights to the translation. The parties will also need to determine who should bear the cost of registering the translation as a trademark in the sub-franchisor's country.

The discussion of "translation" almost always tends to be limited to the technical translation of words and phrases from one language into another. It must however be recognised that, especially when the franchised business entails the sale of goods or the provision of services to large numbers of individual consumers, there is also a cultural dimension to the process of translation.

C. ADVERTISING ALTERNATIVES

I. LOCAL ADVERTISING

Once a determination has been made of the means by which to achieve the objectives of the global standardisation of the image of the franchise network and of the protection abroad of the proprietary marks used with the system, the final major issue for the parties to consider is who should bear the cost of advertising.

The possibilities available are that the sub-franchisor should bear full financial responsibility for advertising in its territory, that the sub-franchisor should bear a substantial part of such responsibility, but should contribute what is normally quite a small percentage of its gross revenues to the franchisor for the franchisor's advertising in the territory and that the franchisor should bear full financial responsibility for advertising in the franchisee's territory.

In the case of either of the last two alternatives the parties should decide the purposes for which the contributions of the sub-franchisors may or may not be used by the franchisor and the manner in which the franchisor will be accountable to the sub-franchisors for the actual expenditures made. In the case of either of the first two alternatives the parties should clarify whether the sub-franchisor's expenditures on local advertising will be credited toward the amount(s) the sub-franchisor is required to spend on other advertising activities (such as, for example, contributions to a regional advertising fund) and whether, and if so by what means, the franchisor is to verify that the sub-franchisor has spent the required amount on local advertising.

This second matter may be significantly more difficult to enforce for a franchisor whose system has expanded abroad than is the case in purely domestic franchising.

With reference to the above discussion on the relationship between franchisor and sub-franchisor, it should be observed that a parallel set of issues must be confronted in the context of the relationship between the sub-franchisor and the sub-franchisees and that these issues must be addressed in the sub-franchise agreement.

II. REGIONAL ADVERTISING FUNDS

Instead of establishing an international franchising system that provides for only local advertising, many franchisors control the manner in which their systems are advertised abroad by establishing national advertising funds. Regional advertising funds are most frequently and most successfully implemented when the areas that comprise a franchised territory have highly differentiated markets and/or are geographically distant.

(a) Agreement Terms

Franchisors that require foreign sub-franchisors to participate in a regional advertising fund will typically include a provision in the international franchise agreement that obliges each franchisee in a specific geographic area periodically to contribute a very small amount of its gross revenues to the fund. The funds that are collected are spent on advertising for the benefit of sub-franchisors in that particular geographic region. The franchise agreement will generally contain a term disclaiming that funds will be spent in proportion to the contribution of any particular sub-franchisor to the fund and that any specific advertising for which the fund is used will benefit any particular contributing franchisee.

(b) Setting Up

Franchisors who set up regional advertising funds will typically either manage such funds themselves, or establish separate entities to manage the activities of the funds. Franchisors choosing the latter option will often institute advertising funds in such a manner that they retain the right to veto the actions of the funds, for example by placing themselves on the Board of Directors of the entity managing the fund. A franchisor may, however, choose to delegate this authority to a sub-franchisor.

(c) Other Contributions

In addition to the sub-franchisor and sub-franchisees themselves, the manufacturers and the suppliers of the network may also contribute to the advertising, marketing and promotional activities of the network, both at a national level and as regards each separate unit.^{iv}

(d) Advantages

While regional advertising funds are used relatively rarely in international franchising, they do have at least two advantages. One advantage is that regional advertising funds allow sub-franchisors to achieve economies of scale through the co-ordination of advertising and promotion efforts. A second advantage is that participating sub-franchisors are able to benefit from the use of uniform or consistent, co-ordinated advertising, as well as from access to more sophisticated research and production resources, than would otherwise be available to any individual sub-franchisor.

D. THE IMPACT OF MASTER FRANCHISING

Master franchising provides the franchisor with an opportunity to delegate a significant amount of decision-making to others intimately involved with the international expansion of the franchise system. Furthermore, it tends to facilitate the setting up of a regional fund for advertising. This is most clearly reflected in the fact that a considerable number of sub-franchisors to whom both development and operational rights are granted, are required to

institute a regional advertising fund at the very least for the sub-franchisor's own franchised outlets. Independently of whether a sub-franchisor is required to set up a regional advertising fund only for its own outlets, or for both its own outlets and the outlets for which it has granted sub-franchises, the franchisor will often retain control over advertising by requiring that the sub-franchisor submit periodic marketing plans for its territory. In addition, the sub-franchisor may be required to periodically account for and substantiate fund expenditures to the sub-franchisees that contribute to the fund.

A decision will be required as to the precise allocation of the funds between the expenditure required for the local advertising and that needed for the international network as a whole. Furthermore, co-ordination is necessary between the advertising and promotional activities that apply to the network as a whole and for which the franchisor will bear the main responsibility, the advertising at a regional or national level for which the sub-franchisor will be responsible (also by reason of its knowledge of the local market and of its capability to adapt any programmes or materials to local requirements) and the local advertising for which the sub-franchisee will bear responsibility. The different levels of permission that are necessary will need to be considered and determined. Thus, for example, the question of whether the local advertising devised by the sub-franchisee will require the approval of both sub-franchisor and franchisor, or whether the approval of the sub-franchisor alone will be sufficient, will need to be examined by the parties.

Finally, it is necessary to consider the issues that might arise where a number of sub-franchisors have been granted master franchises in territories that are close geographically and whose advertising consequently cannot be viewed as limited to their own territories. In some cases several master franchises will be granted in a single country, especially if it is a large country, whereas in other cases the sub-franchisors might be geographically close but in different countries. Even if each sub-franchisor is granted an exclusive territory, as is virtually always the case, the activities of one are likely to affect the others, as it is almost never possible to ensure that each franchised territory is a segregated market for advertising purposes. Even if there is only one sub-franchisor in a country, the growing viability of cross-border and even global advertising, especially through the use of satellites, highlights the need to recognise the fact that the allocation of responsibilities, the accountability for actions and the allocation of the burden of paying for advertising, may all require more complex treatment in international than in domestic arrangements.

CHAPTER 9

SUPPLY OF EQUIPMENT AND OTHER PRODUCTS

Franchising, whatever the form adopted, will always involve the distribution of products or services through the unit franchises. The franchisor will often require key products or services to meet certain well defined specifications and standards. For a franchise network to function properly, and in order to maintain the integrity and quality standards of each unit as well as the uniformity of the franchise system as a whole, it is necessary for the franchisees to have both an adequate supply of these products and access to the services. A proper identification of the sources of supply of the products and services is essential, at times indeed decisive, for the success of most franchise networks, as the franchisor will thereby be able to exercise an appropriate control while the franchisees will be offered an adequate and efficient access to such products and services.

In order to ensure that quality standards are properly maintained, the franchisor often requires the unit franchisees to obtain these key elements from suppliers that it has approved. It is very common for franchisors to leave the supply of these items to persons or companies not in any way affiliated with the franchisor or the franchise system. However, considering that it is the franchisor who has developed the procedures, methods, formulae and specifications that relate to these goods or services, it should come as no surprise that the franchisor will often provide its franchisees with products or services as an integral part of the franchise system. In the international context, the franchisor may arrange to supply equipment, goods or services to the unit franchises either directly or through the sub-franchisor.

The unit franchisees will generally need two different kinds of products or services for their operations. Firstly, they will need the products or services, or component parts thereof, that are distinctive of the franchise system and that might present some proprietary characteristics. These products are generally visible to the public and offered for sale to the customers of the sub-franchisees. Secondly, they will need a wide variety of other products or services of a general nature that are essential to the conduct of their operations. These products are used by the sub-franchisees themselves rather than resold to their customers.

The direct supply by the franchisor (or sub-franchisor) of products that are unique to the franchised system may offer a number of advantages to both the franchisor and the sub-franchisees. Firstly, the maintenance of the necessary quality standards may be assured if the franchisor, or sub-franchisor, is the supplier as opposed to an independent contractor. The resulting uniformity in the products or services offered is important for the maintaining of the integrity of the franchise system as a whole. The franchisor furthermore has a duty to control the quality of the products or services that bear its trademarks, in order to maintain both the enforceability of the trademarks and the standards that form an essential part of the franchise system. Secondly, if the franchisor, or sub-franchisor, supplies the products, this may ensure not only that the products are available, but also that the price that is charged for them is reasonable and one that the franchisees can afford to pay. Thirdly, the franchisor, or sub-franchisor, may expect to realise an additional profit from the products or services it provides the franchisees with.

The supplying of these goods and services may however be cumbersome, inconvenient and expensive for the franchisor, in particular in view of the fact that the franchisor and its sub-franchisors or sub-franchisees are often located at great distances from each other. Moreover, the supplying of these items by the franchisor may often raise questions of fairness because of the lack of independence of the parties.

It should be observed that in many countries the manner in which goods or services are provided, particularly where one of the parties is contractually bound to make such purchases

from the other, is regulated by law. These regulations generally seek to ensure that the purchases are made under competitive conditions and that the purchaser is treated fairly.

A. NATURE OF PRODUCTS OR SERVICES SUPPLIED

The franchisor might supply almost any of the products or services, or any item of the equipment, that a franchisee may need for the operation of its outlet. The products supplied may be of two different categories. In the first instance they may be products that are identified with the trademarks of the system and that are offered to the customers of the franchisees. Such products are an attribute of the system and are often unique to that particular franchise system. The reason they are unique is that the franchisor will use a proprietary method for their manufacture, or alternatively because they have characteristics that are available only within that franchise system. Examples of such products include food items, petroleum products and equipment parts.

On the other hand, equipment, products or services may be supplied that form an integral part of the franchise system and as such they may give the members of the network a competitive advantage. A hotel chain may, for example, have a unique system-wide reservation system that is managed and controlled by the franchisor or by a single authorised representative of the franchisor. In other cases, the products or services may be those that are important to ensure that the operations of the franchisees are conducted in accordance with the quality standards that identify the system. Examples of such products may be proprietary operating software, packaging supplies, fixtures, signage and special equipment.

The products or services supplied may at times be products that, although generally necessary for the conducting of the franchisee's operations, are not unique to the franchise system. The unit franchisees may normally obtain such products or services from independent suppliers, but the franchisor, or sub-franchisor, might be in a special position to ensure that they are available at a competitive price. Examples include financing, advertising aids, book-keeping services, operating software, equipment, supplies, ingredients or component parts and training. The franchisor may provide these products and services either by sale or pursuant to lease or rental agreements. In view of the general availability of these products and services there is usually little need for the franchisor to supply them. The franchisor or sub-franchisor may however wish to do so as a related business activity.

B. SOURCES OF SUPPLY

There are a variety of arrangements that the franchisor may consider for the provision of equipment, products or services to unit franchisees located abroad. The franchisor may provide such products or services directly to the franchisees and may require that they purchase what they need directly from it. Alternatively, the franchisor may authorise the sub-franchisor to supply the products or services. The franchisor, or the sub-franchisor if authorised under the master franchise agreement, may also designate certain approved suppliers. It is possible for such suppliers to be affiliated with the franchisor, either because the franchisor owns the supplier or as a result of an agreement between them. On the other hand they may be completely independent of both franchisor and sub-franchisor and may simply produce and supply the designated products in accordance with the specifications. The franchisor may or may not attempt to receive a payment or commission from any independent supplier that it designates as approved supplier of the specified products or services.

Many franchisors develop approved supplier programmes that lay down specifications for important products and that identify the suppliers who are authorised to supply those products to

the franchisees of the network. Such programmes may also include a procedure for the approval of suppliers proposed either by the sub-franchisor or by a unit franchisee. The approval of the suppliers will usually depend on their fulfilling certain conditions that are intended to ensure both the quality and the availability of the products.

Whatever the method selected for the supplying of the needed products or services, it is possible for the franchisor to derive additional economic benefit therefrom. The franchisor may for example charge the unit franchisees directly for the products or services that it supplies, thus generating an additional profit. When the products or services are provided by the sub-franchisor or by other independent suppliers, the franchisor may receive royalties or consulting fees from these parties. In these cases it is necessary to consider the fairness of the overall compensation that the franchisor receives from all sources, including the revenues generated from the franchising operations themselves, from the licensing or transfer of supporting technology and from the direct supply of products or services.⁵¹

C. FRANCHISOR/SUB-FRANCHISOR RELATIONSHIP

The nature of the relationship between a franchisor and a sub-franchisor in another country has some unique characteristics that may influence the approach adopted by the parties in determining the method that should be followed for the supplying of products by the franchisor. The sub-franchisor, in its capacity as sub-franchisor, does not deal with the public directly, nor does it operate units that use the same products or services as the unit franchises in the system. The provisions of a master franchise agreement that relate to the supplying of products will therefore be different from the supply provisions contained in a standard unit franchise agreement. The sub-franchisor will often set up and operate its own outlets (each of which may be the subject of a specific separate unit franchise agreement with the franchisor), or it may sub-franchise others to operate units pursuant to unit franchise (sub-franchise) agreements. These unit agreements may contain clauses providing for the purchase of products from specified sources, such as the sub-franchisor, independent suppliers who meet certain standards to ensure the necessary quality, any independent suppliers approved by the sub-franchisor, or in some cases the franchisor.

As the franchise system is new in the territory when the first sub-franchisor is granted exclusive territorial rights, a number of products or services that are unique to the system may not be available in that territory. The sub-franchisor may therefore wish to be assured of the initial supply of products or services that are essential to providing the franchise system with its unique characteristics. In this situation the franchisor may also wish to supply the sub-franchisor with what it needs initially so as to ensure the quality of the products or services. The agreement may therefore provide that the franchisor will furnish any such supplies as the sub-franchisor might need.

It should be noted, however, that problems might arise in cases where the franchisor is the sole supplier of the products needed for the franchise. This is the case if trade embargoes or quota restrictions are introduced unexpectedly. The parties should therefore provide for alternative sources of supply, so as to be able to deal with emergency situations of this nature.

Both the franchisor and the sub-franchisor will normally prefer the products or services unique to the system to be supplied from within the territory, also in view of the extra costs involved as a result of the distance between the location of the franchisor in one country and that of the unit franchisees in another. In the case of products this might involve substantial costs of transportation. Tax and other complications might furthermore arise when the products cross the borders of the country of destination and there might be a need to adapt the products to the requirements of the local law or to local market conditions.

⁵¹ See Chapter 4 "Financial Matters".

The franchisor and the sub-franchisor may therefore conclude a detailed agreement, often separate from the main franchise agreement, governing the manufacture of the essential products in the territory. This agreement may provide for an initial period during which the franchisor will supply the products to the sub-franchisor, or even to the unit franchisees in the territory. The sub-franchisor will however in most cases be expected to assume the role of franchisor in the provision of services or products in the relevant territory. Thus, when the number of unit franchisees in the territory has reached a certain level, the sub-franchisor, with the blessing of the franchisor, may come to supply the unit franchisees with the essential services or products that comprise the heart of the franchise system. The agreement concluded between the parties that licenses the manufacture of the products would in this case provide for the eventual transfer of the technology necessary, for the applicability of quality standards and for the payment of royalties. It would also contain any other provisions that might normally appear in a technical assistance agreement relating to the manufacture of goods.

The sub-franchisor may also be authorised by the franchisor to sub-contract the manufacture of the products necessary to an independent supplier. In this case the franchisor will usually require a document in which the manufacturer agrees to respect the trademarks of the franchisor and undertakes to use the trademarks only in a manner approved by the franchisor. Similarly, the sub-franchisor may sub-contract the provision of a number of services to independent contractors.

Alternatively, the parties may agree on the appointment of one or more independent suppliers who have been approved by the franchisor. The franchisor might itself enter into license and manufacturing agreements with such independent suppliers, in which case the parties might agree on the payment of royalties or other compensation to the franchisor.

D. REGULATION OF SUPPLY RELATIONSHIPS

Many countries attempt to avoid abuses that can result from purchase obligations imposed by one party upon the other by regulating the conditions that govern these purchase obligations. Such protective regulations seek to ensure that the obligations are commercially reasonable or needed in order to protect a legitimate interest of the party imposing the obligations, while at the same time securing the supply of the goods or services at a fair price and without foreclosing competitive conditions. These regulations focus on preventing price discrimination, improper payments or compensation to the supplier and the tying or conditioning of the sale of one or more needed products to the sale of any other needed product. In the context of franchising, a franchisor may wish to force the franchisees to purchase certain products from it or from a supplier with whom it has a particular relationship, such as where the franchisor receives compensation from the supplier for purchases made by the franchisees. The United States, the European Union countries and Japan are examples of countries that regulate the way in which entrepreneurs such as franchisors can impose requirements or restrictions upon their affiliates' purchase of products or services. Other countries may regulate these arrangements under technology transfer laws that operate independently from franchise situations.

In the United States, the tying arrangement is regulated as a matter of antitrust law. It is therefore illegal for a franchisor to require the purchase of one or more products ("tied products") as a condition for selling other products when the franchisor has sufficient power to force the sale of the tied products. There may also be a case of a "tied product" when the franchisor sells the products and receives a commission or other compensation for the sale of the tied product. Such tying practices may be justified by the necessity to ensure the protection of trade secrets or the maintenance of unique quality requirements, as well as by other important business reasons. Franchisors often use approved supplier programmes, in which the franchisor approves independent suppliers who are able to supply products meeting the required specifications, in order to avoid the reaches of prohibitions on tying arrangements. Other practices deemed to violate the duty of good faith and fair dealing, such as price discrimination between franchisees

and other distributors and the offering of kickbacks by a supplier to the franchisor, are also proscribed.⁵²

Similarly, in the European Union Article 85 of the Treaty of Rome⁵³ generally prohibits agreements that restrict sources of supply⁵⁴ unless certain economic benefits can be shown to result from this restriction.⁵⁵ As regards franchising, the European Commission Regulation exempting certain categories of franchise agreements from the application of Article 85(1), permits a franchisee to be required to “sell, or use in the course of the provision of services, exclusively goods matching minimum objective quality specifications laid down by the franchisor”,⁵⁶ or to “sell, or use in the course of the provision of services, goods which are manufactured only by the franchisor or by third parties designed by it, where it is impracticable, owing to the nature of the goods which are the subject-matter of the franchise, to apply objective quality specifications”⁵⁷, to the extent that it is necessary to protect the intellectual property of the franchisor or to protect the common identity and reputation of the franchise network.⁵⁸

Several other countries have similar regulations designed to ensure fair treatment of distributors or to promote competition generally. The importance of competition legislation is in fact growing steadily in, for example, the countries of Central and Eastern Europe.

E. CONTRACTUAL PROVISIONS

In the course of the negotiations, when the relationship between the franchisor and the sub-franchisor is defined, an issue that the parties should address is the provision of essential equipment, goods or services. This might not be necessary if products or services essential to the operation of a franchised unit are generally available within the designated territory, although in this case provision should be made for the maintenance of quality standards. For example, in a hotel franchise system the hotels within the system might use products and services that are entirely available from independent suppliers.

In the case of certain products or services that form an essential part of a franchise system, the parties may however wish to define the circumstances under which these specific products or services are to be furnished to the franchise units and to indicate which of the services are regional or global in character. It may be sufficient simply to refer to the supplying of the specified items in the master franchise agreement and/or the unit franchise agreements. For example, a hotel franchise agreement may establish that the franchisees of the network participate in the system-wide reservation system and that a fee is charged for such participation, or that all the franchisees are obliged to participate in a common advertising programme administered by the franchisor or by the sub-franchisor. These items are normally covered in the franchise agreements themselves, rather than in ancillary documents, because of their relative simplicity and because they are such an integral part of the franchise operations.

When the franchise agreement includes these provisions, it is often necessary to consider whether the indemnification provision of the same agreement should be modified. It is not uncommon for a master franchise agreement to require that the sub-franchisor should completely compensate the franchisor for any loss or damage that has been caused as a result of any or all of the sub-franchisor's activities and operations. On the other hand, in cases where the franchisor is also providing products or services to the sub-franchisor, it might be appropriate for the

⁵² See also Chapter 4.

⁵³ *Treaty Establishing the European Economic Community*, signed in Rome, 25 March 1957.

⁵⁴ Article 85(1)(c).

⁵⁵ Article 85(3).

⁵⁶ *Commission Regulation (EEC) No 4087/ 88*, cit., Article 3(1)(a).

⁵⁷ Article 3(1)(b).

⁵⁸ Article 3(1).

franchisor to compensate the sub-franchisor for any loss or damage caused by or relating to those products or services.

It may be appropriate for the parties to conclude a separate supply agreement when numerous items are to be supplied or when there are a considerable number of important issues that relate to the supplying of those items. A separate agreement would permit the parties to deal with all the issues properly. These issues include, for example, the adaptation of product specifications to the needs or requirements of the territory, the manner in which the products should be manufactured within the territory, the manner in which the quality is to be assured, the measures to ensure adequate supplies, the provision of technical assistance, trademark usage and the payment of royalties. When the goods are sold by the franchisor, the supply agreement is in actual fact an agreement for the sale of goods and will include terms dealing with exclusivity, product specifications, pricing, payments, delivery, warranties, non-performance and termination. It may in such instances be appropriate to provide for the franchisor/vendor to retain title in the goods until payment is made. The parties must consider the interplay between this separate agreement and the master franchise agreement, so as to ensure that the two are consistent and to take account of the implications of a possible termination of the master franchise agreement. The franchisor may for instance not want a sub-franchisor whose agreement has been terminated to continue as a supplier to the franchise system. Finally, the applicability of the legislation of both the country of the franchisor and of that of the sub-franchisor, including the applicability of the *United Nations Convention on Contracts for the International Sale of Goods*, must be taken into account when a supply agreement of this nature is entered into.⁵⁹

Alternatively, the franchisor may wish to ensure that supplies of products of the necessary quality are available from suppliers who are completely independent of both the franchisor and the sub-franchisor. To accomplish this, the franchisor may reserve the right to specify that certain products may be supplied only by suppliers whom it has approved and with whom it or the sub-franchisor has entered into a manufacturing or supply agreement. Such an agreement may contain elaborate provisions relating to, for instance, required specifications, factory equipment and conditions, quality standards, maintenance of inventories and product warranties. The franchisor, and possibly the sub-franchisor, may provide for the payment of royalties or other compensation for the right to manufacture and supply the product that is granted by such an agreement. It should be noted that an agreement of this nature may have to be approved by the authorities of the host country if this is required either by the legislation applicable to the transfer of technology or by any other applicable domestic legislation.

The franchisor may not wish to enter into questions of the direct or indirect supply of the required products or services. In this case it is possible for the franchisor in the master franchise agreement simply to reserve the right to approve suppliers that are nominated by the sub-franchisor. In certain circumstances the franchisor may also disqualify suppliers that have already been appointed, such as where the supplier fails to meet certain standards of performance in the supply of the products. Finally, a franchisor may simply reserve the right to insist that certain products meet certain minimum specified quality standards without indicating that it will in any way control the sources of the products in question.

The franchisor may reserve the right to change its specifications of the characteristics of acceptable suppliers from time to time. It may specify the conditions that must be met before a supplier is approved, such as market size, the size of the supplier and the ability of the supplier to monitor, control and test the quality of the products it supplies.

⁵⁹ See Chapter 19 "Ancillary Documents".

CHAPTER 10

INTELLECTUAL PROPERTY

In most countries of the world there are certain rights that are created by government legislation and that the owners are entitled to use to the exclusion of all other parties. Any other party who wishes to make use of such rights is consequently obliged to obtain a license from the owner authorising their use. A number of other rights, although similar in character, are not protected by legislation, but are instead protected exclusively by the terms of the agreements between the parties.⁶⁰ Collectively these rights known as intellectual and industrial property.

In both domestic and international franchise arrangements the rights that are created by statute and that are owned by the franchisor will almost always include the right to a trademark. In certain instances they will also include copyright, for example to an operations manual. Although franchisors will sometimes own also patents and other industrial property rights that they will licence to franchisees, those particular rights relate more typically to license arrangements under which a licensee is granted the right to manufacture a product by making use of the licensor's patents and other industrial property rights and to distribute such products under the licensor's trademark. Most countries have legislation that relates specifically to trademarks and copyright.

A. TRADEMARKS

The use of a trademark is an essential element of a franchise system. The manner in which a franchisor obtains the registration of a trademark from the appropriate government authority and subsequently maintains it, will vary from country to country. How a trademark is used and the different methods that are available to the parties to a master franchise arrangement to protect the trademark, are instead similar from one franchise arrangement to another.

In a master franchise arrangement a franchisor will grant a sub-franchisor not only the right and licence to use the franchisor's trademarks, but also the right, and licence, to grant rights and sub-licences to sub-franchisees. This right to sub-license to sub-franchisees is an essential element of a master franchise arrangement. It should, however, be observed that in certain countries the sub-licensing of a trademark is not permitted and that in these countries a master franchise arrangement that involves the grant of such a sub-license by the sub-franchisor may not be possible.

I. CONTROL BY THE FRANCHISOR OF THE USE OF THE TRADEMARK BY THE SUB-FRANCHISOR AND THE SUB-FRANCHISEES

In most countries trademark legislation will generally provide that for the owner of the trademark to licence the use of the trademark to another it must control the manner in which the latter uses the trademark. In the case of master franchising the franchisor would thus be required to control the manner in which the sub-franchisor uses the trademark. The master franchise agreement will therefore generally include provisions such as the following:

- ◆ a provision by which the use of the trademark by the sub-franchisor is generally restricted to use in accordance with the franchise system and in accordance with the standards and specifications contained in the manual that is owned by the franchisor and lent to the sub-franchisor;

⁶⁰ See Chapter 11 "Know-How and Trade Secrets".

- ◆ a provision prohibiting the sub-franchisor from using the trademark as part of its corporate or trade name without the consent of the franchisor. In the event that the sub-franchisor is permitted to use the trademark as part of its corporate or trade name, the manner in which the sub-franchisor may use the trademark should be dealt with. The sub-franchisor will in these cases be obliged to change its corporate or trade name if the master franchise agreement is terminated or otherwise comes to an end;
- ◆ a provision prohibiting the sub-franchisor from incurring any obligations or indebtedness on behalf of the franchisor. An obligation is generally imposed on the sub-franchisor to identify itself as an independent entity notwithstanding its use of the franchisor's trademark;
- ◆ a provision specifying the manner in which the trademark may be used. To a certain extent this will largely be dictated by the legislation under which the trademark is registered;
- ◆ a provision imposing an obligation on the sub-franchisor to supervise and enforce compliance with the form and manner in which the trademark is used and displayed by the sub-franchisees, including the manner in which services are performed in association with the trademark. The sub-franchisor will also be placed under an obligation to enforce compliance by the sub-franchisees with the standards and specifications established by the franchisor.

Similar provisions are included in the sub-franchise agreement between the sub-franchisor and sub-franchisees.

II. INFRINGEMENT BY NON-AUTHORISED THIRD PERSONS OF ANY OF THE FRANCHISOR'S TRADEMARKS

Master franchise agreements will generally deal with the consequences of infringement, threatened infringement, or piracy of any of the franchisor's trademarks by third persons, as well as with how such incidents should be dealt with. It should be noted that the registration of a trademark typically grants the owner the exclusive right to the use thereof in association with the goods and/or services listed in the registration. The right of the registered trademark owner is deemed to be infringed by any person who sells, distributes, or advertises goods and/or services in association with a confusingly similar trademark. Similarly, a trademark owner may sometimes be permitted to bring an action for passing off, unfair competition or its local equivalent against any person who employs a mark resulting in a misrepresentation in the ordinary course of trade which causes, or is likely to cause, confusion between its goods, services or business and those of another. The options that are available to the parties in cases of infringement or passing off will typically include the following:

- ◆ the franchisor retains the exclusive right, at its discretion, to decide whether or not it will institute an infringement action against third persons for the unauthorised use of the trademark. The different elements to be considered include the cost of infringement proceedings and the possibility that such proceedings, if unsuccessful, may make it possible for others to infringe upon the franchisor's trademark;
- ◆ in certain circumstances, the master franchise agreement may authorise the sub-franchisor to institute an infringement action if the franchisor elects not to do so. The manner in which the sub-franchisor is authorised to prosecute and to settle any such proceedings under such circumstances should be dealt with;
- ◆ another alternative would permit both parties to jointly take infringement proceedings against the unauthorised user of the trademark.

Other issues that are usually dealt with include the allocation of the costs that will be incurred by either the franchisor or the sub-franchisor in instituting infringement proceedings as well as the allocation of any monetary awards that might be obtained.

III. INFRINGEMENT PROCEEDINGS TAKEN BY A THIRD PERSON AGAINST THE SUB-FRANCHISOR

The question of infringement proceedings taken against the sub-franchisor by a third person who claims prior rights to the use of the trademark, is generally dealt with from the point of view

of allocation of risk. In this case the question that should be decided is which of the two parties, the franchisor or the sub-franchisor, will assume the risk if the sub-franchisor is prevented from using the trademark that was licensed to it. If a third person is successful in preventing the sub-franchisor from continuing to use the trademark the consequences may be significant, especially when the use of the trademark by the sub-franchisees is also prohibited as a result.

A major problem in this area is that, even as regards a registered trademark, there is no absolute certainty that someone somewhere will not have major rights by reason of prior use of the same or a similar trademark. Whether or not, or the extent to which, the franchisor can be expected to warrant its ownership of the intellectual property it is licensing, and by extension the extent to which the sub-franchisor can be expected to warrant that it has the right to grant the sub-licence to use the trademarks to its sub-franchisees, is an important issue, not the least because of the consequences the reply is likely to have for the possible liability of the franchisor and the sub-franchisor respectively.

Where the franchisor assumes the risk, it is not uncommon to find a provision limiting the liability of the franchisor. The liability may, for example, be limited to a specific amount of money, or alternatively to the amount of the royalties already paid to the franchisor by the sub-franchisor. Again, the liability may be limited to the expenses that have not been budgeted for and that have been incurred as a result of the need to change the signs of all franchise outlets owned by the sub-franchisor and the sub-franchisees, as well as of the need to modify or substitute any material on which the trademark appears. What is of the utmost importance is that these issues are dealt with not only in the master franchise agreement, but also in the sub-franchise agreements entered into by the sub-franchisor and its sub-franchisees.

IV. UNREGISTERED TRADEMARKS

In many cases when the master franchise agreement is entered into the franchisor will have lodged an application for the registration of the trademark, but the registration will actually not yet have been made. Furthermore, it is not possible to be certain that an application for registration of a trademark will be granted. It is therefore necessary to deal with any consequences that might result if the application for registration is rejected. Again, this is a question of allocation of risk and the consequences and the manner in which this issue is dealt with are similar to those previously discussed as regards infringement proceedings.

V. REGISTERED USER AGREEMENTS

Many countries with a legal system inspired by the British common law have adopted what is known as a "registered user" system for the recording of a party who is not the owner of a trademark, but who has been granted the right to use the trademark by the owner. Generally speaking, a registered user agreement sets out the conditions that govern the relationship between the parties. It will include provisions whereby the owner of the trademark sets the standards as to the quality of the goods or services to be offered, provides for its right to inspect the production of such goods or the performance of such services and indicates the duration of the so-called permitted use. It should be borne in mind that, in view of the type of relationship involved, there may be a need for franchise agreements to be registered with the appropriate authorities even if the country concerned does not have a registered user system.

VI. SUB-LICENSING OF TRADEMARK

As indicated above, master franchise agreements usually entail the grant of a right by the franchisor to the sub-franchisor to sub-licence the franchisor's trademark to sub-franchisees. In certain countries trademark legislation may not permit a sub-franchisor to sub-licence a trademark, as only the owner of a trademark (in this case the franchisor) may license its use to others (such as sub-franchisees). In these countries the structure of the master franchise relationship will therefore be a cause of considerable concern.

In such circumstances one option available to the parties would be to have recourse to three agreements, namely a master franchise agreement between the franchisor and the sub-franchisor, a unit franchise agreement between the sub-franchisor and the sub-franchisee whereby the franchise system is sub-franchised to the sub-franchisee by the sub-franchisor, and a trademark license agreement directly between the franchisor and the sub-franchisee covering the use of the trademark by the sub-franchisee.

Another option would be to use a three-party unit franchise agreement involving the franchisor, the sub-franchisor and the sub-franchisee, pursuant to which the sub-franchisor sub-franchises the use of the franchise system and the franchisor licenses the use of the trademark directly to the sub-franchisee.

A third option would see the sub-franchisor appointed as the agent of the franchisor. In this case the sub-franchisor would be the agent of the franchisor only as regards matters pertaining to the trademark, namely for the actual licensing of the use of the trademark to the sub-franchisees, for the supervision of the manner in which the trademark is being used and for the control of the quality of the products and services bearing the trademark. Provisions to this effect should be contained also in each unit sub-franchise agreement together with an acknowledgement by the sub-franchisee of the appointment of the sub-franchisor as the franchisor's agent for such purposes, with the duties and obligations specified. In addition, any registered user agreement that may be required by law should be executed directly between the franchisor and the sub-franchisee. Alternatively, the sub-franchisor may be given a power of attorney to execute the registered user agreement on behalf of the franchisor.

An examination of the first two options mentioned above should consider the following:

- (a) the factors that influenced the franchisor to choose the master franchising arrangement may militate against the franchisor entering into an agreement directly with the sub-franchisee. The fact that the franchisor does not maintain a physical presence in the foreign country and may not have, or may not wish to commit, the financial resources and/or personnel necessary to establish the franchise system in the foreign country has the consequence that the franchisor must rely on the financial resources and personnel of the sub-franchisor for that purpose. In addition, significant differences may exist between the laws, commercial usages, language, tastes, cultures and customs of the country of the franchisor and those of the foreign country. The geographic distance between the two countries may also be significant. All of these factors may suggest that the franchisor is not in a position to supervise and enforce the correct use of the trademark by the sub-franchisees in the foreign country;
- (b) the owner of a trademark is usually required to supervise the manner in which the wares and services in respect of which the trademark has been registered are being produced and marketed, as well as the quality of the products and services bearing the trademark. This may involve obtaining samples of any such products, of advertising materials and the like. As the franchisor is generally not in a position to perform such supervisory functions, it must somehow transfer this burden or obligation to the sub-franchisor in order to comply with existing legislation and to maintain the distinctiveness of the trademark; and
- (c) the fact that the franchisor enters into license agreements directly with the sub-franchisees or becomes a party to the unit franchise agreement would seem to invite sub-franchisees to look beyond the sub-franchisor for help and supervision and to attempt to deal directly with the franchisor whenever problems arise. This is especially true where such problems relate to the use of the trademark or to the franchise system. The franchisor has entered into a master franchise agreement so as not to deal directly with the sub-franchisees and has transferred most of its responsibilities for the supervision of the use of the trademark to the sub-franchisor. By entering into a direct contractual relationship with the sub-franchisees, the franchisor will have defeated its objectives. In addition, the use of an agreement pursuant to which the franchisor by-passes the sub-franchisor and licenses the right to use the trademark directly to franchisees, or the use of three-party agreements, may result in third party liability claims against the franchisor.

It should however be observed that the option of having the franchisor appoint the sub-franchisor as its agent will not shield the franchisor from potential third party liability claims, especially where such claims are a result of the use of the trademark.

VII. THE INTERNATIONAL REGULATION OF TRADEMARKS

It should also be noted that many countries of the world are signatories to different international conventions dealing with trademarks, the most important of which are dealt with hereunder.

(a) The Paris Convention

Most industrialised nations are Contracting Parties to the *1883 Paris Convention for the Protection of Industrial Property*⁶¹ and as such are members of the *Paris Union*.⁶² The Paris Convention deals with industrial property, which is defined as covering patents, utility models, industrial designs, trademarks, service marks, trade names, indications of source or appellations of origin and the repression of unfair competition.⁶³

Of its principal provisions those that are of most interest in the franchising context are those that provide for “national treatment”. In accordance with this principle each country party to the Paris Convention must grant the same treatment to nationals of the other member countries as it grants its own nationals.⁶⁴ No requirement as to domicile or establishment in the country where protection is claimed may be imposed upon nationals of member countries as a condition for benefiting from an industrial property right.⁶⁵ The same treatment is extended also to nationals of countries that are not party to the Paris Convention if they are domiciled in a member country or if they have a “real and effective” commercial establishment in such a country.⁶⁶

One of the most practical benefits of the Convention is the “right of priority” pursuant to which an applicant may, on the basis of a regular application for an industrial property right filed in one of the member countries, within a specified period of time apply for protection in all the other member countries. These later applications will then be regarded as if they had been filed on the same day as the first application. These later applications will therefore enjoy a priority status with respect to all applications relating to the same item filed after the date of the first application. They also enjoy a priority status with respect to all acts accomplished after that date which would normally be apt to destroy the rights of the applicant. In the case of trademarks the period of time within which the subsequent applications have to be made is six months.⁶⁷

(b) Madrid Agreement

Of the contracting parties to the *1891 Madrid Agreement Concerning the International Registration of Marks*⁶⁸ mention may be made of France, Germany, Egypt, Italy, China, the Russian Federation, Spain and Switzerland. Major countries not signatories to the agreement include the United States and Canada. The contracting parties to this Agreement and to the *1989*

⁶¹ *1883 Paris Convention for the Protection of Industrial Property*, revised at Brussels (1900), Washington (1911), The Hague (1925), London (1934), Lisbon (1958) and Stockholm (1967) and amended in 1979.

