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Unidroit
INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW

STUDY GROUP ON FRANCHISING

Guide to International Franchising
Second Draft

Rome, March 1997
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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 which 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 the 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 Franchising, the purpose of which is to spread knowledge with a view to providing a tool for the better understanding of what franchising is and how it can be used.

The Guide will consider the principal methods used in franchising, although the main emphasis will be on master franchise arrangements in business format franchising. As, with certain adaptations, the same methods may be used in both domestic and international franchising, it is hoped that the Guide will be of use to operators and franchise lawyers active on either or both scenes. It must however be stressed that the principal purpose of the Guide is to assist parties in negotiating and drawing up international franchise agreements by identifying the legal issues involved in those agreements, discussing possible approaches to the solution of the issues and, where appropriate, suggesting solutions which the parties may wish to incorporate in their agreement. It is hoped that by furnishing adequate information this Guide may place the parties on a level where a lack of knowledge would otherwise place one of the parties at a disadvantage. The Guide is also intended to provide those who deal with franchising as judges, arbitrators or scholars with a concise and precise instrument of information.

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-categories. A list which includes a majority of categories of businesses franchised is the following:

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
   haircare 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
  frankfurters
  hot bread kitchens
  Italian
  Mexican
  mobile units
  pancakes/waffles
  roast beef
  sandwiches
  seafood
  smörgåsbord
  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.

FRANCHISING IN THE WORLD 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. A series of estimates which illustrate the extension of the phenomenon are,
however, regularly made. The following table is based on Table 6 of the *Industry and Trade Summary on Franchising* which refers to business format franchising only. The information contained in Table 6 has been integrated with data derived from other sources.

<table>
<thead>
<tr>
<th>Continent</th>
<th>Country</th>
<th>Year</th>
<th>Franchisees number of</th>
<th>Franchised establishments number of</th>
<th>Employees bus.form.fr. number of</th>
<th>Revenues in billion dollars bus.form.fr.</th>
<th>Percentage retail trade all franchising</th>
<th>Annual growth rate all franchising</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td>Austria</td>
<td>1992</td>
<td>80</td>
<td>2,500</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Belgium</td>
<td>1992</td>
<td>90</td>
<td>3,200</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>4.3</td>
</tr>
<tr>
<td></td>
<td>Denmark</td>
<td>1992</td>
<td>42</td>
<td>500</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>France</td>
<td>1993</td>
<td>550</td>
<td>27,000</td>
<td>400,000</td>
<td>39.8</td>
<td>7.5%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Germany</td>
<td>1994</td>
<td>500</td>
<td>22,000</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>12.1</td>
</tr>
<tr>
<td></td>
<td>Ireland</td>
<td>1999</td>
<td>20</td>
<td>unavailable</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>0.1</td>
</tr>
<tr>
<td></td>
<td>Italy</td>
<td>1993</td>
<td>351</td>
<td>17,500</td>
<td>50,550</td>
<td>9.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Netherlands</td>
<td>1992</td>
<td>331</td>
<td>12,840</td>
<td>69,750</td>
<td>8.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Norway</td>
<td>1992</td>
<td>125</td>
<td>3,520</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>3.9</td>
</tr>
<tr>
<td></td>
<td>Portugal</td>
<td>1992</td>
<td>55</td>
<td>900</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Singapore</td>
<td>1992</td>
<td>117</td>
<td>14,500</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>2.7</td>
</tr>
<tr>
<td></td>
<td>Sweden</td>
<td>1992</td>
<td>200</td>
<td>9,000</td>
<td>unavailable</td>
<td>unavailable</td>
<td></td>
<td>7.8</td>
</tr>
<tr>
<td></td>
<td>United States</td>
<td>1993</td>
<td>396</td>
<td>24,900</td>
<td>188,500</td>
<td>7.5</td>
<td>10%</td>
<td></td>
</tr>
<tr>
<td>North &amp; South America</td>
<td>United States</td>
<td>1992</td>
<td>2,500</td>
<td>429,217</td>
<td>4,721,387</td>
<td>249.0</td>
<td>35%</td>
<td>10%</td>
</tr>
<tr>
<td></td>
<td>Mexico</td>
<td>1994</td>
<td>unavailable</td>
<td>5,000</td>
<td>75,000</td>
<td>3.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Brazil</td>
<td>1993</td>
<td>unavailable</td>
<td>21,244</td>
<td>unavailable</td>
<td>4.9</td>
<td></td>
<td>35%</td>
</tr>
<tr>
<td></td>
<td>Chile</td>
<td>1994</td>
<td>35</td>
<td>200</td>
<td>10,000</td>
<td>0.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asia/Pacific</td>
<td>Japan</td>
<td>1994</td>
<td>714</td>
<td>139,798</td>
<td>unavailable</td>
<td>102.9</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hong Kong</td>
<td>1992</td>
<td>100</td>
<td>2,000</td>
<td>unavailable</td>
<td>0.6</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Australia</td>
<td>1994</td>
<td>555</td>
<td>30,500</td>
<td>279,000</td>
<td>29.0</td>
<td></td>
<td>12.7% (1989-1991)</td>
</tr>
<tr>
<td>Africa</td>
<td>South Africa</td>
<td>1992</td>
<td>90</td>
<td>2,700</td>
<td>unavailable</td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The size of the phenomenon of franchising becomes even more evident when the figures relating to 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 dollars 803.2 billion, as against the 249 billion dollars worth of sales from business format franchise outlets. The remaining 554.2 billion US dollars were from product and trade name franchising. In addition to the 429,217 business format franchise outlets, in 1992 there were 128,908 product and trade name outlets in the United States. The number of people employed in franchising amounted to

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2 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.

3 Includes beverages industry

4 Includes product and trade name franchising

5 Includes product and trade name franchising

eight million. In 1992 it was estimated that sales from franchises represented some 35% of retail sales in the U.S.

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%.) 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.

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 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.

In Canada in 1984 retail sales from franchise outlets exceeded CDN $48 billion or approximately 45% of total Canadian retail sales. Of these, it was estimated in 1985 that 50% were generated from business format and what at the time were considered to be other non-traditional forms of franchising. Between 1981 and 1984 franchising in Canada averaged annual sales increases of 15%. In the same period, total Canadian retail sales and GNP increased annually by only 8% and 7% respectively. In 1987 approximately 1000 franchisors located across Canada and operating nearly 45,000 franchise outlets accounted for sales totalling CDN$ 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.

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The European Franchise Federation estimates for franchising in France indicate that in 1993 there were 617 franchisors with over 30,000 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.\(^{14}\)

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.\(^{15}\) 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.\(^{16}\) 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%.

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 amounted to 48.1 billion US dollars, which amounted to 10% of the GNP of the country.\(^{17}\) In 1994 total sales of company-owned and business format franchise outlets totalled 9.87 billion US dollars, while sales of product and trademark franchises totalled 68,389 billion US dollars. In 1994 it was estimated that there were 26,716 business format franchise outlets.\(^{18}\)

In New Zealand, where franchising has only recently begun to develop, it was estimated in 1993 that there were approximately 150 franchisors.\(^{19}\) Lastly, in Australia the annual growth rate of franchising for the years 1989 - 1991 reached 12.7%.\(^{20}\)

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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 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.\(^{21}\) Japan has the highest average number of establishments per franchisor in the world, with approximately 200 establishments per franchisor.\(^{22}\)

The Latin American market is further developing very quickly, with Brazil, Mexico and Argentina in the forefront. It 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 now represents 1-2% of retail trade.\(^{23}\) With few exceptions, notably that of South Africa, franchising has still to develop on the African continent.

**Benefits of Franchising**

The figures cited in the above Section on *Franchising in the World Economy* 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.

1. **Benefits to the National Economy**

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

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creating yet more new jobs. With unemployment rates of 10, 12 or even 20%, the importance of an instrument which creates work opportunities cannot be stressed enough.

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 182% between 1975 and 1988.24

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.25 This represents a substantial increase, as the Survey conducted by Department of Industry, Technology and Commerce in 1990/91 indicated that franchised outlets employed 170,000 people.26

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, 10,000 new jobs were created in 1992.27

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.

According to a study commissioned by the International Franchise Association28 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, going down to a 60% success rate. 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 10% after 10 years.29

28 The professional association essentially of American franchisors, even if it recently opened to membership by franchisees.
According to the BFA/NatWest survey, in the UK the number of individual unit failures by franchisees has remained fairly constant, at 4.3% of all units operating in 1988, 4.4% in 1988, 3.6% in 1989 and 4.6% in 1990.\(^\text{30}\)

The number of bankruptcies is also considerably lower than the average figures for non-franchised retail trade, although here again there is disagreement as to the exact figures.

On the borderline between benefits to the economy and benefits to the operators the creation and training of an entrepreneurial class which results from the development of franchising. 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 consequently lower failure rate of franchisees is a positive element both for the economy as a whole and also 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 that is likely to spread also in developing countries, many of which face problems similar to those faced by the Central and Eastern European countries, including, for instance 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.\(^\text{31}\) 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

\(^{30}\) NatWest/British Franchise Association, Survey of the period 1986 - 1990.

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 it is a system that generates employment opportunities. The countries of Central and Eastern Europe have a tradition of small business enterprises that survived through the decades of socialist rule, but despite this capable entrepreneurs are few and far between. The training of an effective class of entrepreneurs would be of considerable importance for the economic development of these countries. The training and assistance in general business management, in accountancy and in related skills that are among its fundamental characteristics are what make franchising 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.\(^{32}\)

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:\(^{33}\)

- 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.

\(^{32}\) Ibid., p. 317 ff.