⁶² As at 3 July, 1997, the Paris Convention had 142 Contracting States.

⁶³ Article 1(2). Trademarks are dealt with in Article 5C(1), (2) and (3).

⁶⁴ Article 2(1).

⁶⁵ Article 2(2).

⁶⁶ Article 3.

⁶⁷ See Article 4.

⁶⁸ *1891 Madrid Agreement Concerning the International Registration of Marks*, revised at Brussels (1900), Washington (1911), The Hague (1925), London (1934), Nice (1957) and Stockholm (1967) and amended in 1979 and 1989 Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (Madrid Protocol)

Protocol Relating to the Madrid Agreement concerning the International Registration of Marks form the *Madrid Union*.⁶⁹

In accordance with the Madrid Agreement nationals of countries party to the Agreement are entitled to apply for international registration. Similarly, nationals of countries not party to the Madrid Agreement but party to the Paris Convention who have their domicile or a real and effective industrial or commercial establishment in a country party to the Madrid Agreement are placed on an equal footing with nationals of countries party to the Madrid Agreement.

Application for international registration is subject to certain conditions. Firstly, the trademark for which international registration is sought must be registered at the national level with the industrial property Office of the country of origin, where the country of origin is

- “(1) the country of the Madrid Union where the applicant has a real and effective industrial establishment;
- (2) if the applicant has no such establishment in a country of the Union, the country of the Union where he has his domicile;
- (3) if the applicant has no domicile within the Union, the country of the Union of which he is a national”.⁷⁰

Applications for international registration are made to the industrial property Office of the country of origin and it is this office that will forward the application to the *International Bureau* of the *World Intellectual Property Organization (WIPO)*, after checking and certifying that the mark as reproduced in the application for international registration is entered in the national trademark register in the name of the applicant and that the goods and/or services listed in the international application are covered by the national registration. It should be noted that international registration has effect only in those countries for which protection has been explicitly requested.⁷¹ The application is then circulated to the other member States whose local trademark offices have twelve months within which to review and accept or reject the application based on local requirements. Accordingly, an applicant may obtain trademark registration in several countries by means of a single application, although it should be borne in mind that the international registration has no effect in the country of origin, that the trademark is protected in that country under the national registration that constitutes the bases for the international registration.

The agreement has been criticised because the protection resulting from the international registration remains dependent on the protection afforded in the country of origin for a period of five years from the date of the international registration, with the consequence that if during this five-year period the mark ceases to enjoy protection in the country of origin, the protection resulting from the international registration may no longer be invoked in any of the countries for which it was granted. The same holds true if the protection of the mark in the country of origin ceases as a result of proceedings instituted in the five year period (“central attack”). The international registration becomes independent of the national registration when the five year period comes to an end. The protection afforded in other Madrid Union countries by the international registration is thereafter no longer affected by a loss of the protection of the mark in the country of origin.

The regime of the Madrid Agreement was modified by the *Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks*,⁷² which was adopted to make the

⁶⁹ At 3 July, 1997, the Madrid Agreement had 47 Contracting Parties and the Madrid Protocol 19. In total 53 States form the Madrid Union.

⁷⁰ Article 1(3) of the Madrid Agreement.

⁷¹ Article 3^{ter}(1) of the Madrid Agreement.

⁷² Madrid, 27 June, 1989.

Madrid system acceptable to more countries. The main changes introduced by the Madrid Protocol may be summarised as follows:⁷³

- ◆ the Protocol allows that, at the option of the applicant, international registrations be based on national applications (and not only on national registrations);⁷⁴
- ◆ the Protocol allows, as option for the Contracting Parties, eighteen months as opposed to twelve, for refusals and an even longer period in case of oppositions;⁷⁵
- ◆ the Protocol allows the transformation of a failed international registration (failed, for example, because of a central attack) into national or regional applications in each designated Contracting Party. Such applications will have the filing date and, where applicable, the priority date of the international registration.⁷⁶

The modifications introduced by the Madrid Protocol have made the Madrid system acceptable to a number of States that had not adhered to the Madrid Agreement, including the United Kingdom. The United States is examining the possibility of adhering to it in the near future.

A second main purpose of the Madrid Protocol is indicated as being the establishment of a link between the Madrid system and the regional trademark system of the European Communities, with the consequence that a Madrid registration could be based on a Community application or registration and that the European Communities could be designated in a Madrid registration.⁷⁷ This would be possible as a result of the provision in the Madrid Protocol in accordance with which not only States, but also certain intergovernmental organisations, such as the European Communities, can become party to the Protocol.⁷⁸

(c) *The European Community Trademark*⁷⁹

The European Community trademark system is devised to provide a single registration covering all Community member States. The national systems of trademark protection are however not abolished by the adoption of the Community trademark system, the member States being free to maintain their own national legislation on trademark protection protecting trademarks within their national territory. The main features of the national legislations have been harmonised by *Council Directive 89/104/EEC of 21 December 1988*.⁸⁰ A single trademark office has been established in Alicante, with applications with the office being accepted as of 1 January, 1996. Harmonisation of the trademark registration process will clearly facilitate the entrance into the European Union of franchisors wishing to export their franchise system into the European Union and will serve to reduce barriers to trade between member States.

B. COPYRIGHT

Copyright protects original literary, artistic and scientific works. Typically, copyright subsists in the case of most works for the life of the author of the particular work concerned, plus an additional fifty years.

⁷³ See WORLD INTELLECTUAL PROPERTY ORGANIZATION (ed.), *Introduction to Intellectual Property - Theory and Practice*, London/The Hague/Boston, 1997, p. 416.

⁷⁴ Article 2(1)(a).

⁷⁵ Article 5(2)(b) to (d).

⁷⁶ Article 9 *quinquies*.

⁷⁷ See Article 2 of the Protocol.

⁷⁸ Article 14(1)(b).

⁷⁹ *Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trade mark*, O.J. EEC No. L 11/1 of 14 January 1994.

⁸⁰ *First Council Directive 89/104 of 21 December 1988 to approximate the laws of the Member States relating to trade marks*, OJ EEC No. L 40/1 of 11 February 1989.

In most jurisdictions, copyright arises immediately upon creation. There is in other words no requirement to register a particular work in order to obtain enforceable rights. Registration creates a presumption as to the fact that copyright in the work exists and as to the ownership of that copyright. Furthermore, it constitutes notice to the world at large that copyright exists, which may be important in assessing legal remedies.

It is often stated that copyright provides the owner with a package of rights, including the right to produce, reproduce, perform or publish the work, or any substantial part thereof, in any material form.

It is important to bear in mind that copyright does not protect ideas, but only the manner in which those ideas are expressed. A work of copyright is infringed if a third person does something that is the exclusive right of the owner, such as when the third person without the permission of the owner produces a work that is substantially similar to the original or a deceptive imitation thereof.

It is also important to note that if an author is a citizen of country that is a contracting party to an international convention, that author will be able to obtain the same protection in the other contracting States of that convention as in his or her own country. In this connection the provisions of the *1886 Berne Convention for the Protection of Literary and Artistic Works*,⁸¹ the *Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs)*⁸² and regional regulations such as those of the European Communities should be taken into consideration.

⁸¹ *1886 Berne Convention for the Protection of Literary and Artistic Works*, completed at Paris (1896), revised at Berlin (1908), completed at Berne (1914), revised at Rome (1928), at Brussels (1948), at Stockholm (1967) and at Paris (1971) and amended in 1979 (the *Berne Union*).

⁸² Marrakesh 1994, contained in an Annex to the *Agreement Establishing the World Trade Organization*.

CHAPTER 11

KNOW-HOW AND TRADE SECRETS

A. THE FUNCTIONAL ROLE OF KNOW-HOW IN FRANCHISE AGREEMENTS

Commercial know-how is an essential element of franchising. It is of fundamental importance to the franchisor, as it is the communication of the know-how to the sub-franchisor that, together with the granting of the necessary intellectual and industrial property licences and the subsequent control over its correct implementation, will enable the franchisor to ensure that the members of the network conduct the business in a uniform manner.

For the sub-franchisor and the sub-franchisee the communication of the commercial know-how of the franchisor is of great economic value, as it is that commercial know-how which will enable them to benefit from a system that has been tested and that has proved to be successful.

B. KNOW-HOW, TRADE SECRETS AND CONFIDENTIAL OR UNDISCLOSED INFORMATION

Expressions such “know-how”, “trade secrets” and “confidential information” are used in business terminology and in legal drafting. Although legal writers will distinguish between these concepts, the distinctions are so slight that for the purposes of this *Guide* these expressions are used interchangeably.

Trade secrets are that body of information that an enterprise (or person) has developed, that it legitimately possesses and that places the enterprise at an advantage as against its competitors. The development of this knowledge requires an investment on the part of the enterprise. The incentive for such an investment is the profitability of the product or service developed and/or the advantage gained over competitors. This advantage will continue to exist as long as the secrecy of the knowledge is successfully protected.

A characteristic of “trade secrets” is that it is necessary to disclose them to, for example, the employees or collaborators of the owner of the enterprise, for it to be possible to use the knowledge or secrets in the ordinary course of business. They are therefore high risk assets as the more they are exploited, the greater the risk that their secrecy will be lost.

In order to protect trade secrets it is necessary for the persons who acquire knowledge thereof to be bound not to disclose them to other people. This is achieved by means of confidentiality clauses or agreements. Furthermore, they must be bound not to make use of the knowledge or trade secrets they have acquired to engage in a business activity that competes with that of the owner of the secrets. This is normally provided for in what are known as non-competition clauses or covenants not to compete.⁸³

Contractual clauses for the protection of trade secrets may be included in both master franchise and sub-franchise agreements. All legal systems however take care to avoid imposing obligations on the licensee or sub-licensee that may not be imposed on third parties. In industrialised nations this control is exercised by anti-trust provisions and in developing countries by the rules governing the transfer of technology.

“Know-how” is defined in the *Agreement on Trade-Related Aspects of Intellectual Property Rights* (the so called “TRIPs”), which is contained in an annex to the *Agreement Establishing the World Trade Organization* signed in Marrakesh on 15 April 1994. Article 39(2) of this Agreement

⁸³ See page below.

states that “[n]atural and legal persons shall have the possibility of preventing information lawfully within their control from being disclosed to, acquired by, or used by others without their consent in a manner contrary to honest commercial practices so long as such information (a) is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question; (b) has commercial value because it is secret; and (c) has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information, to keep it secret”.⁸⁴ The adoption of, or accession to, the TRIPs Agreement will lead to the protection of know-how in most jurisdictions. It may be observed that a similar definition is given in the European Union in the franchising Block Exemption Regulation⁸⁵ as well as in the domestic legislation of some countries.

The parties to a master franchise agreement must ensure that what they call “know-how” really exists and that it qualifies for protection; in other words that it is secret, that it has commercial value and that the parties have taken positive action to safeguard its secrecy.

I. SECRECY OF KNOW-HOW

The requirement of secrecy is one that is recurrent in the international instruments adopted. Thus, for example, Article 39 of the TRIPs Agreement specifies that for the undisclosed information to be secret, it must not be known or generally accessible to persons within the circles that normally deal with the kind of information concerned. The absolute secrecy of the information is however not necessary, as it is sufficient for the information not to be easily or readily accessible. The communication of the know-how to the licensee must in other words bring with it an economic benefit, allowing the licensee to save time and money.

For the know-how to be considered secret, it is sufficient for the precise configuration and assembly of its components not to be generally known, it is not necessary for each single component part of the know-how to be totally unknown or unobtainable outside the franchisor’s business.

II. COMMERCIAL VALUE

For the undisclosed information to be protected, it is generally required that it has “a commercial value because it is secret”.⁸⁶ The information concerned is therefore only information the economic value of which is a direct result of its secrecy, with the consequence that if the information were to be made public, its value would disappear.

III. STEPS TO SAFEGUARD THE SECRET

In addition, the person lawfully in control of the information is required to take “reasonable steps under the circumstances, [...] to keep it secret”. The obligation to take reasonable steps is thus placed not only on the owner of the information, but also on whoever is legitimately in control thereof. In the case of franchising, therefore, not only the franchisor, but also the sub-franchisor and the sub-franchisees would be required to take the measures necessary to protect the information.

In order to assess what information should be considered to be “secret”, courts in many jurisdictions have applied the so-called “test of reasonableness” to the measures of protection adopted. The philosophy underlying this test is that it is not possible to claim protection against violations of “secret” information if the behaviour of the owner or of the person controlling this information is not compatible with an intention to keep the information secret.

⁸⁴ Article 39(2).

⁸⁵ *Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements*, OJ EEC L 359 of 28 December, 1988, Article 1(3)(f).

⁸⁶ Article 39(2)(b).

C. WARRANTIES BY SUB-FRANCHISOR AND BY FRANCHISOR

Know-how is a special proprietary right that, contrary to what is the case with patents, trademarks and copyright, cannot be opposed to the world at large, its protection being mainly achieved by means of the terms of the agreement between the parties. As a consequence there are no public registers in which rights of ownership to know-how may be ascertained. It is therefore of considerable importance for the sub-franchisor to be certain that the franchisor is the actual owner of the know-how concerned and for the sub-franchisees to know that the sub-franchisor has been granted the rights it is transmitting to them. The questions therefore arise of the extent to which the sub-franchisor should warrant that it has been given the rights that it is granting sub-franchisees and of the extent to which the franchisor should warrant that it is the owner of the rights that it is granting. What is considered appropriate will vary from country to country.

D. THE DIFFERENCE BETWEEN “ASSIGNMENT” AND “LICENSING” OF KNOW-HOW

The owner of the know-how can dispose of it in two ways: by assigning it to another, or by licensing its use. In the case of assignment the owner of the know-how transmits it to a third person together with the actual ownership of the know-how. In its capacity as new owner, the third person will be subject to no limitation in disposing of the know-how, while the previous owner will not be able to exploit it any more. The legal effect of the assignment contract is usually strengthened by means of a non-competition clause that binds the assignor until the know-how becomes public knowledge.

More frequently the know-how is the object of a licence whereby the owner of the know-how grants a third person the right to use it under certain conditions, for a specified period of time and for a specific territory. The licensor however retains the ownership of, or proprietary rights in, the know-how. In this case the licensee acquires a non-proprietary right in the know-how. This is most frequently the case with franchising.

Although licences are not always required by statute to be in writing, it may be assumed that in the case of international franchise agreements all the conditions governing the licensing of the know-how will be set forth in writing.

The duration of a know-how licence cannot exceed the moment in time in which the know-how becomes public knowledge. If only part of the information that forms the know-how becomes public knowledge, the validity of the licence will be reduced correspondingly.

A licence may be limited to specified fields of activity or products (the so-called “field of use restrictions”) and in this case the licensor will retain the right to exploit the know-how, directly or through other licensees, in other fields of activity or for other products. In the case of franchising the know-how may be used only for the exploitation of the franchise formula.

As regards the territory, a licence may be granted without any exclusivity, with limited exclusivity in that the licensee will not be exposed to competition from other licensees, or with absolute exclusivity, in which case the licensee will be protected not only from competition on the part of other licensees, but also from competition on the part of the licensor.

E. THIRD PARTY ACQUISITION OF KNOWLEDGE OF THE KNOW-HOW

A situation that needs to be considered is that in which a third person acquires knowledge of the know-how, irrespective of the manner in which it acquires this knowledge and of whether it is in good faith or not. In this case an important question that arises is whether or not the sub-

franchisor, and the sub-franchisees, would still be bound by the confidentiality agreement relating to this know-how. The situation will vary from jurisdiction to jurisdiction. In some jurisdictions they would still be bound by the confidentiality agreement, whereas in others they would not, as the obligation of confidentiality would cease to exist as soon as the information covered by it no longer is secret. Parties are therefore well advised to devote special attention in the drafting of their agreement to the consequences of the know-how becoming public knowledge through no fault of either party.

F. THE COMMUNICATION OF KNOW-HOW IN MASTER FRANCHISE AGREEMENTS

In a master franchise relationship the franchisor communicates its know-how to the sub-franchisor. It is naturally of considerable importance for the franchisor to ensure that the know-how is correctly used by the sub-franchisor and the sub-franchisees and that its secrecy is fully protected. The franchisor will furthermore need to reserve the right to exploit the know-how itself and to communicate it to other sub-franchisors or franchisees.

In practice, the know-how will normally be communicated by means of the operations manual the franchisor has developed for use by the franchisees, as well as by means of the initial and on-going training provided by the franchisor. The manual contains all the information that is required for the running of the franchise and will be covered by copyright protection.

Know-how is also communicated by means of the training that the franchisor provides, as well as by the testing in practice of the commercial techniques of the franchisor. The techniques adopted by the franchise system will be updated by means of periodical courses and/or meetings. Needless to say, it is the franchisor's responsibility to communicate the know-how to the sub-franchisor throughout the relationship. The sub-franchisor, on the other hand, must undertake the obligation to attend and/or have its personnel and sub-franchisees attend such courses and meetings.

G. COMMUNICATION AND PROTECTION OF KNOW-HOW IN INTERNATIONAL FRANCHISE AGREEMENTS

In a master franchise situation the franchisor communicates its know-how to the sub-franchisor who then in turn communicates it to the sub-franchisees. This obligation to transmit know-how refers not only to the know-how that is available at the beginning of the relationship, but also to that subsequently developed during the life-time of the agreement.

The main problem in this case is preventing the know-how from being disclosed by the sub-franchisees as, the sub-franchisees having no direct contractual relationship with the franchisor, the statutory rules that protect trade secrets in the countries of the sub-franchisees may not be sufficient to grant effective protection. Contractual protection of know-how may however be ensured by the inclusion of appropriate clauses in both the master franchise agreement and the sub-franchise agreement.

The sub-franchisor may be held contractually liable for any breach of the obligation not to disclose the know-how on the part of the sub-franchisees, their employees or collaborators. The disclosure of know-how by sub-franchisees may also be considered to amount to breach of the sub-franchisor's obligation to select the sub-franchisees with care, although it is possible that the sub-franchisor will not be held liable if the agreements to be stipulated between the sub-franchisor and the sub-franchisees are subject to the prior approval of the franchisor. In this case a specific clause would be needed to create such a liability.

In the case of breach of the obligation not to disclose the know-how on the part of the sub-franchisees, the sub-franchisor may furthermore be held liable vis-à-vis the franchisor if it fails to take the appropriate measures to remedy this breach, such as for example to file suit.

H. CLAUSES IN MASTER FRANCHISE AGREEMENTS TO PROTECT KNOW-HOW

The protection of the know-how is of fundamental importance not only for the franchisor, but also for the network as a whole, as it is the know-how that makes the franchise unique and that provides those who have access to it with a competitive advantage.

There are of course statutory rules that afford know-how protection, albeit from a different perspective. Examples of such protection include protection under criminal law rules or in tort as acts of unfair competition. Statutory protection is however inadequate by reason of the nature of know-how. Clauses suitable to ensure this protection, both for the duration of the agreement and after it has come to an end, must therefore be included in every franchise agreement.

I. CLAUSES USED TO PROTECT THE KNOW-HOW FOR THE DURATION OF THE AGREEMENT

a) Confidentiality Clauses

A confidentiality clause is normally inserted in the master and sub-franchise agreements respectively with a view to protecting the know-how and any other confidential information that the franchisor provides the sub-franchisor and the sub-franchisees with. By this clause the sub-franchisor and sub-franchisee undertake not to disclose the know-how of the franchisor to third persons. In this case the third persons clearly do not include those to whom the information must be disclose in order to ensure the proper functioning of the business, such as employees or other collaborators.

This duty of confidentiality may be applicable not only to the sub-franchisor and sub-franchisees themselves, it may be extended also to all their staff members and employees. The franchisor might require a specific confidentiality agreement to be concluded so as to make those persons directly responsible to it, as it might not consider their obligations towards the sub-franchisor and sub-franchisee to be sufficient. Generally speaking, clauses protecting the know-how may legitimately be imposed on employees or former employees in all industrialised countries.

Worthy of note is the fact that the confidentiality clause is not limited to protectable technical and/or commercial know-how, but that it may cover also other information, or even component parts of the know-how that in themselves do not qualify for statutory protection, always provided the recipient was not already in possession of this information. For this purpose a declaration by the sub-franchisor or sub-franchisee indicating what he or she knew or ignored up until the time of signature might be of assistance in delimiting the know-how that is protected.

As to the duration of an obligation of confidentiality, this does not come to an end with the expiration of the agreement, but will last until the information has become public. When, however, the know-how through no fault of the franchisor, sub-franchisor or sub-franchisee has become public during the term of the agreement, the latter might in some jurisdictions still continue to be bound by the confidentiality obligation assumed, even if third persons have acquired knowledge of the know-how or a portion thereof.

Contractual restrictions on the use of confidential information generally do not require specific compensation to be offered the party who is restricted in its activities.

b) Grant-Back Clauses

Grant-back clauses might also be inserted into the master franchise agreement. In accordance with these clauses the sub-franchisor is required to communicate any experience gained in exploiting the franchise to the franchisor and to grant the franchisor, and other sub-franchisors of the network, a non-exclusive licence for the know-how resulting from that

experience. A sub-franchisor or sub-franchisee may in other words be contractually obliged to grant the franchisor a licence for the developments and improvements it has made to the know-how as a result of its own business experience. The reason grant-back clauses are generally admitted, is that the franchise network is an integrated structure that is based on the co-operation of a number of different enterprises and that the franchisor and each and every one of the sub-franchisors and sub-franchisees must therefore equally be able to take advantage of any improvements that are made to the system. The uniformity of the network and its value would decrease if only one of its members were able to benefit from any improvements to the know-how.

c) Field of Use Restrictions

“Field of use restrictions” are contractual clauses that, in the case of a franchise, oblige the sub-franchisor or sub-franchisee not to use the know-how for purposes other than the managing of the franchised enterprise. These clauses in other words ensure that the sub-franchisor or sub-franchisee does not use the know-how of the franchisor to engage in an activity without compensating the franchisor as the owner of the know-how and without the franchisor having any control over how its know-how is used.

d) Non-Competition Clause

Another clause usually included in both master and sub-franchise agreements is the non-competition clause, the validity of which will normally extend for the whole duration of the agreement. The main purpose of this clause is to protect the know-how and to avoid a dilution of the image of the franchise network. The validity of such a clause may be limited in some jurisdictions, in particular as regards territorial restrictions of competition, but even if it is not possible to enforce the clause in respect of territories that are not part of the franchisor’s actual or potential market, the sub-franchisor or sub-franchisee will not be able to use the franchisor’s know-how without permission. Should the sub-franchisor at the time the franchise agreement is signed already be engaged in a competing business, then this fact is best mentioned in the franchise agreement.

The sub-franchisor or sub-franchisee may furthermore be required not to acquire financial interests in the capital of a competing undertaking, as such a financial interest would place the know-how at serious risk of being communicated to competitors and it would be extremely difficult to prove that the competitor had not itself developed the know-how it was using.

II. CLAUSES USED TO PROTECT THE KNOW-HOW AFTER THE AGREEMENT HAS COME TO AN END

Many of the restrictions stipulated for the duration of the agreement may continue to apply after it has come to an end, on condition that this has been provided for in the agreement.

a) Confidentiality Clauses

In the case of the duty of confidentiality, the observance of this duty after the master or sub-franchise agreement has come to an end cannot be imposed on the sub-franchisor or sub-franchisee if the know-how has become generally known or easily accessible. It must be stressed, however, that the know-how cannot be considered as having become generally known if it is not known by, or easily accessible to, persons who may use it for business purposes. The mere fact that a person other than the members of the network has actually acquired knowledge of the know-how is not sufficient to release the sub-franchisor or sub-franchisee from the obligation not to disclose the secret information.

It should be observed that the rule prohibiting post-term protection of generally available know-how does not apply when it is the sub-franchisor or sub-franchisee who has made the know-how generally known despite the duty of confidentiality.

The sub-franchisor and sub-franchisees will often develop thier own know-how in the process of conducting the business. In this case, if the know-how has been developed completely independently by the sub-franchisor or sub-franchisee, it would not be possible to prevent them

from using the know-how they have developed for their own purposes after the franchise agreement has come to an end.

Field of use restrictions may on the other hand be generally extended after the end of the agreement.

b) Post-Term Non-Competition Clauses

Another common post-term restriction is the obligation placed upon the sub-franchisor (or sub-franchisee) not to directly or indirectly engage in any business similar to the franchise in a territory where it would compete with a member of the franchise network or with the franchisor. Furthermore, in the territory where the sub-franchisor exploited the franchise, it may be held to this obligation for a reasonable period of time after the agreement has come to an end.

The agreement should therefore address the extent to which the sub-franchisor is permitted to, or prohibited from, engaging in activities that compete with the franchise system that it was previously a part of. The franchisor will wish to prohibit its former sub-franchisor from engaging in activities that compete with the franchise system for a certain number of years: after all, it may actually have taught the sub-franchisor how to conduct the business that is the object of the franchise. The franchisor will not look favourably on competition that is ultimately the result of its own training. The sub-franchisor, on the other hand, will not want to lose the benefit of what it learned in the course of its period as sub-franchisor, during which it made a considerable commitment in terms of time and resources. The sub-franchisor might ask for compensation if it is to be bound not to use the substantial assets that it invested in the course of its franchise.

The content of a non-competition clause must be negotiated and the laws of the territory examined to establish the extent to which it may be enforced in relation to its duration, scope and territorial applicability. In some jurisdictions the duration cannot exceed one year (this is the case in the European Union), in others the territory must not be so large as to prevent the sub-franchisor from engaging in any business activity at all. As to the scope, the agreement should take into consideration two different situations, namely that in which the sub-franchisor was totally ignorant of the business in that particular trade sector and therefore had to learn everything from the franchisor, and that in which the sub-franchisor was already engaged in the business concerned (for example where the sub-franchisor was already running a hotel before signing an agreement with a hotel franchise network). In the latter case a non-competition clause preventing the sub-franchisor from operating in a sector it already knew can hardly be justified and the defence of the franchisor's know-how is best based on a confidentiality clause drafted so as to include a prohibition on the sub-franchisor using the franchisor's know-how for its own purposes.

CHAPTER 12

SYSTEM CHANGES

A. THE ROLE OF CHANGE IN THE FRANCHISE RELATIONSHIP: AN OVERVIEW

The success of a franchise system depends on its ability to evolve and change over time. The franchise relationship must be fluid and adaptable in order to remain viable. If the relationship is too rigid, the franchise system may become obsolete or, at the very least, un-competitive.

I. *THE DIFFERING OBJECTIVES OF FRANCHISOR AND FRANCHISEE*

It is not possible to draft a franchise agreement that expressly provides for any change in circumstance that might occur during the life of the franchise agreement and that might affect the franchise system. The fact that a franchise relationship is intended to last over time makes it imperative to provide for the adaptation of the agreement due to changed circumstances. The interests of the parties in this respect however differ. Whereas franchisors will wish to retain the maximum flexibility to implement changes in the franchise system, franchisees tend to prefer the certainty and predictability of a franchise agreement that clearly specifies the franchisee's obligations and does not permit change, as the franchisee understandably may fear that a franchisor will unilaterally and without limitation increase the franchisee's obligations and expenditures.

Whatever the stage of development of a franchise system, the franchisor's ability to adapt its system, image and products to changing circumstances is likely to be critical to the long-term success of the whole network. Franchisees are likely to view the change from the perspective of its adverse effect upon them, rather than from the perspective of the long-term benefit to the system. In terms of the relations between the franchisor and the franchisee, the challenge is to create conditions that will enhance the likelihood that the parties will share a vision of the desirability of the change. In terms of drafting, the challenge is to anticipate the need for change and to provide for it in a fashion tolerable to both parties.

This tension between the franchisor's need for flexibility and the franchisee's desire for certitude increases the importance of arriving at a workable compromise, one in which the franchisor retains the ability to modify the franchise system, but in which standards are set to limit the franchisor's ability to exercise its discretion in this area.

While the preceding prefatory observations are cast in terms of the franchisor and the franchisee, and are generally made with respect to domestic franchising, they are no less relevant to the relationship between a franchisor and a sub-franchisor and are equally applicable to cross-border transactions.

II. *THE LIFE CYCLE OF A FRANCHISE: HOW DIFFERENT IMPERATIVES FOR CHANGE WILL ARISE AT DIFFERENT STAGES OF DEVELOPMENT OF A FRANCHISE*

The types of changes that will benefit a franchise system are often related to the stage of development that the system has reached. In a franchise system's infancy, a modification of the system is likely to reflect the early experiences of the franchisor and its initial franchisees. A franchisor in its first experiences may for example adjust the inventory or menu items of the system, introduce additional trademarks to the system, or dictate the use of different advertising media.

As a franchise system grows and becomes well established, and as the franchisor's formula for success becomes more refined, more substantial changes to a franchise system may be

required as a result of, for example, shifting demographics, changing consumer tastes, new technologies, or new competition. In response to these developments, a franchisor may wish to adapt its system in a number of ways, such as:

- ◆ by adding or deleting entire product lines (for example, a restaurant system introducing a hot/cold salad bar or a delivery service);
- ◆ by changing the system's image (for example, by re-designing logos, requiring remodelling of the outlets, or requiring the use of environment-friendly packaging);
- ◆ by increasing advertising and promotional activities (for example, by increasing the payments due to the advertising fund or by initiating a national advertising programme) and
- ◆ by tightening operating standards (for example, by requiring franchisees to purchase and use a point-of-sale inventory tracking system and computerised cash register, both of which transmit daily reports electronically to the franchisor's computer system).

A mature franchise system is likely to encounter the greatest need for change, the franchisors in this case being more likely to undertake a drastic revitalisation or change of direction of the franchise system. These changes may, for example, take the form of:

- ◆ selling products through alternate channels of distribution;
- ◆ penetrating markets by establishing new units (franchised or company-owned) in closer proximity to existing franchised units than originally contemplated;
- ◆ converting franchised locations to company-owned units by not renewing expiring franchise agreements or terminating poorly performing franchisees; or
- ◆ opening a new chain of units (again, franchised or company-owned) that sell a product line which, in the view of the franchisees, directly or indirectly competes with product lines sold by them (for example, selling less well-known lines or labels at the new outlets rather than the premium lines or labels that are sold at existing franchised outlets).

III. *THE SPECIAL ROLE OF CHANGE IN INTERNATIONAL RELATIONSHIPS*

The factors that compel evolution in a franchise system are likely to be more numerous and varied in the international context than in a purely domestic setting. Where franchisees and sub-franchisors are located in countries different from their franchisor, the need for change in the franchise system is likely to be accelerated by the different demographics, competitive conditions, economic conditions, social and cultural environment and legal climate of the local markets of the franchisees. From the point of view of the franchisor the legal issues will also be more complex by virtue of the greater uncertainty it faces with regard to the enforceability of the provisions permitting change that it wishes to include in the agreements. The situation will furthermore differ from country to country.

In the case of international master franchising the sub-franchisor may independently propose changes based on its familiarity with local circumstances. In many instances it will have been that very familiarity that made the franchisor select a particular sub-franchisor. It should however be noted that in some cases the suggestions for improvement will in the first instance have been made by the sub-franchisees.⁸⁷

Shrewd franchisors will welcome proposals for refinement and adaptation independently of whether these were made originally by the sub-franchisor, or by the sub-franchisees and subsequently endorsed by the sub-franchisor. While the franchisor must retain the power to make the ultimate decision approving these proposals in order to preserve the integrity of the system, a franchisor with foresight will balance this power by creating an atmosphere in which the proposing of improvements is encouraged. A balance should also be created in relation to issues

⁸⁷ See the discussion on page 90.

such as the imposition of changes in the operation of the sub-franchises and the ownership of the improvements made as a result of the proposals put forward.

B. CIRCUMSTANCES THAT MAKE CHANGE LIKELY OR INEVITABLE

The factors that give rise to a need for change within franchise systems during the lifetime of the agreement are either external factors or franchisor-driven factors.

I. EXTERNAL FACTORS

Most of the factors that compel a franchisor to modify its system are external to the system itself. These include, for example, the following:

- (a) demographic change: changes in the demographic characteristics of the sub-franchisor's market will frequently have a direct effect on many franchised businesses. The ageing of the population may for example lead temporary nursing personnel agencies to expand into home health care services. The increase in number of families with both spouses working outside the home, or the increase of one-parent households, may result in the development of restaurant delivery services or in a proliferation of residential cleaning services;
- (b) technological change: new technologies may require franchisors to make "defensive" or "offensive" changes. An example of a defensive change was the advent of flexible cost-effective desktop publishing techniques, which compelled traditional offset printing systems to introduce this new technology so as to avoid falling behind their more nimble competitors. A recent example of franchisors using new technology offensively, to gain a temporary competitive advantage, was when photo-finishing franchise systems took advantage of new "one-hour" photo-finishing technology. The development of interactive media technologies and the availability of the Internet will present many opportunities to franchisors who are prepared to take advantage of innovative marketing techniques;
- (c) competitive conditions: a change in competitive conditions often requires a franchise system to innovate. A young franchise system, or one in a market which has still to be developed, may offer a product or service which is unique in that particular market and which will therefore have to face little competition. If successful, however, the franchisor is likely to be copied and to have to face increased competition. Aggressive franchisors will wish to develop and will require their franchisees and sub-franchisees to offer, or use, new and improved products and services or methods of distribution in order to remain ahead of their competitors. A competitor of the franchisor may furthermore develop a new product, service, or method of distribution that the franchisor feels compelled to match;
- (d) legal standards: the legal climate in the host country may change over time, resulting in the need to modify the agreement. There are times in which changes in the law may threaten the very basis of the franchise system. Franchisors that operate in countries that join the European Union must, for example, carefully review the structure of their franchise systems to ensure compliance with a competition law regime that may be quite different from the national competition law originally applicable in the country. Changes in the law will, however, more often require more modest adjustments to a franchise system, such as, for example, changes in the products to reflect evolving environmental concerns, adaptations made to accommodate new product labelling and/or advertising requirements, prohibitions of old sources of supply or the availability of new sources of supply, or to observe new architectural and design standards to make facilities more accessible to the elderly or disabled;
- (e) local infrastructure: products and services that meet the standards of the franchise system may not always be available to the same extent in all countries and the effectiveness of the distribution networks by which those products and services are to be delivered may also differ considerably. At an early stage of the development of the network it may therefore be necessary to use sources of supply from outside the country, although this need may decrease as the local infrastructure develops.

II. *FRANCHISOR-DRIVEN CHANGES*

Franchisors will often decide to modify their franchise system when they estimate that such changes will improve the system. The need to introduce modifications may result for a variety of reasons:

- (a) new products and services: one of the franchisor's traditional roles is to develop new products and services for its system. The successful franchisor will have a research and development programme and a test marketing programme that will enable it to improve its system continuously;
- (b) new customers: many franchisors wish to fine-tune their system so as to be able to serve new customers and markets. As market segmentation and niche competition come to characterise many industries, it becomes increasingly important for a franchisor to have the ability to take advantage of new market opportunities. Furthermore, franchisors often retain the right to serve "national account" customers as they may be able to do so more effectively than their franchisees or sub-franchisees;
- (c) new marketing channels: a franchisor will wish to be able to use new marketing and distribution channels to reach its targeted customers and will therefore often retain a right to, for example, sell its products through supermarkets or through computer shopping services, rather than only through the originally contemplated units. Although the franchisor may feel that without this possibility it is left behind and that it is losing market share to competitors who are exploiting such channels, care must be taken not to infringe upon the rights of the sub-franchisor and the sub-franchisees. As indicated above, the fact that the franchisor retains a right to sell its product or distribute its services through other outlets may reduce the value of the franchise for the sub-franchisee;
- (d) facility upgrade: a franchisor's ability to retain or regain its competitive position may well depend upon its ability to require its sub-franchisees to make a capital expenditure for the renovation or remodelling of the premises of the franchise. The amount of capital required for this purpose will depend on such factors as whether the refurbishing is cosmetic or functional, whether significant investment in equipment is required, whether different or additional marks are being incorporated into the system and how often a refurbishing is required.

C. **THE EFFECT OF LEGAL PRINCIPLES**

A number of generally recognised legal principles will limit the franchisor's ability to modify its franchise system unilaterally. While franchisors might view the limitations as an impediment for them to respond effectively to a changing market, franchisees might on the other hand consider them a guarantee against arbitrary modifications on the part of the franchisor. The following discussion applies equally to the relationship between a sub-franchisor and its sub-franchised network.

I. *CONTRACT LAW ISSUES*

When questions of contract law are considered, the different drafting techniques adopted in the systems belonging to the various legal traditions must be taken into consideration, as must the regulation applicable to unfair contract terms. In general, if the franchise agreement is drafted in a way that does not show that the franchisor and franchisee intended to grant to the franchisor the discretion to modify the obligations of the franchisee with respect to a proposed modification to the franchise system, the franchisor might be unable to implement the changes to the system that it wishes to introduce. For this reason, the franchise agreement may often expressly grant the franchisor the discretionary right to modify the system unilaterally and to introduce modifications that may result in increased obligations being placed on the franchisee. It should however be

observed that a clause of this nature would in all likelihood come under close scrutiny from the point of view of the fairness of the provision. Such a clause might in fact be considered an unfair contract term, in that the unilateral right granted to the franchisor might enable the franchisor to modify the terms of the agreement arbitrarily, thereby increasing the obligations of the franchisee to a point where negative effects on the franchise outlet might ensue. It should also be observed that any ambiguities in a contract will be construed against the drafter of the contract, which in the case of franchise agreements normally is the franchisor, although in the international context the contract is more likely to be the product of intense negotiations between the franchisor and the sub-franchisor.