\(^{33}\) Ibid., p. 320.
Whether or not in practice franchising would be effective as a tool for the privatisation process remains to be seen. Even if the Governments of Hungary, Poland and the Czech Republic have in fact expressed an interest in using franchising to privatise State enterprises, the experience in Hungary has been disappointing, it has indeed been described as a failure, the reason given being that the central organisations did not have the necessary market experience to act as franchisors, nor did they have the training. Furthermore, the organisations did not have a name to sell, or at least not a name that might be attractive to the general public. Franchising might be considered to have all the tools necessary to make it a success also in the privatisation process, but adaptations would be necessary to take into consideration the requirements of the country concerned.

2. **Benefits to 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 drawbacks 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.

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 at the beginning of the agreement so as to enable the franchisee to operate effectively, but also for the whole term of the agreement. This continued assistance service 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 provided during 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, at least at a national level, 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, and also without being liable for the acts of the franchisee as the two are and remain independent entrepreneurs.

(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 (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 franchise. 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.

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.

The Risk Factor

One of the reasons for the popularity of franchising is the fact that the failure rate of franchised businesses is substantially lower than that of other, more traditional forms of business. It must however be stressed that no business is risk-free. Although in principle franchising is less risky than other forms of independent entrepreneurial activities, it does carry a risk. Whereas this risk is considerably reduced in a domestic situation, it remains a factor of considerable importance in international franchising.

In franchising the risk is reduced for both franchisors and franchisees. In the case of franchisors the risk is reduced essentially because 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. This is true in both domestic and international franchising, as the appeal of a franchise will in both cases depend on how well it is known. It is natural that the greater the success of the system the greater the appeal of a franchise for prospective franchisees; if a system is successful it may be considered a truly proven concept and it will therefore appeal to prospective franchisees both nationally and internationally, as it offers greater guarantees than less well-known systems.

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. Decision makers can never be certain of the outcome and effect of their decisions as it is not possible that
they and/or their advisors will ever be fully informed of all factors that may influence this outcome.

A franchisor entering into an international master franchise relationship will therefore need to calculate not merely what an acceptable price for franchise rights in a given country is, but also the costs and benefits of gathering the information that is needed to acquire a more reliable picture of the target country. To minimise risk the franchisor might prefer to charge a significant up-front fee which is designed to cover all costs and to provide an acceptable return in the event that no further funds are forthcoming from the area or country to which it has sold franchise rights. The advisability of such a course may however be questioned. It is not unknown for franchisors to charge substantial up-front fees and then not to service the franchise system as it should, perhaps because of the uncertainty of returns from that particular system. This may however be considered a practice that is questionable in the extreme, as the continued assistance on the part of the franchisor is an element which may be considered essential in the description of what constitutes a franchise.

So as to reduce uncertainty a franchisor must 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.

1. **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 target 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 following issues in relation to the country the franchisor would like to enter:

- the legal environment: the general regulation of contracts, legislation relating to specific areas of importance to franchising, such as intellectual and industrial property, currency control and exchange regulations, the control exercised by the authorities, taxation, the export of fees and royalties to the franchisor’s country, the corporate laws that influence the selection of the appropriate company structure
the situation of the market: purchasing power in relation to the products and services to be franchised

- 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
- the possible ways of sharing the unavoidable risk.

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

2. **INTERNAL RISK FACTORS**

Internal factors include the organisational arrangements within the domestic operation and the available financial and human resources of the franchisor. 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 a three-tier system. In such a case the franchisor would need to hire additional staff to service the multi-level operation. If the franchisor’s system does not already have a unit able to handle the necessary administration, training and control, 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. If such factors are not taken into account, the risk is that the international activities create a heavy drain on the financial and staff resources of the franchisor, thereby harming the domestic operations of the franchisor and in the ultimate analysis also jeopardising the international activities.

When the franchisor decides the form its international expansion is to take, a number of risk factors may be under its control, such as domestic staff resources or the organisational settings in the targeted country. Others are beyond its control, such as for instance the political climate of the host country or socio-economic and legal factors. A sharing of the risks 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 therefore often provided for in the contract or in the arrangements made. The setting up of a joint venture in the host country could for example lead to such a sharing of risk.
3. **Evaluation of the Risk by the Sub-Franchisor**

The importance of information for the reduction of risk cannot be overly stressed. This is true also for the sub-franchisor, or indeed for the sub-franchisee. The sub-franchisor is investing a substantial amount of money and time in the franchise and it risks losing its investment if the operation does not succeed. It will therefore need to make a careful assessment of the risk involved in the enterprise before entering into it.

The sub-franchisor will need to make a careful assessment of the investment that is necessary, not only in terms of the fees and royalties that the franchisor will charge, but also in terms of investment in premises, in the acquisition of whatever is necessary for the fitting and decoration of the premises, in terms of the 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 might be involved. To be considered, is also the cost of setting up a pilot operation.

A certain amount of training, as well as assistance, will be necessary no matter how sophisticated an entrepreneur the sub-franchisor is, as the sub-franchisor is to run a system in conformity with the specifications of the franchisor and this system to all intents and purposes is new to the sub-franchisor. The risk is that the training and assistance the franchisor provides will prove to be insufficient, which might result in an impairment of the sub-franchisor to manage the system adequately and to furnish adequate assistance to sub-franchisees. 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 which in actual fact is out of proportion with the rights it acquires and the services it receives.

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, but also the sub-franchisor. In addition, the sub-franchisor might 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 find alternative sources or find that the network will not be able to provide goods or services of the required quality or that fit the specifications of the franchisor. This leaves the sub-franchisor open to claims from both the franchisor for not having respected 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 they expect.

The elements listed above as important for franchisors to consider in a feasibility study are relevant also to sub-franchisors, even if the sub-franchisor will consider these
elements 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 that is proposed to it. This is closely linked to the local customs, culture and habits as the viability of the product or service might well depend on such factors. Geographical 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 furnishing of goods or materials.

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 the franchisor is prepared to offer. If the franchisor does not furnish the training and the 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.

Internal factors are important also for the sub-franchisor, as a mistaken evaluation of the capability of, for example, its 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 and of the effectiveness with which it will be able to use them, as well as of the financial implications.

Most of the risks indicated above are not specific to franchising. There are, however, a number of risk factors 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 ensure 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 prevent the sub-franchisor from adopting a more convenient alternative, for example in the provision of goods, than what is offered by the franchisor.
HISTORY OF THE UNIDROIT PROJECT

The purposes of Unidroit as laid down in Article 1 of its Statute are to examine ways of harmonising and co-ordinating the private law of States and of groups of States, and to prepare gradually for the adoption by the various States of uniform rules of private law. To achieve its purposes the Institute shall:

"(a) prepare drafts of laws and conventions with the object of establishing uniform internal law;
(b) prepare drafts of agreements with a view to facilitating international relations in the field of private law;
(c) undertake studies in comparative private law;
(d) take an interest in projects already undertaken in any of these fields by other institutions with which it may maintain relations as necessary;
(e) organise conferences and publish works which the Institute considers worthy of wide circulation".

In the course of its seventy-year history the Institute has concentrated mainly on preparing international conventions, which is the traditional expression of international cooperation between States. It is however convinced that also non-binding instruments have an important role to play in the harmonisation of private law. Indeed, the scope of harmonisation can be considerably broadened if the number of instruments possible is increased.

There are a variety of ways in which to harmonise law: through the preparation of international conventions, through uniform laws, through model laws or through guidelines, for instance. 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 calls 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 seen as abuses on the part of the franchisor and will involve attempts to redress the balance between the parties to an agreement where the necessary balance either does not exist or has been distorted. The most common of such abuses include too stringent provisions as regards the control exercised by the franchisor or as regards the rights retained by the franchisor to terminate the agreement, inadequate rights of the other party to terminate for breach on the part of the franchisor, the structuring of the agreements in such a way that a legal vacuum is created and the weaker party ends up having no rights and perhaps losing its investment, omissions on the part of the franchisor as regards the assistance to be offered its
franchisees or the sub-franchisor and the provision of inadequate training on the part of the franchisor.

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 on the other hand taking the form of breaches of contract which will be dealt with accordingly. While this corresponds to reality in a majority of cases, it should however be noted that the situation might be reversed, in that particularly in master or area development franchising the foreign sub-franchisor or area developer may be considerably larger than the franchisor.

It was concern caused by instances of what might be considered abuse on the part of the franchisor that occasioned the proposal that Unidroit consider the preparation of uniform rules on franchising. Unidroit thus first began to examine the possibility of working on franchising in 1985 when, following a proposal from its Canadian member, the Governing Council of the Institute requested the Secretariat to draw up a preliminary report with a view to deciding whether franchising should be included in the Work Programme of the Institute. This preliminary study was presented to the Governing Council at its 65th session.\textsuperscript{36}

At the request of the Governing Council this report, together with a questionnaire designed to elicit further information, was submitted to Governments, professional circles and recognised experts in the field. At its 67th session the Governing Council was seized of a survey of the answers to the questionnaire.\textsuperscript{37} Following an examination of this report, the Governing Council requested the Secretariat to submit a paper examining the actual terms used in franchising agreements to its 68th session. The Governing Council was duly seized of a report examining the terms of the franchise agreements received.\textsuperscript{38}

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.

\textsuperscript{36} See C.D. 65 - Doc. 12, also published as Study LXVIII - Doc. 1, UNIDROIT 1986.
\textsuperscript{37} See C.D. 67 - Doc. 9, also published as Study LXVIII - Doc. 2, UNIDROIT 1988.
\textsuperscript{38} See C.D. 68 - Doc. 11, also published as Study LXVIII - Doc. 3, UNIDROIT 1989.
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 tripartite nature of the relationship between franchisor, sub-franchisor and sub-franchisees, particularly in relation to termination, and disclosure.

The findings of the Group\textsuperscript{39} 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.

Whereas a binding instrument such as an international convention was considered to be inappropriate or even harmful to international franchising, 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.

The guide approach has several advantages for a subject such as franchising. In the first place it can illustrate the problems that might arise in connection with issues that have already been regulated in one way or another by national legislation but which are of particular importance in the context of franchising (such as intellectual and industrial property). It can 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 can be prepared in a relatively short period of time, which is definitely not the case for an instrument such as a convention. A guide can be launched on the market upon completion and will 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

\textsuperscript{39} See Study LXVIII - Doc. 9, UNIDROIT 1994.
which may take a long time. If the purpose of the international instrument to be adopted is to reach out quickly to the franchising community, then an instrument such as a guide is the most appropriate.

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.

Only a few States have adopted legislation specifically on franchising, but this does not mean that there is no law to apply. The characteristics of franchising are such that a large number of areas of law are involved, a majority of which have already been regulated. The areas in which a regulation would be possible and effective are therefore considerably reduced.

Although nothing would prevent the elaboration of an international convention, the proposed subject-matters would require a considerable number of mandatory provisions. The stringent nature of an international convention would furthermore not permit adaptations that might be felt to be essential for the 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 the convention by the different nations of the world. The utility of such an instrument might therefore seriously be questioned.

A uniform law would not be more suitable and may indeed often be considered to present the same drawbacks as an international convention.

A more feasible instrument might in this case be a model law. A major advantage of model laws are their flexibility, which permits the legislators that turn to them for inspiration to make the modifications that they consider to be imperative. There is consequently the possibility to include in the model law a number of provisions that the experts preparing the law deem to constitute the most appropriate solution to a specific problem even if some States would politically be unable to accept them if the final instrument were 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. The underlying principles should however remain the same.

The majority of the franchise associations have adopted a Code of Ethics or Best Practices, which however remain voluntary instruments and need to be evaluated as such in terms of their effectiveness.

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40 See the Annex on legislation.
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 appropriate. Furthermore, the International Chamber of Commerce in Paris was preparing a model franchising contract for international, direct unit franchises, which the ICC hoped would be ready within the next couple of years. The Study Group therefore decided to exclude the model contract from the options open for consideration.

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.

The Governing Council of the Institute endorsed these recommendations at its 74th session in 1995 and requested that work on the legal guide to master franchise agreements advance as rapidly as possible. This Guide is the outcome of the labours of the Study Group.
CHAPTER 1

FUNDAMENTAL CONCEPTS AND ELEMENTS

DEFINITIONS

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 to be considered 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.\(^1\) 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.\(^2\)

Business format franchising is increasingly coming to be recognised as the typical franchise notwithstanding the fact that a number of different types of business are included under the term “franchising”. 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.

\(^1\) 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.

\(^2\) See the description contained in the Introduction to the Commerce Clearing House Business Franchise Guide, at ¶100.
BASIC ELEMENTS OF BUSINESS FORMAT FRANCHISING

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.

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. 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:

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3 For a more detailed examination of ancillary agreements, see Chapter 22.
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 for 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 has 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 franchisee ("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 franchisee first and foremost within the 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, but considering their importance in the latter they are examined in the context of international franchising.

**Franchise Agreements and Other Agreements**

The description of the basic elements of franchising highlights the fact that 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 specific to 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.
1. **COMMERCIAL AGENCY AGREEMENTS**

The concept of the commercial agent is traditionally unknown in the common law. 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.\(^4\) 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.\(^5\)

Under the civil law the agent therefore in essence has the power to create direct legal relationships between the principal and third parties. The agent acts on behalf of, and in the name of, the principal. It is necessary for the agent to act in the name of the principal, or to disclose that he is acting for a principal even if he does not immediately reveal the identity of that principal, for the principal to be bound by the agreement concluded by the agent. If the agent does not disclose that he is acting for a principal, it is the agent who will be personally liable. The powers of the agent may however be more restricted, in that the agent may at times only have the power to negotiate the agreement without actually being able to conclude it.

The figure of the commercial agent has been introduced into the European common law systems by the European Directive, traditionally, however, in the common law agency is 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".\(^6\) 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. Also in the common law an agent may act for a non-disclosed principal. The main difference with the civil law systems is, however, that under the common law, in addition to the agent who has concluded the contract in his own name, a completely undisclosed principal may also be liable and entitled under the contract concluded by the agent.

In franchising, 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

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\(^4\) 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.

\(^5\) Cf. Article 1(2).

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.

2. **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 and it may even have competing or conflicting lines. Exclusive distribution arrangements, on the other hand, normally grant the distributor the exclusive right to sell the products in a specified area. In the relevant Regulations the European Communities distinguish between exclusive distribution agreements, by which the manufacturer or supplier grants the distributor the exclusive right to sell the products in a pre-defined area,\(^7\) and exclusive purchasing agreements, by which the distributor agrees to purchase the goods specified in the agreement for resale only from the manufacturer or supplier.\(^8\) The two agreements are often incorporated into one and this one agreement is then classified as an exclusive distribution agreement.

In franchise agreements there is instead in most cases an exclusivity clause which provides that the franchisee should 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 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 the distribution (the organising of the sales, purchase and maintenance of a stock and of assistance to clients), exclusive purchase requirements and prohibitions to sell competing products or territorial exclusivity, the way they are to be performed in the different arrangements might differ considerably. A clear distinction

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between franchise and distribution agreements is however to be found in the fundamental elements of training and assistance on the part of the franchisor and the control exercised by the franchisor over the operation of the franchisee.

3. **Licence and Technology Transfer 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 here 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 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.

The licensor's main obligation is to make the intellectual or industrial property available to the licensee in accordance with the agreement. The licensor must therefore ensure that the intellectual and industrial property rights are valid, that the licensor has the right to dispose of them and that there are no third party rights that conflict with the agreement.

The licensee's main obligation is to pay the licence fee. Consequently, the licensee is obliged to give the licensor the possibility to check the production and sale to the extent necessary to ensure that payment is made in accordance with the agreement. In practice this is done through an independent auditor who, on the licensor's behalf, is granted access to the accountancy of the licensee.

The licensee is normally under no obligation to use the intellectual or industrial property, unless this is specifically agreed. The licensor may not actually control the products produced by the licensee unless this is specifically provided for in the agreement. An exclusive licensee is always fully empowered to take action against infringements of the intellectual or industrial property rights.

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.

Franchising is often included under the all-embracing transfer of technology provisions adopted 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. The consequence is that, for example, the registration requirements that are provided for technology transfer agreements may also apply to franchise agreements.

INTERNATIONAL FRANCHISING

There are essentially two ways to franchise internationally: directly or through master franchise agreements. 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 conjunctions with area development agreements or master franchise agreements in particular.

1. DIRECT FRANCHISING

Direct franchising includes traditional unit franchising, franchising through a branch or subsidiary and franchising by means of area development agreements.

(i) 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.

(ii) Franchising through a Branch or Subsidiary

Franchising through a subsidiary or through a branch office are often treated together, despite the fact that there are differences deriving from the fact that a subsidiary, albeit controlled by the franchisor, 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. Whatever the differences, both the subsidiary and the
branch office act 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.

(iii) 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 far away 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 a problem that is limited to international franchising or indeed to area development agreements.

2. 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. 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.⁹

In this case two agreements are involved: an international agreement between the franchisor and the sub-franchisor (the master franchise agreement), and national franchise agreements between the sub-franchisor and the sub-franchisees (the sub-franchise agreements). There is generally speaking no direct relationship between the franchisor and

⁹ See Chapter 5 "Financial Matters".
the sub-franchisees, although in some countries intellectual property legislation will make a
direct link necessary for those particular rights. 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 that country or
territory. If a sub-franchisee does not fulfil its obligations it is the duty of the sub-franchisor
to intervene, the franchisor will normally not be able to do so. All the franchisor will be able
to do is to sue the sub-franchisee for non-performance if it does not fulfil its obligation to
enforce the sub-franchise agreements as laid down in the master franchise agreement.

(i) 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.

(a) Advantages

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, might be more substantial than
many franchisors think before they enter into the agreement. Furthermore, the two countries
will in all likelihood differ considerably as to culture, customs and traditions, legislation,
language and religion, not to speak of social and economic organisation. It is therefore of
considerable advantage to 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 legal requirements so as to be able 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 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
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
contribution of the franchisor will be minimal when compared with the obligations of the sub-
franchisor.

A major advantage of master franchising to the sub-franchisor, as to franchisees in
simple unit franchising, is that it has the benefit of investing in a well-known and tested
business concept. How well-known the business concept is in the country of the 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. 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 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.

(b) Disadvantages

In general terms the disadvantages with master franchising are seen by franchisors as being a sometimes substantial reduction in their financial return as the revenue from the network will be divided between the franchisor and the sub-franchisor. The larger sum will in most instances remain with the sub-franchisor, as it is the sub-franchisor who sets up, organises and runs the network. Furthermore, the franchisor is obliged to rely on the sub-franchisor to enforce the sub-franchise agreements and to ensure that the franchisor’s rights, such as intellectual and industrial property rights, are not infringed upon. The franchisor consequently loses a substantial amount of the control it would otherwise exercise over operations. This loss of control is the single most important drawback of master franchising to franchisors, and its importance should not be minimised.