In addition to the express obligations of the parties as laid down in the terms of the agreement, each party will in most countries have an implied duty not to take actions that will prevent the other party from benefiting from the agreement. While this duty may not be used to override the express terms of a contract, the extent to which the parties have expressly covered a subject in their franchise agreement is not always clear. As it is not possible to foresee every type of change that may be necessary, it might be especially difficult to demonstrate that this implied duty is not violated when a franchisor exercises its contractually granted discretion to modify the franchise system and consequently varies the obligations laid down in the agreement itself. Unless the contract is drafted with both foresight and skill, this principle could present franchisors with considerable difficulties in implementing changes in their franchise systems. A clearly drafted agreement will also benefit the franchisees who will be able to assess their position with greater ease as a consequence.

In common law systems other principles of contract law that may influence the ability of the franchisor to introduce modifications are those of vagueness and mutuality. According to the latter the modification of a contract is not permitted without there being adequate reciprocation between the parties. Additionally, under the doctrine of compulsion the coerced modification of contracts is not enforceable, with the consequence that an arbitrary or bad faith demand for modification of a contract will not be permitted.

Other legal principles that might come into play in this context are *force majeure* and the principle dealing with the discriminatory treatment of similarly placed parties. The useful technique of effecting change by incorporating by reference other documents the modification of which is natural in view of their nature, for example the operations manuals, may furthermore be thwarted by the rigid application of certain principles of contract law. These rules have however been mitigated in most jurisdictions and a standard of good faith and reasonableness pervades this area of contract law. Consequently, when unforeseen difficulties arise in the performance of a contract, or when a proposed modification to a contract conforms to commercial standards of reasonableness, the franchisor will usually be permitted to introduce the modifications it deems necessary.

II. STATUTORY ISSUES

The need to modify the franchise system may arise at any time during the term of the franchise agreement. Some changes that are more substantial or that are less urgent are delayed until the franchise agreement is due to be renewed. In either case the laws or regulations of a number of jurisdictions may limit the franchisor's ability to change the system. These statutes or regulations may, for example, prohibit both the discriminatory treatment of franchisees and discrimination in the renewal of existing franchisees, unless the discrimination is justified as it is due to "good cause" or is in conformity with the franchisor's current policies and standards. Thus, in most jurisdictions reasonable system-wide changes are permitted, although whether a particular modification is for good cause or is reasonable is frequently a point of contention. There are however jurisdictions that have statutes that are even more restrictive when it comes to modification of franchise agreements.

D. ASPECTS OF THE RELATIONSHIP WHERE CHANGE IS MOST LIKELY TO BE NECESSARY

A franchise relationship is a long-term relationship. It is therefore natural that many aspects of the relationship are likely to require modification over the years. To the greatest extent possible these aspects should be considered in the franchise agreement itself. The most common of these areas concern the nature of the business, the external appearance, changes in the obligations of the sub-franchisee and changes in the scope of the franchisor's activities.

I. THE NATURE OF THE BUSINESS

- (a) Location and nature of facility: as the demographics, traffic patterns, or zoning in the marketplace change over time, it may be desirable to re-locate the premises of the franchise. Changes may for example occur as a result of which a free-standing unit would be more viable if it were located within a larger facility such as a shopping mall, rather than if it simply were located somewhere in the city. A sub-franchisee that has successfully cultivated a market might wish to relocate to a larger facility, or yet again, in other circumstances the development of additional locations might be appropriate.
- (b) Territorial rights: the market considerations that determined the extent of the territorial rights granted to a franchisee or sub-franchisee are likely to change over time. In many cases, territorial rights will be granted to a franchisee on condition that it satisfy certain objective criteria or sales objectives. If the objectives are not reached, the franchisor may need to modify the territorial rights granted to the franchisee by reducing them or even by eliminating them altogether. Changing population concentrations may result in territories being inadequately served by the number and pattern of existing units. A franchisee may furthermore be granted temporary rights to solicit for business in a territory that has not yet been granted to another franchisee, perhaps only for so long as it has not been granted to another.
- (c) Customers towards which system is directed: a franchise system's target customer will often change over time. As a franchise system grows, it may be able to serve regional and/or national accounts, something which it was incapable of doing with fewer locations. The emergence of a new, or previously unrecognised, category of prospective customers may furthermore dictate changes in what is offered and how.
- (d) Products and services offered: the franchisor will typically retain a tight control over the products and services that its sub-franchisees are permitted to offer and sell, as well as over those that they must offer and sell. In a domestic situation the franchisor is the party best able to engage in market research, to discern changes and trends and to respond by adding to, deleting from, or improving upon the products and services that are a part of the system. In a master franchise situation it is instead the sub-franchisor who is best placed to undertake these tasks, typically by proposing changes.
- (e) Methods of marketing and delivery: considering that advertising and promotional programmes increasingly influence the behaviour of consumers and that new media are being developed and are rapidly becoming cost-effective, the franchisor must be in a position to take advantage of the new marketing opportunities that become available as a result. In a similar manner, many franchisors are trying to satisfy consumer demand for convenience by making use of alternative channels of distribution, by engaging in combination franchising and by making use of other similar techniques. Consequently, this is a fertile area for changes to be made to the franchise relationship.

II. THE EXTERNAL APPEARANCE

- (a) Trademarks/trade dress: it is quite common for the franchisor to modify the trademarks, logos, or trade dress of the system in the course of the franchise agreement. These changes often stem more from a desire to introduce a fresh colour scheme or a modern logo than from an actual need. In some cases, however, the system may evolve to such an extent that the marks no longer represent the full range of products or services offered by the franchise system. In that case, as well as when the validity of the marks are in question, the franchisor will be compelled to introduce additional or substitute marks to increase the effectiveness of the system.

- (b) Renovation: the renovation of the franchise premises is frequently a precondition for the renewal or transfer of a franchise. Many franchisors also require their franchisees to remodel and upgrade their premises and equipment in the course of the franchise agreement, especially when the agreement is of long duration. Remodelling and upgrading of the franchise premises will typically entail a significant capital investment by the franchisee. Many franchise agreements will therefore provide a level of comfort to franchisees by setting forth standards or by otherwise limiting the franchisor's discretion in this area. This limitation is often expressed either as a maximum amount of money that a franchisee will be required to invest in the renovation of the premises, as a specific number of renovations that will be required over the term of the franchise agreement, or as a requirement that the renovation bring the franchise outlet into compliance with the franchisor's then current standards for the system. In the context of a master franchise structure the franchisor will want to ensure that these rights and obligations are clearly outlined in the sub-franchise agreement.

III. CHANGES IN THE OBLIGATIONS OF THE SUB-FRANCHISOR AND SUB-FRANCHISEES

- (a) New obligations: the franchisor must be able to establish and maintain the quality and uniformity of the products or services its network offers, as well as acceptance by the consumers. The franchisor's capacity to do so will often depend upon its ability to adjust the obligations of the franchisee, in particular those obligations that deal with advertising fund contributions, new marketing programmes and the like.

For example, the type of advertising programme that is appropriate for an entrepreneur who is entering the market as franchisor is likely to be inappropriate for a mature system. The franchise agreement must therefore be drafted in such a manner that it will permit the franchisor to impose additional obligations on the franchisee as the system grows. In the early stages of a franchise system, it may be appropriate to have the franchisee spend only a modest amount on local advertising and/or pay a modest advertising fee to the franchisor to help offset some of the franchisor's production costs. However, regional and national advertising programmes may well become the preferred advertising vehicle of the franchisor once the system reaches a critical mass and becomes widespread. It is therefore common practice to include in franchise agreements a provision giving the franchisor the right (but not the obligation) to establish a national advertising fund with required contributions by all its franchisees. It is also common practice for franchise agreements to permit the franchisor to increase the required advertising fee to a specified level.⁸⁸

- (b) Higher standards of performance: in addition to having evolving obligations imposed upon it, the franchisee may also find that its standards of performance are adjusted in the course of the agreement. For some types of performance standards it might be feasible to state those standards, as well as any changes that are to be made to them, directly in the franchise agreement itself. The agreement might, for example, specify a sales quota that increases annually according to a pre-determined formula or according to a schedule that is set forth in the agreement. This is however frequently a cumbersome procedure. Most franchise systems will therefore require franchisees to comply with the standards and procedures specified in the system's operations manuals and the franchise agreement will instead typically reserve to the franchisor the right to update those manuals for the whole duration of the agreement. In this way the franchisor has a convenient and flexible mechanism in place for the modification of the standards with which the franchisees must comply, subject to the limitations discussed elsewhere in this chapter.

IV. CHANGES IN THE SCOPE OF THE FRANCHISOR'S ACTIVITIES

Not only do the obligations of franchisees change in the course of the franchise agreement, the franchisor's obligations *vis-à-vis* its franchisees are also subject to modification as the franchise system evolves. Certain obligations of the franchisor may arise only after a period of time has passed or a specific event has occurred, while others may be present at the outset of the

⁸⁸ See the more detailed discussion in Chapter 8 "Advertising and the Control of Advertising".

relationship but may subsequently be eliminated or become less important. The franchise agreement may therefore grant the franchisor the faculty to decide which of its obligations should be permanent, which should be in effect intermittently or only when circumstances so dictate and which should be introduced to, or phased out of, the system. This decision may depend on factors such as the cost of the obligation to the franchisor and the benefit of the obligation to the sub-franchisors.

A number of obligations are for example best treated as conditional, with the franchisor having the discretion to decide when the conditions that give rise to the obligation concerned have been satisfied. The franchisor's commitment to establish a national advertising programme once the system has reached a critical mass would fall into this category. An example of an obligation that may be present at the beginning of the relationship, but that would be affected by subsequent events, would be a commitment by the franchisor to supply products to its franchisees. Initially, the franchisor may be the sole source of this product, but if other, more efficient and less expensive producers enter the market, then the franchisor might not wish to continue to serve as the supplier of those products. In some cases it is instead the changed circumstances of the franchisee or sub-franchisee that will dictate change, for example when the training requirements become different or less or the sub-franchisee opens additional units.

Not all changes in the scope of the franchisor's activities should be viewed as lessening, or designed to lessen, the obligations of the franchisor, or as lessening the benefits to the franchisee. A number of agreements provide for temporary assistance to franchisees for specific periods, for example in case of product shortage, of the advent of unanticipated competition, or of a disruption of buying patterns due to the construction of a highway or underground train network. This assistance may be provided at the discretion of the franchisor, or might even be obligatory in certain cases.

E. TECHNIQUES FOR EFFECTING CHANGE

A number of different techniques are at the disposal of franchisors who wish to implement changes in their franchise systems. A few of the more common techniques are outlined below.

I. THE USE OF THE TERM OF THE AGREEMENT

- (a) Term of agreement: the most obvious opportunity to effect change arises at the expiration of the franchise agreement. The importance of implementing changes in a particular franchise system will often be of relevance in determining the duration of the agreement. A shorter term may be warranted if a greater need to implement changes is foreseen, considering that a long term might make the franchisor vulnerable to changed circumstances as it might not be able to make the necessary changes. This factor will however generally be weighed against the marketing of the franchise rights, as also against other considerations that militate in favour of a longer term. A franchisor must balance these factors in determining the length of duration of the agreement.
- (b) Renewal of agreement: an almost equally effective opportunity arises in the context of the renewal of the franchise agreement, assuming that renewal is an option that is provided for. If the franchisee is granted a right to renew the agreement, this right may be made conditional upon the franchisee's acceptance of the franchisor's form of franchise agreement that is current at the time of renewal. Such a condition may however not be entirely realistic in the case of an international master franchise agreement which will be negotiated in any event.⁸⁹ The franchise agreement may furthermore include other provisions conditioning the renewal of the agreement. The agreement may however also provide that, for example, no additional fees will be payable upon renewal.

⁸⁹ See Chapter 3 "Term of Agreement and Conditions of Renewal". The discussion in this section, as that in Chapter 3, should be understood as applicable to the relationship between a franchisor and its sub-franchisor or, where appropriate, its sub-franchisees.

In a number of jurisdictions the non-renewal of a franchise might be limited by statute or by case law unless there is good cause for the non-renewal. The view that has emerged is that a franchisor is considered to have good cause for non-renewal if a franchisee upon renewal refuses to accept essential, reasonable and non-discriminatory changes in its relationship. The essential, reasonable and non-discriminatory character of the changes should be capable of being demonstrated.

II. *OTHER TECHNIQUES*

In addition to the use of the term as a technique for effecting change, other techniques may be available in the course of drafting.⁹⁰ An example of such techniques which is becoming increasingly important in a time of rapid change is the reservation of rights. This would include the franchisor reserving the right to market the same or similar products or services through alternative channels of distribution, perhaps at a later time and perhaps in a manner not readily accessible to a sub-franchisor (catalogue sales, for instance). While a sub-franchisor might be concerned that this could eat up its own sales, it might well realise a net benefit due to the increased exposure of the products or services that it offers to the consuming public. The two parties should address this issue, and the methods of satisfying the objectives of each, at the outset.

III. *USE OF DOCUMENTS OTHER THAN THE FRANCHISE AGREEMENT*

As suggested above, a very common way for the franchisor to retain flexibility and to make changes in the franchise relationship is for it to incorporate the franchisor's operations manual into the franchise agreement by reference and to require that the sub-franchisors and, where appropriate, the sub-franchisees comply with all of the policies, procedures and standards set forth in the manual which may be amended from time to time by the franchisor. It is also possible for the franchisor to modify the system by requiring compliance with changes that are communicated by means less formal than an amendment of the operations manual, such as for example bulletins, policy statements, notices and similar communications.

While the operations manual is typically thought of as the most suitable vehicle to spell out details that it would be awkward to set out extensively in the agreement itself,⁹¹ its use as a means to introduce changes into the system should not be overlooked. As is the case with other methods of effecting change, the use of the operations manuals and similar documents is limited by applicable principles of contract law. The franchisor will, indeed should, have great difficulty enforcing provisions contained in the manual that contradict the express terms of the franchise agreement. Moreover, the use of the manual to implement major changes in the system, or to impose significant new and previously un contemplated obligations, or to impose them in a manner that is demonstrably inconsistent with the reasonable expectations of the franchisees, may be problematic or not possible at all, an express acceptance of the new terms possibly being required in some legal systems.

IV. *MAKING CHANGE DEPENDENT ON THE OCCURRENCE OF OBJECTIVELY DETERMINABLE EVENTS*

- (a) Occurring outside the system: an example would be the payment of a different royalty upon the reaching of a specified date. Another example would be the payment of an additional advertising fund fee when certain specified actions have been taken by competitors of the system.
- (b) Occurring within the system: royalties are sometimes set on sliding scales, in other words they rise or fall depending on the sales made by the sub-franchisor. Another example would be the revocation of the sub-franchisor's or sub-franchisee's exclusivity in the territory it has

⁹⁰ See, generally, the discussion of negotiation and drafting in Chapter 1.

⁹¹ See the discussion on page

been granted, or a reduction in the size of the territory, if it fails to reach the sales quotas set in the agreement.

- (c) Occurring as a consequence of actions of other franchisees: the installation of a computer system linked to the franchisor, or the instituting of a national advertising fund payment, may depend upon the system reaching a specified number of units. The franchisor may furthermore wish to implement certain changes only after a qualified, or absolute, majority of its sub-franchisors approve them. Franchisors who employ this form of democracy tend to reserve this procedure for modifications that would require a substantial capital investment by sub-franchisors or that would be considered a major change to the system. In the context of a master franchise arrangement these changes will typically depend upon the growth, or the actions, of the sub-franchisees.

V. CIRCUMSTANCES THAT MAY PROVIDE APPROPRIATE OPPORTUNITIES TO EFFECT CHANGE

Franchisors are often presented with a number of circumstances that facilitate the introduction of modifications to the system. The franchisor will in these cases not rely on its right to impose the modifications, but will instead require the introduction of the changes in exchange for the granting of what the sub-franchisor has requested. These circumstances often arise on the following occasions:

- (a) sub-franchisor's desire to expand: the sub-franchisor may wish to have a right to operate in a larger territory or may wish to acquire an additional territory or franchise. The franchisor, who has no obligation to grant an additional territory or franchise, may elect to do so on condition that the sub-franchisor agrees to introduce the modifications it proposes and to require its sub-franchisees to comply with them;
- (b) sub-franchisor's desire to extend term: the sub-franchisor may wish to extend the term of the franchise agreement, or may wish to renew the franchise agreement even if it has no legal right to the extension or renewal. The franchisor might agree to such an extension or renewal on condition that the sub-franchisor agrees to introduce the modifications proposed by the franchisor;
- (c) sub-franchisor's desire to transfer: the transfer of a franchise to another sub-franchisor will usually require the prior consent of the franchisor under the terms of the franchise agreement. A sub-franchisor's request to transfer some or all of its interest in the franchise therefore presents the franchisor with an opportunity, for example, to insist upon compliance by the transferee with its current requirements and standards. This may be expressly provided for in the agreement itself;⁹²
- (d) when sub-franchisor is in default: if the sub-franchisor has not adequately performed the franchise agreement, or wishes to be excused for a debt it owes the franchisor, the franchisor may request that the sub-franchisor agree to introduce the modifications it proposes as a condition for not proceeding against the sub-franchisor for non-performance;
- (e) franchisor develops new product or service which it is not contractually obliged to make available to sub-franchisor: if the sub-franchisor considers the new products or services developed by the franchisor to be desirable, the franchisor might grant it the right to offer these new products or services in exchange for its introduction of the proposed changes. Franchisors may however in this case expose themselves to charges of discriminatory treatment of sub-franchisors. Any differences in treatment of the sub-franchisors must therefore be based on reasonable criteria, although this might be a less relevant consideration where a single master license has been granted for an entire country. Care should also be taken not to withhold such opportunities from a sub-franchisor if to do so would have a negative effect on the viability of the sub-franchisor's operation.

VI. CORRECTIVE AND ENFORCEMENT MECHANISMS

⁹² See the more extensive discussion in Chapter 13.

A franchisor who anticipates and plans for future changes in the system will often include corrective measures in the franchise agreement for cases of, for example, sub-franchisor shortcomings. These measures are generally self-executing (which tends to reduce confrontation between the franchisor and the sub-franchisor) and will usually result in changes that are less drastic than an actual termination of the relationship (which increases the likelihood that such measures will be used by the franchisor). A common example is the reduction of the sub-franchisor's exclusive territory or the elimination of the sub-franchisor's exclusive right to the territory if it fails to satisfy certain requirements, such as the attainment of a certain sales quota. Other sanctions applied to sub-franchisors for failing to conform to the required standards could be the loss of the sub-franchisor's right to renew the agreement, or the loss of the sub-franchisor's right to carry all the products or services offered by the franchisor. This way of proceeding might permit the franchisor to facilitate change in the franchise system in a manner that may cause less friction between the parties than would otherwise be the case.

VII. MAKING CHANGES MORE PALATABLE

Franchisors have a number of devices at their disposal to make changes in the franchise system more palatable to sub-franchisors. These may play an important role in facilitating the modification of franchise programmes and in preserving a constructive relationship. Many franchisors will consequently elect to employ these devices even though they have no legal obligation to do so.

- (a) Disclosure of likelihood: franchisors may be able to inform sub-franchisors by means of an appropriate disclosure of information that a modification of the franchise system is likely to occur. To the extent possible, this disclosure should specify what changes may be expected.
- (b) Ensuring the practicability of effecting the changes: an example of a device to ensure that it is possible for the sub-franchisors to introduce the changes required is the setting up of a sinking fund, that requires the sub-franchisors to set aside a specified amount of money each year in anticipation of the renovation of the premises or of other alterations that will require a significant capital infusion by the sub-franchisor. This "required savings programme" ensures that sub-franchisors will have the resources to make required changes when it is time to do so.
- (c) Inducements: the franchisor may be able to encourage its sub-franchisors and sub-franchisees to implement the required changes by offering them certain inducements. These may include the granting of a larger, or of an additional, territory, the granting of an extended term or of a renewal, the approval of a request for the transfer of the franchise, the waiving of the right to proceed against the sub-franchisor and/or, where possible, the sub-franchisee for non-performance and making available an additional product or service that the franchisor is not obliged to provide.
- (d) Assistance: the franchisor may be willing to offer, or arrange for, financial benefits or other assistance to those who make the desired modifications. Financial benefits could be in the form of favourable financing terms, direct cost sharing, the waiving of debts, a temporary reduction or suspension of royalty payments and other similar assistance. Non-financial assistance might include on-site visits by representatives of the franchisor, the analysis and evaluation of business plans, or the provision of special marketing materials.
- (e) Limitations upon required changes: sub-franchisors or sub-franchisees may be more sympathetic to requests for modifications if they are aware that such requests will not be open-ended. The franchise agreement or operations manual should therefore specify any limitations that the franchisor has established regarding the desired changes. These limitations might relate to the frequency of such requests, the maximum number of such requests, the maximum amount of capital investment that will be required, or the events or conditions that could trigger requests for modifications of the franchise system.

CHAPTER 13

SALE, ASSIGNMENT AND TRANSFER

The possibility that the franchisor or the sub-franchisor might need to transfer its rights under the franchise agreement to third parties during the term of the agreement and not only when the agreement comes to an end, is usually not contemplated at the time the contract is entered into. In most cases the parties enter into the franchise relationship with the intention of remaining in the relationship for the initial term and beyond. To a considerable extent each of the parties will base its decision to enter into the relationship on the nature and quality of the other party, on its commitment and on its ability to perform its obligations in a manner that will maximise the opportunity for successful development of the franchise system. Each of the parties will therefore prefer the other party not to transfer its rights under the agreement, or will at least prefer to restrict the ability of the other party to transfer its rights. In all probability, however, each of the parties will wish to have the possibility to transfer its own rights. It is therefore important that the franchisor and the sub-franchisor consider the circumstances in which they might wish to transfer their rights under the master franchise agreement to another party in the course of the agreement.

Even if the parties at the beginning do not contemplate the possibility of a transfer of rights during the agreement, the circumstances of either party might change in such a manner that it becomes desirable or necessary for it to transfer its rights to a third party, one whose identity, and therefore acceptability, was unknown at the time the master franchise agreement was entered into. Both the franchisor and the sub-franchisor have an interest in dealing with this future contingency by defining the circumstances under which such a transfer may be allowed.

The laws of most jurisdictions do provide rules governing the transfer or assignment of rights under agreements such as franchise agreements, but the parties may consider these rules to be unacceptable or insufficient in detail. Master franchise and sub-franchise agreements will therefore usually contain provisions governing the transfer of rights. The provisions contained in sub-franchise agreements are likely to be fairly detailed as to the different conditions under which the franchisor will consent to the transfer, whereas international master franchise agreements might merely state that a transfer is not possible without the consent of the franchisor, who however should not withhold its consent unreasonably.

A. CIRCUMSTANCES GIVING RISE TO A TRANSFER

A party to a franchise agreement, be it a master franchise agreement or a sub-franchise agreement, may wish to transfer its interests in the agreement for a variety of different reasons. It may, for example, simply wish to restructure its interests internally, either by the assignment or by the transfer of its franchise agreement interests to a different legal entity for business or legal reasons, while having no intention to alter its ultimate ownership of, participation in or commitment to the franchise relationship. Such changes may be motivated by tax considerations, internal corporate governance, facilitation of ownership succession or the like. Changes in the political world may also be the cause of changes of this nature. There may, for example, be situations in emerging economies in which wholly or partially State-owned enterprises that originally received franchises are privatised and this might require special treatment in the contract. The other party to the franchise agreement will normally have no objection to an assignment that is a part of such a reorganisation. Although technically the result of the assignment is that a new entity becomes a party to the agreement, there is in reality no change in the ultimate ownership of the franchise system. The non-transferring party may however wish to have assurances that the new entity's performance will be backed or guaranteed by the transferring party.

It may be necessary to transfer the interests of an individual who is a party to a master franchise agreement because of disability or death. Assignment provisions must somehow address the issues that arise in these circumstances, such as under what circumstances the heirs of, or successors to, an individual may be entitled to assume its rights and obligations under the agreement. Although the sub-franchisor must have some rights to transfer its interests in these cases, the franchisor may want to be able to exercise a certain amount of control over who steps into the franchise relationship by virtue of such a transfer.

The insolvency of a party may also give rise to a transfer of all or part of the insolvent party's interests in the master franchise agreement. In such cases the laws of the country in which that party resides may dictate how and under what circumstances the transfer is to be made. These insolvency laws may overrule the contractual provisions that the parties have developed, but in many instances the parties will have the ability to draft provisions to suit their wishes in such a manner that they do not conflict with the applicable insolvency laws.

On the other hand, either party may for financial or other reasons wish to transfer its rights in a manner that will terminate its involvement in the franchise relationship. This desire to transfer its rights may reflect a change in that party's assessment of the attractiveness of the franchise, or it may reflect changes in its business purpose or a desire to capture a financial opportunity by selling its interests to an unrelated third person. When a party wishes to transfer its interests for reasons of this kind, the other party will often be motivated to ensure that the transferee is acceptable to it. Indeed, its concern in this regard will be fully justified. If it is to permit such transfers it may require that it approve the transfer before it is made and may therefore set forth certain conditions as a prerequisite for the granting of this prior approval. Any conditions of this nature will be designed to give it some assurance that performance of the assumed or transferred obligations will continue with the new party.

B. REASONS TO PREVENT UNRESTRICTED TRANSFERS

The reason a franchisor may wish to restrict the sub-franchisor's right to transfer its interests is to prevent an assignment of the sub-franchisor's interests to a party whose financial standing, ability or reputation is not satisfactory. It would clearly also wish to prevent assignment to a party affiliated with a competing business. A franchise relationship is based on the trust of each of the parties in the other. The franchisor has entered into the relationship on the basis of its conviction of the quality of the sub-franchisor and of its belief that the sub-franchisor is well suited and committed to making the relationship successful. It is understandably hesitant to allow for the possibility of another sub-franchisor whose ability or commitment is unknown to it taking the place of the first. If the quality of the sub-franchisor is the primary factor in the franchisor's decision to enter into the agreement, then allowing a substitute party to take that party's place without restriction is to be avoided.

The franchisor will require more than an assurance that the new party will comply with the provisions of the master franchise agreement. It will prefer a new sub-franchisor that has the ability and the desire to aggressively pursue the franchising opportunity. The qualities that permit a sub-franchisor to pursue the franchising opportunity are often difficult to determine and are at least to a certain extent a matter of subjective judgment.⁹³

C. TRANSFERS OF FRANCHISING INTERESTS SELDOM RESTRICTED

The reasons for which a sub-franchisor would like to have the right to restrict transfers of the franchisor's interests and obligations in the master franchise agreement are similar to those for which the franchisor would like to restrict transfers of the sub-franchisor's interests. It is however unusual for a master franchise agreement to restrict the franchisor's rights to transfer or assign its rights. There are three main reasons for which the franchisor is not restricted in this

⁹³ See the discussion of the selection of a sub-franchisor on page 25.

regard. Firstly, a franchisor is likely to have many different sub-franchisors in its system. To make the franchisor's transfer of rights subject to the consent of all of its sub-franchisors would at the very least create a procedure that is burdensome in the extreme. It might in fact effectively bar the franchisor from assigning its rights. Secondly, restrictions on the franchisor's ability to assign its interests would greatly reduce the marketability of both the franchisor itself and of the franchisor's franchise system should it wish to sell the franchise business. This consideration usually motivates the franchisor to resist the introduction into the agreement of provisions that restrict its assignment rights. Finally, as the drafter of the master franchise agreement the franchisor will initially insert a provision to allow it to assign its rights without restriction. This provision is seldom subject to any major discussion. The reason for this is perhaps that an assignment by the franchisor of its interests is viewed as a very remote possibility. Most franchise agreements will therefore give the franchisor the freedom to transfer its interests as franchisor as it wishes. Moreover, such a change often also fully releases the franchisor from any further responsibilities to the sub-franchisor to the extent that the franchisor's assignee has assumed these obligations.

D. COMMON CONTRACTUAL APPROACHES

Contractual provisions governing the rights of the sub-franchisor to sell, assign or otherwise transfer its rights in a master franchise agreement can be simple or very complex, depending on the variety of circumstances that the parties want to address.

I. WHAT CONSTITUTES A TRANSFER

Most contracts describe what constitutes a restricted transfer. Any direct transfer or assignment of the sub-franchisor's interests will be covered, as will usually also any pledge or mortgage or other contingent assignment of the sub-franchisor's interests. The transfer clause will often restrict any "direct or indirect" transfer of interests. The agreement will usually treat a change of ownership or control in a corporate sub-franchisor as an assignment or transfer of the sub-franchisor's interests that is subject to the approval of the franchisor. It will at times specify what constitutes a change of ownership or control. A change of ownership amounting to more than 49% ownership in the sub-franchisor within any three year time period may for example be considered as a transfer that is subject to restrictions.

II. CONDITIONS FOR PERMITTING TRANSFER

The master franchise agreement will often require the written consent of the franchisor for any transaction that constitutes a restricted transfer. The franchisor may be given the sole and absolute right to grant or withhold its consent, or its consent may be subject to the satisfaction of certain conditions. The conditions that are imposed are usually designed to ensure that the new sub-franchisor has the qualities that are deemed to be necessary in a good sub-franchisor. Examples of the kinds of conditions that are imposed are:

- ◆ the sub-franchisor must be in compliance in all respects with the master franchise agreement;
- ◆ the sub-franchisor must give up and release any claims that it may have against the franchisor at the time of the proposed transfer or assignment;
- ◆ the proposed transferee must demonstrate to the satisfaction of the franchisor that it has the appropriate managerial, financial and business characteristics to become a suitable sub-franchisor. This condition may contain elaborate detail, making reference to, for example, the prospective sub-franchisor's good reputation, net worth, credit rating, ability to actively supervise the operation of the franchised units in the territory, general aptitude, economic and business experience, or it may simply refer to the franchisor's established standards for the appointment of new sub-franchisors. Satisfaction of conditions of this kind will to a certain extent depend on a subjective evaluation on the part of the franchisor and sub-franchisor and might lead to possible differences of opinion;

- ◆ the payment by the transferring sub-franchisor of a transfer fee that serves as a partial reimbursement of the expenses incurred by the franchisor in its review of the proposed transfer;
- ◆ the execution of a new master franchise agreement by the proposed transferee that conforms to the latest version of franchisor's master franchise agreement as well as of other documentation that the franchisor normally requires when it appoints new sub-franchisors; and
- ◆ the completion by the proposed transferee of the franchisor's training requirements.

The first and second conditions indicated above attempt to identify, address and resolve differences between the original franchisor and sub-franchisor before the relationship between them is severed. While the first condition is seldom one that is debated during the negotiation of the master franchise agreement, the second condition, the sub-franchisor's release of the franchisor, is sometimes protested by the prospective sub-franchisor, who may wonder why it should give up rights that it has vis-à-vis the franchisor in order to exercise its assignment right. The franchisor's response might be that it is desirable or important to clean the slate of any claims between them when they are still working together. If that is the franchisor's purpose, then a provision that is more clearly balanced might be drafted to accomplish the franchisor's objective.

The third, fifth and sixth conditions are generally regarded as reasonable safeguards to ensure that the new sub-franchisor is properly qualified and committed to fulfilling its role as a sub-franchisor. A prospective initial sub-franchisor may nevertheless understandably object to subjective standards that give the franchisor excessive discretion in determining whether a proposed transferee is suited to be a good sub-franchisor. The parties may find a compromise by providing that the franchisor's approval of a proposed assignee will not be unreasonably withheld.

The sub-franchisor will of course wish to have the freedom to transfer its interests in the franchise agreement in appropriate circumstances and should therefore at the very least seek to ensure that the conditions that must be satisfied for it to obtain the consent of the franchisor to the transfer are reasonable. The sub-franchisor may furthermore seek to impose the application of standards of reasonableness in the actual determination of the satisfaction of the required conditions when the franchisor exercises any discretion that it might have in this regard.

Finally, different conditions may be imposed for the transfer of interests depending on the circumstances. A transfer caused by the insolvency or bankruptcy of the sub-franchisor will for example be subject to different rules or procedures than a transfer that is completely voluntary. In this connection the special insolvency laws of the countries involved must be examined to understand the implications of either of the parties coming under the special requirements of these laws.

Similarly, an involuntary transfer due to the death or disability of a party may merit a treatment that is different from that of a transfer initiated voluntarily by the party wishing to transfer its interests.

III. RIGHT OF FIRST REFUSAL

The franchisor may wish to be able prevent the proposed transfer by retaining the right to acquire the sub-franchisor's interests on the same terms and conditions as those offered by the proposed transferee. If the franchisor exercises this right, then the franchised units that were operated by the sub-franchisor will become units of the franchisor and the units that were operated by the sub-franchisees will become ordinary franchised units. If the franchisor does not exercise its right to acquire the sub-franchisor's interests, then the transfer to the proposed transferee might be subject to the satisfaction of conditions of the kind described above.

CHAPTER 14

VICARIOUS LIABILITY, INDEMNIFICATION AND INSURANCE

Any franchise agreement, whether national or international, should include provisions dealing with vicarious liability, indemnification and insurance issues. The provision or provisions concerned have to take into account the legal rules relating to liability as well as any insurance practices in the host country. Wherever possible, the provisions should not only specify the general obligations of the parties, they should indicate with more precision both the content and the extent of such obligations.

It should be observed that the issues under consideration in this chapter are the consequences of problems with, or claims and actions brought by, third persons. The chapter does not deal with the liability of either party for the performance or non-performance of its contractual obligations.

A. VICARIOUS LIABILITY

I. LEGAL PRINCIPLES

Suits by tort plaintiffs attempting to hold a franchisor liable for the torts of a member of its network are an increasingly common phenomenon in international franchising. The general rule is that the franchisor is not vicariously liable for the sub-franchisor's, or indeed the sub-franchisees', torts absent an agency relationship, which must include some degree of control by the franchisor over the conduct causing the injury.

Such an agency relationship is based on the right of the principal (in this case the franchisor) to control the day-to-day operations of the agent's (franchisee's) business. In an agency relationship, the right to control will extend not only to the day-to-day business, but to the result of the work and the manner in which the work is accomplished. Several courts have held that the franchisor's right to terminate the agreement at will is the critical element for determining the existence of day-to-day control.

Courts vary both in their analysis of the legal theories under which vicarious liability of franchisors may arise and in their analysis of the relevant facts and circumstances that support those legal theories. The general rule, however, is that where a franchise agreement gives the franchisor the right to complete or substantial control over the franchise, an agency relationship exists.

Three of the main reasons for placing the burden of vicarious liability on franchisors are, firstly, the spreading of the risk (it is best to spread risks and costs broadly among people over time and the franchisor is in the best position to accomplish this, primarily by raising prices); secondly, the prevention of loss (the franchisor is in the best position to select qualified people who act responsibly and this is an incentive to do so); and thirdly, the availability of financial resources (franchisors can bear the costs of an injury better than innocent victims). The impact and influence of these theories on a given jurisdiction will greatly affect its interpretation of vicarious liability.

II. APPLICATION TO MASTER FRANCHISE ARRANGEMENTS

The essential element that must be assessed in determining vicarious liability is the reality of the relationships between the parties. The nature of the three-tiered relationship of master

franchise arrangements can make this extremely complicated.⁹⁴ In many cases, the relationship between the franchisor and the sub-franchisee is tenuous at best, as there is no direct relationship between the franchisor and the sub-franchisee. This makes the application of agency law even more difficult than in situations involving a simple franchisor/franchisee relationship. It is therefore advisable for the parties to thoroughly research the applicable legislation of the jurisdiction where a franchise will be located.

The parties involved frequently attempt to solve problems relating to vicarious liability by drafting vague franchise agreements. This can be a costly mistake. The creation at the outset of a clear relationship between the parties will not only facilitate the resolution of future problems, it will help to prevent them from occurring.

B. INDEMNIFICATION

I. RESPONSIBILITIES OF THE SUB-FRANCHISOR

It is usual for a sub-franchisor to assume responsibility for any loss, damage, cost or expense (including court costs and reasonable legal fees) arising out of any claims, actions, administrative enquiries or other investigations that relate to its operation of the business. These claims, actions or enquiries can, and from the franchisor's point of view should, include any claim or action attributable to the conduct of any sub-franchisee of the sub-franchisor, if applicable also by way of vicarious liability. This responsibility may further include an obligation to indemnify the franchisor, and where necessary its directors, officers or other licensees, for any loss, damage, cost or expense (including court costs and reasonable legal fees) that they may have incurred or that arises out of any claim, action, administrative inquiry or investigation, whether or not the claim of any third person is based on vicarious liability. This can include damages incurred by the franchisor as a result of an activity of the sub-franchisor that results in the loss of any rights belonging to the franchisor, such as for example intellectual property rights, in the loss of benefits or in the non-application of advantageous laws, such as tax laws, any other particular law favourable to the franchisor or, in the European Union, the Block Exemption Regulation on franchising.

On the other hand, the sub-franchisor does not have to hold the franchisor without responsibility if actions are brought against the sub-franchisor following accidents that have happened as a consequence of a legitimate and proper use of the franchise, or if actions are brought against the franchisor as a consequence of the sub-franchisor's use of the trademarks or of the franchise system if this use was in conformity with the agreement.

II. RESPONSIBILITIES OF THE FRANCHISOR

It is however also natural for the franchisor to assume sole and entire responsibility for any loss, damage, cost or expense (including court costs and reasonable legal fees) arising out of any claims, actions, administrative inquiries or other investigations relating to its own operation of the business, independently of the reason for which they were made, whether, for example, reasons of product liability or infringement of third parties' intellectual property rights. It would appear to be appropriate for a statement in this respect to be made in the master franchise agreement itself.

III. DUTY TO INFORM

It is also usual for each of the parties, the franchisor or the sub-franchisor as the case may be, to be obliged to inform the other promptly or within a specified short period of time of any liability claim brought, of any law suit, proceedings, administrative inquiries or other investigations initiated, as well as of the issuance of any order, injunction, award or decree by any court, agency or other institution, under which that other party, its directors or officers, are alleged to be at fault or by which they might be affected.

⁹⁴ See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

IV. *RESPONSIBILITY FOR DEFENCE*

It is advisable for the sub-franchise agreement to set out rules specifying when the franchisor or the sub-franchisor is entitled, or under what circumstances either of them is obliged, to undertake or assume the defence of any liability claim, action, inquiry or investigation, at whose risk and expense such a defence should be undertaken and the conditions under which a settlement might be made. It is normal that the party in whose country the action takes place assumes the primary defence, but always providing the other with full information. The franchisor is usually entitled to choose whether or not it should itself assume the defence against the third person's claim, provided that this is permitted by the procedural laws of the host country. As far as the franchisor's intellectual property rights are concerned, the situation will vary from country to country. In a number of jurisdictions it is only the owner, the franchisor in this case, who has the right to assume their defence, whereas in others it is possible for an exclusive licensee, the sub-franchisor in this case, to do so.⁹⁵ Where the necessity of such a defence results from the way the sub-franchisor operates its business, it is natural that it is the sub-franchisor that will bear the cost and expense of such a defence. Whoever assumes the defence, the prior written consent of the other party is normally necessary before a settlement can be made.

V. *RESPONSIBILITY OF INDIVIDUALS*

The responsibilities mentioned above will normally fall upon the party who has actually concluded the contract, namely the franchisor or the sub-franchisor, and not upon its directors, officers, shareholders or partners, unless claims arise as a result of any tortious acts of such persons. Directors or other persons may however be personally liable if, in the master franchise agreement or in an ancillary agreement, they have taken over a personal guarantee for the contractual party's obligations.

VI. *LIMITS ON REPRESENTATIONS AND WARRANTIES*

In order to reduce liability risks, the master franchise agreement will usually contain wording prohibiting the sub-franchisor from making any representations or giving any warranties with regard to any product that it has obtained from the franchisor which go beyond the representations or warranties given by the franchisor and/or beyond the standards usual in the host country.

VII. *CORRESPONDING INSURANCE COVER*

Finally, it is very important for both the franchisor and the sub-franchisor to examine their own liability insurance policies in detail. It is advisable for them to ensure that these insurance policies cover the extent of their possible liability risks, or at least that the indemnification provisions in the contracts they conclude do not go beyond the insurance cover.

C. INSURANCE

The liability risks and indemnification obligations discussed in Sections A and B above naturally lead to a consideration of possible solutions to the problem of ensuring that payments are obtained also in the event that the party liable cannot afford the amounts involved (which could easily be the case with a sub-franchisee). A civil liability insurance might be the most appropriate solution to this problem.

I. *INSURANCE OBLIGATIONS OF THE SUB-FRANCHISOR*

⁹⁵ See Chapter 11 "Know-How and Trade Secrets".

In master franchise and sub-franchise agreements of North American, European or Australian origin it is usual to include a provision under which the sub-franchisor is under an obligation to take out insurance, in the first instance for third party liability risks, but also for property risks. The sub-franchisor is further usually obliged to impose similar obligations on its sub-franchisees. Quite often such contractual clauses will only provide for a general obligation to "take out an appropriate insurance policy" and will then leave it to the sub-franchisor or the sub-franchisees to decide what they consider to be "appropriate".

If a franchisor wishes to include in its contracts provisions requiring insurance it might be more appropriate for it to indicate clearly what risks should be insured and the extent of the insurance coverage that it considers to be a minimum. The franchisor and the sub-franchisor should then discuss the liability risks that exist in the host country both under statutory law and under case law, as well as what insurance coverage is available or usually taken out in that country. There may be countries in which taking out an insurance for third party liability risks is unusual or unheard of, or in which an insurance cover is very expensive or simply not available. In such countries it might also be unusual to go to court with third party liability claims. There is however always a risk that third parties, such as clients of the sub-franchisees, may bring an action directly against the franchisor, either in the host country or in the franchisor's home country, where the courts might be used to such claims being brought and where they might even grant substantial sums in compensation. As this risk may increase in the future, franchisors and sub-franchisors have a great interest in finding a way to insure against it. A possibility might be to include the sub-franchisor and the sub-franchisees in the insurance policy of the franchisor, another to find insurance coverage in a foreign insurance market. The latter possibility may however be less viable in cases where the host country's foreign exchange laws prohibit or limit the export of money for foreign insurance policies.

II. EXTENT OF INSURANCE OBLIGATIONS

Insurance clauses that are commonly included in master franchise agreements will normally prescribe that the sub-franchisor shall at its own expense take out and maintain full insurance cover in all cases where it is legally prescribed, or where it is otherwise necessary or at least useful to ensure the continued existence of the sub-franchisor. It is to be recommended that the franchisor fix minimum coverage for damage to property and for damages caused by the interruption of business, as well as for third party liability for personal injury, death, damage to property and for product liability. This minimum coverage should be adjusted to the risks and practice prevailing in the host country. From time to time the agreements should be reviewed and, where necessary, the minimum amounts of the insurance coverage adjusted.

The sub-franchisor may be obliged to provide the franchisor with copies of the insurance policies before initiating the master franchise operations and may thereafter be obliged regularly to provide evidence that such insurance policies are still in force, either automatically, at specified intervals or only at the specific request of the franchisor.

The franchisor usually requires the insurance coverage to be extended to it and to its directors, officers, shareholders, partners or other licensees wherever the interests of these persons may be concerned by the risks covered by the insurance policies. The insurance practice of the host country must of course permit such an extension of the insurance policy, which must also be available at a reasonable price. If this is not the case, it might be more appropriate for the franchisor to extend its own insurance coverage to possible risks stemming from third persons and to recover the additional insurance premium through the franchise fees.

III. STEPPING IN OF FRANCHISOR

The franchisor will usually require the insurance policies to provide that the franchisor must receive notice of cancellation within a specified period of time before any cancellation by the sub-franchisor can take effect and that the franchisor should receive copies of all cancellations made by the sub-franchisor.

If it is permitted, the franchisor may also require that it be allowed to step into the sub-franchisor's insurance policies, should it wish to do so in case of cancellation or non-payment of the insurance premiums by the sub-franchisor. The franchisor may also require that it be entitled to take out insurance coverage and to pay the insurance premiums in cases where the insurance coverage required by the master franchise agreement has not been taken out by the sub-franchisor. In such cases the franchisor will subsequently request reimbursement from the sub-franchisor of all costs and expenses it has incurred.

IV. INSURANCE OBLIGATIONS OF THE SUB-FRANCHISEES

In all cases in which the franchisor considers a sufficient insurance coverage to be an imperative for a sub-franchisor, it is advisable for it also to prescribe and ensure that corresponding insurance policies are required in the sub-franchise agreements and that consequently the sub-franchisees maintain such insurance policies and pay their insurance premiums in a timely fashion. In order to avoid that the insurance provisions of the sub-franchise agreements remain a dead letter, the franchisor should encourage the sub-franchisor and try to ensure that a comprehensive insurance package with appropriate coverage and advantageous premiums is offered to the sub-franchisees.

CHAPTER 15

REMEDIES FOR NON-PERFORMANCE

The non-performance of a master franchise agreement will relate to two main areas:

- ◆ the development right, its exercise and the timing of the opening of units; and
- ◆ the sub-franchisor's functions in relation to its activities as "franchisor" in the host country and in dealing with the network of sub-franchisees.

In addition to having a natural desire to see the franchise system develop in conformity with the development schedule, the franchisor will be concerned to ensure that the sub-franchisor monitor and control the quality and standards of performance of the sub-franchisees. The sub-franchisees are, after all, trading using the franchisor's know-how and systems and are benefiting from the goodwill associated with its name and trade marks. The franchisor's assets are at risk if anything happens that can adversely affect its interests and property rights. The sub-franchisor is the custodian of those interests and rights in the territory in respect of which it has been granted the right to develop the franchise system. The agreement should therefore provide for the monitoring and maintenance of quality performance standards, but it should also provide for remedies should the sub-franchisor fail to ensure that these standards are maintained. These remedies will be based on the default provisions in the contract. It is recommended that these provisions should be drafted with precision, since they deal with what are crucial issues not only for the franchisor, but also for the sub-franchisor and the sub-franchisees.

Regard must be had to legislation applicable within the host country which may impose legal limitations on the right to terminate a contract or the payment of compensation.

A. REMEDIES SHORT OF TERMINATION

A number of possible remedies are normally provided for in the agreement, the most drastic of which is termination. In master franchise agreements provisions are to be found permitting termination by the franchisor for non-performance by the sub-franchisor. There are also cases in which the agreements provide for formal termination by the sub-franchisor for non-performance by the franchisor, but these are in the minority. It should be noted that in case of breach by the franchisor a sub-franchisor will of course have access to the remedies that normally are available for breach of contract. It is sometimes suggested that reciprocity demands that the sub-franchisor should have the same termination rights as the franchisor. The nature of the arrangement and the rights to be protected are however such as to render that possibility impracticable.

Termination is however not a step that franchisors like to take. It is far better and less traumatic for both parties to seek to achieve either a return to satisfactory contractual performance or a negotiated arrangement.

The relationship between franchisor and sub-franchisor is not as close as that between franchisor and franchisee. The performance at unit level in a master franchise arrangement is delivered by the sub-franchisees. The sub-franchisor's role, apart from performing the development obligations, is to recruit, train and supervise the performance by the sub-franchisees and to provide them with the appropriate range of "franchisor" services. The franchisor's supervisory functions will not normally involve a day to day participation in the activities of the network in the host country. While, of course, the franchisor can visit the host country, it may not be able to keep sufficiently up to date with the performance of the network or with any dissatisfaction of the sub-franchisees with the performance of the sub-franchisor. This underlines

one of the main difficulties for a franchisor in ensuring quality performance by sub-franchisor and sub-franchisee.

By the time a franchisor discovers the nature and extent of non-performance by the sub-franchisor, which will often have led to poor performance by sub-franchisees, a great deal of damage may have occurred.

Any delay by the franchisor may lead to a variety of consequences the severity of which will depend upon how long it has taken the franchisor to discover the problems. They can range from a sub-franchisor who has strayed from the franchisor's system and who is resistant to the franchisor's attempts to re-impose the necessary discipline to a badly run network of sub-franchisees, who may be very unhappy with the poor performance of the sub-franchisor and disillusioned with the franchisor and the system. The sub-franchisor may have reached the conclusion that it knows better than the franchisor how the system should be operated. This is an attitude that is often adopted by franchisees but in a sub-franchisor it presents far greater problems for the franchisor.

If the relationship is affected by these problems, then correcting them by direct discussion and persuasion may be difficult. Nevertheless, the franchisor, and indeed the sub-franchisor, will be better off if the issues can be negotiated and the system and standards restored. The overall possibility that the arrangement can be terminated, and the great cost to both parties if this should occur, should encourage them to seek an agreed way forward.

It is unlikely that a franchisor will be prepared to compromise the system operational standards and performance requirements unless there is a compelling case which demonstrates that, due to local business practices or market behaviour, some changes are necessary or desirable.

In order to avoid termination some means have therefore to be found to alleviate the problems that are causing the difficulties so as to remove the threat of termination. In this connection the parties should consider:

- ◆ the provision by the franchisor of a greater level of support in the territory to assist in raising standards to the franchisor's required level;
- ◆ the training and retraining of the sub-franchisor's key staff, so as to ensure that they understand what is required and the way in which they are failing; and
- ◆ the possibility of marketing and advertising support to stimulate the growth of sales by the network.

A sub-franchisor experiencing financial difficulties may be encouraged or assisted:

- ◆ to consider selling the business to a well financed third person;
- ◆ to find a financial partner; or
- ◆ to obtain support from a venture capital fund.

The franchisor may not be prepared to agree to reschedule debts at all, or may be prepared to do so only if the prospect exists that adequate capital will be made available with which to ensure that future payments can be made in full and on time.

Remedies that fall short of termination, but that involve legal proceedings, are unlikely to result in an improvement in working relations unless they can assist the parties in reaching a mutually satisfactory arrangement. Remedies such as injunctions or specific performance are inappropriate, as a franchisor would not want to have a reluctant sub-franchisor operating merely because the court has made an order. There are jurisdictions in which injunctive relief is not available and there is doubt as to whether orders for specific performance of franchise agreements would be made by courts in many countries.

In cases where only a debt has been incurred, franchisors may not wish to exercise a right to terminate the agreement and may instead choose to sue to recover the debt and/or damages, while insisting otherwise on contractual performance.

A number of remedies short of termination are available to the sub-franchisor in the case of non-performance of the agreement on the part of the franchisor, or where the franchisor becomes bankrupt. These include turning the agreement into a bare-bones licence agreement and buying the trademarks of the system for use in its country. These will of course involve negotiations, perhaps with a liquidator or receiver of the franchisor's business or with the franchisor. It is rare to find these issues dealt with in a master franchise agreement.

B. TERMINATION

I. TERMINATION BY THE FRANCHISOR

The termination provisions in a master franchise agreement will generally fall into six categories:

- ◆ those that deal with issues such as insolvency, liquidation and bankruptcy: these will be the same as those commonly found in all commercial agreements;
- ◆ those that deal with operational and contract issues such as the performance by sub-franchisees of their obligations under the unit franchise agreements;
- ◆ those that deal with reporting and payment obligations;
- ◆ those that deal with the failure by the sub-franchisor to maintain the agreed development schedule;
- ◆ those relating to a failure to comply with any other provisions of the agreement; and
- ◆ those that relate to the misuse or infringement of trademarks and other intellectual property rights owned by the franchisor that the sub-franchisor and sub-franchisee are licensed to use.

In most of these cases there is no parallel between the obligations and defaults of the sub-franchisor and those of the franchisor such as to require reciprocal provisions. Indeed, if one reviews the cases listed it is only in the case of the first that there is any common ground. In the other cases operational issues, reprinting and payment obligations, breach of development schedule and infringement of intellectual property rights, it is only the sub-franchisor who can be in default.

A provision found is that which permits a franchisor to terminate in the event of a material or substantial default. Expressions such as “material or substantial default” are often difficult to interpret. What a franchisor regards as a “material or substantial default” may not be regarded as so material or substantial by a sub-franchisor. How a court would determine the dispute could be open to question. It is important for both parties to know where they stand. If an expression such as “material or substantial default” is to be used, then it should be clearly defined. An example of a definition of “material default” could be “any default under the agreement of which the franchisor has given notice to the sub-franchisor requiring it to be remedied and which remains unremedied after a fixed period of time.” The period of time has to be appropriate for the nature of the breach complained of. In the case of sums of money that have not been paid, the default is likely to be treated more seriously by a franchisor, with a shorter period of notice being given for curing the default. Quality control defaults may need a longer period for the default to be put right as the action to be taken to do so will invariably involve enforcing rights against sub-franchisees. For a number of defaults, however, a short period is sufficient, such as for example in the case of non-observance of hygiene requirements in fast food operations. This issue raises a number of important considerations, as one of the perceived weaknesses of master franchising for a franchisor is the need to delegate the enforcement of quality control to the sub-franchisor, with a consequent difficulty of policing compliance.

Failure by a sub-franchisor to ensure that sub-franchisees comply with the terms of their agreements is a serious issue for a franchisor, but the franchisor may have to accept that compliance may require reasonable time and careful handling to be achieved. The problem is not necessarily best solved by requiring the sub-franchisor to undertake legal proceedings. The solution of operational problems that have led to a lowering of standards can often be dealt with by direct discussion, persuasion, retraining and support, rather than by resorting to the law. The parties must acknowledge that there are a wide range of methods available to cope with these problems and the agreement should recognise the need to be flexible. Ultimately, of course, the franchisor must be able to bring matters to a head to protect its interests and the integrity of its name and other intellectual property rights. The franchisor and sub-franchisor must ascertain

whether the law applicable to the contract (which may in this case be the law of the host country as a matter of public policy) provides special procedures, restriction of direct or indirect penalties in some form or other which may inhibit the exercise of a contractual right to terminate the contract.

Termination of Development Right

The development right will in all probability carry with it territorial exclusivity and the development schedule will state how many sub-franchises have to be established and within what time frame.^v

The agreement will therefore be expected to deal with the issues that will arise if the development schedule is not performed as required. The development schedule will frequently span a long period of time. It is certain that within that time-span new circumstances could arise over which the parties have no control and which could affect the ability of the sub-franchisor to meet the requirements of the development schedule. These circumstances could include fluctuations in the availability of suitable premises at reasonable rental levels, a recession which has an adverse impact on profitability, leading to a shortage of prospective franchisees and timing difficulties which result in a delay in achieving openings.

The franchisor will wish to have swift and effective remedies available, whereas the sub-franchisor will probably wish to see flexibility in the arrangements. These opposing views are often difficult to reconcile and both parties will, if an agreement is to be reached, have to consider the various sanctions that may be imposed for non-performance in achieving the development schedule. The agreement may provide for:

- ◆ the loss by the sub-franchisor of the exclusive territorial rights it has been granted by the franchisor;
- ◆ the keeping of exclusivity for only part of the territory;
- ◆ the reduction of the contractual territory;
- ◆ a reduction in the number of sub-franchisees who can be appointed or a loss of the right to appoint further sub-franchisees;
- ◆ the loss of the sub-franchisors' right to renew or extend the development right;
- ◆ the payment of a penalty (if legally possible in the territory);
- ◆ the payment of liquidated damages;
- ◆ the loss of the development right of the sub-franchisor, who however has a right to retain the then existing number of sub-franchisees, although this might also cause practical problems; and
- ◆ increases of royalty payments or the loss of the benefit of a reducing sliding scale for the franchise fees (although such a scale is not common).

In some cases where there is a failure to perform the development schedule the parties may agree upon a formula which enables the sub-franchisor to pay what are called "phantom royalties" in order to preserve the development rights. Phantom royalties would be a sum calculated in accordance with a predetermined formula, which will compensate the franchisor for the loss of income it has suffered as a result of the non-performance on the part of the sub-franchisor in achieving the development schedule. This right to pay phantom royalties will normally be limited to a two or three year period so that if the sub-franchisor does not catch up with the schedule during that period, the right to make phantom royalty payments will cease and the contractual remedies for failure to achieve the schedule become available to the franchisor. It is also possible that the parties may re-negotiate the development schedule if it becomes apparent that it was unrealistic.

Removing the sub-franchisor's exclusive territorial rights when it has not performed its obligations under the development schedule may not achieve the result that the franchisor and

the sub-franchisor seek. In this case the sub-franchisor may continue to open further franchise units, but may be de-motivated and this loss of morale may well be reflected in a failure properly to discharge its obligations to its sub-franchisees.

The franchisor may not only have this problem with the sub-franchisor, it may also have difficulty persuading someone else to take up the challenge of developing the remaining potential of the development area. The continued presence of the first sub-franchisor in control of a network, possibly with under-performing sub-franchisees but still trying to sell sub-franchises in competition with its successor, makes it difficult for a successor to establish a network that will not be tainted by the predecessor's shortcomings. This is a factor that is likely to deter many prospective sub-franchisors.

Consumers could furthermore be confused by the existence of two networks under the same name but which might not have the same quality standards. If the first sub-franchisor continues to sell, there may be encroachment problems with the first sub-franchisor wishing to sell to sub-franchisees who will be too close in location to sub-franchisees appointed by the second sub-franchisor. There may also be problems with the re-location of existing franchise units which has become necessary as a result of demographic changes or because it is not possible to renew a lease. There can also be difficulties over the exercise of rights of renewal as it will probably not be possible to extend the first sub-franchisor's contract. Sub-franchisees would not be able to expand their operations. Advertising programmes have to be co-ordinated and the first sub-franchisor may be sufficiently upset at the loss of its rights not to be co-operative. For these essentially practical reasons many franchisors may not wish to agree to an agreement that provides for the termination of the sub-franchisor's rights of exclusivity in cases of non-performance of the development schedule, but may instead insist on termination of the agreement in its entirety.

The situation where the sub-franchisor loses its development right but is permitted to retain the sub-franchisees it has in its network should not be overlooked. In such cases the problems outlined above will not disappear. The parties will have to confront them and devise methods of minimising their effect. It is also possible that the sub-franchisor would not wish to continue if its scope is curtailed.

It should be pointed out that the termination of the development right may not necessarily result in the termination of other provisions in the agreement that are not related to that right or its exercise.

II. TERMINATION BY THE SUB-FRANCHISOR

In practice it is rare to find provisions that entitle a sub-franchisor to terminate for default on the part of the franchisor. The view usually adopted by franchisors is that the sub-franchisor should rely on the remedies available at law for non-performance of the agreement on the part of the franchisor. The franchisor will on the other hand consider that it needs the specific termination provisions so as to enable it to act swiftly to pursue the remedies necessary to preserve its trade name, trademarks, service marks and the goodwill associated with them and its other intellectual property rights, as well as to protect its confidential information and know-how. It will also consider that it needs to be able swiftly to decide what to do with the network of sub-franchisees and to act upon its decision without a delay which could cause considerable harm.

The sub-franchisor does not have the same urgent needs if there is a default by the franchisor. If the sub-franchisor considers the franchisor to be failing to provide the services or products it is under an obligation to provide and considers this failure to have adverse consequences for itself and its sub-franchisees, then the remedy of damages for non-performance of the agreement is available. The sub-franchisor will in any event have to decide whether it wishes to continue with the relationship notwithstanding the non-performance on the part of the franchisor, considering that the reason for the non-performance might be temporary and might be remedied in the future. There are often provisions in agreements that deal with the failure or inability of the franchisor to supply goods that would enable the sub-franchisor to obtain goods of comparable quality elsewhere.^{vi}

It should also be borne in mind that either party may dispute the validity of any termination by the other of the master franchise agreement, whether or not it was terminated by notice in accordance with its terms. It would always be open to the aggrieved party to challenge whether the facts relied upon justify the termination of the agreement. In these circumstances the dispute would have to be brought before the courts. A franchisor may however have to seek a court order to enforce its rights even where it has validly terminated under the provisions of the agreement.

If the sub-franchisor is entitled to terminate the franchise agreement when the franchisor is in "material" default of its obligations, becomes bankrupt or is put into liquidation, then the problem of the consequences of such a termination for the sub-franchisor and the network arises. The question is whether in the circumstances the sub-franchisor should be in the same position as it would be if the agreement were terminated for breach by the sub-franchisor. A sub-franchisor may claim in these circumstances that it should be entitled to continue as before, using to the full the franchisor's intellectual property rights, including the name and know-how and, if so, on what basis.

A franchisor would have to consider whether it could agree that the sub-franchisor should have that right, bearing in mind that the effect would be to remove an asset which consequently in the case of an insolvency related cause would not be available for creditors or its shareholders. Consideration may need to be given to the effect of the bankruptcy procedures in the franchisor's jurisdiction, particularly of those procedures that permit continued trading under court supervision with a moratorium on creditors' claims and that prevent termination in accordance with the agreement. Another effect of such a provision could be to eliminate the incentive for the franchisor to resolve its difficulties and to restore proper performance, or to dispose of its business to a third person who will provide the ongoing service.

In practical terms, however unfair it may seem, very few franchisors will consider the consequences of termination by a sub-franchisor for non-performance on the part of the franchisor to be any different from what they would be if the sub-franchisor were the non-performing party. The reality is that in practice the sub-franchisor will be confronted with the risk of losing its business when the franchisor is at fault, independently of whether the fault arises voluntarily or involuntarily. This places a greater responsibility on the sub-franchisor to ensure that the franchisor is viable and financially secure. There are many franchisors who offer master franchise opportunities who may find it difficult to satisfy that criterion.

CHAPTER 16

THE END OF THE RELATIONSHIP AND ITS CONSEQUENCES

There are four possible ways in which the master franchise relationship may come or be brought to an end:⁹⁶

- ◆ the term of the contract may come to an end;
- ◆ the contract may be terminated by the franchisor in accordance with its terms;
- ◆ the contract may be terminated by the sub-franchisor in accordance with its terms if the agreement provides for such a remedy;⁹⁷
- ◆ the sub-franchisor may exercise a legal remedy such as rescission, accepting a repudiation by the franchisor, or claiming some substantial breach.

Each of these possibilities are considered in turn below. Before examining them it is however convenient to review the full range of consequences that most franchisors will seek to introduce into the agreement.

A. CONSEQUENCES OF THE MASTER FRANCHISE RELATIONSHIP COMING TO AN END

When the master franchise relationship comes to an end the consequences for the sub-franchisor will normally be that it will:

- ◆ lose future development rights;
- ◆ have to cease operating as the "franchisor" of the sub-franchisees in the development area;
- ◆ be required to discontinue the use of the franchisor's:
 - ◇ trade marks, trade names and other branding;
 - ◇ copyright materials;
 - ◇ systems, know-how and confidential information;
 - ◇ other intellectual property rights which could be quite wide and include, for example, in the case of fast food, the recipes;
- ◆ be required not use the system know-how or confidential information in the future;
- ◆ have to de-identify all premises;
- ◆ have to cease the use of all materials bearing the franchisor's trademarks, trade names or indicating an association between the franchisor and the sub-franchisor;
- ◆ be required to return all copies of the operations manuals that the franchisor has issued to it or that it has in its possession or under its control;
- ◆ at the franchisor's option, be required to transfer to the franchisor the benefit of all sub-franchise agreements;
- ◆ for a limited period of time, be required not conduct any business that competes with the franchisor's type of business; and
- ◆ in some cases, be required to grant the franchisor an option to acquire certain of its assets.

⁹⁶ For a discussion of the ways in which the relationship may come or be brought to an end, see Chapter 15 "Remedies for Non-Performance".

⁹⁷ See Chapter 15.

Provisions of the local laws may well affect a number of these consequences. Thus, for example,

- ◆ intellectual property laws will have to be complied with to ensure that the rights that have been exercised are correctly terminated;
- ◆ restraints on the use of systems, know-how and confidential information will be affected by the general law applicable to such property rights, but also by competition (anti-trust) laws in some countries;
- ◆ the transfer of master franchise agreements may be affected by:
 - ◇ local laws regulating who can carry on business in a territory (for example, in some countries it is a requirement that local nationals must own at least 51% of any entity trading in that country);
 - ◇ the possibility that if the master franchise agreement is terminated, sub-franchise agreements also terminate unless the agreements deal with this issue;
- ◆ post-term restraints against competition will be affected by local laws in general application as well as in some countries by the application of competition (anti-trust) laws;
- ◆ local laws may confer a right on the sub-franchisor to claim compensation; and
- ◆ it is possible that, if the agreement is sought to be terminated for insolvency or other related reasons, there may be laws under which administrators are appointed to preserve assets for creditors and which affect the right to terminate.

Where there is an option to acquire certain assets the nature and extent of the assets will need to be anticipated to the extent possible. The range of the sub-franchisor's assets (other than the sub-franchise agreements) may include:

- ◆ the sub-franchisor's head office premises;
- ◆ the sub-franchisor's warehouse (if it is a product franchise); and
- ◆ the freehold or leasehold interest in the premises occupied by sub-franchisees where the sub-franchisor has become involved with property.

There may also be a range of other agreements between the sub-franchisor and the sub-franchisees.⁹⁸ It is important that the way in which each of these ancillary agreements is to be dealt with at the end of the relationship is considered by the parties, although the desired outcome may not be easy to achieve, particularly where those agreements deal with assets (for example leases of real estate) that may have an aggregate value that make "buy outs" too expensive.

B. WAYS IN WHICH THE MASTER FRANCHISE RELATIONSHIP MAY COME OR BE BROUGHT TO AN END

I. THE TERM OF THE CONTRACT MAY COME TO AN END

The circumstances to be considered include:

- ◆ if the agreement was for a fixed term with no rights to extend or renew the term. This would result in the sub-franchisor having no further rights except what it may be able to negotiate if it wishes to continue. It may not be entirely at the mercy of the franchisor, which is clearly undesirable, because there will be a network of sub-franchisees in place who will need to be considered. The franchisor will need someone to service that network and will have to decide whether it should be itself, the sub-franchisor whose term has come to an end, or a newly

⁹⁸ See Chapter 19 "Ancillary Documents".

recruited sub-franchisor that does so. To take over the network the franchisor will need to be well resourced and to find a third person to take it over may not be so easy. Provided the existing sub-franchisor has done its job well it will have some bargaining power. In the circumstances, if the sub-franchisor cannot negotiate an extension or renewal it will no doubt consider that the business it has built up has a value for which it should be paid. The franchisor will probably resist that claim on the basis that the sub-franchisor had a finite agreement and could only expect to benefit while it lasted and that the sub-franchisee network using the franchisor's name and system belongs to the franchisor once the master franchise agreement comes to an end. These are issues that need to be considered and negotiated on when setting up the contractual arrangements. The survival by the sub-franchisee agreements of the termination of the master franchise agreement will need to be dealt with in the master franchise and in the sub-franchise agreements;⁹⁹

- ◆ if the agreement was for a fixed term and the sub-franchisor had the option to extend or renew the term. This could result in any one of three alternatives:
 - ◇ this being an option, the sub-franchisor decides not to exercise it. In this case the sub-franchisor is making a conscious decision not to proceed for whatever reason. At the time of the negotiation it is unlikely that the sub-franchisor would contemplate such an outcome but the parties should consider that possibility and discuss how to cope with it;
 - ◇ the sub-franchisor decides to exercise the option but the franchisor refuses to accept it because the sub-franchisor has not substantially observed the contract or is currently in default. These two qualifications are commonly found in master franchise agreements. The consequences are likely to be similar to those discussed above in the case of a fixed term with no right to renew; and
 - ◇ the sub-franchisor decides to exercise the option and the parties enter into an appropriate new agreement.¹⁰⁰

III. *THE CONTRACT MAY BE TERMINATED BY THE FRANCHISOR IN ACCORDANCE WITH ITS TERMS*

In cases in which there is lawful termination in accordance with the provision dealing with termination in the master franchise agreement, the franchisor would expect the full range of consequences listed in Section A above to take effect. A sub-franchisor who is not happy with any of those consequences must negotiate on those issues when the contract is being established. It is however likely to prove difficult to persuade the franchisor to accept any "watering down" of what it will probably regard as fundamental requirements. There are some breaches which are more likely to arise and these include:

- ◆ failure to make payments when due;
- ◆ failure to submit reports;
- ◆ failure to follow procedures for the transfer of the business (which might even include making an unauthorised transfer);
- ◆ failure to respect confidential information and to ensure that also sub-franchisees do so;
- ◆ failure observe restrictions on involvement in competitive businesses; and
- ◆ failure to ensure a proper use of trademarks and trade names and system by sub-franchisees.

There are two other issues that may arise:

- ◆ franchisors would expect to be able to restrain a sub-franchisor from breach of these post term restrictions by court order or injunction. In some countries these remedies are not available, whereas there is usually some form of penalty payments or other lawful financial

⁹⁹ See the discussion on page 55.

¹⁰⁰ See Chapter 3 "Term of the Agreement and Conditions of Renewal".

constraints to act as a disincentive to a sub-franchisor to ignore the contractual requirements;

- ◆ the question of whether the franchisor should be required to make a payment to the sub-franchisor for the transfer of the benefit of the agreements with the network of sub-franchisees. The following issues arise:
 - ◇ a sub-franchisor who wishes to terminate for any reason or who wants to sell but cannot find a purchaser could deliberately breach the contract to force the franchisor to terminate and "buy" the network;
 - ◇ there are obligations under the sub-franchise agreements that cost money to perform;
 - ◇ the sub-franchise network may be unhappy with the sub-franchisor resulting in rebellious sub-franchisees who are seeking to break away from the franchise;
 - ◇ whether the franchisor will in any event be obliged, or merely have the option, to take over the sub-franchised network or whether it should be able to select the sub-franchisees it wants to deal with and to terminate the others;
 - ◇ in view of the problems that the franchisor may perceive could exist with a sub-franchised network in these circumstances, whether the franchisor should be able to require the terminated sub-franchisor to make a payment to the franchisor to compensate it for the additional expense it will incur and for the likely losses of dissatisfied sub-franchisees.

It should be remembered that other provisions dealing with termination would inevitably include the bankruptcy, insolvency or liquidation of the sub-franchisor. The effect of such a course is referred to above but the local laws may have an impact on what happens to sub-franchised networks. These issues therefore require careful consideration when negotiations take place.

III. *THE CONTRACT MAY BE TERMINATED BY THE SUB-FRANCHISOR IN ACCORDANCE WITH ITS TERMS*

It is comparatively rare to find a provision in a master franchise agreement permitting termination by the sub-franchisor for breach by the franchisor. Indeed it is not even common to find a provision in a unit franchise agreement giving the franchisee a right contractually to terminate the agreement. In master franchise agreements the debate regards the inherent injustice in the situation in which the consequences for the sub-franchisee are the same whether or not it or the franchisor is in breach of the agreement. The problem to be confronted, and about which a franchisor needs to be satisfied, is that its property assets can be adequately protected if its name and system cease for whatever reason to be issued by the sub-franchisor in the host country. The sub-franchisor on the other hand would find it difficult to understand why when the franchisor is in default it has to decide whether or not to permit the default to continue or to terminate and lose the right to continue to trade as before.

IV. *THE SUB-FRANCHISOR EXERCISES A LEGAL REMEDY TO TERMINATE THE AGREEMENT*

The two most common remedies available to a sub-franchisor are a right to terminate the agreement and the possibility to accept a rescission or repudiation by the franchisor. The nature and extent of the remedies may well vary from country to country and the sub-franchisor will need to be aware of these remedies and of the circumstances under which they may be available. In addition to these remedies (as well as usually being a part of them) the sub-franchisor may be able to claim damages for breach of contract. In some countries it may also be possible to ask a court to order the franchisor to perform its obligations.¹⁰¹

¹⁰¹ See Chapter 17 "Applicable Law and Dispute Resolution" for a discussion on choice of law and forum.

CHAPTER 17

APPLICABLE LAW AND DISPUTE RESOLUTION

The achieving of a degree of certainty in the enforceability of an international master franchise agreement will to a large extent depend on the parties having made an effective choice of law to apply to their relationship and on their agreeing on the approach to be adopted to resolve any disputes that arise between them. This includes their agreeing on the forum in which disputes might be resolved. In this connection parties should consider at the outset the possibility of having recourse to arbitration as opposed to litigation, as well as the use of mediation, negotiation or conciliation.

These matters are what are usually considered in settling the traditional choice of forum and choice of law clauses in an international contract.

A. THE DESIRABILITY OF MAKING A CHOICE

The selection of the law that is to apply to an international agreement within a master franchise arrangement and the reaching of an agreement on the preferred forum for the settlement of disputes should not be overlooked in negotiating international master franchise agreements or left until after all the substantive elements of such agreements between the parties have been settled, or, even less acceptably, until a real disagreement arises.

Decisions on these two issues are closely related and similar considerations apply to both. Indicating the legal regime that is to apply helps clarify at the outset the interpretation that the parties intend should be given to principal terms of their agreement.

The law chosen will determine much about the actual obligations entered into by the parties. It is relevant to many of the issues addressed in the other chapters of this Guide and cross-referencing in those chapters identifies those linkages and the importance of choosing the law of a particular jurisdiction to apply to the master franchise agreement.

If a choice of applicable law is not made a master franchise agreement will in general be governed by the laws of a particular State selected in accordance with the rules of conflict of laws. In this process any applicable international treaty or convention, such as the *European Convention on the Law Applicable to Contractual Obligations*,¹⁰² the *Inter-American Convention on the Law Applicable to International Contracts*¹⁰³ and other relevant principles of international law will be taken into account.

In many cases this conflict of laws analysis may result in the applicable law being the law of the country in which the sub-franchisor operates the franchised business, but it might also be that different laws are found to be applicable to the different component parts of the master franchise package.

B. APPLICABLE LAW

The application of the conflict of laws rules of a State used to determine the applicable law is rather sophisticated and at times complex. In the case of contracts there are several different rules that are used to determine what law is applicable. According to one of these rules the law of the

¹⁰² Rome, 1980.

¹⁰³ Mexico, 1994.

place where the contract was concluded is applicable, according to another it is the law of the place of performance that will govern the relationship, or the law that the parties decide. The law governing the validity of a contract is not necessarily the same as the law that governs other issues, such as the capacity of a party to conclude a contract or the formalities that are required. The subject-matter of the contract is also relevant. Thus, for example, banking and negotiable instruments have their own choice of law rules and special rules may be prescribed in some jurisdictions for competition law and consumer transactions.

When parties do make a choice of law they will tend to press for the choice to fall on the law of their own jurisdiction. There are many possible reasons for this: familiarity of that legal system to the legal representatives of the parties, the assumption that that particular law will offer advantages, or, in the case of franchisors, because they want the same law to apply to all the master franchise agreements they have in place around the world. Rather than proceed on this largely intuitive basis, the parties would be better served by considering in a systematic way the situations in which disputes are likely to arise and where litigation would most effectively take place for the outcome to be enforceable. It should be borne in mind that a court selected as the forum will, in all probability, be more comfortable in applying the law of its own jurisdiction.