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

1. 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 given up control of its franchise system, including its trade marks, in the foreign country to the sub-franchisor. This lack of control by the franchisor is a direct result of the fact that there is typically no direct contractual relationship between the franchisor and the sub-franchisees. As a result, the franchisor may 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 therefore 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 sub-franchisees, as, for example, where the franchisor is made a party to the sub-franchise agreement, the termination of a master sub-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 provisions of the master franchise agreement requiring 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 a carefully prepared master franchise agreement and sub-franchise agreement can alleviate the problems of loss of control, these problems, due to the nature of master franchising, cannot be eliminated or even avoided.

2. Problems with Terminating Master Franchise Agreements

The nature of master franchising is such that it is difficult to enforce the franchisor’s rights to terminate a master franchise agreement. This could result in 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 termination on sub-franchisees, as termination impacts 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 are a party to the master franchise agreement. This is the result of the close relationship of the master franchise agreement and the sub-franchise agreements, in that the rights granted by the sub-franchise agreements are derived from 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. It is the manner in which the future of unit sub-franchise agreements is dealt with in the master franchise agreement following its termination that creates the greatest difficulty.

3. Splitting of Fees

When compared to direct franchising, development agreements included, master franchising will reduce, at times considerably, the financial returns to the franchisor. This will to some extent, be offset by the lesser 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. The question may therefore arise whether the revenue from the fees is sufficient for both the franchisor and the sub-franchisor once these fees have been split. Although master franchising arrangements typically provide for the splitting of fees in a proportion that generally favours the sub-franchisor, the issue nevertheless remains as to whether the fees left in the hands of the sub-franchisor are 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 system. The question is just as relevant for franchisors who typically receive the smaller proportion of the fees paid by sub-franchisees. Franchisors are in fact beginning to question whether the fees are 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 in the foreign country, 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 of master franchising for sub-franchisors are mainly the reduced freedom of action coupled with the fact that they answer to the franchisor for the way in which they operate their network, the substantial investments that are required and the reduced income. There is furthermore 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.

As regards development agreements, it is still too early to predict whether the franchise community will accept their increased use by franchisors in their international expansion. For smaller franchisors contemplating international expansion for the first time, who do not have the financial and other resources required, master franchise arrangements will continue to be the preferred vehicle for international expansion.

(ii) Problematic areas

There are a number of other issues that may be problematic in master franchise arrangements. These include intellectual and industrial property rights, product liability, labour law, choice of law and jurisdiction, taxation and, perhaps most problematic of all, the consequences of the agreement coming to an end.10

In the case of intellectual and industrial property rights a major question is whether both the sub-franchisor and the sub-franchisee may be granted the right to use the intellectual and industrial property of the franchisor, whether it is possible to have a registered user in the country concerned. This is a fundamental question considering that the trademark licence is an essential component of the franchise.11

As regards the liability of the parties to master franchise arrangements, for example for defective products, the main questions are whether, and the extent to which, the franchisor can be held liable for acts and omissions of the sub-franchisor and even of sub-franchisees. As regards liability for acts or omissions by the sub-franchisor, such a liability

10 See Chapter 19 "The End of the Relationship and its Consequences".
11 See Chapters 12 "Rights Created by Statute" and 13 "Rights Protected by Contract".
might be envisaged vis-à-vis sub-franchisees, as the franchisor would presumably be required to control that the sub-franchisor meets its obligations under the master franchise agreement. As instead regards acts or omissions on the part of sub-franchisees, the question is whether a consumer can sue the franchisor for damages caused by defective products produced or sold by a sub-franchisee, considering that the sub-franchise agreement is a contract between the sub-franchisor and the sub-franchisee to which the franchisor would normally not be a party.12

A distinctive feature of franchise agreements in general is the control exercised by the franchisor over the operation of the franchise by the franchisee. In the case of master franchising this control will be more difficult to implement, first and foremost as a result of the three-tier structure of master franchising. Secondly, the entrepreneurial independence of the franchisor, the sub-franchisor and the sub-franchisees needs to be safeguarded so as to avoid undesired liability being placed on one or other party or the tie between them being considered to be more in the nature of an employment contract than an agreement between independent entrepreneurs. Problems might further arise in situations where a foreign franchise does not adequately take into account the work habits and labour legislation of the country it is entering. A certain amount of adaptation of the system to local needs might be required, both as regards the organisation of the work and as regards the requirements of local legislation.

Choice of law and jurisdiction questions are of importance in connection with master franchise agreements. The possibility, or at times the advisability, of having different laws apply to the master franchise agreement and to the sub-franchise agreements will need to be considered. As the sub-franchise agreement is a domestic agreement it is more than likely that the law applicable to the agreement will be that of the country in which the sub-franchisor and sub-franchisees are located, whereas the master franchise agreement may be subject to the law of the country of the franchisor. The advantages and/or disadvantages of such an arrangement need to be evaluated on a case by case basis.13 Not to be forgotten in the context of the choice of law are the possibility to have recourse to arbitration and the advisability of preliminary mediation proceedings. Informal attempts to resolve difficulties through a procedure such as mediation will often permit the parties to maintain the relationship despite the disagreement and this is essential for long-term agreements of this nature.

Each party to the franchise arrangement, franchisor, sub-franchisor and sub-franchisees, will have to consider the taxation implications of the different options open to them. Of importance in this regard is the question of who should be responsible for paying the withholding tax when the revenue from the fees and the royalties is exported. In general terms issues associated with the exportation of profits and currency restrictions, or more

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12 See Chapter 7 "Rights and Obligations of Franchisor".
13 See Chapter 20 "Choice of Law".
simply those associated with import restrictions and/or quotas for products needed in the franchise, need to be evaluated by the parties.\textsuperscript{14}

As briefly indicated above, one of the most problematic areas of all relates to the effects of the master franchise agreement coming to an end. Although most of the issues that arise in relation to the expiration of the agreement will also arise in relation to termination,\textsuperscript{15} a distinction should be made between the two situations. The most important issue concerns the fate of the sub-franchise agreements as the rights granted under the sub-franchise agreements are directly derived from the master franchise agreement. The question is therefore whether or not the sub-franchise agreements automatically expire when the master franchise agreement no longer exists. This question is particularly acute when the master franchise agreement ends as a result of termination for non-performance on the part of the sub-franchisor, as the agreement will not have run its full course and the provisions applicable to the situation where the master franchise agreement comes to an end might not be applicable in the case of termination. A number of options might be envisaged to solve this question. Provision might for example be made for the sub-franchise agreements to expire at the same time as the master franchise agreement, or for the transfer of the rights and obligations of the sub-franchisor to the franchisor. All too often, however, this question is not given sufficient consideration in the agreements themselves, neither in the master franchise agreement nor in the sub-franchise agreements, despite the fact that it is a question that is vital for the survival of the network.\textsuperscript{16}

3. \textit{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 would do. 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.

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

\textsuperscript{14}See Chapter 5 "Financial Matters".
\textsuperscript{15}See Chapter 18 "Remedies for Non-Performance".
\textsuperscript{16}See Chapter 19 "The End of the Relationship and its Consequences."
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.

**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 might not be appropriate in every situation and that other methods of distribution, such as a “bare bones” license agreement, a scaled down version of a master franchise agreement, a “hybrid franchise/license” agreement, an area representation agreement or even a distribution agreement, may be better suited under certain circumstances.

1. **“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 simply neither adequate nor appropriate in the circumstances.

   Thus, in countries where the franchisor has reason to believe that:

   (a) notwithstanding the terms and conditions of a carefully drafted master franchise agreement the sub-franchisor will not in any meaningful way follow the franchise system, or will not accurately report on sales generated at franchise outlets, or on the number of franchise outlets operating in the foreign country, or

   (b) where the location of the foreign country is such that the operation of the franchisor’s franchise system in the foreign country will have little or no impact on the operation of the franchise system in other areas of the world, or

   (c) where, for whatever reason, the franchisor’s trade marks will not be used in connection with the franchise system or where the franchisor is forced to adopt new and different trade marks for that particular foreign country, or
(d) where the franchisor's rights cannot meaningfully be enforced by resorting to the courts or even to arbitration,

the franchisor's interests may best be served by taking a realistic approach and 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 the franchisor 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.

A "bare bones" license agreement would therefore contain few of the control mechanisms or of the obligations normally imposed on a franchisee in typical franchise agreements.

A number of legitimate questions surrounding the use of a "bare bones" license agreement should be asked before such an agreement is resorted to. These questions, and the possible answers thereto, would include, but not be limited to, the following:

(a) would it not be better to use a more typical agreement, such as a master franchise or development agreement, even though the franchisor knows or has reason to believe that it will be not respected and that realistically the franchisor will not be in a position to enforce its rights? The answer is to be found in the often unrealistic expectations of the parties and in the problems that arise when such expectations are not realised by either or both of the parties. It is a problem not only for the franchisor, but also for the members of its organisation who may not have had a role in negotiating the agreement: when they see that the agreement is not being respected, their morale can only be adversely affected;

(b) why not use a typical form of agreement and rely on the courts to enforce the contractual provisions? The answer is simply that the franchisor may not obtain the same standards of justice that it can expect in its own country. In certain countries it may take as much as eight to ten years to obtain a final judgement, even where arbitration in a neutral country
is provided for in the agreement. Even if the franchise agreement permits the franchisor to seek redress before the courts of its own country, it may very well find it impossible to enforce such a judgement in the foreign country;

(c) if the differences between the franchisor’s country and the targeted foreign country are so great and the potential problems, and lack of solutions, so realistic, why do business in that country? This is a legitimate question which franchisors all too often do not ask of themselves. A legitimate response might well be for the franchisor to avoid doing business in the country concerned. Another, equally legitimate answer is that the initial payment under the "bare bones" license agreement and the subsequent fixed monthly payments, when tied to significantly reduced obligations on the part of the franchisor, might make the venture economically worthwhile for the franchisor. This may be especially true where the manner in which the franchise system is operated in the country concerned will not negatively impact on the franchisor’s other international operations.