Quite apart from the effect of the choice of law on the master franchise agreement, the parties will have to comply with the particular laws of the jurisdiction where the franchised business is to be exploited, not only with those intended to enforce intellectual property rights, but also with those that enshrine domestic public policy, such as competition laws and consumer protection and foreign investment laws. Laws such as these are mandatory and are likely to provide that certain of their provisions shall not be overridden by inconsistent contractual terms or by the application of conflict of laws rules. Particular features of the following areas of substantive law of the relevant jurisdiction need to be closely considered in this regard:

- ◆ public policy;
- ◆ foreign investment law;
- ◆ corporation law and regulatory regimes;
- ◆ competition law/anti-trust/trade practices;
- ◆ intellectual and industrial property protection;
- ◆ banking/finance/credit law/currency export laws;
- ◆ sale of goods law;
- ◆ customs law;
- ◆ consumer protection;
- ◆ insurance law and third party liability;
- ◆ taxation law, including withholding tax;
- ◆ labour law; and, where applicable,
- ◆ specific domestic franchising regulation.

If the jurisdiction in which the franchise is to be exploited does not have a well developed system of business law that will provide effective protection, in particular of the trademarks and other intellectual property rights associated with the franchised business but also of the business as such, then the franchisor will have little option but to choose the law of its own domicile if it wishes to proceed with its commercial development in such a high risk environment.

I. ENFORCEABILITY OF CHOICE

In a number of countries the parties to an agreement are not permitted to determine the law applicable to their agreement, as legislation exists that either stipulates what the applicable law should be, or otherwise limits the parties' choice by agreement. In most jurisdictions parties are however permitted to determine the law that they wish to apply to their agreement, although subject to some specific limitations.

The more common position applies, for example, within the European Union, the United States, Australia and Japan and ensures that courts, while retaining some discretion, will enforce

choice of law clauses in international agreements as indicating the law applicable to the interpretation of that agreement.

In each individual case the parties will need to identify, and consider the effects of, the particular limitations that apply in the specific jurisdictions with which they are concerned. In those jurisdictions where a choice of law may be made the following are the most commonly found limitations:

- ◆ the agreement concerned must have a genuine international element;
- ◆ a reasonable relationship should exist between the law of the state chosen and the master franchise agreement or the parties to it;
- ◆ the choice of law is made in good faith and is legal and is not made merely to validate what would otherwise be invalid under what in the absence of a choice of law would be the law governing the contract (for example attempts to evade mandatory rules of public policy); and
- ◆ specific statutory provisions directed to franchise agreements, including international master franchise agreements.

II. MOST LIKELY OUTCOME

Unless the country in which it is proposed that the franchise system should be developed has no sophisticated system of business law and commercial usage and practice, the parties are most likely to choose the law of the sub-franchisor's domicile as the law applicable to all but the master franchise agreement itself. This outcome might also be sought by a sub-franchisor even if the laws of the jurisdiction of the franchisor would give the sub-franchisor better protection of its interests than the laws of its own jurisdiction, as might be the case if the jurisdiction of the franchisor is a state of the United States with strong franchising and consumer protection laws. It may however be extremely expensive and difficult to enforce the sub-franchisor's rights in such a situation.

Independently of the choice made, it will in any event be the laws of the jurisdiction of the sub-franchisor, particularly its intellectual property legislation, that will govern the filing, registration and enforcement of the franchisor's trademarks and other intellectual and industrial property rights and that will therefore be especially important. In the majority of circumstances it is also likely to be the law of the sub-franchisor's jurisdiction that will govern the relationships between the sub-franchisor and the sub-franchisees, the legal status of property and the transactions of those parties. The application of the law of one jurisdiction to all dealings and arrangements falling within the franchisor/sub-franchisor/sub-franchisee relationships would have significant practical benefits.

Such a practical outcome may not always be possible. In some international franchise agreements the domicile of neither the franchisor nor the sub-franchisor will be in the jurisdiction in which the franchised business is to be conducted. The law applicable to the master franchise agreement and to the protection of intellectual property rights may therefore for good reason be different from that applicable to the sub-franchise agreements.

III. EFFECTS OF INTERNATIONAL UNIFORM LAW

When the parties make a choice of law in these and other international franchising circumstances they also need to bear in mind that it is not just national law, conflict of laws rules included, that should be taken into account, international uniform law must also be considered. Thus, for example, if the State of domicile of each of the parties is a party to the *United Nations Convention on Contracts for the International Sale of Goods (CISG)*, the provisions of CISG, rather than any national law, will apply to any sales contract that is part of the franchise arrangement unless expressly excluded by the terms of the contract.

The parties may quite reasonably wish to go further and, to the extent that a master franchise agreement concerns the sale of goods, seek to incorporate by reference the provisions of CISG even though they might not otherwise apply.

In addition, if the parties wish to pursue the alternative of seeking to have the same legal principles apply to all the agreements in the master franchise arrangement, they could provide that the interpretation of the provisions of their agreement should be in accordance with the Unidroit *Principles of International Commercial Contracts*.

On the other hand, in selecting the law applicable to the agreement the parties may consider whether or not this choice is meant to include also the uniform international law (treaties, conventions) to which the country whose law has been selected is a party and its conflict of laws rules in addition to its domestic laws. If it is intended to include only its domestic law and not its public and private international law, then the latter should be expressly excluded. Otherwise the parties might find that in the specific circumstances of the dispute to be resolved the laws of that particular jurisdiction, especially the conflict of laws rules, may determine the selection of the laws of a jurisdiction not contemplated by the parties.

In summary, while there are a range of legal considerations that the parties need to make to ensure the overall workability and enforceability of the whole master franchise arrangement (master franchise agreement and sub-franchise agreements), practical and policy considerations most often lead quite sensibly to the law chosen as the law applicable to the agreement being the law of the jurisdiction in which the franchise outlets are located, unless the sub-franchisor is not domiciled in that country, the master franchise agreement covers more than one country, or the franchised business is being exploited in a country with an unsophisticated legal system.

C. DISPUTE RESOLUTION

I. NEGOTIATION, MEDIATION AND CONCILIATION

In commercial dispute resolution there has in recent years been a move away from litigation and arbitration, with the adoption of other techniques and procedures such as mediation. Use is also being made of more structured negotiations between the parties, partnering arrangements and conciliation. These processes differ from arbitration and litigation because no third person involved is authorised to resolve the dispute by making a binding determination: the third person will simply assist the parties in settling the dispute themselves.

The mini-trial as used in the United States is another novel technique. It involves a brief presentation of each party's case to a panel consisting of representatives of each party and a neutral facilitator. The party representatives are senior executives who have authority to settle the dispute. After the case presentations the executives meet to discuss avenues of resolution. They may seek the assistance of the neutral facilitator whom they may ask to express a view about the merits of the case, but again, no third person has authority to issue a binding determination. Settlement is left to the parties themselves.

The advantages seen in these consensual dispute resolution processes is that on the whole, as compared with compulsive processes, they are less expensive, more expeditious and conducive to the maintenance of an on-going business relationship after the disagreement has been resolved.

By contrast, arbitration and litigation involve a binding determination by a third person (the judge or arbitrator). This distinguishes these procedures from negotiation and mediation. Despite the fact that the jurisdiction of the arbitrator is derived from the original agreement of the parties to refer disputes to arbitration, arbitration is not truly consensual, indeed, it has much of the mandatory character of litigation. In important respects arbitration does however differ from litigation. Arbitrators do not exercise the judicial authority of the State and the composition of the arbitral tribunal is, to a significant extent, determined by the agreement of the parties, as are the

scope and procedures of the arbitration and its rules, the language to be employed and the place of arbitration.

It is important for the parties to a master franchise agreement to consider how dispute resolution may be affected by the international character of their agreement. First and foremost there is the question of the legal effectiveness of the dispute resolution procedure. With respect to litigation in an international transaction the authority of the court may not be at all clear. If the defendant is not present within the territory of the court, a question of jurisdiction or competence may arise. Moreover, the effectiveness of a judgment outside the country of rendition may also be questionable. Cultural considerations are also of importance in this context.

Parties with different cultural backgrounds may have differing perceptions of the bargain they are striking, they may not understand their contractual obligations in the same way and may attach different significance to the master franchise agreement itself.

Persons of a particular cultural background may have a preference for one form of dispute resolution over another. People from common law countries are, for example, used to an adversarial system of dispute resolution and have until recently tended to regard litigation as usual and acceptable. Persons from some Asian backgrounds have on the other hand traditionally shied away from adversarial confrontation and have sought the resolution of disputes by more consensual and informal means.

In international master franchising transactions it is important for the parties to be proactive and to consider dispute resolution at the initial stage of the formation of their agreement. The agreement itself should contain provisions for dispute resolution and should set out the procedures that the parties agree should be followed. If dispute resolution is not dealt with in the agreement, then one of the parties may find that there is no effective method of resolving a dispute when a problem subsequently arises. Alternatively, a party may find itself involved in a form of dispute resolution that is inappropriate or undesirable.

With respect to the actual provisions made in the master franchise agreement, the parties need to consider the possible requirement for injunctive relief and other interim measures in case of non-performance. While both judges and arbitrators may be able to grant interim measures from the perspective of enforceability, normally the State court systems are likely to be more efficient and effective in this regard. It is not unusual for the convening of an arbitral tribunal to involve an element of delay. If parties do opt for arbitration as a dispute settling approach, it would therefore be prudent to exclude any matters requiring urgent and interim relief measures from the application of the arbitration clause and instead to have recourse to the nominated State court system for these matters.

If arbitration is chosen, it might also be preferable for enforceability reasons to exclude other possible breaches, such as intellectual property infringements, from arbitration and to subject them instead to litigation.¹⁰⁴ The outcome of such an approach would be to have different dispute resolution processes applying to different clauses of the master franchise agreement. This would seem to be a better approach and one which would be more acceptable to most courts than, for example, having to consider terminating the whole agreement before being able to proceed against the sub-franchisor in the case of a trademark infringement.

If a dispute does arise under a master franchise agreement, it is preferable for the first response of the parties to be to seek to resolve it themselves through discussion. If this is not feasible, then structured negotiations through written or electronic communications would be a next best step.

¹⁰⁴ It should be noted that in the case of some matters, notably intellectual and industrial property rights, in most countries it will in any event not be possible to have recourse to arbitration, as this possibility will be excluded by law.

It might on the other hand be that the circumstances that exist at the time of the dispute have as a consequence that personal negotiations would be facilitated by the involvement of a neutral intermediary. The role of such a mediator or conciliator is not to resolve the dispute: it is for the parties to do that. The mediator facilitates discussions between the parties, identifies the issues and the interests of the parties in relation thereto, helps the parties in developing options for settlement and keeps the negotiations moving on a constructive basis.

The Conciliation Rules published by the *United Nations Commission on International Trade Law (UNCITRAL)* and the *International Chamber of Commerce (ICC)* are useful guides to parties and their mediators or conciliators in the conducting of such consensual methods of dispute resolution.

II. LITIGATION AND ARBITRATION

If consensual approaches fail, or if binding orders are considered to be necessary by one or both parties, arbitration or litigation will need to be considered.

From the standpoint of the potential plaintiff international litigation requires a decision on where the action should be instituted. Once the action has been commenced the defendant will have to determine its response. It may participate in the litigation and contest the action, it may stay away from the proceedings or it may seek to terminate those proceedings. A defendant can seek to terminate proceedings either in the court in which the action has been instituted (by an application to stay the proceedings on grounds of lack of jurisdiction or *forum non conveniens*) or by an application to a court in another state to enjoin the plaintiff from proceeding in the original court.

In selecting the forum of litigation the plaintiff may have a choice of courts available to it. The alternatives include the court in the plaintiff's place of residence, the court in the defendant's place of residence or the court of a third country with which the subject matter of the action is connected or where the defendant has assets.

The main criteria in selecting the forum for litigation relate to the effectiveness of the court proceedings. This primarily depends on the jurisdiction of the court and on the enforceability of any resulting judgment. Courts do not claim universal jurisdiction and the plaintiff must determine whether the contemplated court or judicial system possesses jurisdiction or competence under its own rules. Having determined that jurisdiction exists, the plaintiff must consider the question of enforcement. If the defendant possesses assets in the jurisdiction of the selected court, then enforcement will be relatively easy, although the plaintiff may wish to avail itself of provisional measures to ensure that the defendant does not transfer those assets. If, however, the defendant does not possess assets in the jurisdiction of the selected court, then the judgment will only be effective if the defendant voluntarily agrees to satisfy it, or if it is enforceable in the courts of another country where the defendant has assets. This will depend on the rules for the enforcement of foreign judgments of the place of enforcement.

Apart from considerations of jurisdiction and enforcement the plaintiff should also evaluate the comparative costs of litigating in the various forums. This will depend on several matters, including the legal expenses that will be incurred in litigating in the various forums and whether the courts of those jurisdictions award legal costs to the winning party or whether each party bears its own costs.

Another consideration is convenience. This involves geographic considerations such as the residences of the parties and of the witnesses likely to be called to give evidence. It also involves legal considerations such as the law that governs the contract. Language is a relevant matter, having regard to the language of each of the parties and the language of the agreement. Another matter to consider is the time within which an action will be heard and finally determined, both in the trial court and, perhaps, in appellate courts. The longer the litigation process, the more expensive it becomes and the greater the delay in resolving the dispute. Yet another consideration

is the performance of the court selected, especially in handling commercial matters, and whether it has a reputation for shrewd judgment.

Rather than wait until a dispute arises that requires litigation, the parties should consider whether the master franchise agreement should contain a forum agreement that provides for the submission of disputes to the court, or courts, of a particular country. A number of questions arise in relation to such an agreement. The first is whether the forum agreement is exclusive or non-exclusive. A non-exclusive forum agreement constitutes a submission to the jurisdiction of the designated courts, but does not purport to exclude suits elsewhere. An exclusive forum agreement, on the other hand, is double-sided: it confers jurisdiction on the designated courts and purports to prevent suits elsewhere. Sometimes the non-exclusive forum agreement will specifically refer to the possibility of filing suits elsewhere. Such an agreement may be included in the initial agreement or in a particular agreement concluded with reference to the particular litigation.

Legal advisers to the parties will be looking to ensure that the choice of forum made will be recognised in the jurisdiction selected.

III. RECOGNITION OF CHOICE OF FORUM CLAUSES

While it is preferable for the parties to agree on a forum when the original master franchise agreement is negotiated, there are a number of jurisdictions in which the choice of a forum is proscribed by law. In some parts of the Middle East, moreover, legal doctrines prevail that hold that foreigners should not have more extensive legal rights than nationals and that the remedies available to foreigners should therefore be those obtainable from the local courts.

Legal advisers need to assess how their particular clause will be interpreted when they consider whether a choice will be recognised in jurisdictions where there is no absolute proscription of a choice of forum. In terms of the recognition of a choice, a distinction appears to have been drawn in a number of jurisdictions between clauses that confer jurisdiction on the court of the country concerned (prorogation) and those that remove jurisdiction from that court (derogation). Courts are on the whole more likely not to recognise a derogation clause than a prorogation clause, especially if the derogation clause would operate to prevent a party normally domiciled in the jurisdiction from maintaining an action available under local law.

The parties and their legal representatives need to test the effectiveness of their proposed choice of forum by deciding whether, in the case of derogation, the court selected will stay an action where it would otherwise have jurisdiction, or whether in the case of prorogation it will accept jurisdiction despite proceedings being underway in another jurisdiction.

Over the years a line of authority has developed in a number of jurisdictions according to which a choice of forum clause may not be upheld where:

- ◆ substantial inconvenience is caused by litigating in the chosen forum, including added expense and language difficulties; or
- ◆ an effective remedy, otherwise available in the court whose jurisdiction is being ousted, is being denied by the choice; or
- ◆ there is evidence that the choice of forum clause resulted from fraud, undue influence or overreaching; or
- ◆ the enforcement of the choice would amount to a violation of the public policy of the forum in which the suit is brought.

In the United States, Japan, the European Union and other countries of the OECD however, in the last two to three decades a general trend has developed for courts to uphold the freedom of the parties to restrict litigation to a particular forum as long as the parties make it clear that their forum of choice is their exclusive choice.

One significant attempt at producing a uniform law solution of sensible compromised sovereignty in the matter of choice of forum is the *European Communities Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters*¹⁰⁵ and its extension to the *European Free Trade Association (EFTA) membership in the Lugano Convention*.¹⁰⁶ Articles 17 of these Conventions (Brussels/Lugano) provide that where one of the parties to the contract is domiciled in a contracting State, the court designated in a choice of forum clause has exclusive jurisdiction to settle any disputes in connection with that particular legal relationship.

The Conventions apply to choices of forum in European Union or EFTA contracting States in agreements:

- ◆ between one party domiciled in a European Union or EFTA contracting State and the other party domiciled in another European Union or EFTA contracting State; or
- ◆ where only one party is domiciled in a European Union or EFTA contracting State and the other is domiciled outside the European Union and EFTA areas.

The Convention does not apply to agreements that confer jurisdiction on courts outside the European Union and EFTA contracting States.

It is relevant also to note that when it does apply, pursuant to Article 16 exclusive jurisdiction, regardless of domicile, is provided for as follows:

- ◆ rights *in rem* in real property or concerning the leasing of real property: jurisdiction of the courts in the State where real property is located;
- ◆ validity, nullity, or dissolution of a company or legal person of a particular State: jurisdiction of the courts of that State;
- ◆ validity of entries in public registers: jurisdiction of the courts of the State in which the registers are kept;
- ◆ validity of patents, trademarks, designs and models and similar intellectual and industrial property rights requiring filing or registration: jurisdiction of the courts of the State in which filing or registration was applied for or effected; and
- ◆ enforcement of judgments: jurisdiction of the courts of the State of the place of enforcement.

Each of these areas of exclusive jurisdiction is relevant to the extent that either Convention applies to the relationships among and between franchisor, sub-franchisor and sub-franchisees. In practice they substantially qualify the area of freedom of choice of the forum.

To the extent that litigation might need to be depended on as the applicable dispute resolution method and a forum either exclusively or non-exclusively chosen, it is also important for the parties to determine whether the *1965 Hague Convention on the Service abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters* applies with respect to service overseas.

IV. ENFORCEMENT OF COURT JUDGMENTS

The crucial test of a successful choice of forum clause is whether the judgment and orders of the court selected will be enforced in other relevant jurisdictions. The courts of one jurisdiction will not necessarily enforce a judgment or order of a court of another State if that judgment or order is contrary to a strong public policy consideration of their own.

In practice, before a choice of forum is agreed, each party should have received assurance by its legal adviser that not only will the relevant court accept jurisdiction, its orders will be

¹⁰⁵ Brussels, 1968. The Convention was subsequently modified to permit the accession to the Convention by the States that joined the European Communities after 1968 (Adhesion Conventions of Luxembourg, 1982 and Donostia-San Sebastián, 1989).

¹⁰⁶ Lugano, 1988.

enforceable in the country in which the other party is normally domiciled and/or in which its relevant property is located. Ideally, there should exist bilateral treaty obligations between the jurisdictions concerned, or provisions in the form of recognition of foreign judgments legislation in each jurisdiction in which enforcement is sought, which would enable a relatively simple registration system of enforcement to apply to foreign judgments.

Again, the Brussels/Lugano Conventions conveniently in Title III set out recognition and enforcement procedures that are to apply to the enforcement of decisions rendered in a contracting State in all other contracting States.

With respect to decisions rendered by courts of other States, separate enforcement proceedings will have to be initiated by bringing an action on the foreign judgment in the jurisdiction where enforcement is sought, unless separate multilateral or bilateral treaties apply a convenient registration or execution process. The only alternative is likely to be suing on the original cause of action pursued before the foreign court.

A third possibility exists in jurisdictions the domestic foreign judgments legislation of which on a reciprocal basis permits the executive of that State to extend enforcement to the money judgments of a foreign court by means of the procedural law of the jurisdiction concerned even without a bilateral treaty.

Given the significant position that franchisors from the United States play in international franchising, it should be noted that the United States has no treaties with other countries to ensure enforcement abroad of judgments rendered by federal or state courts. With the exception of the twenty-four states that have adopted the *Uniform Foreign Money-Judgments Recognition Act (UFMJRA)*, and therefore have available a summary judgment process, judgments are enforced by instituting a new action either on the foreign judgment or on the original cause of action. Sub-division 5(a)(3) of UFMJRA provides that a foreign judgment shall not be refused recognition for lack of personal jurisdiction if the defendant prior to the commencement of the proceedings had agreed to submit to the jurisdiction of the foreign court with respect to the subject-matter involved. The inclusion of a choice of forum clause is likely to remove any argument about whether a party is subject to the *in personam* jurisdiction of the court selected.

The parties and their legal advisers need to conduct careful research to identify whether there are multi-lateral and bilateral foreign judgment enforcement treaties and/or whether the relevant States might have foreign judgments legislation providing for enforcement on a reciprocal basis.

V. CHOICE OF ARBITRATION

In addition to agreeing on a forum for judicial dispute resolution, the parties are likely to opt to include an arbitration clause as an alternative, as:

- ◆ it allows them to agree on the form of arbitration and on who the arbitrators will be or on how they are to be selected;
- ◆ they can either determine the law to be applied or decide that the arbitrators will have the power of *amiable compositeurs* with no law being specified;
- ◆ they are also able to choose the arbitration rules;
- ◆ they can maintain the confidentiality of the proceedings;
- ◆ with respect to a majority of jurisdictions they have available a summary proceeding process for the enforcement of an award in the form of the 1958 *United Nations Conventions on the Recognition and Enforcement of Arbitral Awards*,¹⁰⁷ and

¹⁰⁷ As at 21 May, 1997, 112 States were Contracting Parties to the New York Convention.

- ◆ the interests of innocent third persons are able to be taken into account in an arbitration, which, depending on the nature of the action, may not always be the case in a court.

Recourse to courts would on the other hand be preferable to arbitration in cases involving allegations of fraud and disputes which require a compulsory discovery process.

In the majority of OECD jurisdictions, there is a policy and local arbitration law that favours the recognition of arbitration clauses in international contracts and provides a straightforward method of meeting New York Convention obligations.

The agreement to arbitrate of the parties to international franchise agreements will almost always preclude either party from seeking redress in a court of law and thereby by-pass arbitration if the other party objects. Courts will generally allow arbitrators a broad scope to decide matters that arguably come within the ambit of their own mandate.

In drafting their clause the parties should also consider whether, the jurisdiction whose law is chosen permitting, any arbitration is intended to deal with causes of action beyond, for example, contract interpretation and non-performance and to include statutory remedies of the substantive law of the jurisdiction of choice, such as under anti-trust, securities, consumer protection and anti-fraud laws. The law in the United States at the federal level appears to support committing such claims to arbitration in cases of international transactions.

Courts asked to enforce arbitral awards under the New York Convention, or asked to re-institute proceedings if an arbitral panel has failed to consider a statutory cause of action, may in such circumstances look to the competence of the arbitrator and attempt to go behind the award. In practical terms, however, this may be difficult as the strong policy of the courts in favour of arbitration is likely to ensure that in such circumstances finality is given to the arbitral award.

There are in addition difficult issues for the parties concerning the extent to which the assistance of the courts may be resorted to when arbitration has been accepted as the dispute resolution mechanism. It may for example be difficult for a party to obtain pre-judgment attachment of assets to secure a claim that is to be presented to arbitrators.

It is moreover unlikely that arbitration proceedings will be significantly cheaper to run than legal proceedings and unfortunately the delays in reaching a result can be almost as great as with litigation.

All of this suggests that in practice negotiation and mediation are likely to be far preferable in resolving disputes that do not threaten to end the master franchise relationship.

When the parties do choose arbitration, they should in their arbitration clause select:

- ◆ an administrative body to have authority over any arbitration conducted, such as the *American Arbitration Association*, the *International Court of Arbitration* of the International Chamber of Commerce, the *London Court of International Arbitration* or the *Australian Centre for International Commercial Arbitration*; and
- ◆ depending on which administrative body is selected, the arbitration rules to be followed. Each of the above-mentioned bodies has its own rules. There are however also the Arbitration Rules of the *United Nations Commission on International Trade Law* which may be selected regardless of which administrative body is chosen.

VI. ENFORCEMENT OF INTERNATIONAL COMMERCIAL ARBITRATION AWARDS

The 1958 New York Convention is rightly regarded as one of the most successful of conventions in terms of the number of ratifications or accessions to it, as a very high proportion of the members of the United Nations are parties to the Convention, including States from all regions of the world encompassing differing legal, social and economic systems.

In itself this does not guarantee its effectiveness: ratification does not mean that enforcement is little more than a formality in the country of ratification. The parties to the franchise agreement will therefore need to verify whether:

- ◆ the State(s) concerned have made any reservations to the obligations of the Convention and, if they have, what these reservations are;
- ◆ the necessary domestic legislation has been passed to give affect to the Convention if the constitutional law of the jurisdiction so requires;
- ◆ the relevant domestic legal provisions for enforcement are workable and particularly whether they favour and support arbitration and treat the parties even-handedly; and
- ◆ whether they fully understand what effects the following seven grounds on which a court may refuse to enforce an award will have on them:
 - ◇ the incapacity of the parties to the agreement;
 - ◇ the denial of a fair hearing;
 - ◇ excess of authority or lack of jurisdiction;
 - ◇ procedural irregularities;
 - ◇ the award was not yet final;
 - ◇ subject-matter was not arbitrable according to the law of the country in which the award was made; and
 - ◇ the award was contrary to local public policy.

CHAPTER 18

GENERALLY USED CLAUSES

In addition to the clauses that relate specifically to the franchise, there are a number of other clauses which are to be found in master franchise agreements and which might be of considerable importance. These include

- ◆ clauses relating to severability
- ◆ entire agreement clauses
- ◆ waivers
- ◆ force majeure and hardship clauses
- ◆ clauses relating to the nature of the agreement
- ◆ cumulative rights clauses
- ◆ clauses relating to currency conversion
- ◆ notice provisions and
- ◆ clauses relating to damages.

A. CLAUSES RELATING TO SEVERABILITY

Not surprisingly, it is very important for both franchisor and sub-franchisor to ensure that their agreement continues in force for a considerable length of time, not the least because the investments made by the parties are often considerable. Master franchise agreements will therefore contain clauses providing that if a particular clause, or even part of a clause, becomes unenforceable, invalid or illegal, then the invalidity, illegality or unenforceability of this particular clause or part thereof shall not affect the validity or enforceability of the remainder of the agreement. The invalid or illegal clause or part thereof is in other words considered to be severable from the remaining contract. At times, this severability is conditional upon the remaining contract not appearing to be distorted or unfair to one of the parties. In case of severability

- ◆ the clause is considered as if it had never been stipulated, or
- ◆ the clause is replaced by another which is valid, legal and enforceable but achieves the objectives of the parties, or
- ◆ the clause is modified and interpreted in such a manner that its purpose may be achieved in all legality.

Similar constructions are resorted to in the case of a gap in the agreement.

Clauses that are only partially invalid may at times be indicated as being enforceable to the extent that they are valid.

There are agreements which give a certain discretion to the franchisor, in that they provide that the franchisor may terminate the agreement if it considers that the exclusion of the provision adversely affects its right to receive payment of fees or other remuneration, if the exclusion adversely affects the trademarks, trade name, trade secrets, know-how or methods of the system, or if the franchisor determines that the finding of illegality adversely affects the foundations on which the agreement is based.

The contracts will often list the bodies which may declare the clauses invalid, for example domestic courts, the European Court of Justice or the European Commission, and the types of instrument by which this is done: decisions of the courts, an Act of Parliament, domestic legislation, European Community legislation, statutory or other by-laws or regulations, and any other requirements having the force of law.

Contracts that are used in a number of different jurisdictions may contain clauses to the effect that if a clause is invalid in one jurisdiction it shall have no force or effect in that jurisdiction, but that the validity or effect of the clause in other jurisdictions is not affected.

B. ENTIRE AGREEMENT CLAUSES

So as to safeguard themselves against any surprising claims, franchisors will often include a clause which states that the agreement is the entire agreement between the parties, that it embodies all prior negotiations and/or all prior agreements reached. The degree of detail of such clauses will vary from very short statements to the effect that, for example, oral collateral agreements are not valid, to long description of what is intended. Contracts originating in the common law world generally tend to be far more detailed than others. In other instances the entire agreement clause may specify that in addition to the main agreements there are also specific agreements between the parties, for example a lease agreement for the premises, or that other documents are annexed, such as general conditions of trade or, in the case of American franchises, the Franchise Offering Circular.

At times certain exceptions will be provided for. Thus, for example, the sub-franchisor's obligation to comply with specifications of the franchisor as determined from time to time will not be affected by the fact that no collateral or oral agreements are considered to be valid.

Other provisions may be linked to the entire agreement clause. Examples of such provisions include an acknowledgement by the sub-franchisor that it has not entered into the agreement as a result of any representations, warranties, inducements or promises and a requirement that if the sub-franchisor thinks that any representations, warranties, inducements or promises have been made, and that they have been instrumental in making it take the decision to enter into the agreement, then it should submit a written statement to the franchisor to this effect, so as to permit the inclusion in the agreement of the contents of the written statement.

C. WAIVERS

Franchise agreements will often contain clauses waiving liability for the franchisor and/or disclaiming the waiving of any rights of the franchisor. Again, the amount of detail will vary depending on the origin of the contract, those from the common law countries entering into far greater detail.

The waiver of liability will often be in the form of a recognition by the sub-franchisor that the success or otherwise of the business depends on its own efforts and that even if the franchisor and its staff have provided advice and assistance, operations manuals and training courses, the franchisor, its directors and employees will not be liable for any loss or damage suffered by the sub-franchisor. At times this waiver of liability will extend even to loss or damage suffered as a result of the system or of the advice and assistance given. The exception might be if the loss or damage was directly caused by the franchisor's breach of an express provision of the agreement, or by fraud on the part of the franchisor, but even then there might be a limitation in the amount of compensation that the agreement admits.

Disclaimers of the waiving of the rights of the franchisor will take the form of provisions stating that the fact that the franchisor does not exercise its rights or the powers it has been given does not mean that it waives these rights or that it will never be able to exercise them in the future. This will be stated as applying in general as well as for any specific non-performance. In most cases these clauses will not refer to time-limits for the exercise of the rights by the franchisor, although an implicit indication might be seen in the reference to the possibility for the franchisor to exercise its powers in the future. On occasion there may however be such a reference, even if it is a reference which excludes any time-limit at all for the exercise of the rights.

The agreement may also specify that if the franchisor does not exercise its rights on one occasion, this does not mean that it will not do so on any other occasion.

In the case of the franchise being sold to a new sub-franchisor, it is possible that the successor sub-franchisor may be required to waive any rights or remedies it might inherit as a result of a non-performance by the franchisor under the agreement with the previous sub-franchisor. In most cases these clauses will only refer to the franchisor, although there are those that do refer to non-performances on the part of both the franchisor and the sub-franchisor, and disclaim any waiver on the part of either party.

D. FORCE MAJEURE AND HARDSHIP

Contracts will often contain clauses that provide either for the re-negotiation of the agreement in cases of changed circumstances (so-called "hardship clauses") or for a suspension in performance in cases of "*force majeure*". The existence of a veritable *force majeure* situation might in fact be considered a valid reason for a party to be excused from performance indefinitely. The formulation of these clauses in master franchise agreements will follow the formulation of similar clauses in other types of agreement.

It is not always easy to distinguish clearly between events that give rise to a hardship situation and events that are to be considered *force majeure*. An indication might however be the seriousness and the nature of the event. Hardship will often not make performance totally impossible, even if it becomes unduly onerous or difficult (for example an unexpected exorbitant increase in the cost of raw materials) and a re-negotiation of the agreement consequently becomes necessary if the relationship is to be maintained. *Force majeure* on the other hand is likely to result in an objective impossibility to perform, even if it is an impossibility that is limited in time (for example a declaration of war). These clauses will in general concern the non-performance of either party.

A definition of hardship that was prepared at international level and is achieving increasing international recognition is that contained in the *Unidroit Principles of International Commercial Contracts*:

"There is a case of hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and

- (a) the events occur or become known to the disadvantaged party after the conclusion of the contract;
- (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;
- (c) the events are beyond the control of the disadvantaged party; and
- (d) the risk of the events was not assumed by the disadvantaged party":¹⁰⁸

Similarly, the definition of *force majeure* contained in the *Unidroit Principles* states that

"(1) Non-performance by a party is excused if that party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

¹⁰⁸ Article 6.2.2.

(2) When the impediment is only temporary, the excuse shall have effect for such period as is reasonable having regard to the effect of the impediment on the performance of the contract.

(3) The party who fails to perform must give notice to the other party of the impediment and its effect on its ability to perform. If the notice is not received by the other party within a reasonable time after the party who fails to perform knew or ought to have known of the impediment, it is liable for damages resulting from such non-receipt.

(4) Nothing in this article prevents a party from exercising a right to terminate the contract or to withhold performance or request interest on money due".¹⁰⁹

The purpose of the hardship clause is therefore not to terminate the contract, but to make a re-negotiation of its terms possible. *Force majeure* clauses on the other hand may be considered to be the basis on which a non-performance may be excused, often permanently, but also temporarily. As the borderline between the two concepts is not always clear, the same event might be considered a case of hardship or alternatively a case of *force majeure*. It is then for the court to decide whether the event constitutes hardship or *force majeure*.

Force majeure clauses may be either in the form of general formulas or in the form of lists of events that should be considered to constitute *force majeure*. Examples of the events included in *force majeure* provisions are fire, storm, flood, earthquake, act of God, explosions, accidents, acts of a public enemy, war, insurrection, sabotage, epidemic, transportation embargoes, delays in transportation, energy or petrol cuts, labour disputes, strikes, non-performance of sub-contractors, acts of any government whether national, municipal or otherwise and judicial action. General formulas may be to the effect that *force majeure* is caused by any contingency beyond the control of the non-performing party, or to the effect that the non-performance is due to a cause or circumstance beyond the reasonable control of the party, or beyond the reasonable ability of the party to control. Often the two approaches will be combined, with a general statement followed by a list of examples.

If the events constituting *force majeure* are limited in time, then the duty to perform the obligation will be suspended only for the duration of the event and not indefinitely.

There are also *force majeure* clauses which state that they shall have effect only at the discretion of the franchisor, unless the event renders performance impossible for a longer and continuous period of time.

Other conditions may also be attached to the application of the clause, such as the requirement that the event should not have been caused or exacerbated by the non-performing party.

The relevance of these clauses for master franchise agreements should be considered, in particular as concerns hardship as an excuse for non-performance of the development schedule.

E. CLAUSES RELATING TO THE NATURE OF THE AGREEMENT

The nature of the franchise agreement is often a point of contention. This is also due to the fact that in most countries franchise agreements are not specifically regulated. In several jurisdictions courts will apply legislation written for other types of agreement. They will therefore examine the relationship and will determine the legal form to which the contract has most similarity: an agency agreement, for example, or an instalment sales contract, or even a contract of employment.

¹⁰⁹ Article 7.1.7.

In an attempt to avoid that the agreement may be considered to be something which to all intents and purposes it is not, the contract may specifically state that it should not be equated with, for example, an agency agreement or a partnership, a joint venture or a contract of employment, or that it does not create a fiduciary relationship between the parties. It will in most cases state clearly that the parties to the agreement are independent contractors. To stress this point it may also state that the franchisor has no control over the employment contracts of the employees of the sub-franchisor, even if in fact this is not always the case.¹¹⁰

The contract might furthermore state that the sub-franchisor is in no way authorised to make any contract, agreement, warranty or representation on behalf of the franchisor, and that the sub-franchisor may not create any obligation on behalf of the franchisor. Linked with this is often a provision stating that the sub-franchisor must ensure that franchisees indicate clearly that their units are franchises operated by them.

A statement to the effect that the agreement is not one of agency or employment will of course not necessarily lead to the desired result, as in some jurisdictions judges will not necessarily accept such a statement off hand, but will look at the contents of the agreement to determine whether or not it is correct. If it is not, the parties may find that the legislation that is applied will be that which the judge considers to come closest to the real nature of the agreement.

F. CUMULATIVE RIGHTS

In master franchise agreements a clause may be found to the effect that the rights and duties of the franchisor are cumulative and that the enforcement of any one of these rights or duties shall not preclude the enforcement of any other right or duty. A similar provision regarding the rights and duties of the sub-franchisor may also be found.

G. PROVISIONS ON CURRENCY

In master franchise agreements, as in all international agreements, provision should be made not only for the payments that have to be made, but also for the currency in which they have to be made and for who should bear the cost of any currency conversion. This is clearly a necessity in jurisdictions in which exchange controls regulations apply. It might however be appropriate even if there are no restrictions or exchange controls on payments made abroad, as the bank charges or commissions or other fees might be extremely high.

The provisions on currency conversion might also specify the manner in which the currency of the foreign country is to be converted into the currency in which the fee is to be paid. Such a conversion will usually be based on the prevailing "buying" foreign exchange rate at a specifically named bank or financial institution on the day that payment is due. Provision may alternatively be made for the franchisor to open an account in the currency in which payment is to be made and have the sub-franchisor deposit payments into that account.

Lastly, provision might also be made for the payment of interest to be paid by the sub-franchisor in the case of delayed payments and for the calculation of such interest.