2. **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.

3. **Hybrid Franchise/License Agreement**

For many business people the global economy has become a reality in recent years, to the point that their only realistic hope of success is to export their products and/or services to foreign markets. At the present time many manufacturers distribute their products in their own countries by using salesmen, sales representatives or distribution arrangements and are not in any way involved in franchising or licensing. For many of these 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 manufacturers 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.

4. **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. Those who support this form of arrangement have taken the position that area representation agreements provide the franchisor with the same benefits as master franchising while at the same time avoiding certain of the problems associated with it, namely the handing over of 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. Others have a certain bias against using area representation arrangements in international franchising and therefore have a certain difficulty in recommending such arrangements as a variation of master franchising or as an alternative to master franchising. Moreover, many of the objections that are raised against franchisors who do not use their own employees to sell franchises, but prefer to appoint independent sales representatives and brokers, are equally applicable to area representation arrangements. In addition, 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.
Provisions commonly found in area representation agreements

Although area representation agreements will vary from franchise system to franchise system, and even within the same franchise system, they nevertheless have certain provisions in common. These include:

(a) **grant of area representation rights**: the area representative is typically granted the right to solicit and evaluate potential franchisees as well as the right to fulfil some of the obligations that the franchisor is required to fulfil under the terms of the franchise agreement;

(b) **exclusive territory**: the area representative is typically granted the exclusive rights to a specific territory. This territory varies from franchise system to franchise system and may cover a city, a state or province or even an entire country. Although the area representative may be given the exclusive right to solicit prospective franchisees, it is nevertheless usual for the franchisor itself to receive requests for a franchise which it will then pass on to the area representative. Requests by prospective franchisees that are made directly to the franchisor are, however, to all intents and purposes included in the development schedule. As far as the training and supervision of franchisees is concerned, the area representative's obligations will apply to all franchise outlets. The exclusivity provision will normally deprive the franchisor of the right to open franchisor-owned outlets within the exclusive territory, but that is a matter of negotiation;

(c) **fees payable to the franchisor**: a number of area representation agreements provide for the payment of an initial area representation fee by the area representative to the franchisor in return for the exclusive rights that the franchisor grants the area representative. Such a fee will normally be charged by the franchisor in situations where the area representative is not itself a franchisee;

(d) **fees payable by franchisor to the area representative**: typically, the franchisor will pay to the area representative a percentage of the initial franchise fee paid by franchisees for each franchise granted by the franchisor within the area representative's exclusive territory. This fee is essentially a brokerage or sales commission fee similar to what is paid by franchisors to franchise brokers or sales representatives. Whether or not the area representative is paid a portion of the initial franchise fee for franchisor-owned outlets or when the franchisor is solicited directly by the prospective franchisee is a negotiated point. If the area representative is not paid a portion of the initial franchise fee for franchisor-owned outlets, it may be argued that if requests for franchises by prospective franchisees are made directly to the franchisor rather than to the area representative, the latter is deprived of a source of income.

In addition to a percentage of the initial franchise fee payable by franchisees, the franchisor will pay the area representative a percentage of the royalty fees that it collects from franchisees within the exclusive territory. Again, whether or not a fee is to be paid
for the outlets that are owned by the franchisor is a negotiated issue. The fees, or portions of fees, that the franchisor is due to pay the area representative are normally paid when actually received by the franchisor.

In international area representation agreements the payment of fees takes on added significance and requires careful tax planning, especially as regards withholding tax issues. To the extent that the franchisor is domiciled in a country different from that in which the franchise system is being set up, the fees payable to the franchisor will be subject to withholding taxes. This is the case also with the portion of the fees that will be remitted to the area representative by the franchisor. It might therefore be appropriate for such fees to be paid directly to the area representative by the franchisee. This would avert the need to pay withholding taxes on the fees paid to the area representative;

(e) **development schedule:** as is the case in master franchise arrangements and development agreements, area representation agreements involve the area representative complying with a development schedule pursuant to which a minimum number of new franchises must be granted during each year of the term of the area representation agreement. It must however be recognised that in such situations the granting of a new franchise is within the exclusive rights retained by the franchisor irrespective of the number of applicants for franchises that may be submitted by the area representative. The development schedule might therefore in certain circumstances provide for the submitting to the franchisor of a certain number of candidates who meet pre-established criteria as opposed to the area representative being responsible for the execution of a specified number of franchise agreements. Such a provision might be appropriate as failure to comply will typically result in the loss of exclusivity or termination of the area representation agreement. A franchisor who wishes to terminate the agreement with the area representative could therefore simply refuse applications submitted by the area representative;

(f) **duties of franchisor:** the duties and obligations normally imposed on the franchisor include some or all of the following:

(i) the training of the area representative, not only in all elements of the franchise system but also in such matters as the manner of interviewing prospective franchisees and sales techniques. In addition, the area representative must be trained so that it in turn may train and supervise new franchisees;

(ii) providing the area representative with suitable sales materials, brochures as well as supervisory forms and schedules;

(iii) providing the area representative with specific criteria for the choice of new franchisees as well as for the choice of new locations;
(g) **obligations of the area representative:** the obligations of the area representative are usually broken down into two categories, namely the solicitation of new franchisees and the servicing and supervising of franchisees. The obligations of the area representative would thus include interviewing and evaluating prospective franchisees who meet the criteria established by the franchisor. With regard to servicing and supervising franchisees, depending on the franchise system the area representative may or may not be required to provide franchisees with initial training. In addition to training, the area representative may be required to assist the franchisee in finding new locations for franchise outlets, in negotiating leases as well as in providing assistance to franchisees in constructing and equipping new franchise outlets. Following the opening of the franchise outlet, the area representative is typically required to make periodic inspections of the franchise outlet, to provide additional training programs, as well as to report on compliance by each franchisee with the franchise system and on the manner in which the franchisor’s trademarks are being used. Additional duties that may be imposed on the area developer might include assisting the franchisor in collecting unpaid fees and even in the taking of legal proceedings against non-performing franchisees;

(h) **term and renewal:** the duration of a typical area representation agreement ranges from five to ten years. This term may be broken down into two different terms, with the shorter term covering the solicitation of new franchisees and the longer term covering the supervision of the network;

(i) **other provisions:** other provisions typically found in area representation agreements, such as provisions relating to termination, transfer and indemnification, are largely similar to those found in most unit franchise agreements.

A number of area representation agreements provide that prior to soliciting new franchisees the area representative is required to open and operate a franchise itself. It is sometimes considered essential for an area representatives to act in a meaningful and responsible manner, that it should be required to own and operate not one but several franchise outlets, or even that it at all times should be required to own and operate no less than a fixed percentage of all franchise outlets that are open in the exclusive territory. It is hoped that in this manner the area representative will act less as a franchise salesman or broker and will think more in terms of itself being a “franchisor”.

In international franchising area representative agreements may be most appropriate in direct franchising arrangements, where the franchisor actually supplies products to its franchisees. In this case the area representative would be required to establish a warehousing and distribution facility for all the products it purchases from the franchisor and sells to the franchisees within the exclusive territory. The profit the area representative earns on the products it purchases from the franchisor and subsequently resells to the franchisee will compensate it for establishing and maintaining a warehousing and distribution facility.
FACTORS TO CONSIDER WHEN DETERMINING THE VEHICLE THAT IS THE MOST APPROPRIATE

An entrepreneur who has decided to expand abroad must decide what commercial vehicle is the most appropriate for the type of business concerned 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 a 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.

1. OBJECTIVE FACTORS

(i) The Market

Of fundamental importance in the choice of a vehicle is the condition of the market that the system is intending to penetrate. 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 alternate 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, although the possibility of a franchisor providing such a study for a foreign country is considerably reduced. In this case the franchisor might have to rely on its local partner to make such an assessment.

The general attitude of the local authorities is also of importance. If, for example, the local authorities introduce currency restrictions, the interest of a system under which fees and royalties should be exported is considerably reduced.
(ii) 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 will ensure that the local operators are adequately trained and therefore able to function effectively, might be the 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. It would, for example, not be feasible to open a fast food restaurant serving pork meat in a Muslim country. Nor would it be acceptable in a number of countries for women to work late at night. A type of business that is based on the late night labour of women would inevitably fail in such circumstances.

(iii) 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 for amendments to be made in order to make it conform to the requirements. These amendments might radically change the nature of the relationship, which could no longer be satisfactory to the parties. If this is the case, it might be advisable for the parties to consider recourse to another commercial vehicle.

2. Subjective Factors

(i) 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 areas, 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 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 and to react to a changing local market, in which case a distributorship might be preferable. A number of businesses might further be of such a nature that, for example, an exact conformity of interior decorating among all outlets is not necessary. In this case, again, a distributorship might be preferable.

In determining whether of 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 the franchisee to earn a reasonable income and to enable the franchisee to pay the franchisor a reasonable fee for the services it supplies and the income generated by the franchisor from the operation of the franchise must be sufficient to cover the franchisor's overheads and to permit the franchisor to earn a reasonable profit.

(ii) 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 would 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 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 that actually have to set up and to 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.
(iii) 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, there is a considerable difference between running a chain of wholly-owned outlets and running a network of outlets by using a master franchise arrangement. If the prospective franchisor has no experience in franchising, it is probably advisable for it to proceed step by step, 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 it attempts to go 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 experience in business, 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 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 resolving of legal and economic stumbling blocks.