H. NOTICE PROVISIONS

The provisions of importance in a master franchise agreement include also the notice provisions. These should specify what constitutes valid notice and what constitutes valid

¹¹⁰ See the section on *Labour Relations* under *Other Provisions in Unit Franchise Agreements*.

acceptance (for example, a requirement that any such communication be in writing) the manner in which the notice should be delivered and the dead-lines applicable to it.

I. DAMAGES

The types of damages that are permitted vary from legal system to legal system. In some legal systems, for example, penalty clauses are not permitted (for example in the common law countries which instead admit what are known as liquidated damages), whereas in other countries they are (for example in Germany). Often the amount of compensation will depend on the type of damages admitted. As the concepts vary from one country to another,¹¹¹ master franchise agreements may choose to specify exactly for what compensation is recoverable (for example, only for the actual harm sustained).

J. THE PREAMBLE TO THE AGREEMENT

The Preamble to the agreement might also be of importance, although how important it is will to a large extent depend upon the drafting technique adopted. The Preamble is therefore likely to be of greater importance in common law countries than in civil law countries.

In the common law tradition the Preamble is designed to aid the identification of parties and terms. In some cases it is used to identify the basic purpose of the contract or the background surrounding the performance of the contract.

The importance of the Preamble in international master franchise agreements may be found in the need to clarify concepts, rights and duties, as a result of the possible disparities in experience and understanding of the two parties to the agreement. Thus, for example, a definition of the franchise system and its constituent elements and of the sub-franchisor's main obligation might be included in the Preamble.

Furthermore, the Preamble may serve as a guide to the interpretation of the contract in case of litigation if it is to be enforced in a country in which franchising is not a well-known form of business, or if the courts and/or arbitrators are not familiar with franchising.

In some jurisdictions the law might require a court to refer to the purpose of the agreement it is interpreting and the Preamble might serve to state precisely this. In a number of civil law countries the Preamble might further refer to the relevant sections of the legislation, civil or commercial code or law, that is applicable.

K. IMPLIED OBLIGATIONS

A certain number of obligations might not be expressly stated, but might be implied, either from the contract or from the law. The extent to which obligations may be implied will vary from legal system to legal system. In general, the civil law systems are more inclined to accept the idea of implied obligations than the common law systems. This is also a consequence of the drafting style adopted. In civil law countries the relevant non-mandatory provisions of the codes will be considered part of the contract unless the parties provide otherwise (clearly the mandatory provisions will always be applicable). It is also possible that obligations might be implied from the contract itself, through an interpretation of its terms. This is the case in particular where the contract is silent on specific points and the court must interpret it to arrive at the will of the parties.

¹¹¹ The different concepts include: damages for future benefits lost, for lost chances, for lost profits, for losses suffered, "*negatives Vertragsinteresse*", "*positives Vertragsinteresse*", etc.

There are also a number of general principles that are considered to apply even if they are not expressly referred to in the contract. An example illustrating this is the principle of good faith. In civil law countries the principle of good faith permeates the whole legal system, parties are expected to deal with each other in good faith not only once the contract has been concluded, but also in the pre-contractual stage. Traditionally this is not the case in common law countries, although there is a slow movement towards a recognition of the need to apply the principle of good faith also in the pre-contractual stage, especially in Australia. In the United States the good faith requirement is also becoming more accepted generally, as can be seen in the franchise laws that have been adopted recently and in the proposals for legislation presented to Congress.¹¹² However, the duty of good faith has often been held by courts not to override express contractual terms.

¹¹² See, for example, Section 5(a) of the proposed Federal Fair Franchise Practices Act, H.R. 1717, introduced 25 May 1995 to the United States Congress.

CHAPTER 19

ANCILLARY DOCUMENTS

A. DOCUMENTING OTHER RELATIONSHIPS

A franchisor frequently has relationships with a sub-franchisor, or franchisee, which strictly speaking are not inherent in the franchise relationship itself. In addition to their relationship as franchisor and sub-franchisor or franchisee, the parties may also be, for example:

- ◆ seller and buyer;
- ◆ lender and borrower;
- ◆ landlord and tenant; and
- ◆ principal and agent.

Almost any traditional commercial relationship may in fact exist simultaneously with the franchise relationship. These other relationships, like the franchise itself, will inevitably entail rights and obligations, benefits and burdens. The parties will therefore find it necessary, or desirable, to document their respective obligations.

Where these other obligations are of the type listed above, this will not present major difficulties: loan or lease agreements are after all familiar documents. While the practice may differ depending on the nature of the business, the documents will typically be separate from the franchise agreement although they may be connected by cross-default provisions or by other techniques.

There are however many other obligations which one party may wish to impose upon the other, which to a great extent form an integral part of the franchise relationship, but which, for one reason or another, may be included in a separate document rather than in the standard agreement between the franchisor and the sub-franchisor or franchisee. These separate documents are often referred to as "ancillary documents".

B. DESCRIPTION OF ANCILLARY DOCUMENTS

The term "ancillary documents" refers to the preliminary agreements, side agreements and addenda that, in addition to the master franchise agreement itself, are used in forming and administering a master franchise relationship. Ancillary documents tend to be separate agreements for a number of reasons. Some ancillary documents logically precede the master franchise agreement, such as joint venture agreements. Others logically follow the master franchise agreement, such as transfer agreements. Many involve parties other than the sub-franchisor. Confidentiality agreements are, for example, usually agreements between the owners of a sub-franchisor (when the sub-franchisor is a corporation) and its employees. A number of ancillary documents are used only in certain instances, for example financing agreements or letters of credit, depending on the country or the characteristics of the sub-franchisor or the size of the transaction. The terms of some ancillary documents are not likely to be known when the master franchise agreement is entered into, as is the case with negotiated termination agreements. Ancillary agreements may also be documents that are separate from the master franchise agreement and that are simply intended to highlight their terms and importance.

In situations where a franchisor uses a certain ancillary document routinely in almost every master franchise transaction, its terms could be made a part of the master franchise agreement itself. This is the case, for example, with supply agreements in certain franchise systems. By and large, however, ancillary agreements tend to remain separate documents.

Many of the same, or similar, ancillary documents as those used between a franchisor and sub-franchisor might be used also between the sub-franchisor and a sub-franchisee. In fact, the franchisor may expressly require the sub-franchisor to use certain ancillary documents with its sub-franchisees, especially confidentiality and non-competition agreements. Ancillary documents used by the sub-franchisor are likely to be similar in substance to those used by the franchisor, but there may be differences as the sub-franchisor and the sub-franchisees are likely to be located in the same country whereas the franchisor and sub-franchisor in general tend to be situated in different countries. This may affect such matters as the law governing the ancillary agreement and the forum for resolving disputes that arise in connection with it. The franchisor may moreover wish to insert a clause giving it the right to enforce the ancillary agreement directly against the sub-franchisee or its owners, officers, or employees.

In this connection mention should also be made of the franchise manuals. Although manuals are not, and should not be considered to be, agreements themselves, an obligation to adhere to the manuals is usually found in franchise agreements. In the light of this obligation, the effect of the laws of a number of jurisdictions will be that the franchisee must be permitted to review the manuals prior to executing the franchise agreement. This is to avoid first, that the party receiving the manuals, the franchisee in this case, commits itself to obligations without being fully informed of their content and, second, that the party who owns the manuals, the franchisor in this case, is exposed to claims that the franchise agreements are contracts of adhesion.

C. THE PURPOSES OF ANCILLARY DOCUMENTS

Franchisors use ancillary documents for a variety of reasons. Firstly, by separating out into ancillary documents negotiated terms, one-time-only transactions, or issues not central to a master franchise arrangement, franchisors are able to maintain a uniform master franchise agreement that contains all of the terms that are to remain consistent from one sub-franchisor to another. This consistency is important to franchisors, sub-franchisors, and sub-franchisees alike, as the value of the franchise will in all likelihood be based on brand recognition and consistency of quality of the product or service offered.

Secondly, ancillary documents are used to bind particular persons to promises to which they would not be bound by the master franchise agreement. Covenants of confidentiality and non-competition, and sometimes covenants against transfers of ownership interests in the sub-franchisor entity, are for example typically included in separate documents to be signed by individuals who did not sign the master franchise agreement, such as shareholders and employees of the sub-franchisor. Enforcing such promises against these individuals may be difficult or impossible if they do not sign separate agreements.

Thirdly, franchisors use ancillary documents to make adjustments if the relationship changes after it is formed, for example if the sub-franchisor sells its business or brings in new investors. Changes of this nature will typically not require the execution of a new master franchise agreement, indeed, re-negotiating the agreement is often undesirable. Changes in the franchise relationship may therefore be documented by means of ancillary documents without disturbing the underlying obligations of the parties.

Fourthly, franchisors use ancillary documents to comply with the laws of a particular jurisdiction. Some countries for example require the filing of a registered user agreement for trademark licenses, or a separate trademark license agreement.

D. EXAMPLES OF ANCILLARY DOCUMENTS

The examples of ancillary documents given below are grouped as follows: the first group includes ancillary documents that often accompany master franchise agreements; the second group includes agreements the use of which depends on the nature of the franchised business; the third group includes ancillary documents the use of which depends on the structure of the transaction; and the fourth group includes documents that may be required by local law.

I. ANCILLARY DOCUMENTS COMMONLY USED WITH MASTER FRANCHISE AGREEMENTS

(a) Confidentiality Agreement

Confidentiality agreements are used almost universally in international franchising. Their purpose is to bind persons who have not signed the master or sub-franchise agreements (for example shareholders, officers and employees of the sub-franchisor and of the sub-franchisees) to the covenants of confidentiality found in the master franchise agreement or in the unit franchise agreement. These covenants are critical for the protection of the franchisor's know-how and trade secrets. It is therefore in the interest of both the franchisor and the sub-franchisor to ensure that all individuals with access to confidential information are bound by an agreement not to disclose that information.

Confidentiality agreements are also used before the master franchise relationship is entered into. In this case the intention is to protect each of the parties, particularly the franchisor, from disclosure by the other party of confidential information exchanged during the negotiation of the master franchise agreement. If the negotiations do not lead to the conclusion of a master franchise agreement, the parties will still be legally bound not to disclose confidential information about the other or the other's business.

Confidentiality agreements usually contain terms that correspond to the covenants of confidentiality found in the master franchise agreement or in the unit franchise agreement. They will therefore contain promises that the individual signing the confidentiality agreement will not disclose, disseminate, or misuse confidential information gained through the sub-franchisor's or the sub-franchisee's operations in the franchise system. A confidentiality agreement may also specify certain remedies against an individual who violates the agreement, such as an injunction or damages. Liquidated damages are often the only viable remedy in the case of a violation, either because injunctions or similar forms of relief are not available in the country where the violation occurs, or because the confidential information, once disclosed, in all probability cannot be retrieved.

(b) Non-Competition Agreement

As is the case with confidentiality agreements, non-competition agreements are separate documents used to bind non-signatories of the master or sub-franchise agreements (for example shareholders, officers and employees) to the non-competition covenants found in the master franchise agreement or in the unit franchise agreement. Non-competition covenants are important to franchisors as a way of preserving the uniqueness of their systems and the goodwill associated with the system in the territory of a present or former franchisee. By preventing former franchisees from using their knowledge of the operating methods and marketing plans of the system to diminish the franchise system's competitive edge in the marketplace, the franchisor also preserves its ability to re-franchise the territory.

In the case of the member States of the European Union, non-competition agreements will be subject to the competition laws both of the European Union and of the individual countries. Problems could therefore be encountered under these laws in relation to the enforcement of these agreements. The non-competition agreements most easily challenged are those with employees of the sub-franchisors or of the sub-franchisees who might find it difficult to earn a living if bound by non-competition restrictions after their employment has come to an end.

Non-competition agreements will usually contain terms that correspond to the non-competition covenants found in the master franchise agreement. These include, for example, promises that the individual signing the non-competition agreement will not own an interest in, or

otherwise be involved in, businesses similar to the sub-franchisor's business, both during and for a limited period of time after its association with the sub-franchisor. The time period for which the non-competition agreement lasts after the association ends, for example the time period after the employee resigns or the owner transfers its interest in the sub-franchisor, may vary, but one to two years is common.

Non-competition agreements may also specify the remedies for violation. The remedy may either be an injunction or, in countries where injunctions or specific performance are not available remedies, liquidated damages. If the non-competition agreement is between the sub-franchisor and its sub-franchisee, shareholder or employee, the franchisor may insist on a provision giving it the right to enforce the agreement directly if the sub-franchisor fails to do so.

(c) Guarantee and Indemnity

Guarantee and indemnity agreements are designed to protect the franchisor from losses caused by a sub-franchisor's failure to perform under a master franchise agreement. Guarantees are commonly used when the sub-franchisor is a corporation or other entity; typically, the sub-franchisor's shareholders must sign the guarantee. The guarantee gives the franchisor recourse to the shareholders if the sub-franchisor does not fulfil its obligations to the franchisor. The franchisor primarily seeks assurance of payment, but the guarantee may cover performance of the sub-franchisor's non-monetary obligations as well. Alternatively, and perhaps more realistically since shareholders are generally not in a position to perform non-monetary obligations, the non-monetary obligations may be covered by an indemnity. The indemnity obliges the shareholders to compensate the franchisor for losses it may suffer as a result of the sub-franchisor's failure to perform. For example, if the sub-franchisor fails to provide training to a sub-franchisee and the franchisor is forced to provide the training directly, the franchisor might recover its expenses from the shareholders who signed a guarantee and indemnity agreement.

The indemnity may also be written to protect the franchisor from any losses it may incur as a result of the operation of the sub-franchisor's business. If, for example, a customer sues the franchisor for compensation for an injury suffered at a franchised outlet, the indemnity would give the franchisor a right to reimbursement of any amount it was forced to pay the customer, as well as of the costs it incurred defending the claim.

A guarantee is a simple promise to perform the obligations of the sub-franchisor in the event the sub-franchisor fails to do so. These obligations will certainly include the payment of royalties by the sub-franchisor, but may also include other obligations, such as whatever is necessary for the operation of the network. Typically, the guarantee will state that the guarantors have joint and several liability and that they waive any right to require that the franchisor first proceed against the sub-franchisor for payment, or exhaust any remedy against the sub-franchisor. It may also provide for the survival of the obligations of a guarantor if the master franchise agreement terminates or if the guarantor ceases to be a shareholder. Typically, the guarantor will remain liable for the period up to the time of termination or up to the time it ceases to be a shareholder. Less commonly, the guarantee may limit the monetary liability of each guarantor. If there is an indemnity provision, it may specify that the guarantors must furnish counsel to defend the franchisor against claims or losses, as well as reimburse the franchisor for the losses themselves. Finally, the guarantee may contain provisions relating to legal requirements, such as waivers of statutory provisions or notarisation requirements. It is highly desirable for the franchisor to seek the opinion of local counsel in the sub-franchisor's country in relation to the terms of the guarantee and indemnity agreement.

(d) Transfer Agreements

In a master franchise relationship no decision is more important to a franchisor than the selection of the sub-franchisor. Once it has made that difficult decision, the franchisor is generally unwilling to permit the sub-franchisor to transfer the rights it has been granted to someone else as it pleases. The master franchise agreement will therefore typically contain severe limitations on the ability of the sub-franchisor to transfer its rights. A complete prohibition is however unlikely to be acceptable as a business matter. The typical compromise is an ability to transfer, but only with the consent of the franchisor. Transfer agreements set out the terms and conditions under

which the franchisor will give its consent to the transfer of a master franchise agreement by the sub-franchisor to a third party, or to a transfer of the ownership of the sub-franchisor entity. The purpose is to ensure an orderly transfer of the business to a new sub-franchisor who meets the franchisor's standards on terms that do not jeopardise the continuity of the business.

Transfer agreements identify the particular transaction for which the franchisor is giving consent, state the assumption of rights and obligations by the transferee and specify terms such as whether defaults of the transferring sub-franchisor will be waived (usually they are not). Additional obligations of the seller (such as a release of claims against the franchisor or arrangements for the payment of outstanding debts) or of the buyer (such as a refurbishing obligation) are often included. The transfer agreement may require the buyer to sign an updated form of the master franchise agreement, or it may require new or additional guarantors to sign a guarantee. Other terms may be included, depending on the specific circumstances of the transfer.

(e) Termination Agreement

Termination agreements set out the conditions for the termination of a master franchise agreement by mutual consent of the parties. Their purpose is to establish a framework for an amicable parting of the ways when the franchisor and sub-franchisor determine that the relationship should not continue despite the fact that the contract has not expired.

In addition to the basic agreement to terminate the master franchise agreement, termination agreements may include clauses that have been agreed upon by the franchisor and the sub-franchisor and that regulate the resolution of disputes between them. Termination agreements may also reaffirm or adjust the post-termination obligations of the sub-franchisor as originally set out in the master franchise agreement, including the covenants of confidentiality and non-competition. Termination agreements may furthermore contain an acknowledgement that the sub-franchisor's obligation to indemnify the franchisor survives termination, a release of claims by one or both parties, as well as any terms thought desirable to facilitate the enforcement of the agreement, such as choice of law and forum selection provisions.

(f) Release

By means of release agreements the releasing party renounces any claims that it may have against the other party. The purpose of these agreements is essentially to give the franchisor and the sub-franchisor the opportunity to start again at certain key stages of the relationship, to give the released party the assurance that long-forgotten incidents will not suddenly be brought forth as legal claims. Releases are most often used upon the renewal or transfer of a master franchise agreement. They may also be used upon expiration or termination of a master franchise agreement, but this is less common. It is unusual for releases to be executed except in the context of a triggering event of this nature or of the settlement of litigation.

The release may be one-sided, in which case it will typically be the sub-franchisor who releases the franchisor, or it may be mutual. The release may apply only to particular claims, or it may be general, with or without exceptions to preserve specific claims. Releases will often include statements to the effect that the party releasing the other has authority to make such promises; acknowledgements that the release will bar any claim subsequently made by the party releasing the other with reference to events occurring up to and including the date of the release; as well as other terms to facilitate enforcement, such as choice of law and forum selection provisions. It is important to note that in some countries releases of certain claims may violate public policy and may therefore not be valid.

II. *ANCILLARY DOCUMENTS THAT MAY BE REQUIRED FOR THE FRANCHISED BUSINESS*

(a) Supply Agreements

When the purpose of the franchise is to distribute products of a particular trademark the supply agreement may specify the terms on which the products are sold to the sub-franchisor by the franchisor. Although supply agreements are sometimes incorporated into the master franchise agreement itself, a separate agreement allows greater flexibility to alter the terms of sale in the

course of the agreement. As supply agreements potentially impose restraints on trade, they should always be reviewed for consistency with the relevant competition laws of the country in which the agreement will be used.

Supply agreements will typically include terms specifying:

- ◆ the price, quantity and conditions of delivery of the product;
- ◆ liability for damaged goods, for non-delivery or late delivery;
- ◆ allocation of the risk of loss;
- ◆ credit terms (if any);
- ◆ warranties;
- ◆ requirements for the sub-franchisor to comply with customs laws; and
- ◆ any other terms thought desirable to facilitate enforcement, such as choice of law and forum provisions.

The parties may also decide that certain other statutes, conventions, or principles of law, such as for example the *United Nations Convention on Contracts for the International Sale of Goods (CISG)*, should apply, or alternatively that their application should be excluded.

(b) Equipment Purchase or Lease Agreement

If the franchise requires specialised equipment the franchisor may recommend approved suppliers or give equipment specifications to the sub-franchisor. Alternatively, the franchisor may itself sell or lease such equipment to the sub-franchisor. This last arrangement is more likely to be used in markets where comparable equipment is not available. Equipment purchase and lease terms may appear in the master franchise agreement or in a separate agreement, which again allows for greater flexibility.

As is the case with supply agreements, the equipment purchase and lease agreements should be reviewed under the local competition laws. Practices such as making the purchase of products or services that are not necessary for the franchise a condition for the granting of a franchise will in all probability be deemed an abusive practice under the competition laws of several countries. Sub-franchisors and sub-franchisees may also negotiate to avoid what they see as unnecessary or exploitative purchasing requirements of the franchisor. They might for example insist on a commitment by the franchisor to repurchase equipment at its depreciated value when the relationship ends. Demonstrating that alternative sources of supply are available might however temper the franchisor's demands.

With the exception of a possible cross-default provision or other link to the master franchise agreement, equipment purchase and lease agreements are likely to be similar to such agreements found outside the franchising context. Typically, they will cover:

- ◆ the price and/or periodic payments;
- ◆ the term in the case of leases;
- ◆ services offered by the seller/lessor (for example installation, updating, and repair);
- ◆ warranties, if any;
- ◆ restrictions on use, sale, or sublease of the equipment;
- ◆ minimum insurance requirements;
- ◆ liability regarding injuries from use of the equipment;
- ◆ the passing of ownership of the equipment to the purchaser in cases of sales;
- ◆ non-performance and remedies; and
- ◆ any general provisions, for example choice of law and forum selection provisions.

(c) Software License Agreement

Computer software is increasingly becoming a central element in franchise systems. Software license agreements set out the terms under which the sub-franchisor may use and sub-license software developed for the system. If the franchisor owns the software, then the software

license agreement will be between the franchisor and the sub-franchisor. Often, however, software is developed for the franchisor by an independent software development company. In this case the software license agreement may be between the sub-franchisor and the creator, or vendor, of the software.

A typical software license agreement defines the scope of the license to use the software. The licence may for example be for a specific location or for use of the software only on certain hardware. It will specify:

- ◆ the right (if any) to sub-license the software to others (in the case of master franchising the sub-franchisees);
- ◆ the obligations of the franchisor or vendor to support and upgrade the software;
- ◆ warranties and/or disclaimers as to the performance of the software;
- ◆ a limitation of liability if the software does not perform as warranted;
- ◆ the franchisor's or vendor's obligations (if any) if the software is found to infringe intellectual property rights of others; and
- ◆ grounds for termination, which usually includes the termination of the master franchise agreement and procedures for dispute resolution.

Upon termination of the license the software user will generally be obliged to remove the software from its computer system, not to retain any copies of the software and to return all user manuals and similar documentation to the franchisor or vendor.

III. *ANCILLARY DOCUMENTS REQUIRED BY THE STRUCTURE OF CERTAIN TRANSACTIONS*

(a) Letter of Intent

In a letter of intent parties who are contemplating entering into a definitive agreement set out their agreement in principle on major terms. It is similar to a "commitment agreement" and may be used in the context of negotiations for master franchise or joint venture agreements. Letters of intent are used most often in relation to transactions that entail large capital expenditures, such as hotels. The letter of intent is used to express the basic terms of the anticipated agreement. Any further negotiations on those terms are thereby reduced to a minimum. A letter of intent may also provide the prospective sub-franchisor with the proof of the intended arrangement that it needs in order to raise money from investors or to borrow money from banks.

The terms of a letter of intent will naturally depend upon the transaction anticipated in the letter. A letter of intent will typically

- ◆ identify the parties and the nature of the transaction;
- ◆ describe any further investigation to be performed by either party;
- ◆ oblige the parties to use best efforts to negotiate a definitive agreement by a certain deadline;
- ◆ allocate responsibility for the expenses that will be incurred in negotiating and drafting the final agreement;
- ◆ prohibit the disclosure of information shared during the negotiations; and
- ◆ oblige the parties to co-ordinate any public announcement of their transaction.

Most importantly, the letter of intent will specify which obligations are, and which are not, intended to be binding on the parties. If the letter of intent is intended to be binding, it will probably include terms for dispute resolution. If the letter of intent refers to a master franchise agreement, it is also likely to contain terms regarding the territory of the franchise, franchise fees, on-going royalty fees, development obligations, and possibly choice of law and forum to govern the master franchise agreement.

(b) Joint Venture Agreement

The franchisor and a foreign partner may wish to create a jointly-owned entity that will be the sub-franchisor (or franchisee even if this is less common) in a particular country or countries.¹¹³ Partial ownership of the operating entity allows the franchisor more control over the franchising operation, and a greater share in the profits, than it would have through only a master franchise or unit franchise agreement. The legal framework of a country may in some cases not permit direct franchising and a joint venture arrangement may therefore be required for practical reasons. Similarly, a joint venture may be desirable in countries where foreign technical assistance laws are not favourable to licensing and/or franchising relationships. In such cases it might be preferable for the franchisor to licence its technology to a joint venture.

Joint ventures are created also for financial reasons. They are used when the foreign party has operational expertise or other desirable qualities, but does not have adequate capital to conduct the franchised business. The foreign partner might insist on an investment by the franchisor in the stocks of the joint venture simply as a demonstration of the franchisor's commitment to the country of its partner.

Joint venture agreements often take the form of shareholders agreements or, if the joint venture entity is not a corporation, of an analogous agreement between the owners of the entity. The contents of a joint venture agreement will vary considerably depending on the arrangements between the parties. Generally, however, the agreement will define

- ◆ the joint venture's juridical form and authorised activities;
- ◆ the capital contributions and in-kind contributions to be provided by each party;
- ◆ the distribution of ownership interests and income between or among the parties;
- ◆ control and decision-making authority (for example the board of directors, or its equivalent, in the host country);
- ◆ the circumstances under which the joint venture will be dissolved, as well as the terms of dissolution; and
- ◆ the procedures for dispute resolution.

In a market where the franchise concept has not been tested, a test phase for the joint venture might also be provided for.

(c) Agreements on Methods of Payment

A master franchise agreement will typically specify the method by which the sub-franchisor is to pay the royalties and other amounts owed to the franchisor, for example by wire transfer to a bank account in the franchisor's country. In some circumstances, however, the franchisor might wish to require payment by other methods, such as by letter of credit. A letter of credit is essentially a letter from the financial institution of the sub-franchisor to the franchisor, stating that the sub-franchisor has deposited funds that the franchisor may withdraw upon presentation of certain documents. Letters of credit are often used with supply agreements. In this case the franchisor, or the seller of the goods, is entitled to collect the purchase price of the goods from the bank of the buyer upon exhibition of the bank proof of the shipment of the goods. Letters of credit are occasionally used to back royalty obligations. This arrangement significantly reduces the risk of non-payment by the sub-franchisor to the franchisor.

A letter of credit is therefore little more than a promise by the bank of the sub-franchisor to make payment to the franchisor upon presentation of appropriate documents. Other terms may include the revocability of the letter of credit, the expiration of the letter and the procedures by which the franchisor may obtain payment.

¹¹³ See Chapter 1 "Fundamental Concepts and Elements" for a brief description of the use of joint venture agreements in franchising.

(d) Agreements Evidencing Financing Arrangements

Franchisors do not often lend money internationally to finance the initial investment or operation of a sub-franchisor. The franchisor might however assist a sub-franchisor by deferring payment of the initial fees or royalties and/or by providing start-up inventory or equipment on credit and possibly by taking a security interest in the inventory or equipment being financed. In such cases, and in the rare cases where a franchisor advances funds as a lender, the parties are likely to execute specific agreements for this financing on the part of the franchisor. An arrangement of this kind may have several advantages for the sub-franchisor. The franchisor might charge a lower rate of interest than would other financiers and the franchisor can be expected to be more knowledgeable of, and committed to the ultimate success of, the sub-franchisor's business. Borrowing from the franchisor might also enable the sub-franchisor to avoid burdensome application procedures and more elaborate documentation. On the other hand, a disadvantage for the sub-franchisor is that the debt is likely to be linked to the master franchise agreement, which would not necessarily be the case with financing from an independent source. If the sub-franchisor does not meet its obligations in relation to its debt, it might therefore find that the entire master franchise agreement is jeopardised.

The financing agreement may be as simple as a promissory note if the franchisor is merely deferring the payment of fees. The franchisor may however require the sub-franchisor to provide security for the payment of the debt, or request shareholders or others to guarantee the payment. In this case the financing agreements may include a security agreement, which maintains the franchisor's claim to the property pledged in the event that the sub-franchisor fails to make timely payments, and separate written guarantees. The terms of the financing agreements are not likely to differ from similar agreements found outside the franchising context.

IV. ANCILLARY DOCUMENTS THAT MAY BE REQUIRED BY LOCAL LAW

(a) Trademark License Agreement

In the context of franchising, trademark license agreements are agreements that grant the right to use a trademark associated with a particular franchise. Although the trademark licence is not always contained in a separate agreement, in a number of countries regulatory constraints, such as registration requirements, or tax considerations may at times render this advisable. When trademark license agreements are used, the master franchise agreement will be divided into a trademark license agreement and a technical assistance agreement. By dividing the master franchise agreement into these two parts the franchisor is able to register the trademark licence agreement with the appropriate authority, while the terms of the technical assistance agreement remain confidential between the franchisor and the sub-franchisor.

The division of the master franchise agreement into a trademark licence agreement and a technical assistance agreement may also permit a division of the royalties for tax purposes. A number of countries impose different withholding rates for trademark royalties and technical assistance royalties. The franchisor may therefore benefit by shifting a portion of the ordinary royalty to the lower withholding rate.

Trademark license agreements contain the terms that would normally be included in the master franchise agreement in relation to the use of the franchisor's trademarks. The trademark licence will last for the same length of time as the technical assistance agreement. The renewal of the trademark license agreement is often subject to the renewal of the technical assistance agreement. Royalties for the use of the marks are also included, as are limitations of the manner in which the marks may be used and an acknowledgement of the franchisor's ownership of the marks by the sub-franchisor. The agreement will also cover the consequences of misuse of the marks, which will usually be the termination of the trademark license agreement and consequently also of the technical assistance agreement. Other common provisions are:

- ◆ prohibitions or conditions for the transfer or sub-licensing of the right to use the trademarks;

- ◆ grounds for termination;
- ◆ obligations upon termination;
- ◆ indemnification;
- ◆ government filings and approvals;
- ◆ dispute resolution; and sometimes
- ◆ a statement of the sub-franchisor's responsibility to maintain the trademarks and to notify the franchisor of any potential infringement.

Typically, the agreement will reserve to the franchisor the exclusive right to take action against infringers, as franchisors normally prefer to retain complete control over the policing of their marks.¹¹⁴

(b) Registered User Agreement

Registered user agreements are agreements that are separate from trademark license agreements and master franchise agreements and that identify the sub-franchisor or sub-franchisee as a rightful and authorised user of the franchisor's trademark in the eyes of the enforcement authorities of a given country. The laws of some countries require registered user agreements to be filed with the trademark office.

Registered user agreements contain terms similar to those found in trademark license agreements, as well as any relating to specific formalities required by local law. Although local law may authorise registered users to enforce their rights to the trademark against third parties, and thus to pursue infringers of the trademark in their country, by contract the franchisor will typically prohibit the sub-franchisor from taking any such action unless specifically authorised to do so.

¹¹⁴ See Chapter 10 "Intellectual Property".

CHAPTER 20

REGULATORY REQUIREMENTS

The operation of any commercial enterprise is subject to a number of preconditions, some of a subjective nature, such as adequate financial means or sufficient expertise and know-how on the part of the entrepreneur, others objective in character, such as the legislative requirements that must be fulfilled.

The legislative requirements applicable to an international agreement may to a certain extent differ from those relevant in a purely domestic situation. In the former case a number of requirements additional to those applicable to a domestic agreement will need to be fulfilled, such as, for example, the obtaining of prior approval of the underlying international trade agreement by the authorities of the host country and the obtaining of specific licences and permits.

The domestic requirements will include industry specific requirements (compliance with health regulations in the case of restaurants, for example) and general requirements applicable to all businesses (registration in the appropriate commercial registers, registration of trademarks). The permits required may furthermore be of either national, regional or municipal applicability, depending on what they concern. Any entrepreneur that begins an activity must make sure that all the necessary permits are obtained and that all legal requirements are met. This is normal sound business practice and is no different in the case of franchising from any other business.

Any entrepreneur engaged in a business that is international in character must therefore make sure that, in addition to all the requirements applicable to domestic businesses, also those applicable specifically to the international activity concerned have been met. The advice of specialised legal counsel is best sought in such instances, not the least because the situation will differ from case to case. The registrations that are required, the permits and licences that must be obtained, and above all who has to obtain them, will vary also depending on the type of franchise involved, on whether it is a direct franchise or a master franchise, as well as on whether a branch or subsidiary or a joint venture is used, although there are some permits for which responsibility is clearly with one or other party.

The examples given in this chapter are therefore illustrations of what might be required in general terms and not specifically for franchising, but it should be stressed that the list is not exhaustive. Other requirements specific to either a trade or a certain country, such as the sales tax registration that is applicable in some countries, should also be carefully considered by each and every entrepreneur.

A. EXAMPLES OF LICENCE AND PERMIT REQUIREMENTS

The licences and permits required might cover a whole range of different issues, a few examples of which are set out below.

I. PRIOR APPROVAL

Prior approval by a Government authority might be required for the setting up or incorporation of, for example, branch offices, subsidiaries, joint ventures and holding companies.

In a number of countries transfer of technology laws might also require prior approval of the agreement concerned. Where prior approval is required, the agreement must be filed with the competent authorities which will examine it and will thereafter either grant or refuse approval. Alternatively, the authorities may require certain amendments to be made as a condition for the

obtaining of the approval. Following the approval, the agreement may also have to be registered in the appropriate register.

Requests by the authorities for an amendment to the franchise agreement might not be well received by the franchisor. Franchisors are often reluctant to introduce changes into their agreements and may therefore want to have the possibility to evaluate the effects of the proposed amendments on their system. To cover also the eventuality that the changes required might prove to be unacceptable to them, clauses may be found in agreements stating that the franchisor may terminate the agreement if it in good faith determines that the amendments required are detrimental to its interests. It is possible that, in view of the fact that the termination does not depend upon the sub-franchisor's acts or omissions, the possibility of a reimbursement of the expenses incurred by the sub-franchisor might be provided for in the agreement.

II. REGISTRATION IN THE APPROPRIATE REGISTERS

The procedure for the prior approval of the trade agreement may end with the actual registration of the agreement. On the other hand, prior approval by a Government authority may be necessary for registration in the commercial register or in any other official register with which the agreement or the business must be registered.

Examples of registration that might be required include:

- ◆ registration in commercial registers of the company or enterprise concerned; and
- ◆ registration of the trademarks, trade names, symbols, patents and designs.^{vii}

Examples of Government authorities with which the agreement should be filed for prior approval and subsequently registered include:

- ◆ the *Fair Trade Commissions* that have been set up in a number of countries;
- ◆ the competition authorities; and
- ◆ the authorities that look after the transfer of technology.

The facility with which an administrative decision is obtained will vary from country to country. It should be noted that the obtaining of prior approval or registration might be conditioned by the adoption in the host country of policies protecting the interests of the national entrepreneurs, particularly the artisans. Protective policies of this nature may heavily affect the saleability of a franchise and might limit the market for the foreign franchise network.

As concerns trademarks, the franchisor will in most cases try to keep the trademark registration in its own name, so as to avoid that the sub-franchisor or anyone else obtain any rights in its trademark. Sub-franchisors will therefore normally not be involved with the registration of the trademark.

It should be noted that a growing number of countries are introducing franchise specific legislation.^{viii} While most of these do not provide for any registration requirement, they do require specific procedures to be followed. This legislation is modified frequently and parties should therefore make a point of reviewing it regularly so as to ensure that all current legislative requirements are met by their system.

III. PERMITS REQUIRED FOR THE FOREIGN ELEMENTS

In a cross-border situation the position of the foreign elements, whether of the foreigners themselves, for example restrictions in the number of foreigners allowed to sit on the Board of Directors of a company, or of other elements such as the permits required for a foreign investment or the registration requirements for a foreign trademark, need to be ascertained. What is required must therefore be carefully considered in each particular case.

IV. *FOREIGN PERSONNEL OF THE FRANCHISOR*

An important aspect of the master franchise agreement is the training and assistance the franchisor offers its sub-franchisors. This training and assistance will often involve the physical presence of employees of the franchisor at the foreign franchise outlet or business head office. For these employees to be able to stay for any length of time in the foreign country, and for them to be able to operate and work there, they need to have visas, residence and work permits issued by the authorities of the country concerned. Master franchise agreements will often provide that the obtaining of these permits is an obligation on the part of the sub-franchisor.

V. *AGENTS OF THE FRANCHISOR*

If the franchisor operates through an agent, that agent may have to register as such, assuming there is a register for agents in the country concerned. Permits allowing the agent to operate may also have to be obtained from the appropriate authorities.

VI. *IMPORT AND EXPORT LICENCES AND PERMITS REQUIRED AS A RESULT OF IMPORT OR EXPORT RESTRICTIONS*

Licences will often be required when the franchise involves the export or import of end-products or the import of products or items that are to be used in the franchise (raw materials, for example). In most cases the obtaining of these licences will fall upon the sub-franchisor. The question of quotas and other associated restrictions will need to be considered, as the existence of any such quota may result in the necessity to apply for an exemption.

VII. *EXPORT OF PROFITS AND CURRENCY RESTRICTIONS*

The export of profits in the form of royalties and fees will often require special permits from Government authorities. This is particularly true in countries that have a shortage of hard currency, as these will often require profits to be reinvested in the country. These permits will relate to currency restrictions in general and also to the applicable tax regime. In general terms it will normally be the sub-franchisor who applies for the necessary permits and who will be required to pay any associated taxes.