(iv) The Division of Responsibilities and Revenue

The division of responsibilities, and consequently of revenue, between the parties will differ from one business technique 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 training and assisting the sub-franchisees, 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 would not have any responsibility for a network, nor would it have to enforce the intellectual and industrial property rights of the franchisor, in all likelihood it would 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.

(v) 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 distributorship agreements. Furthermore, within franchising the degree of control will vary depending on the form of franchising adopted. The control is the greatest when there is most direct involvement, gradually subsiding to the point where there is least direct involvement and therefore least control. The control will therefore be least in master franchise arrangements, 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 very stringent control might, for example, not be acceptable to a person of independent nature who is instead able to perform best when required to take independent initiatives. A balance between the interests of the two parties must be created also in this respect.

THE FORM OF FRANCHISING DEALT WITH IN THE GUIDE

Of the forms of franchising examined in this Chapter, master franchising is without doubt the most common type of agreement in international franchising. The Governing Council of Unidroit therefore decided to endorse the recommendation of the Study Group that master franchise arrangements should be the form of franchising to be primarily dealt with in this Guide.
CHAPTER 2

GENERAL QUESTIONS CONCERNING NEGOTIATION AND DRAFTING

NEGOTIATING INTERNATIONAL AGREEMENTS

In a majority of countries franchise agreements are not regulated by specific legislation. This factor, together with the general unfamiliarity of courts with this new type of agreement, have led to an equating of franchise agreements with any one of a number of other forms of agreement, depending upon the characteristic that is considered to be predominant in the particular relationship concerned. Consequently, the legislation that regulates these other types of agreement is often applied by analogy by the courts. As franchisors tend to use standard form contracts throughout their systems, and as the possibilities for prospective franchisees to negotiate separate arrangements are often negligible, franchise agreements are frequently treated as a type of contract of adhesion.

If the equating of unit-franchise agreements with contracts of adhesion might find a certain justification, the same is not necessarily true of master franchise agreements as the latter 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 essential 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 may thus not be appropriate 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.

In international master franchising the sub-franchisor acts in the place of the franchisor in the foreign country. It is the sub-franchisor who selects and concludes sub-franchise agreements with sub-franchisees, who is under an obligation to ensure that sub-franchisees follow the instructions imparted to them and who must act to protect the franchise system against any form of breach, both internal to the system, such as when a sub-franchisee does not conform to the quality standards required of members of the network, and external, such as intellectual and industrial property infringements by third persons. Furthermore, the sub-franchisor is the point of reference for the sub-franchisees as they have no contractual relationship with the franchisor and must be able to furnish the sub-franchisees with services of the same quality as the franchisor. The sub-franchisees must know that they can rely on the sub-franchisor and the franchisor must be able to trust
the sub-franchisor to do all in its power to assist the sub-franchisees and to look after the system. The importance of selecting a good sub-franchisor cannot be stressed too much. The master franchise relationship is intended to last over time, often for twenty years or more, even for a lifetime. The franchisor and sub-franchisor must be able to build a relationship of mutual trust and understanding if the arrangement is to work effectively. Already in the negotiation process both parties should use the necessary diligence to ensure that the relationship is anchored on firm ground. This includes gathering information on the other party (financial solidity, business experience and litigation history, for instance), adopting a constructive attitude to the relationship and the requirements and needs of the other party.

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 desirable.

Similarly, a prospective sub-franchisor must ensure that the franchisor is financially sound, that it provides adequate training and assistance and that it has a good record in its dealings with its franchisees. 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 or of business.

Master franchise arrangements are used both domestically and internationally. The technique adopted is essentially the same, although a number of differences exist between the two situations as a result of their different nature. The role of the sub-franchisor is for example likely to be of far greater importance in an international situation, as the franchisor will have less knowledge of the local market of the foreign country than the sub-franchisor. In a domestic situation the franchisor delegates certain duties to the sub-franchisor for a specific territory, but does not have to rely on the sub-franchisor, and on the information furnished by the sub-franchisor, to the extent it must do so in an international situation, as the franchisor will itself know the market of its own country. The franchisor is therefore able to control the activities and the performance of the sub-franchisor in a way that is not possible in international arrangements, where the franchisor and sub-franchisor might not even speak the same language.

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.

**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 franchisees with regarding the operation of the unit, reports and records to be furnished to the franchisees, advertising guidelines, separate agreements regarding the intellectual property and licence agreements. 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 a separate agreement. 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 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 agreement or the actual format in which they are couched or the law that is to apply to them. This is understandable, considering that franchisors operating internationally will often be active in a number of different countries and their contracts would therefore need to be written in a considerable number of different languages and ways, which makes it difficult for the franchisor and the franchisor's lawyers to maintain control over 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 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.

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1. For a number of collateral agreements, see Chapter 23 on Ancillary Documents.
2. The question of the law applicable to the agreement is examined at greater length in Chapter 20.
1. **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 discrepancies between the two versions. It should however be borne in mind that the courts of the country of the sub-franchisor might 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 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 the language of the franchisor. 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.

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.

2. 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 of the procedure adopted by the courts in adjudicating disputes.

(i) Civil Law Legal Systems

A number of different legal systems are normally grouped together under the term "civil law". These include the legal systems that are the descendants of the 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 traditions is the systematic codification of different areas of law (civil law, commercial law or criminal law) which is carried out in these systems. 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 details 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 court which may analyse the agreement in the future, a precise indication of their agreed will. 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 codifies 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.

(ii) The Common Law Legal Systems

What first strikes a civil law lawyer 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 will therefore try to imagine every potential conflict that might arise in the future and draft their contract accordingly.
3. **Drafting Alternatives**

A number of different drafting alternatives are therefore possible. Which is the most suitable will depend on the jurisdiction in which the contract is to be implemented. The main alternatives are first, 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 (for example, ICC arbitration).

**Clauses of Importance in Master Franchise Agreements**

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 clauses include:

- clauses relating to severability
- entire agreement clauses
- waivers
- force majeure and hardship
- clauses relating to the nature of the agreement
- cumulative rights and
- damages.

1. **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 quite considerable. Master franchise agreements will therefore contain clauses providing that if a particular clause, or even a part of a clause, becomes unenforceable, invalid or illegal, then this particular clause or part thereof shall not affect the validity or enforceability of the remainder of the agreement, at times on condition that the remaining contract does not appear to be distorted or unfair to one of the parties. Several different solutions are possible in this case:

- the clause is considered as if it had never been stipulated,
• 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.

A similar procedure is followed for cases where there is 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 may provide that the franchisor may terminate the agreement if, in the opinion of the franchisor, the exclusion of the provision adversely affects the franchisor's right to receive payment of fees or other remuneration, or if it adversely affects the trade marks, 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 that does not invalidate or affect the validity or effect of the clause in other jurisdictions.

2. **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 whole agreement between the parties, that it embodies all prior negotiations and/or all prior agreements reached. The degree of detail will vary from very short statements to the effect that, for example, oral collateral agreements are not valid, to clauses that are very much more detailed, usually in the case of contracts originating in the common law world. In other instances the clause may specify that in addition to the main agreements there are also, for example, specific agreements between the parties, such as 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 fact that no collateral or oral agreements are considered to be valid does not affect the franchisee’s obligation to comply with specifications of the franchisor as determined from time to time.

Linked with the provision stating that the agreement is the entire agreement may be statements such as an acknowledgement by the franchisee that it has not entered into the agreement as a result of any representations, warranties, inducements or promises, or the requirement that if the franchisee thinks that these 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 that the contents of the written statement can be included in the agreement in an agreed form.

3. 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 franchisee that the success or otherwise of the business depends on itself 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 franchisee. 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 generally 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 franchisee, it is possible that the successor franchisee may be required to waive any rights or remedies it might have as a
result of a non-performance by the franchisor under the agreement with the previous franchisee. 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 franchisee, and disclaim any waiver on behalf of either party.

4. \textit{FORCE MAJEURE AND HARDSHIP}

Contracts will often contain clauses that either provide for the re-negotiation of the agreement in cases of changed circumstances (so-called "hardship clauses") or that provide for a suspension in performance, or even for an excuse from performance, in cases of "force majeure". The formulation of these clauses will follow the formulation of similar clauses in other types of agreement. It is not always easy to distinguish clearly between these two different types of clauses, although an indication might be the seriousness of the event which determine the occurrence of a case of hardship or \textit{force majeure}. 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 \textit{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".3

Similarly, the definition of \textit{force majeure} contained in the \textit{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.

(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 Article 6.2.2."
(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.4

The purpose of the hardship clause is not to terminate the contract, but to make a renegotiation of the terms possible. *Force majeure* clauses on the other hand would in most cases be considered to be the basis on which to excuse a non-performance, often permanently, but also temporarilly. As the borderline between the two concepts is not always clear, the same events might trigger either hardship or *force majeure*. It is then for the court to decide whether or not there is a case of hardship or *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.

Clauses may on the other hand contain general formulas rather than a listing of events. Such general formulas may be to the effect that *force majeure* is caused by any contingency beyond the control of the non-performing party, or that the non-performance is due to a cause or circumstance beyond the reasonable control of the party, or is 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.

When these events are limited in time, the performance is suspended only for such time 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.

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4 Article 7.1.7.
5. **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 therefore apply legislation written for other types of agreement. To do this, they will examine the relationship and will determine to which legal form the contract has most similarity: an agency agreement, for example, or an instalment sale contract, or a contract of employment.

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 specify that it should not be interpreted as, 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 contract of the employees of the franchisee - which might not always be the case.5

The contract might furthermore state that the franchisee is in no way authorised to make any contract, agreement, warranty or representation on behalf of the franchisor, and that the franchisee may not create any obligation on behalf of the franchisor. Linked with this is often a provision stating that the franchisee must indicate clearly that the unit is a franchise which is operated by the franchisee.

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 in any case look at the contents of the agreement to determine whether or not the statement is correct. If it is not, the parties may find that the law applied to the agreement will be that which the judge considers to come closest to the real nature of the agreement.

6. **Cumulative rights**

In master franchise agreements a clause may be found to the effect that the rights of the franchisor and of the sub-franchisor are cumulative and that the enforcement of any of their rights or remedies shall not preclude the enforcement of any other right or duty.

7. **Damages**

The type of damages that are permitted varies 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 what type of damages are admitted. As the concepts vary

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5 See the section on Labour Relations under Other Provisions in Unit Franchise Agreements.
from one country to another, master franchise agreements may choose to specify exactly for what compensation is recoverable, for example, only for the actual harm sustained.

**The Preamble to the Agreement**

In addition, the Preamble to the agreement might also be of importance, although this 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 which it might be considerably reduced.

In the common law tradition the Preamble is designed to aid identify 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, if the contract 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, the Preamble may serve as a guide to the interpretation of the contract in case of litigation.

In some jurisdictions the Preamble serves to state the purpose of the contract and the law of a particular country might require a court to refer to the purpose when interpreting the agreements. In a number of civil law countries the Preamble might further refer to the relevant sections of the civil or commercial code or of the law that is applicable.

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 particularly the case where the contract is silent on specific points and the court interprets it to arrive at the will of the parties.

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6 The different concepts include: damages for future benefits lost, for lost chances, for lost profits, for losses suffered, "negatives Vertragsinteresse", "positives Vertragsinteresse", etc.
IMPLIED OBLIGATIONS

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 not only to deal with each other in good faith 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. However, the duty of good faith has often been held by courts not to override express contractual terms.

PRE-CONTRACTUAL DISCLOSURE

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 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.

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 be mutual, even if statutes 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, even if no such obligation is provided for in legislation. 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.

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7 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.
8 See the Annex to this Guide.
CHAPTER 3

NATURE AND EXTENT OF THE GRANT OF RIGHTS

A successful franchise system enables the affiliated franchisees to use a proven business method for the delivery of a product or service. In other words, it provides the franchisees with a competitive advantage. The 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 the right to use the franchised system is fundamental and central to the relationship between the franchisor and the franchisee. In the case of 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 the same, even if the master franchise agreement will delimit the rights that the sub-franchisor is authorised to grant the sub-franchisees in addition to specifying the rights that the sub-franchisor itself is granted. References to the franchise agreement and to the franchisee are to be understood as comprising also the master franchise agreement and the sub-franchisor, in view of the fact that the rights granted and evaluations necessary are similar in the case of master franchise agreements and unit franchise agreements.

The granting of rights is not a one-time transaction, but rather the beginning of a long-term relationship between the two parties. The clause granting the right to use the franchise system delimits the franchisee’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 lay down in greater detail the terms of the relationship as 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 license. The franchisee is licensed to use the specified assets of the franchisor 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 franchisee;
♦ 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 franchisee may use those assets; and
♦ the degree of exclusivity given to the franchisee (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 franchisee. 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.

**WHAT IS GRANTED?**

The grant simply licenses the franchisee to use the intangible assets that comprise the method of doing business being franchised. 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.

In the simplest of franchises, there may be only one licensed asset, namely a trademark which identifies a product or service. The franchisee is in this case authorised to provide certain products or services, or even a single product or service, under the licensed trademark and to identify itself as someone who is authorised to sell that product, which is produced by the franchisor or by another party who has been licensed by the franchisor to manufacture it. Even if no other rights are licensed by the franchisor to the franchisee, other provisions of the agreement may describe how the parties should work together and may also establish the standards required for the conduct of the franchisee's business.

Most franchise systems however 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 franchisee have an interest in clearly identifying which assets are being licensed to the franchisee.

When a franchisee obtains a license to use all the assets that comprise the business system, it is granted what is known as a combination know-how and trademark license. In other words it obtains the right to use all the know-how that is part of the franchised business. Each franchised unit can then easily be identified as forming part of the larger franchise network, as it has distinctive attributes common to all business units in the network.

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 may be proprietary or non-proprietary. Know-how is considered to be proprietary if it is not available to unlicensed parties because it is patented, covered by copyright or secret. In other words, the know-how is proprietary because the intellectual property and other laws of the jurisdiction in which the franchise is to be operated gives the owner, the franchisor in this case, the right to bar others from using it. The franchisor thus has the legal right to
reserve this proprietary know-how for use only in the franchised system and the grant of a license is necessary to properly authorise the franchisee to use it.

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 proprietary in nature. Non-proprietary know-how may generally be legally copied by others who are not licensed, including franchisees whose license has expired. It nevertheless acquires great value by having been developed into a system which is identified by the distinguishing trademarks and by those other assets that are proprietary in nature. 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 a large franchise system.

The grant of franchise rights may be compared with a package deal, in that it normally includes a license to use all the know-how, both proprietary and non-proprietary. This avoids any doubt as to whether the franchisee 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.

1. **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, both proprietary and non-proprietary, that comprises the system: patents, copyrights and trade secrets may be identified as part of this package;

- 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 as to 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 franchisee is called upon to develop; and

the goodwill of the system, as well as a description of the uniform and attractive public image that all franchised units are required to reflect.

2. **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 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 so as to include trademarks that may be developed in the future.

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

**WARRANTIES FOR THE RIGHTS GRANTED**

The rights that are granted are in effect the assets that the sub-franchisor will rely on for its business and for which it is paying the franchisor. The sub-franchisor will therefore require assurances that the franchisor has the unencumbered ownership of the rights it is granting. It will require warranties that the franchisor has ownership rights to the intellectual
and industrial property in the territory concerned, that these rights do not infringe upon the
devices, methods, processes, and other third parties do not infringe upon the rights of the
franchisor in the territory.

The franchisor may however be hesitant to provide warranties of full ownership, as the
ownership of these rights is often dependent upon filings or registrations with the local
authorities. Registration procedures may take months or years to complete, with the
consequence that in the meantime the franchisor will not be in a position to know the exact
extent of its rights in that jurisdiction and will therefore not be able to warrant ownership with
complete confidence. It is therefore common for the franchisor to warrant that it has taken,
or will take, the appropriate steps to perfect ownership in its intellectual and industrial
property in the jurisdiction concerned and to warrant that it knows of no other rights of or
use by third parties that could constitute an infringement.

**HOW THE LICENSED ASSETS MAY BE USED**

The way in which the franchisee may employ the system is specified in the other
terms of the grant clause. There are three basic alternatives: (1) the franchisee may be
given the right to develop and operate its own franchised units using the system (as in
direct unit franchising or area development agreements); (2) the franchisee may be given
the right to sub-license others to use the system (area representation agreements); or (3)
the franchisee may be licensed to engage in both of these activities (master franchise
agreements).

It should however be recognised that it is one thing to operate business units
successfully; it is quite another to identify sub-franchisees who are qualified to operate
business units and to train and supervise these sub-franchisees after their appointment. In
practice, the franchisee will therefore at times be granted only the right to establish its own
units, as the franchisor will prefer to retain a direct relationship with the operator of all the
units. Sometimes this limitation is imposed only until such time as the franchisee has
successfully established a certain minimum number of its own units, so as to ensure that
the franchisee understands the system and can train and supervise its sub-franchisees
properly.

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 becomes 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.

Although it would be possible to authorise the sub-franchisor to permit its sub-franchisees to license others to develop units, this is usually not done as any such franchise operators would be too far removed from the franchisor for it to be able to exercise any form of control, as it would have to rely not only on the sub-franchisor, but also on the sub-franchisees with whom it has no contractual relationship. Sub-franchisors will therefore usually be prohibited from authorising its sub-franchisees to further sub-license the franchise rights to others.

WHERE THE RIGHTS MAY BE EMPLOYED

The geographic territory in which the franchisee may engage in the franchised business is defined in the grant clause. A single unit franchise is generally limited to a specific site and the franchisee is limited to operating the franchised business from that site. In the case of a master franchise, 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 often an issue of much discussion and negotiation between franchisor and franchisee. The franchisee will often want a large territory, as a large territory will logically enable the franchisee 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 franchisee. If the territory is too large, parts of the territory will not be developed because the franchisee will not have the personnel or resources necessary to develop them properly. Furthermore, if the franchisor grants a large territory to the franchisee, the franchisor may for the whole duration of the franchise agreement be barred from granting other franchisees the right to develop those parts of the territory that the first franchisee is not able to develop.

The franchisee often insists on a territory that is larger than its current resources can support in terms of rapid development, 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 types of skill and ability. The franchisor will furthermore wish to be assured that the franchisee 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 franchisee 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 franchisee 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 franchisee to delimit the boundaries of the territory of the franchise, in terms of size and cultural requirements, in such a manner that the franchisee, 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 avoid the friction that might arise between the franchisor and the sub-franchisor in relation to the determination of the size of the territory. It is thus possible for the sub-franchisor to be given contingent rights to other territories in addition to the initial territory; the sub-franchisor might be eligible to expand its territory if certain conditions are satisfied, if, for example, a certain number of units have been developed successfully in the initial territory or if an additional fee is paid; or the sub-franchisor might be given a right of first refusal when the development of additional territories is considered: in other words, the sub-franchisor would be granted the right to acquire one or more additional territories on the same terms as those offered by another potential sub-franchisor. It should be noted that when these rights are given, they substantially limit the franchisor's possibilities to permit qualified and interested third parties develop the additional territory.