VIII. *WITHHOLDING TAXES*

An important point relating to the export of profits is that which concerns withholding tax. It should be noted that there are countries in which it is necessary to obtain permission from a specified bank for the payment of withholding tax when royalties and other fees are transmitted abroad.^{ix}

IX. *TRADE-SPECIFIC REQUIREMENTS*

Each trade requires a certain number of permits specific to that trade. Thus, for example, the food industry requires licences to sell food or alcoholic beverages. Health legislation will set certain standards that must be observed, non-compliance with which might lead to a suspension of the licence. The location chosen for a particular activity may also necessitate a particular permit, although in this case the permit necessary will in all likelihood be of municipal character and not of nation-wide application.

B. WHO SHOULD OBTAIN THE PERMITS

In general terms it is logical that the party responsible for the obtaining of any permits should be the local party, the sub-franchisor in the case of master franchising. The sub-franchisor will clearly have the knowledge necessary to determine which permits and registrations are necessary and will know how to proceed to comply with these requirements. It will therefore in

most cases fall upon the sub-franchisor to exercise due diligence both in the determination of the requirements and in the compliance with them. It should be noted that the risk of non-compliance is that the agreement might be considered void.

A number of the permits or licences listed in Section A above would normally come under the competences of the franchisor, such as the registration of the trademark, trade name, patents, designs and symbols associated with the franchise. In many countries the owner will be required to file for the registration, in others it is advisable for the owner to do so in order not to lose the possibility of enforcing its rights against infringement or other forms of abuse. Where a system of registered users of the intellectual property exists, the sub-franchisee must be entered as the registered user.^x

As the sub-franchisor is an entrepreneur in its own right, it will be subject to the registration requirements usual for its trade. The sub-franchisor will therefore have to register in the commercial register in its own name and not in that of the franchisor. If possible, an annotation might be added to the effect that the entry in the register refers to a franchise of this or that other franchisor. Where the franchisor sets up a branch office or subsidiary in the foreign country, that branch office or subsidiary will need to be registered in the commercial register.

If the franchisor intends to operate through a branch office or a subsidiary, it will fall upon the local directors of the franchisor to obtain all the permits necessary for the conducting of the business. In the case of a joint venture established by the franchisor together with a local partner, the franchisor will naturally rely on the local partner for assistance in obtaining the permits, although the responsibility would fall to both. What would clearly fall upon the franchisor is the obtaining of the permits required for the investment it intends to make, as foreign investments are often subject to a series of conditions.

As in an international situation the franchise is to be operated abroad, the obtaining of the majority of the permits will in fact fall to the local sub-franchisor. In most cases the agreement will merely indicate an obligation on the part of the sub-franchisor to obtain any such permits or licences as might be necessary for the operation of the business and to cover the expenses associated with the obtaining of the permits, applicable duties included. At times, the very existence of the contract will be conditional upon the obtaining of all the necessary permits. Similarly, the temporary, or permanent, suspension of any permits or licences the possession of which is a prerequisite for the operation of the franchise, may result in the termination of the agreement for non-performance on the part of the sub-franchisor. This will follow from the obligation that is placed on the sub-franchisor to maintain in good standing all required permits and licences.

There are many instances in which there is no natural candidate for the obtaining of the necessary permits. In such cases it is of considerable importance that the parties determine in their contract who should obtain what permit. The importance of this issue is further increased as a result of the fact that there is a cost factor associated with the obtaining of the permits. Who should answer for these costs and/or how the costs should be divided between the parties are also best defined in the agreement.

ANNEX 1

FRANCHISING: GENERAL NOTIONS

A variety of different business arrangements are known as “franchising”. There is no single, recognised definition that is applicable to all situations, even if a certain number of basic elements are present in all the different arrangements that are considered to be franchising.

Franchising is often divided into industrial franchises, distribution franchises and service franchises. In this case industrial franchises concern the manufacturing of goods and consist of manufacturing licences based on patents and/or technical know-how combined with trademark licences; distribution franchises concern the sale of goods and service franchises concern the supplying of services.^{xi} Other descriptions of franchising divide franchises into product distribution franchises and business format franchises (of which more below). In this case a product distribution franchise is where the franchisee sells products manufactured or supplied by the franchisor under the franchisor’s trademark in exchange for the payment of fees and, most often, the promise to confine its sales to the products of the manufacturer or supplier.^{xii}

A. BUSINESS FORMAT FRANCHISING

The form of franchising which is known as business format franchising is increasingly coming to symbolise franchising as a whole. Most people who hear the word “franchising” in fact think of businesses such as McDonald’s or Pizza Hut, all of which are business format franchises.

In business format franchising a franchisor has elaborated and tested a specific business procedure (the “business format”), be it for the distribution of goods or the supplying of services, which it then proceeds to grant franchisees the right to use. A business format franchise agreement is thus concluded between two independent undertakings, whereby one, the franchisor, against compensation (normally in the form of an entry fee and/or royalties) grants the other, the franchisee, the right to market goods or supply services under its trademark and/or trade name following the business method or procedures which it has elaborated and tested. In order to permit the franchisee to do so, the franchisor will provide the franchisee with the know-how required and with the training needed to use this know-how. The franchisor will also in most cases provide a detailed manual containing the necessary instructions for the running of the business. Furthermore, for the duration of the agreement the franchisor will provide the franchisee with any assistance it might need in the operation of the franchise.

I. BASIC ELEMENTS

The basic elements of a business format franchise are therefore that:

- ◆ an entrepreneur (the franchisor) has developed a system of doing business that works, and decides to grant another entrepreneur (the franchisee) the right to use its system;
- ◆ the two entrepreneurs are legally and financially independent enterprises; the franchisee invests its own money and takes the risk of losing the money it has invested if the enterprise does not succeed;
- ◆ the granting of the right to use the franchise system involves the right of the franchisee to use the franchisor’s intellectual and industrial property, know-how, business and technical methods, procedural system and other intellectual property rights;
- ◆ the franchisee in exchange undertakes to follow the method elaborated by the franchisor and to pay an entrance fee and/or royalties, the latter of which are normally calculated as a percentage of the turnover;

- ◆ the franchisor retains rights of supervision over the manner in which the franchisee implements the franchise system; and
- ◆ the franchisor undertakes to provide the franchisee with training and on-going assistance.

It is therefore a package which includes (but is not necessarily limited to) intellectual property rights, non-patented know-how, training and continued assistance on the part of the franchisor, franchisor control rights vis-à-vis the franchisee and obligations of the franchisee to follow the instructions of the franchisor and to comply with the financial terms of the agreement. It further permits the franchise outlet to be clearly identified as a member of a particular franchise network.

II. *ADDITIONAL UNDERTAKINGS*

In addition to the above a variety of arrangements and undertakings by the parties may be present in the agreement or in ancillary documents.^{xiii} Some of these are potentially controversial and not all are present in all contracts at the same time. Which are present will be determined by the subject-matter of the agreement. Examples of such arrangements or undertakings are:

- ◆ an undertaking by the franchisor not to grant other franchises or itself to engage in the franchised business within a certain specified area which the franchisee is granted the right to develop ("territorial exclusivity");
- ◆ an obligation on the part of the franchisee to sell only the products of the franchisor ("product exclusivity");
- ◆ an obligation on the part of the franchisee to buy the products it sells or uses in the franchise business only from the franchisor or from suppliers approved and/or indicated by the franchisor; and
- ◆ the providing by the franchisor of indicative price lists to the franchisee for the goods the franchisee will be selling or the services it will be providing.

This last element at times comes close to, or may actually become, a form of price fixing. It is therefore of great importance that the contract term in question be prepared in conformity with the competition law of the country concerned.

In addition, the franchisor might lease the equipment that the franchisee needs for its activity to the franchisee, or might even be the owner or lessee of the premises the franchisee is to use and might lease or sub-lease them to the franchisee, thus creating a landlord/tenant relationship. The franchisor might also assist the franchisee to find financial resources through its contacts with financial institutions and might even provide for the accountancy of the whole franchise network to be centralised. Contract clauses are also to be found by which the franchisor is freed from liability for actions or omissions on the part of the franchisee, as are special clauses requiring insurance coverage on the part of the franchisee with the franchisor as beneficiary. Often, though not always even if there are those who would consider it to be a prime element of a franchise arrangement, the franchisor will assist the franchisee in selecting the site of the outlet. The franchisor will in this case provide market studies examining the community in which the proposed outlet is to be located and may estimate the possibilities of success of the franchise and the possible income of the franchisee in that particular area ("earnings claim"). Whether or not the franchisor will be able, or will wish, to provide such estimates will vary from country to country, depending also on the possible liability of the franchisor if the estimate turns out to be mistaken. Clearly, the possibility of the franchisor to provide this type of assistance in an international situation is greatly limited by the difficulties that arise as a result of the franchisor and the franchisee being located in two different countries. The franchisor will in addition often provide assistance for the interior decorating of the outlet so as to ensure that it conforms to that of the other outlets in the network. Clauses may further be found by which the franchisor reserves the right to distribute the goods that are the subject of the franchise by alternative means of distribution, i.e. the franchisor reserves the right to sell the goods it provides the franchisee with,

and therefore to compete with the franchisee, in, for example, the big department store a block away, or through other shops that it does not own or franchise.

Depending on the type of franchise involved, the franchisee will undertake to comply with the standards and/or procedures elaborated by the franchisor, not to disclose the know-how transmitted to it by the franchisor to third parties (the so-called "confidentiality clauses"), and not to engage in an activity competing with that of the franchise ("restrictive covenants"). Restrictive covenants will often be imposed also for a certain period of time after the termination of the franchise agreement. The franchisee will in this case be prevented from engaging in an activity competing with that of the franchise first and foremost within the geographic area the franchisee was in charge of developing, but at times also within a certain distance from other franchise outlets of the franchise network.

If the members of the franchise network are to benefit from the common image they present to the consumer, there must be some control over the quality of the goods or services they offer so as to ensure that these are not below standard. The franchisor, as the owner of the trademark and business format concerned, has a legitimate interest in ensuring that the quality of the performance of the franchisees is maintained. Franchise agreements will therefore provide the franchisor with extensive powers to control that the franchisee maintain the standards required and follow the procedures laid down. It will also provide for extensive rights for the franchisor to terminate the agreement if the franchisee does not comply with its terms. It should perhaps be noted that provisions on termination normally concern only the right of the franchisor to terminate if the franchisee does not perform. A specific right of the franchisee to terminate should the franchisor fail to perform its obligations is provided for only very rarely in unit franchise agreements, although they are to be found in master franchise agreements. General contract law will therefore apply in these cases.

The basic elements of a franchise agreement described above are present in the different techniques adopted to franchise. These techniques (direct franchising, franchising through a branch or subsidiary, area development agreements, master franchise agreements and franchising by means of a joint venture) are present in both domestic and international franchising.^{xiv}

B. ADVANTAGES AND DISADVANTAGES OF FRANCHISING FOR THE OPERATORS

Franchising is often characterised as a form of business which benefits all parties concerned. In essence this may be considered to be correct, but there is no form of business which does not have its draw-backs and franchising is no exception to this rule.

I. ADVANTAGES FOR THE FRANCHISEE

One of the main advantages for the franchisee is the fact that it enters into a business that already has a well-known trademark or trade name. The franchisee in other words does not have to spend time, money and efforts trying to make itself known and appreciated in the market. In effect the franchisee already has a potential clientele.

As the franchisee is not required to invest to make an entirely new trademark known and profitable, the investment it has to make will normally be of an advantageous size, as compared with the investment that would be required for an entirely new business. Statistical information on failure rates of unit franchises would also indicate that the failure rate of unit franchises is substantially lower than that of traditional businesses. An important factor in this connection is the maturity of the franchise system. If a franchise system is not mature, if the franchisor does not have sufficient experience and if the system has not been adequately tested, then the failure rate may be far superior even to that of a traditional business.

Of particular importance for franchisees who enter a business with which they are completely unfamiliar is the training and assistance provided by the franchisor. This training and

assistance is provided first and foremost at the beginning of the relationship so as to enable the franchisee to operate effectively, but also in the course of the agreement. The continued assistance on the part of the franchisor will provide any assistance that the franchisee might need to solve the problems which the running of the business gives rise to. Some large franchisors will have a twenty-four hour service at the disposal of the franchisees of the network. Further training is often regularly provided in the course of the agreement so as to ensure that the franchisee is always up to date with new developments.

Co-ordinated advertising is an effective means to spread a unitary image of the network and in the case of domestic franchising is therefore often conducted by the franchisor for the whole franchise network, the expense being shared by all participants. Local advertising is often left to the local franchisees.

Lastly, in some businesses a network can obtain preferential rates for bulk purchases.

II. *ADVANTAGES FOR THE FRANCHISOR*

For the franchisor the main advantage is the possibility to expand the business over a relatively short period of time without having to make direct investments in a new place of business, as it is the franchisees that make the capital investment. In addition, the franchisor receives fees from the franchisees.

By expanding its business with the help of franchisees, the franchisor is able to reach also smaller markets as the franchisees will have knowledge of the local conditions and interests.

The franchisor is furthermore not liable for the acts of the franchisee as the two are and remain independent entrepreneurs.

Other advantages include the fact that franchisees are motivated business owners with an entrepreneurial spirit and this is likely to produce increased sales. In general franchisees will also have better relations with employees than managers of company-owned outlets and a greater ability to motivate employees, which will result in increased productivity. Furthermore, for company employees the possibility that they might become franchisees in the future may be an incentive to improve their performance.

III. *DISADVANTAGES FOR THE FRANCHISEE*

To be weighed against the advantages described above is the fact that the franchisee is not completely independent and is therefore not in a position always to decide the policy of its business. Any major decisions will be taken either by the franchisor or by the franchisor in concert with the whole network of franchisees.

Furthermore the control exercised by the franchisor might appear to be excessive, indeed might on occasion *be* excessive. This will weigh heavily on the franchisee once it begins to know the business and to feel that it can manage without the franchisor.

The franchise is granted for a fixed period of time, which normally is renewable. There is, however, no absolute guarantee that the contract will always be renewed upon expiration. The franchisee therefore runs the risk of setting up an effective and profitable business only to see it being taken over by the franchisor at the expiration of the agreement.

It is very difficult to estimate what the financial return of the business will be. The franchisee therefore has to accept that it might at first be rather less than expected. To be added to this is the fact that the fees the franchisee has to pay the franchisor might be considerable and might therefore further reduce, at times quite dramatically, the earnings of the franchisee.

To be stressed is the fact that the franchisee has to bear the financial risk of the activity: if it fails, it is the franchisee that loses the money it has invested.

IV. DISADVANTAGES FOR THE FRANCHISOR

If the franchise relationship does not work the damage suffered by the franchisor, indeed by the whole network, could be quite considerable. In fact, as the owner of the trademark or trade name the franchisor is ultimately the one who will suffer most (by, for example, a reduction in sales throughout the network) if any of the outlets does not conform to the quality standards set.

It is very important for the franchisor to be able to exercise control over the performance of the franchisees, precisely to avoid any detrimental effect to the good name of the system. For the franchisor a disadvantage of the franchise arrangement is that the degree of control the franchisor has over the units is less than if they were company-owned outlets. The possibility of several franchisees acting together in an action against the franchisor might furthermore prove to be a disadvantage for the franchisor.

The risk of franchisees breaking away from the system and setting up competing businesses is also to be counted among the disadvantages of franchising as opposed to company-owned outlets.

The franchise relationship furthermore has built into it a certain number of natural tensions. These include a resistance on the part of franchisees to modernise their premises and to acquire more modern equipment, which might not always be perceived as necessary. Indeed, it might not always be necessary and unjustified requests to this effect may be considered to be abuses on the part of the franchisor. This is also true of system changes that the franchisor may wish to introduce in the course of the agreement.

Lastly, the financial returns of the franchisor will be lower than would be the case with a subsidiary or a wholly-owned outlet, as it will not receive all the financial returns of the enterprise but only a percentage thereof.

ANNEX 2

FRANCHISING IN THE ECONOMY

Statistics for franchising are often difficult to compare as different types of businesses are included under the term "franchising" in different countries. Petrol distributors are, for example, included under franchising in the United States of America whereas they are not in Europe. The criteria adopted for the surveys conducted also differ, as do the time-spans covered by the data. A series of estimates which illustrate the extension of the phenomenon are, however, regularly made.

A recent attempt to come to terms with the unreliable statistics that have hitherto existed was made by the *British Franchise Association* acting in its capacity as Secretariat to the *European Franchise Federation*. In August, 1997, the BFA on behalf of the EFF published a *European Franchise Survey*¹¹⁵ covering twelve European countries¹¹⁶ and containing information regarding several others. The data referring to the European countries in the table on page is taken from this survey.¹¹⁷ The data referring to non-European countries is on the other hand based on Table 6 of the *Industry and Trade Summary on Franchising*.¹¹⁸ In both cases the data refers only to business format franchising.

The size of the phenomenon of franchising becomes even more evident when the figures for other forms of franchising are added to those relating to business format franchising. Thus, in the United States the total volume of sales of goods and services from franchise outlets in 1992 was estimated at US \$ 803.2 billion, as against the 249 billion dollars-worth of sales from business format franchise outlets. The remaining US \$ 554.2 billion related to product and trade name franchising.¹¹⁹ In addition to the 429,217 business format franchise outlets, in 1992 there were 128,908 product and trade name outlets. The number of people employed in franchising amounted to eight million. In 1992 it was estimated that sales from franchises represented some 35% of retail sales in the U.S. This figure is still deemed to be valid.

According to the *Industry and Trade Summary*, the number of franchised establishments in the United States has grown significantly over the last 25 years. As of 1994 approximately one out of every 12 business establishments was a franchised business. In the period 1969 to 1992 the number of franchised establishments increased by approximately 45%, representing an annual growth rate of 1.7%. (Other sources indicate an annual growth rate of 10%.¹²⁰) In addition, franchising represents a decided asset for the country's balance of payments. It is estimated that in 1993 exports of franchising services amounted to approximately US \$ 408 billion, while imports were only US \$ 5 billion. The resulting trade surplus was therefore of a full US\$ 403 billion.¹²¹

Domestic sales through franchised establishments in the United States increased from US \$ 113 billion in 1969 to US \$ 803 billion in 1992. When adjusted for inflation, sales grew by about 86% during the period 1969 - 1992, with an annual growth rate of 2.7%. During 1970 - 1992

¹¹⁵ *EFF European Franchise Survey*, sponsored by NatWest Bank, August, 1997.

¹¹⁶ Austria, Belgium, Denmark, France, Germany, Hungary, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom

¹¹⁷ Courtesy of the EFF.

¹¹⁸ U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, Report by the Office of Industries, September 1995, p. 23. Sources of the information are the International Franchise Association, the Canadian Franchise Association, the Japanese franchise Association, the European Franchise Federation, the British Franchise Association, the Mexican Franchise Association, US&FCS Cables and USITC staff estimates.

¹¹⁹ International Franchise Association, *Franchise Fact Sheet* (April/May 1994).

¹²⁰ U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, cit., p. 4.

¹²¹ U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, cit., p. 27.

franchising sales thus grew faster than the retail trade industry as a whole, which experienced an inflation-adjusted average growth rate of 1.7%. As franchising has grown, retail sales through franchised establishments have accounted for an increasingly large proportion of total retail sales, moving from 28.2% of total retail sales in 1975 to 34% in 1990.¹²²

In Canada in 1984 retail sales from franchise outlets exceeded CDN \$ 48 billion or approximately 45% of total Canadian retail sales.¹²³ Of these, it was estimated in 1985 that 50% were generated from business format and what at the time were considered to be other non-traditional forms of franchising.¹²⁴ Between 1981 and 1984 franchising in Canada averaged annual sales increases of 15%. In the same period, total Canadian retail sales and GNP increased annually by only 8% and 7% respectively.¹²⁵ In 1987 approximately 1000 franchisors located across Canada and operating nearly 45,000 franchise outlets accounted for sales totalling CDN \$ 61 billion. The annual growth rate of Canadian franchising sales was 20% in 1985, 25% in 1986 and was projected to be 40% for the period 1988 to 1992, although as yet no confirmation of this prediction is available.¹²⁶

The *European Franchise Federation* estimates for franchising in France indicated that in 1993 there were 617 franchisors with over 30,500 outlets. Those employed in franchising amounted to 150,000 with 10,000 new jobs being created in franchising in 1992. Sales generated by franchising in 1993 exceeded 21 billion ECU, or approximately 7.5% of all retail sales.¹²⁷

Statistics from the United Kingdom indicate that in 1988 there were 270 franchisors in the UK with 20,000 outlets. The overall sales figure from franchise outlets for the same period was US\$ 6.1 billion.¹²⁸ In 1990 the yearly survey that the British Franchise Association conducts together with the National Westminster Bank plc (NatWest) indicated that in the year to 31 May 1990 the number of franchised systems in the UK increased by 28%, from 295 to 379. The number of franchised units rose by 10% from 16,600 to 18,260 while sales rose by 11% from £ 4.73 billion to £ 5.24 billion.¹²⁹ In the United Kingdom franchising is estimated to answer for 5% of all retail sales, but if tenanted pubs, petrol stations and car dealerships are included it covers as much as 32%. The growth rate in 1993 in the UK was 10%.¹³⁰

Franchising is also entering the newly opened markets of the countries of Eastern Europe, in which national franchise associations have actively promoted this type of business. The enthusiasm engendered by franchising was, and to a certain extent still is, due to the hopes that franchising might be a useful tool in the privatisation process. It is furthermore seen as a source of foreign investment. The only statistics available are for Hungary, in which franchising in 1994 represented 1-2% of retail trade.¹³¹ At the time, the number of franchisors was 150, there were 5,000 franchised establishments with a total of 30,000 employees engaged in business format franchising. The revenue generated by the franchised businesses amounted to US \$ 2,5 billion and the annual growth rate was 25%.

¹²² U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, cit., p. 7.

¹²³ Canadian Franchise Association, *Franchising: The Current Situation*, Toronto, 1985, cited in A.S. KONIGSBERG, *International Franchising*, Second Edition, Juris Publishing, New York, 1996, at II.III.7.

¹²⁴ U.S. Department of Commerce, International Trade Administration, Office of Service Industries, *Franchising in the Canadian Economy 1976 - 1981*, Washington DC, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.III.7.

¹²⁵ A. TREBILCOCK, *Bringing your Franchise to Canada: Regulation of Selling Practices and the Use of Disclosure Documents*, (unpublished), 1988, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.III.7.

¹²⁶ A. TREBILCOCK, paper presented at the *Salon international de la franchise*, Paris, 1989, p. 24, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.III.7.

¹²⁷ European Franchise Federation, *Newsletter*, Quarterly No. 1, October 1993, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.IV.9. For the most recent statistics, see the table on page .

¹²⁸ Adlers and Arthur Young, *Franchising in the UK: The Business, Taxation and Legal Implications*, 1987, p. 7, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.V.10.

¹²⁹ See M. MENDELSON, *The Guide to Franchising*, 5th edition, Cassells, London, 1992, p. 23.

¹³⁰ For the most recent statistics, see the table on page .

¹³¹ Hungarian Franchise Association, *Yearbook 1993/94*, p. 38.

The Latin American market is developing very quickly, with Brazil, Mexico and Argentina in the forefront. Brazil has seen an explosive growth of franchising, with an annual growth rate of about 35% since the mid 1980's. In fact, in 1993 the annual revenue from franchising as a whole totalled US \$ 48.1 billion, which amounted to 10% of the GNP of the country.¹³² In 1994 total sales of company-owned and business format franchise outlets totalled US \$ 9.87 billion, while sales of product and trademark franchises amounted to US \$ 68,389. In 1994 it was estimated that there were 26,716 business format franchise outlets.¹³³

Franchising is growing rapidly in Asia, where it is spreading in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand and even China. The expansion of franchising in Japan has in fact been exponential. In 1963 there were only 2 franchisors, in 1978 there were 350 and in 1994 there were 714. These 714 franchisors operated 139,788 establishments with sales amounting to US \$ 102.8 billion. Despite this astonishing growth, in 1987 franchising accounted for only 3.7% of total retail sales.¹³⁴ Japan has the highest average number of establishments per franchisor in the world, with approximately 200 establishments per franchisor.¹³⁵

In New Zealand, where franchising has only recently begun to develop, it was estimated in 1993 that there were approximately 150 franchisors,¹³⁶ and in Australia the annual growth rate of franchising for the years 1989 - 1991 reached 12.7%.¹³⁷

With few exceptions, notably that of South Africa, franchising has still to develop on the African continent.

A. BENEFITS OF FRANCHISING TO THE NATIONAL ECONOMY

The figures cited in the section above are a clear indication of the importance of this business technique in economic terms. The effects of franchising are however more far-reaching, both for the national economy of the countries concerned and for the operators engaged in this form of business.¹³⁸

The most obvious benefit of franchising to the national economy is the creation of new jobs, not only directly in the franchising industry itself, but also indirectly in the connected industries. Thus, for example, if a food franchise network is established, a demand will be created for the products and services that are used in, or in connection with, the franchise. The industries that provide these products and services will need to expand to meet the increasing demands placed upon them and will therefore hire more employees. As the franchise network spreads, the new franchisees will also be hiring employees, thereby creating yet more new jobs. With unemployment rates of 10, 12 or even 20%, the importance of a business technique which creates employment opportunities cannot be stressed enough.

¹³² Figures of the Brazilian Franchising Association, cited in LUIZ HENRIQUE O DO AMARAL, *Brazil is bound to introduce disclosure requirements*, in *Journal of International Franchising & Distribution Law*, Vol. 8, 1994, p. 102.

¹³³ Statistics of the *Associação Brasileira de Franchising*, cited in A.S. KONIGSBERG, *Op. Cit.*, at II.XIV.19.

¹³⁴ M. FUSE and R. MATSUZAKI, paper presented at the *Salon international de la franchise*, Paris, 1989, Chapter II, Section VI, Note 1, p. 96, cited in A.S. KONIGSBERG, *Op. Cit.*, at II.VI.11.

¹³⁵ U.S. Department of Commerce, International Trade Administration, *Japan - Franchising Industry - ISA9009*, Market Research Reports, August 27 1994, National Trade Data Bank, IT market 111107290, in U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, cit., p. 26.

¹³⁶ Franchisors Association of Australia and New Zealand, Chapter II, Section XII, Note 3, in A.S. KONIGSBERG, *Op. Cit.*, at II.XII.17.

¹³⁷ *Franchising - Australia and Abroad*, Supplement to the Franchising Task Force Final report, March 1992, p. 12.

¹³⁸ For an indication of the advantages of franchising for the operators, see Annex 1.

In the United States employment in franchised establishments doubled from 3.5 million in 1975 to 7.0 million in 1988. Approximately 90% of this increase was generated by business format franchises for which the employment level grew by 162% between 1975 and 1988.¹³⁹

For Australia the *Review of the Franchising Code of Practice* indicates the 30,500 establishments as offering jobs to 279,000 full-time, part-time and casual workers.¹⁴⁰ This represents a substantial increase, as the Survey conducted by the *Department of Industry, Technology and Commerce* in 1990/91 indicated that franchised outlets employed 170,000 people.¹⁴¹

The statistics for the United Kingdom show a greater fluctuation than those of other countries. Thus, those directly employed in franchising in the UK increased from 126,000 in 1986 to 185,000 in 1989, but decreased to 184,000 in 1990. In France, on the other hand, 10,000 new jobs were created only in 1992.¹⁴²

Another factor which is of importance, and which indeed is connected with the issue of unemployment, is the failure rate of franchised businesses. This is often substantially lower than that of more traditional businesses, although figures on how much lower vary considerably.

The number of bankruptcies is also considerably lower than the average figures for non-franchised retail businesses, although here again there is disagreement as to the exact figures.

According to a study commissioned by the *International Franchise Association*,¹⁴³ approximately 97% of franchised establishments founded within five years of the study were still in operation, and approximately 86% were still owned by the original owners. Other estimates are more conservative, the success rate being estimated at 60%. Even if lower, this figure is still substantially higher than the overall new business success rates, which are estimated at 40% after 2 years and at 10% after 10 years.¹⁴⁴

The BFA/NatWest survey covering the period 1986 to 1990 indicates that in the UK the number of individual unit failures by franchisees remained fairly constant, at 4.3% of all units operating in 1986, 4.4% in 1988, 3.6% in 1989 and 4.6% in 1990.¹⁴⁵

It should however be stressed that franchise units have substantially lower failure rates where the franchise system concerned is mature, where the franchisor has experience and the system has been fully tested and proved. The situation is reversed if the franchise system is not mature, if the franchisor does not have the necessary experience to develop a system and where the system itself suffers from inadequacies and inefficiencies as a result of a lack of testing. In these cases the failure rate of franchise units might even be higher than that of more traditional businesses.

¹³⁹ U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, *cit.*, p. 7.

¹⁴⁰ R. GARDINI, *Review of the Franchising Code of Practice*, Report to the Hon Chris Schacht, Minister for Small Business, Customs and Construction, Australian Government Publishing Service, Canberra, 1995, p. 1.

¹⁴¹ *Franchising - Australia and Abroad*, Supplement to the Franchising Task Force Final report, March 1992, p. 3.

¹⁴² European Franchise Federation, *Newsletter*, Quarterly No. 1, October 1993, cited in A.S. KONIGSBERG, *Op.Cit.*, at II.IV.9.

¹⁴³ Arthur Andersen & Co., *Franchising in the Economy 1989 - 1992*, p. 16, cited in U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, *cit.*, p. 3. The IFA is the professional association essentially of American franchisors, even if it recently opened to membership by franchisees.

¹⁴⁴ U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, *cit.*, p. 3.

¹⁴⁵ NatWest/British Franchise Association, Survey of the period 1986 - 1990.

One of the distinguishing features of franchising is the fact that the franchisor provides the franchisees with training, so as to enable franchisees, who often have no business experience whatsoever, to operate in the most effective manner possible. This training may be both an initial training, which the franchisor provides before the franchisee begins operating the outlet, and on-going training to bring the franchisee up to date on all new developments. Depending on the type of franchise, and also on the level of expertise of the franchisee, this training may include basic skills such as accountancy. The close ties between franchisor and franchisee, as illustrated by the continued assistance that is a constituent part of most franchise agreements and by the supervisory function of the franchisor, will furthermore provide the franchisee with backing should this be required. The consequent lower failure rate of franchisees is a positive element for the economy as a whole as well as for the franchisees themselves.

These characteristic features of franchising have made it a form of business that is particularly attractive to the countries of Central and Eastern Europe and to developing countries, many of which face problems similar to those faced by the Central and Eastern European countries. As is well-known, a major challenge these countries face is the transformation of a planned economy into an open market economy.

The tasks the Governments of countries that have or have had a planned or partially planned economy face in the transformation of their economies include the dismantling of centralised economic controls, the creation of private enterprises able to provide goods and services in quantities and qualities that meet local needs and the solution of the unemployment problem.

It is precisely as an aid to the solution of these problems that franchising has a role to play.¹⁴⁶ As indicated above, it offers a rapid expansion of individual businesses with a greater chance of success than the average non-franchised business, it provides a system that permits the production of goods or the provision of services of consistent quality and price, it improves the production and distribution of consumer goods and is a system that generates employment opportunities.

In the case of the countries of Central and Eastern Europe, which have actively been pursuing the transformation of their economies for a certain number of years now, a tradition of small business enterprises that survived through the decades of socialist rule already existed. Despite this, a class of capable entrepreneurs needed, and to a certain extent still needs, to be trained. The training and assistance in general business management, in accountancy and in related skills that are among the fundamental characteristics of franchising are what make it an effective tool in the creation, or re-creation, of an effective class of entrepreneurs in as brief a period of time as possible. These same characteristics are also what suggest that franchising might have a role to play in the privatisation process.¹⁴⁷

Franchising would clearly be most effective in the privatisation of state-owned enterprises that have been structured and managed in a form that is not very different from the franchise concept. This is the case with certain hotel chains and some distribution facilities that are owned by the State, are centrally operated by a senior State executive, and the branches of which are managed by local State executives. In this case the central organisation operates like a franchisor and the local branches function in a way similar to franchisees. With an original structure of this kind, the transformation into a franchised system ought not to present too many difficulties.

The advantages of utilising franchising for privatisation purposes would be:¹⁴⁸

¹⁴⁶ For an examination of these tasks and the role of franchising in Central and Eastern Europe, see P. F. Zeidman/M. AVNER/ S.P. PETRI, *Franchising in the New Markets of Eastern Europe*, in *BNA Eastern European Reporter*, vol. 1, 1991, p. 190 ff., and P.F. ZEIDMAN/M. AVNER, *Franchising in Eastern Europe and the Soviet Union*, in *DePaul Business Law Journal*, vol. 3, 1991, p. 307 ff.

¹⁴⁷ *Ibid.*, p. 317 ff.

¹⁴⁸ *Ibid.*, p. 320.

- ◆ that investment and business involvement would be spread over a wide field and would utilise existing businesses as the base;
- ◆ that by utilising and reforming existing businesses it may be possible to minimise the extent to which privatisation results in the closure of State-owned businesses, thereby avoiding additional unemployment of resources and workers;
- ◆ that by applying franchise techniques in the privatisation of large State-owned conglomerates there could be flexibility in restructuring the enterprise into viable separate units, yet allowances could be made for limited central control of the individual businesses;
- ◆ that the need for the relatively large amounts of investment that would be required for the purchase of any substantial State-owned enterprise could be eliminated;
- ◆ that the individual units that comprise large chains could be sold to current employees or managers; and
- ◆ that franchising offers the possibility of local ownership of businesses that would serve to reduce or minimise reliance on foreign capital for investment and operations.

Whether or not in practice franchising would be effective as a tool for the privatisation process is still to be seen and will to a large extent depend on the local conditions of the country concerned. Thus, even if the Governments of Hungary, Poland and the Czech Republic have expressed an interest in using franchising to privatise State enterprises,¹⁴⁹ this has not been the case in Hungary.

In Hungary the officials of the *State Property Agency (SPA)* indicated that franchising would not be a tool used directly in privatisation, as on the one hand there was not enough capital within the country and on the other the *Privatisation Act* did not provide for the allocation of resources to franchise conversion, which in fact the Act did not consider at all.¹⁵⁰ The SPA however invited the *Hungarian Franchise Association (HFA)* to submit a study on franchising,¹⁵¹ subsequent to which the SPA issued a booklet in its series on privatisation, dealing with how the concept of franchising can be used in the privatisation process.¹⁵²

In the privatisation process in Hungary, foreign capital was preferred to the credits available to Hungarian investors. Thus, for example, the Pannonia Hotel and Catering Company was sold to the French hotel group ACCOR, the largest franchisor in this branch of business in Europe. Smaller companies running chains of shops were either first sold on the domestic market, subsequent to which the new owners proceeded with a franchise conversion, or one by one followed by the emergence of franchises at the lowest level. There are presently more than 200 franchises in Hungary, 50% of which are domestic networks.

B. WHAT IS FRANCHISED?

It has been said that there is no activity that cannot be franchised and this statement would appear to be supported by the diverse nature of the businesses that have chosen franchising as a vehicle for their expansion. The listings of franchised businesses that have been prepared, in particular by national franchise associations, often divide the businesses into categories and sub-

¹⁴⁹ In 1990 the Hungarian State Property Agency suggested that franchising might have a role to play in the privatisation of two hotel chains (the Dannubius Hotel and Spa Company, and the Pannonia Hotel and Catering Company): State and Property Agency, *First Privatization Program 1990*, cited in P.F. ZEIDMAN/M. AVNER, *Franchising in Eastern Europe and the Soviet Union, cit.*, p. 319.

¹⁵⁰ A hajó elment ... (Interview with Tóth Attila), *Figyelő, Franchise Supplement*, 7 May, 1991, p. 34.

¹⁵¹ HUNGARIAN FRANCHISE ASSOCIATION, *Franchising as a method of privatisation*, 1992 (a shortened version of this study is published in Hungarian and in English in *PRIVINFO* 1993/6.)

¹⁵² I. KISS/J. SAJÓ, *Franchising and privatisation* (in Hungarian), Privatisation Series No. 21, SPA, Budapest, 1994.

categories. A list which includes a majority of categories of businesses franchised is the following:¹⁵³

accounting/tax services (tax preparation, computerised accounting systems for specialised professions, small businesses and traders
 agribusiness
 art galleries
 auto diagnostic centres
 auto rentals/leasing
 auto supply stores
 auto transmission repair centres
 auto washes/products/equipment
 automotive products/services (motor vehicle services)
 24-hour mobile windscreen replacement service
 automobile parts
 car tuning service
 car valet services
 exhaust systems replacement
 motor accessories, cycles, cycle accessories
 rust proofing
 vehicle security system
 beauty and slimming salons
 brewers
 building and construction
 business aids/services
 campgrounds
 catalogue sales
 chauffeur services
 chemical maintenance products
 children's products/services
 cleaning/maintenance/sanitation services
 concrete delivery services
 convenience stores
 cosmetics
 hairecare and beauty products
 credit/collection services
 dance studios
 dispensing equipment (food and beverages)
 domestic services
 drain and pipe cleaning
 employment and temporary help services
 entertainment
 estate agency
 food operations, including:
 barbecue
 Cantonese
 donuts
 fast foods
 baked potatoes
 baking and coffee
 fish and chips
 fried chicken
 hamburgers
 pizza
 full menu

¹⁵³ List derived from the merging of two lists contained in M. MENDELSON, *The Guide to Franchising*, 5th edition, Cassell, London, 1992, p. 43 ff.

frankfurters
 hot bread kitchens
 Italian
 Mexican
 mobile units
 pancakes/waffles
 roast beef
 sandwiches
 seafood
 smörgålsbord
 speciality
 steaks
 miscellaneous food operations (e.g. bakery routes)

fund raising
 glass tinting
 hair dressing
 health aids/services
 health clubs
 hearing aids
 home improvement

- bathroom suite renovations
- ceramic tiles
- bedroom furniture
- damp proofing
- double glazing
- hire of marquees
- internal decoration
- kitchen and bathroom furniture
- kitchen renewal
- leading windows
- roof thatching
- security locks
- stripping and restoration of furniture
- window blinds
- woodworm/dryrot eradication services

hotels
 industrial supplies/services
 industrial chemicals
 industrial vehicle cleaning
 instant picture framing services
 insurance brokers
 investigation bureau
 landscape maintenance services
 lawn and garden care
 maid services
 manufacture and sale of name badge signage etc.
 marketing sales promotion
 milk and dairy produce distribution
 motels
 motoring schools
 nursing homes
 office and industrial cleaning
 office machines/systems
 one-hour film developing and printing
 parcel delivery services
 paint/chemical coatings
 paint stripping
 pest control

pet shops and services
physical conditioning equipment
printing/duplicating services
publishing
rack merchandising
removal and storage facilities
rentals and leasing (general equipment)
repairing service for brick and stone buildings
safety systems
sales training
schools/instructions
scientific social introductions
secretarial and word processing training centres
sewer cleaning
signs
sport/recreation
stained glass
stores (retail)

- aquatic centres
- bridal salons
- coffee, tea
- coin-up laundries
- confectionary
- dry cleaners
- garden buildings and sheds
- gift shops
- health and skin care
- household furnishings
- ice-cream
- internal and external floor furniture in brass and other metals
- jewellers
- ladies fashion
- neckware and accessories
- non-branded foodstuffs
- pharmacies
- sewing machines
- shoe and heel bars
- soft drinks

swimming pools
telecopy systems
television systems
tool and equipment
travel agencies
vending operations
vinyl/plastic repair
water conditioning systems
weight control
wigs/hair pieces
workshop consumables and maintenance for industrial users
miscellaneous products and services.

Continent	Country	Year	Franchisors number of	Franchised establishments bus.form.fr. number of	Employees bus.form.fr. number of	Revenues in billion dollars bus.form.fr.	Percentage of retail trade	Annual growth rate all franchising
Europe	Austria*	1997	210	3,000	40,000	1.7		
	Belgium*	1997	170	3,500	28,500	2.5		
	Denmark*	1997	98	2,000	40,000	1.0		
	France*	1997	470	25,750	355,500	9.8		
	Germany*	1997	530	22,000	230,000	15.6		
	Hungary*	1997	220	5,000	45,000	2.7		
	Italy*	1997	436	21,390	49,658	12.8		
	Netherlands*	1997	345	11,910	100,000	9.8		
	Norway	1992	125	3,500		3.9		
	Portugal*	1997	220	2,000	35,000	1.0		
	Spain*	1997	288	13,161	69,000	7.2	5%**	
	Sweden*	1997	230	9,150	71,000	6.1	8%***	
United Kingdom*	1997	474	25,700	222,700	9.5	19%****	10%	
North & South America	United States	1992	2,500	429,217	4,721,387	249.0	35%	10%
	Canada	1992	1,134	25,052		12.9	45% (1984)	40% (1988-1992)
	Mexico	1994		5,000	75,000	3.0		
	Brazil	1993		21,244		4.9		35%
	Chile	1994	35	200	10,000	0.1		
Asia/Pacific	Japan	1994	714	139,788		102.8	4%	
	Hong Kong	1992	100	2,000		0.6		
	Australia*****	1994	555	30,500	279,000	29.0		14%
Africa	South Africa*****	1992	90	2,700		1.5		

* Figures taken from the *EFF European Franchise Survey*, August, 1997. Figures in ECU have been converted to US dollars for comparison purposes.

** Figure in *Franchising International*, published by the Franchise Development Services, Summer 1997, p. 46

*** Figure provided by the Swedish Franchise Association

**** NatWest News Release 43/97 of 18 March 1997, *Franchising Sector continues to grow says NatWest*, p. 1.

***** Includes product and trade name franchising. Figures of the Australian Bureau of Statistics, *Franchising Sector Survey Results - 1994*, Department of Industry, Science and Technology, 1994, p. 3.

***** Includes product and trade name franchising

ANNEX 3

LAWS AND REGULATIONS RELEVANT FOR FRANCHISING

A healthy commercial law environment is of paramount importance for franchising. Indeed, without it franchising is not able to function. A “healthy commercial law environment” may be defined as one with general legislation on commercial contracts, with an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are in place and enforced and where companies can rely on ownership of trademarks and know-how as well as on confidentiality agreements. This legislation covers elements essential to franchising independently of the type of franchise agreement concerned.

Franchise agreements are subject to a considerable number of other laws and regulations in addition to those indicated above. Essentially, these additional laws and regulations fall into two separate categories. The first category includes laws and regulations that are applicable to contracts in general, the second those that are applicable to the specific contract concerned (industry specific laws and regulations, for example).

Although an increasing number of States are considering the introduction of legislation, still only a very few countries regulate franchising as such. Furthermore, the legislation adopted refers to simple domestic franchising and not to international franchising. In part, this lack of franchise-specific legislation is due to the complexity of the relationship and to the great number of areas of law involved in a franchise relationship. With few exceptions the legislation adopted is disclosure legislation and not legislation regulating the relationship between the parties. The disclosure legislation specifies the information with which a franchisor must provide a prospective franchisee in order to permit the latter to make an informed decision on whether or not to buy the franchise. The European Union regulation of franchising falls into a separate category in that it deals only with competition law issues.

A. GENERAL LEGISLATION

Franchising is a form of business that touches upon a great many different areas of law, the majority of which are regulated in most countries and at times also internationally.

I. GENERAL CONTRACT LAW

General contract law will apply to the contract as such, even if in countries that regulate commercial contracts and other contracts in separate laws or codes some aspects will be covered by provisions in those codes.

II. AGENCY LAW AND THE LAW REGULATING OTHER DISTRIBUTION CONTRACTS

There may be aspects of the relationship between the franchisor and the franchisees that are covered by agency law, independently of whether the courts actually assimilate the franchise relationship concerned to one of agency. The same applies to the law regulating other distribution contracts.

III. LEASING AND SECURITY INTERESTS

Equipment and premises might be leased and security interests might be involved. This is particularly the case where specific equipment is needed for the franchise and where the franchisor provides that equipment.

IV. FINANCIAL INVESTMENTS

Financial investments will be covered by the legislation that specifically regulates these matters. In this connection it should be recalled that there are banks and other financial institutions that have franchise financing programmes in place.

V. *INTELLECTUAL AND INDUSTRIAL PROPERTY*

Intellectual and industrial property rights are the basis on which the franchise relationship is constructed and are therefore of fundamental importance. In international relationships the international conventions and other regulations of international origin must be taken into account.¹⁵⁴

VI. *COMPETITION LAW*

Competition law is highly relevant, in particular by reason of the exclusive rights granted franchisees in a franchise relationship. The terms of the franchise agreement that might be covered by competition law are those relating to prices and exclusivities, which might give rise to suspicions of market sharing and concerted action between the members of the network. The importance of competition law is evidenced by the fact that the European Union concentrated its regulation of franchising on the competition law aspects of the relationship. The problem in franchising is ensuring that the franchisee is given the best possible protection to develop its territory, for example by being granted exclusive territorial rights, but without the terms of the agreement falling under the terms of the competition or anti-trust legislation. Care should therefore be taken in drafting the agreements.

VII. *FAIR TRADE PRACTICES LAW*

Fair trade practices law is of relevance when the post-term non-competition clauses are considered, as also in relation to the possible alternate channels of distribution the franchisor might make use of. Legislation relating specifically to fair trade practices should therefore be considered, as should that dealing with particular trading schemes, such as the *1996 Trading Schemes Act* adopted in the United Kingdom which covers pyramid selling. Although not directly applicable to franchising, this latter legislation can have a direct effect also on certain types of franchising and should therefore be considered carefully. An issue to be determined with reference to pyramid selling is whether the statutes cover also the internal relationship between the franchisor and the franchisee and not only that between the franchisee and the consumer.

III. *CORPORATE LAW*

The corporate form the franchisor and the franchisees adopt will also be relevant, particularly for questions of liability and taxation.¹⁵⁵

IX. *TAXATION*

Taxation regulation is of considerable importance, not the least because taxation issues are what often decide the corporate form the parties adopt, the franchisor for its presence in the host country and the franchisee for its outlet. Issues such as who has to pay withholding taxes need to be regulated in the franchise agreement as these are of considerable importance because of the costs involved.¹⁵⁶

X. *PROPERTY LAW*

¹⁵⁴ See Chapter 10 "Intellectual Property".

¹⁵⁵ See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties" for an examination of the relationship of the parties and Chapter 14 "Vicarious Liability, Indemnification and Insurance" for questions of liability.

¹⁵⁶ See Chapter 4 "Financial Matters".

Property law will also need to be considered in relation to the assets of the franchise, particularly in the case of termination of the agreement.

XI. LEGISLATION ON CONSUMER PROTECTION AND PRODUCTS LIABILITY

Legislation on consumer protection and products liability is of relevance particularly where the possible liability of the franchisor for products or services sold by the franchisee is concerned.¹⁵⁷ Consumer protection must be considered at two levels: firstly, at the level of liability towards the consumer in the ordinary sense, secondly at the level of whether or not the sub-franchisor or franchisee can itself be regarded as a consumer and therefore be covered by the protection of the consumer protection statutes. The question is whether the reach of those statutes can be viewed as broad enough to protect franchisees who are not purchasing items for consumption, but are making an investment and are therefore traditionally not thought of as consumers, although they might be treated as consumers for the purpose of the statutes.

XII. INSURANCE LAW

Insurance law is relevant as agreements will often require that franchisees take out insurance with the franchisor as beneficiary.¹⁵⁸

XIII. LABOUR LAW

Labour law is relevant in particular where the nature of the relationship between the franchisor and the franchisee is concerned, but also in relation to the rights some franchisors retain to approve the employees of the franchisee. The issue of the applicability of labour legislation to the franchise relationship has been studied in particular in countries with a highly developed regulation of labour relations, such as Germany and Sweden. A number of different questions are involved, first of all the relationship between the franchisor and the franchisee, secondly the relationship between the employees of the franchisee and the franchise system, particularly as regards the right of the employees to be consulted on important business decisions. In this connection the possible application of the *European Council Directive 94/95 on the establishment of a European Works Council or a procedure in Community-scale groups of undertakings for the purpose of informing and consulting employees* should be taken into account.¹⁵⁹

XIV. INDUSTRY SPECIFIC LAWS OR REGULATIONS

Any laws or regulations specific to the trade sector involved (for example health regulations for food franchises) need to be carefully considered in each particular case.

XV. THE LAW REGULATING THE TRANSFER OF TECHNOLOGY

Franchising is often covered by the broad definition of technology transfer contained in national legislation. This may involve having the franchise agreement approved by the local authorities responsible for contracts for the transfer of technology and registered in the appropriate register. In this context the recent European Regulation on technology transfer agreement should be noted.¹⁶⁰ Adopted on 31 January 1996, it replaced the existing regulations on patent and know-how licensing agreements.¹⁶¹

¹⁵⁷ See Chapter 14 for questions of vicarious liability.

¹⁵⁸ See Chapter 14.

¹⁵⁹ *OJ EEC L 254/64* of 24 October 1995.

¹⁶⁰ *Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85(3) of the Treaty to certain categories of technology transfer agreements (Text with EEA relevance)*, published in *OJ EEC L 31* of 9 February 1996, p. 2 ff.

¹⁶¹ *Regulation (EEC) No 2349/84 of 23 July 1984 on the application of Article 85(3) of the Treaty to certain categories of patent licensing agreements* (in *OJ EEC L 219/15* of 16 August 1984), as last amended by *Regulation (EC) No 2131/95* (in *OJ EEC L 214/6* of 8 September 1995); and *Regulation (EEC) 556/89*

XVI. *LEGISLATION REGULATING FOREIGN INVESTMENTS CURRENCY CONTROL REGULATIONS AND IMPORT RESTRICTIONS AND/OR QUOTAS*

Legislation regulating foreign investments needs to be considered, as do the connected currency control regulations and import restrictions and/or quotas.

XVII. *LEGISLATION REGULATING JOINT VENTURES*

Joint ventures are frequently used for the international expansion of franchise systems, particularly in situations where the local partners suffer from a lack of financial means. In such cases the legislation on joint ventures will also need to be considered.

B. SPECIFIC LEGISLATION

I. *THE UNITED STATES OF AMERICA*

Franchise specific legislation exists at two levels in the United States. At federal level the *1979 Federal Trade Commission (FTC) Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures*¹⁶² regulates the information a franchisor is supposed to supply the prospective franchisee with in order to provide it with all the elements necessary to evaluate the franchise it is proposing to acquire. It applies to franchises as well as to a number of business opportunities. The FTC Rule applies in all fifty states and is intended to provide a minimum protection. It therefore applies wherever states have not adopted more stringent requirements.

At state level the majority of states have no legislation regulating franchising. Seventeen states have however adopted legislation requiring disclosure, some of which also require registration of the disclosure document. Other states have adopted legislation regulating aspects of the franchise relationship, including termination. Twenty-two states have adopted legislation regulating the offer and sale of a business opportunity and these might be applicable also to franchise agreements. It should be noted that in addition to the above legislation there is legislation that is industry specific, such as that applicable to gasoline retail and distribution franchises.

Under the legislation that regulates the franchise relationship the franchisor has to go through a process of registration and examination by state administrators. This is the case also under the disclosure legislation when the obligation is imposed at state level, but not if it is imposed at federal level as there is no federal Government agency with which to file the disclosure document.

The FTC Rule, which as indicated above is a disclosure law, requires franchisors to provide prospective franchisees with a document with detailed information regarding:

- ◆ the franchisor;
- ◆ the directors and executive officers of the franchisor;
- ◆ litigation and bankruptcy histories;
- ◆ the franchise to be purchased;
- ◆ initial and recurring payments;
- ◆ obligations to purchase;
- ◆ financing;
- ◆ required personal participation;
- ◆ termination, cancellation and renewal provisions;
- ◆ statistics on the number of franchisees;

of 30 November 1988 on the application of Article 85(3) of the Treaty to certain categories of know-how licensing agreements (in OJ EEC L 61/1 of 4 March 1989).

¹⁶² 16 C.F.R. § 436.

- ◆ training;
- ◆ site selection; and
- ◆ financial reporting, including audited financial statements.¹⁶³

The *North American Securities Administrators Association (NASAA)*¹⁶⁴ has also adopted a *Uniform Franchise Offering Circular (UFOC)* that indicates what information should be furnished to prospective franchisees. The format prescribed varies from that in the FTC Rule, but the substance is essentially the same. The FTC permits the use of the UFOC as an alternative to the basic document it has prescribed in its Rule. The UFOC has been accepted for use, with minor modifications, in all states that regulate the offer and sale of franchises by registration and/or disclosure.¹⁶⁵ In August 1990 the NASAA adopted a *Model Franchise Investment Act* to be offered to states and provinces for enactment. The Model Act requires franchisors to provide a disclosure document containing detailed information as above and in addition requires state administrative agencies to review and approve the disclosed information and other information prior to all franchise offerings.¹⁶⁶

II. CANADA

In Canada only the province of Alberta has legislation on franchising. This legislation, which was considered to be particularly draconian, was recently modified, a new franchise disclosure law and its implementing regulations becoming effective on 1 November 1995.¹⁶⁷ The new *Franchises Act* abolishes the registration requirement contained in the previous version of the Act, but still requires pre-sale disclosure. It also provides civil remedies and promotes self-government by the franchising community. The recent adoption of the *New Civil Code* in Quebec, which contains a broad definition of contracts of adhesion in its Article 1379, has raised the question of the applicability of the provisions relating to adhesion contracts to franchise agreements.¹⁶⁸ The possibility of introducing legislation in the province of Ontario has also recently be aired, but as yet nothing more specific has been developed.

III. FRANCE

In Europe, the first country to adopt legislation relating to franchising was France: on 31 December 1989 *Law No. 89-1008, concerning the development of commercial and artisanal enterprises and the improvement of their economic, legal and social environment*¹⁶⁹ was adopted, the first article of which is relevant for franchising. It is a disclosure law, the details of which were

¹⁶³ See P. ZEIDMAN, *United States*, p. 2, in *Survey of Foreign Laws and Regulations Affecting International Franchising*, *cit.* For the text of the FTC Rule and interpretative guides thereto, see CCH, *Business Franchise Guide*, at ¶ 6080 ff.

¹⁶⁴ The *North American Securities Administrators Association* includes among its members both US state and Canadian provincial administrators. For the text of the Uniform Franchise Offering Circular, see CCH, *Business Franchise Guide*, at ¶ 5750. The UFOC was recently revised. The revised edition was adopted by NASAA on 25 April 1993 and approved by the FTC on 30 December 1993. It is reproduced in CCH, *Business Franchise Guide*, at ¶ 5900.

¹⁶⁵ It is reproduced in CCH, *Business Franchise Guide*, at ¶ 3700.

¹⁶⁶ *Report from America* by P. ZEIDMAN/A. LOEWINGER/J. GILBERT, in *The Journal of International Franchising and Distribution Law*, 1991, p. 147 f.

¹⁶⁷ *Franchises Act, (Chapter F-17.1)*, assented to May 17, 1995, effective November 1, 1995. The text of the Alberta Franchises Act and implementing regulations is reproduced in CCH, *Business Franchise Guide*, at ¶ 7010 ff.

¹⁶⁸ The New Civil Code of Quebec entered into force on 1 January 1994. For a consideration of the applicability of the Civil Code to franchise agreements, see B. FLORIANI, *The impact of the Civil Code of Quebec on franchising*, in *Journal of International Franchising and Distribution Law*, 1995, p. 124 ff.

¹⁶⁹ *Loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social*, published in the *Journal Officiel* of 2 January 1990. This law is more commonly known as the *Loi Doubin* after the minister who introduced it.

subsequently laid down in government *Decree No. 91-337 of 4 April 1991*.¹⁷⁰ It should be noted that this law is not franchise-specific, but nevertheless covers franchising.

IV. SPAIN

In Spain, provisions relating to franchising were introduced as Article 62 of Law No. 7/1996 relating to the retail trade.¹⁷¹ Also this provision relates mainly to disclosure, although it does contain a registration requirement. To date, the implementing regulations have not been adopted.

V. BRAZIL

In Brazil, a law relating to franchising contracts and other measures was adopted on 15 December 1994.¹⁷² This law deals mainly with disclosure but contains provisions also on other aspects of franchise agreements, such as royalties and fees.

¹⁷⁰ *Décret n° 91-337 du 4 avril 1991 portant application de l'article 1er de la loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social*, published in the *Journal Officiel* of 6 April 1991 (a correction to the Decree was published in the *Journal Officiel* of 4 May 1991).

¹⁷¹ *Ley 7/1996, de 15 de enero, de Ordenación del Comercio Minorista*, published in the *Boletín Oficial del Estado*, número 15 of 17 January 1996.

¹⁷² Law No. 8955 of 15 December 1994 - *Dispõe sobre o contrato de franquia empresarial ("franchising"), e dá outras providências*. It entered into force sixty days after its official publication.

VI. MEXICO

A country that has included provisions regulating franchising in its law on industrial property is Mexico.¹⁷³ Pre-sale disclosure of information to prospective franchisees is required, as is the filing of information about the franchisor and registration of the transmission of trademark rights to the franchisee. The long-awaited regulations implementing these provisions and specifying in more detail the exact requirements of the disclosure were adopted in November 1994.¹⁷⁴

VII. JAPAN

A general duty of disclosure is provided by the 1973 *Medium-Small Retail Business Promotion Act*.¹⁷⁵ The act was implemented by the *Medium-Small Retail Business Promotion Act Enforcement Regulation*¹⁷⁶ and is administered by the Ministry of International Trade and Industry (MITI). The Act is not franchise specific, but is nevertheless of relevance to franchising.

VIII. RUSSIA

The legislation adopted in Russia does not regulate disclosure, but proposes instead to regulate certain aspects of the relationship between the parties. The provisions are contained in Chapter 54 of the new *Russian Civil Code* (Part 2, Articles 1027 - 1040) which entered into force on 1 March 1996. Chapter 54 does not actually refer to franchising in the text, but only to "Commercial Concessions". The descriptions of aspects of the relationship that the provisions are aiming to regulate are however clearly referred to franchising and indeed the commentaries published refer explicitly to franchising. The provisions *inter alia* deal with the form and registration of the contract, sub-concessions, the obligations of the parties and the consequences of the termination of the exclusive rights granted in the agreement.

IX. AUSTRALIA

In Australia attempts to legislate met with opposition from all sectors involved. In December, 1990 the Minister for Small Business and Customs appointed a *Franchising Task Force* to examine and propose mechanisms for the reduction of barriers and impediments to the efficiency and growth of the franchising sector. The terms of reference of the Task Force were to examine and report on the potential of self-regulatory codes for countering marketing failure in franchising, focusing on business format franchising, and to recommend the measures by which industry and Government could enhance the efficiency and growth of the franchising sector.

The outcome of the work of the Task Force was the development of a voluntary and self-regulatory *Franchising Code of Practice*¹⁷⁷ applicable to franchisors (including sub-franchisors), franchisees, service providers (including banking and financial institutions that provide franchise-related financial support to franchisors and franchisees and publishers or advertising media providers who accept work and publish advertising for the purpose of selling or promoting franchise systems), advisers (persons, firms or associations such as lawyers, accountants, marketing or management consultants and business brokers who provide advise to franchisors and franchisees) and State Small Business Corporations. The Code provides for and regulates prior disclosure, the certification by franchisees of receipt of the disclosure document, of a *Guide for Franchisees* and of a copy of the Code of Practice, it provides for cooling off periods for

¹⁷³ Law on Industrial Property, published in the *Diario Oficial*, 27 June 1991, effective as of 28 June 1991. The relevant sections of this law are reproduced in the CCH, *Business Franchise Guide*, at ¶ 7210, in an English translation by CCH staff and the Monterey Office of the law firm of Brownstein Zeidman and Schomer, Washington, D.C.

¹⁷⁴ *Diario Oficial*, 23 November 1994. These Regulations came into effect on 8 December 1994. They are reproduced in the CCH, *Business Franchise Guide*, at ¶ 7215.

¹⁷⁵ Law No. 101 of 1973.

¹⁷⁶ MITI Ordinance No. 100 of 1973.

¹⁷⁷ See *Report by the Franchising Task Force To the Minister for Small Business and Customs The Hon. David Beddall M.P.*, December 1991, Recommendation 6.

franchisees within which they may terminate the franchise agreement, regulates unconscionable conduct, alternate dispute resolution, and contains the requirement that the franchisee be identified as being a franchisee. To be noted is that the Code does not apply to master franchise arrangements between a foreign franchisor and a domestic franchisee.

The Minister for Customs and Small Business reviewed the functioning of the Code in 1994. The report was completed in October 1994 and released some time thereafter.¹⁷⁸ The publishing of this report caused renewed debate as to the necessity of introducing legislation for franchising. The reason for this was the finding that between 40 and 50% of franchisors had chosen not to register under the Code, most importantly the motor vehicle industry and significant areas in the real estate sector. Furthermore, a number of important banks had not registered as service providers. Other findings of the Reviewer were that there was a significant number of non-registered franchisors who failed to provide adequate disclosure, who failed to offer a cooling-off period for new franchise agreements and who failed to observe the standards of conduct contained in the Code. A number of recommendations were proposed by the Reviewer and extensively debated.

To administer the Code a *Franchising Code Council* was set up in early 1993 with initial funding from the Department of Industry, Science and Technology. The Council comprised five franchisor representatives, five franchisee representatives, two members representing service providers and advisers and one lawyer representative. Following a decision on the part of the Department of Industry, Science and Technology to discontinue the funding as from 1997/1998, the Council ceased to operate on 31 December, 1996.

The situation of franchising was reviewed by *the House of Representatives Standing Committee on Industry, Science and Technology* in its examination of business conduct. In its report the Committee arrived at the conclusion that self-regulation has not worked and that it is necessary to underpin codes of conduct with legislation.¹⁷⁹ This possibility is currently being debated.



As is the case with the American legislation, the disclosure laws enacted or proposed in other countries require documents of information to be furnished on:

- ◆ the franchisor and the directors of the enterprise;
- ◆ the history of the enterprise;
- ◆ the legal constitution of the enterprise;
- ◆ the intellectual property concerned;
- ◆ financial statements for the two or three preceding years;
- ◆ lists of other franchisees in the chain;
- ◆ information on the franchise agreement, such as the duration of the contract, conditions for renewal, for termination and for assignment of the contract; as well as
- ◆ information on any exclusivities.

What varies is the degree of detail that is considered to be necessary.

It should be noted that although it is not sanctioned by law, there is also an extensive duty on the part of the prospective franchisee to disclose all relevant information to the franchisor, so that the franchisor can evaluate whether or not the prospective franchisee has the necessary requirements to become a member of the network. This exchange of information is essential for

¹⁷⁸ R. GARDINI, *Review of the Franchising Code of Practice, Report to Senator the Hon. Chris Schacht, Minister for Small Business, Customs and Construction*, Australian Government Publishing Service, Canberra, October 1994.

¹⁷⁹ *Finding a balance - Towards fair trading in Australia, Report by the House of Representatives Standing Committee on Industry, Science and Technology*, Australian Government Publishing Service, Canberra, May 1997, p. 114 and Recommendation on p. 120.

the building up of trust between the parties, which is a prerequisite for the success of the enterprise.

C. THE EUROPEAN UNION AND FRANCHISING¹⁸⁰

The European Union has to date limited its activities in relation to franchising to the field of competition law. The examination of franchising within the Communities began with the decision of the European Court of Justice in the case of *Pronuptia de Paris GmbH* (Frankfurt am Main) and *Pronuptia de Paris Irmgard Schilligalis* (Hamburg).¹⁸¹ The case was referred to the Court of Justice under Article 177 of the EEC Treaty by the German Federal Court of Justice for a preliminary ruling on the interpretation of Article 85 of the EEC Treaty and Commission Regulation No 67/67/EEC of 22 March 1967 on the application of Article 85(3) of the Treaty to certain categories of exclusive dealing agreements. It concerned the franchisee's obligation to pay the franchisor arrears of fees. The Court came to a series of conclusions of general applicability in its discussion of the *Pronuptia* case. *Inter alia* the Court admitted that the franchisor must be in a position to protect certain interests vital to the business and to the identity of the network (for example the know-how), although the provisions must be essential for this purpose. However, certain categories of clauses that limit the franchisee's activities (for example price determination clauses) were not considered acceptable by the Court.

Following the landmark *Pronuptia* decision, the Commission of the European Communities has rendered five Decisions on franchising cases¹⁸² and has adopted a Block Exemption Regulation on franchise agreements.¹⁸³

The Block Exemption Regulation identifies different categories of franchise agreements (industrial franchises, distribution franchises and service franchises), specifying that it covers "[...] franchise agreements between two undertakings, the franchisor and the franchisee, for the retailing of goods or the provision of services to end users, or a combination of these activities, such as the processing or adaptation of goods to fit specific needs of their customers. It also covers cases where the relationship between franchisor and franchisees is made through a third undertaking, the master franchisee. It does not cover wholesale franchise agreements because of the lack of experience of the Commission in that field".¹⁸⁴

The text of the Regulation further gives what within the Communities has come to be regarded as a more or less standard definition of franchising, when it states that "[f]or the purposes of the Regulation: (a) "franchise" means a package of industrial or intellectual property rights relating to trade marks, trade names, shop signs, utility models, designs, copyrights, know-how or patents, to be exploited for the resale of goods or the provision of services to end users; (b) "franchise agreement" means an agreement whereby one undertaking, the franchisor, grants the other, the franchisee, in exchange for direct or indirect financial consideration, the right to exploit a franchise for the purposes of marketing specified goods and/or services; it includes at least obligations relating to: - the use of a common name or shop sign and a uniform presentation of contract premises and/or means of transport, - the communication by the franchisor to the

¹⁸⁰ For an examination of the regulation of franchising within the EU, see V. KORAH, *Franchising and the EEC Competition Rules Regulation 4087/88*, Oxford 1989, and M. MENDELSON/B. HARRIS, *Franchising and the Block Exemption Regulation*, London 1991.

¹⁸¹ Case 161/84 of 28 January 1986.

¹⁸² Decision 87/14/EEC, Yves Rocher, of 17 December 1986, published in *OJEECL* 8/49 of 10 January 1987; Decision 87/17/EEC, Pronuptia, of 17 December 1986, published in *OJEECL* 13/39 of 15 January 1987; Decision 87/407, Computerland, of 13 July 1987, published in *OJEECL* 222/12 of 10 August 1987; Decision 88/604, ServiceMaster, of 20 August 1988, published in *OJEECL* 332/38 of 3 December 1988; and Decision 89/94/EEC, Charles Jourdan, of 2 December 1988, published in *OJEECL* 35/31 of 7 January 1989.

¹⁸³ *Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements*, published in *OJEECL* 359/46 of 28 December 1988.

¹⁸⁴ Recital (5).

franchisee of know-how, - the continuing provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement [...]"¹⁸⁵

The Regulation indicates to which restrictions of competition the exemption shall apply,¹⁸⁶ to which it shall apply notwithstanding the presence of certain obligations,¹⁸⁷ to which it shall apply on certain conditions¹⁸⁸ and to which it shall not apply.¹⁸⁹ The Regulation also provides for an opposition procedure, in that it provides that the exemption shall also apply to franchise agreements that fulfil the conditions laid down in Article 4 and include obligations restrictive of competition that are not covered by Articles 2 and 3(3) and do not fall within the scope of Article 5, on condition that the agreements in question are notified to the Commission and the Commission does not oppose such exemption within six months.¹⁹⁰

The Regulation entered into force on 1 February 1989 and will remain in force until 31 December 1999. The discussions for its renewal, and for possible modifications to be introduced, have already begun, an active part being taken by franchise lawyers and franchise associations.

D. VOLUNTARY REGULATION OF FRANCHISING

A number of franchise associations, both national and international, have adopted Codes of Ethics that are to regulate the behaviour of their members. These Codes of Ethics often also deal with disclosure, albeit in a more summary manner: in general they provide that prospective franchisees have to be provided with accurate and full disclosure, but do not contain detailed provisions as to what is to be understood thereby.

I. THE CODE OF ETHICS OF THE EUROPEAN FRANCHISE FEDERATION

¹⁸⁵ Article 1(3). The *European Franchise Federation (EFF)* has adopted a definition of franchising in its Code of Ethics which is in substantial agreement with the definition in the Regulation - it was in fact prepared in consultation with the Commission. This definition indicates that: "franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor grants its individual franchisees the right, and imposes the obligation, to conduct a business in accordance with the franchisor's concept. The right entitles and compels the individual franchisee, in exchange for a direct or indirect financial consideration, to use the franchisor's trade name, and/or trademark and/or service mark, know-how, business and technical methods, procedural system, and other intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between the parties for this purpose". A footnote specifies that "know-how" means a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified. The footnote goes on to specify that "secret" means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible and is not limited in the narrow sense that each individual component of the know-how should be totally unknown or unobtainable outside the franchisor's business; that "substantial" means that the know-how includes information which is of importance for the sale of goods or the provision of services to end users, and in particular for the presentation of goods for sale, the processing of goods in connection with the provision of services, methods of dealing with customers, and administration and financial management, and that "identified" means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality. The know-how must be useful for the franchisee by being capable, at the date of conclusion of the agreement, of improving the competitive position of the franchisee, in particular by improving the franchisee's performance or helping it to enter a new market.

¹⁸⁶ Article 2.

¹⁸⁷ Article 3.

¹⁸⁸ Article 4.

¹⁸⁹ Article 5.

¹⁹⁰ Article 6.

The European *Code of Ethics for Franchising* adopted by the *European Franchise Federation (EFF)*, a federation of the national franchise associations of Austria, Belgium, Denmark, France, Germany, Hungary, Italy, the Netherlands, Portugal and the United Kingdom, provides that "[i]n order to allow prospective Individual Franchisees to enter into any binding document with full knowledge, they shall be given a copy of the present *Code of Ethics* as well as full and accurate written disclosure of all information material to the franchise relationship, within a reasonable time prior to the execution of these binding documents".¹⁹¹ The EFF is in the process of laying down guidelines on how this reference to disclosure should be interpreted. The *Code* further provides for a general obligation that "[a]dvertising for the recruitment of Individual Franchisees shall be free of ambiguity and misleading statements",¹⁹² specifying that "[a]ny publicly available recruitment, advertising and publicity material, containing direct or indirect references to future possible results, figures or earnings to be expected by Individual Franchisees, shall be objective and shall not be misleading".¹⁹³ The European Code is applicable to the members of the national associations that are members of the EFF.

II. CODES OF ETHICS OF NATIONAL FRANCHISE ASSOCIATIONS

In addition to the European Code that it has adopted as a member of the EFF, the *British Franchise Association (BFA)* has adopted an *Extension and Interpretation* of the Code that contains further indications on its application and on how some of its terms should be understood. As regards disclosure, this *Extension and Interpretation* states that "[t]he objectivity of recruitment literature (Clause 3.2) refers *specifically* to publicly available material. It is recognised that in discussing individual business projections with Franchisees, Franchisors are invariably involved in making assumptions which can only be tested by the passage of time".¹⁹⁴

In October 1994 the *Italian Franchise Association (Assofranchising)* adopted internal Regulations integrating the European Code. These Regulations entered into force on 1 January 1995.

The *Code of Principles and Standards of Conduct* of the *American International Franchise Association* provides that "[f]ranchise relationships should be established by a clear and unambiguous franchise agreement, and by prior delivery of clear and complete disclosure documents as required by law".¹⁹⁵ This general obligation is reiterated further on in the Code, where it is stated that "[...] in the advertisement and grant of franchises, a franchisor shall comply with all applicable laws and regulations. Disclosure documents shall comply with all applicable legal requirements"¹⁹⁶ and "[a]ll matters material to the granting of a franchise shall be contained in or referred to in one or more written documents, which shall clearly set forth the terms of the relationship and the respective rights and obligations of the parties. [...] Disclosure documents shall be provided to a prospective franchisee on a timely basis as required by law".¹⁹⁷ In this case it is therefore to the franchise legislation that one must turn to have a clearer idea of what is required as to disclosure. It should however be noted that this Code of Principles is applicable only to the domestic activities of the members of the IFA.

The *Franchise Association of Southern Africa (FASA)* has adopted a *Code of Ethics and Business Practices* which in Appendix 1 gives details on the disclosure document required. It should be noted that the information that should be disclosed in accordance with this Code is considerably more detailed than that required by the European Code. The Code also calls for fairness in the dealings between franchisors and their franchisees¹⁹⁸ and for every effort to be made on the part of the franchisor to resolve complaints, grievances and disputes with its

¹⁹¹ Clause 3.3.

¹⁹² Clause 3.1.

¹⁹³ Clause 3.2.

¹⁹⁴ Clause 2.

¹⁹⁵ Section III, Clause 1 para. 2.

¹⁹⁶ Section IV, Clause 1 para. 1.

¹⁹⁷ Section IV, Clause 1 para. 2.

¹⁹⁸ Clause 15.

franchisees with good faith and good will through fair and reasonable direct communication and negotiation, failing which consideration should be given to mediation or arbitration.¹⁹⁹

Of the other Codes of Ethics or Practice that have been adopted mention may be made of that adopted by the *Canadian Franchise Association*, the *Franchise Association of New Zealand (FANZ)*, the *Philippine Franchise Association (PFA)*, the *Singapore International Franchise Association* and the *Hong Kong Franchise Association*. Of these the *Code of Ethics* of the Hong Kong Franchise Association is of particular interest, as it contains not only provisions of general applicability, it also contains provisions that relate specifically to the franchisor, others that relate to the franchisee and others yet again that relate to franchise consultants. A point of interest is the fact that the franchisee is required to “provide full and frank disclosure of all information considered material to facilitate Franchisor’s selection of an appropriate franchisee for the franchise business”.²⁰⁰

¹⁹⁹ Clause 17.

²⁰⁰ Clause 19.

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- i See Chapters 5 "Obligations of the Franchisor", 6 "Obligations of the Sub-Franchisor" and 7 "The Unit Sub-Franchise Agreement".
- ii See Study LXVIII - Doc. 9, UNIDROIT 1994.
- iii See Chapter 8 "Advertising and the Control of Advertising".
- iv See the discussion in Chapter 4 "Financial Matters".
- v See Chapter 1 "Fundamental Concepts and Elements".
- vi See Chapter 9 "Supply of Equipment and other Products".
- vii See Chapter 10.
- viii See Annex 3 "Laws and Regulations Relevant for Franchising".
- ix For a discussion of the financial issues in general, see Chapter 4.
- x For a review of the problems associated with registered user systems and master franchise agreements, see Chapter 10.
- xi *Commission Regulation (EEC) No 4087/88 on the application of Article 85(3) of the Treaty to categories of franchise agreements*, Recitals 2 and 3.
- xii See the description contained in the Introduction to *the Commerce Clearing House Business Franchise Guide*, at ¶ 100.
- xiii For a more detailed examination of ancillary documents, see Chapter 19.
- xiv See Chapter 1 "Fundamental Concepts and Elements"