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 franchisee may for example be required to develop 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 franchisee has authority if that pace of development is not kept. Conversely, there may be a
provision which grants the franchisee an expanded territory if certain development objectives are met.

**Exclusivity v. Non-Exclusivity.**

The grant clause will specify the extent to which the rights granted to the sub-franchisor are to be considered exclusive. There are three basic categories of other parties 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 parties 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 party to use any of the licensed assets in that territory.

It is also possible for the franchisor to grant more than one master franchise within a certain territory. In this situation, each sub-franchisor has non-exclusive rights to establish franchised units within the territory as well as to sub-franchise. 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 license to develop franchised units. The major disadvantage may spring from the same competitive pressure, in that qualified prospective sub-franchisors might refuse to accept appointments under such circumstances.

The franchisor will at times reserve the right to establish its own units in the territory even if it agrees to exclude third parties from using the licensed assets.

The franchisor may furthermore reserve the right to sell certain products associated with the franchise system through third parties who are not operating within the franchise system, e.g., a certain product may 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. The franchisor may want to increase its market penetration by providing for product distribution in these alternate ways. This may cause problems for the 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 alternate 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 in which they share in the alternative distribution activities and benefits. In any event, the possibility to distribute products outside the franchised system should be addressed as a typical grant clause will not include such important rights.
It is common for the franchisee 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 franchisee in order to foster the greatest possible commitment on its part.

If the rights granted to the franchisee 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.
CHAPTER 4

TERM OF AGREEMENT AND CONDITIONS OF RENEWAL

Lengthy initial terms of duration are common in the case of master franchise agreements. Terms of twenty years are not uncommon, 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 for five or ten years. In a number of countries the maximum or minimum terms of the agreement are fixed by law, at times coupled with the fact that at the end of the term of the agreement it is not possible to protect the know-how, as the know-how 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, where 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.

From the franchisor’s point of view the standard rationale for short term agreements, at least for domestic agreements, is that the franchisor must be given the opportunity to update its franchise agreement so as to reflect developments. One of the conditions of renewal is in fact often that the franchisee must accept the unit franchise agreement of the franchisor that is current at the time of renewal. Regrettably, not all franchisors always realise the fundamental differences between domestic and international franchising and will therefore attempt to apply their domestic experience to international franchising by insisting 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. 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.

Following such a process 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 the concept of the sub-franchisor upon renewal entering into the franchisor's then current form of international master franchise agreement may not be realistic in the circumstances.

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.

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, to remove any decorations or indications identifying the premises in which the franchise outlet is situated as belonging to the franchise network and would probably be forced to comply with non-competition covenants. The repercussions of the failure to deal with the effect of termination 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 effect 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 each unit sub-franchise 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 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 the provisions requiring 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, as 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 effect of the expiration of its term therefore requires careful consideration by both the franchisor and the 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 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 will begin to lose any motivation to comply with the development schedule, despite the fact that the sub-franchisor 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 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 lose its right to develop additional franchise outlets under the master franchise agreement, which 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 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 effect 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.

The renewal of the term of the master franchise agreement, if this 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
(b) that the sub-franchisor has paid all amounts due to the franchisor on time throughout the
class term of the master franchise agreement, independently of whether or not such default
d has been cured;
(c) that the sub-franchisor sign a general release of any claims that it may have against the
(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 further condition for the renewal of master franchise agreements may be that the form of
master franchise agreement that the franchisor uses at the time of renewal be adopted. This
condition is not realistic in most international master franchise arrangements as these
arrangements are typically negotiated. 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.
CHAPTER 5

FINANCIAL MATTERS

WHAT PROVIDES INCOME?

In the final analysis the financial resources that provide income to franchisor, sub-franchisor and sub-franchisees must flow from the profits generated by the franchised units. Franchise fees, whichever way they are to be calculated, can only be paid if the operations are successful. If the profitability of the 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 to 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, rental costs, competitive products and services that affect the pricing structure.

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.

There is a tendency on the part of numerous sub-franchisors to focus on the initial fee rather than on the continuing fees. This is a natural tendency, considering that the initial fee is frequently high and the sub-franchisor will perceive it as an important factor in the evaluation of the cost of setting up the business. It is also easier to compare the initial fee with what others pay for other territories or for other franchises in the same territory. In reality, however, the amount that sub-franchisees will pay in continuing fees and service fees far exceeds the amount paid as an initial fee. It should also be observed that all or part of the initial fee may be considered a non-refundable advance payment of continuing fees or even as an advance of unit franchise fees.
A sub-franchisor will be able to obtain its income from the following sources:

(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 part of a franchisor's income. This part 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. 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;
- 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 which 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 where the fiscal consequences are concerned, 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 trade marks;
- 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 would 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.
(ii) 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.

1. **PRODUCT MARK UPS**

Mark ups may be defined as an increase in the sales price which is made by adding overhead expenditure and a certain margin of profit to the costs. The franchisor, whether manufacturer of wholesaler, may thus “mark up” the products to provide an income. The sub-franchisor may 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 marks up made by the franchisor and the sub-franchisor that 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 profitably 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.

2. **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 retrospectives rebates. These are volume related discounts that are to be paid when agreed volume 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 instead contend that these benefits should be made available to the sub-franchisees, as it would be their efforts in achieving sales that would give rise to the payments.
In addition to offering these benefits, manufacturers and suppliers will at times contribute to advertising, marketing and promotional activities, both nationally and at the different points of sale.¹

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.

**THE SOURCES OF INCOME OF THE FRANCHISOR.**

1. **INITIAL FRANCHISE FEES**

One of the most difficult issues that arise 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 transfer of 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 in the re-negotiation of the financial provisions. It is sensible to make the effort to agree on a realistic financial structure already in the initial negotiations.

A number of franchisors deal with all fees together, whereas others deal with the different fees separately. Tax considerations and legal issues come into play when the decision of the structuring of the fees is taken. If, for example, the fees are dealt with separately, it will be easier for a sub-franchisee to sue its franchisor by claiming that the franchisor had promised, and was charging for, an item or service that it was not providing.

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:

(a) 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;

¹ See Chapter 10 “Advertising and the Control of Advertising".
(b) 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;

(c) 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;

(d) 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 of US$1,000,000;

(e) the fact that the franchisor has developed in its own country a system that has been proved successful and that has a value as it should, with pilot testing and continuing specific variations, 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 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 effective 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 however very often have an impact on levels of payment, they may in fact govern the basis upon which payment is made and must therefore be carefully considered. 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 with which the fees should be paid as well as on the amounts that may be charged for the transfer 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.

2. **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 profitability 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. It is necessary 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 to appreciate fully the impact of the payment of continuing franchise fees on its profitability. It should be noted that there are countries in which agreements will provide that continuing fees are paid only after the franchise has become profitable.

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. A number of these franchisors also charge a continuing franchise fee.

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 product 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 minimum fee above which the continuing fees will not rise.

PROBLEMS CAUSED BY PRODUCT SALES WITH "MARKS-UPS"

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.

CALCULATION OF PAYMENTS AND PROCEDURES

The method adopted for the actual making of the payment of continuing fees should relate to 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 would be impossible for it to meet. This notwithstanding, 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 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 possible 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. The 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 stand for 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.

**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 find that the initial fee is subject to withhold 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 proposition unacceptable.
CHAPTER 6

THE TRIPARTITE RELATIONSHIP OF MASTER FRANCHISE AGREEMENTS

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 referred to as tripartite. The three-tier, or tripartite, structure of franchising is one which gives rise to certain specific problems.

The master franchise agreement used in international franchising is typically 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 that transaction the two parties to the master franchise agreement therefore envisage 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 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).

In this type of arrangement there is usually no direct 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. 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.

“TRIPARTITE” NATURE OF THE RELATIONSHIP

The “tripartite” nature of the relationship between franchisor, sub-franchisor and sub-franchisee envisaged by the master franchise agreement raises a number of issues, many of which are inherent in the relationship itself and others of which 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 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 consent or approval must be obtained regarding various matters relating to the sub-franchisor's relationship with its sub-franchisees 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-franchisees'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 lay down 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 lay down 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 of 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. Numerous international master franchise agreements will therefore require that each sub-franchise agreement 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 tripartite 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 for the offering and sale of franchises applicable 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.

Franchisors may 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 be required by the master franchise agreement 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.
A franchisor may be obliged under the master franchise agreement to 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 are do not comply with the sub-franchise agreements.

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-license the software to each sub-franchisee.

The master franchise agreement may require the sub-franchisor to grant a franchise 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 included as 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-franchise units to the franchisor. So as 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 recipient of the indemnity and the insurance provisions may require the franchisor to be named as an additional insured in the sub-franchisee’s insurance policies.

**DIRECT CONTRACTUAL RELATIONS**

As noted above, there is no direct contractual relationship between a franchisor and a sub-franchisee under the typical master franchise arrangement. 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 arrangement unless 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 agreement. In these jurisdictions the franchisor will usually insist on having a direct contractual relationship with the sub-franchisees for that particular purpose.

Even when not necessary for protection of intellectual property, a direct contractual relationship between franchisor and sub-franchisees may be desirable 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 mean 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 can be no 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 for intellectual property rights. There are two basics methods in which these direct contractual relationships may be created under a master franchise agreement. First, 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 licenses the sub-franchisee to use the intellectual property concerned. In this case a separate tripartite agreement will be necessary for each sub-franchise granted. A more common solution is for the franchisor and the sub-franchisee to enter into a license agreement in which the franchisor grants the sub-franchisee a license to use the intellectual property in connection with the operation of the sub-franchised business. This license 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 license agreement as a condition to entering into the sub-franchise agreement with the sub-franchisor and both agreements should include cross-default provisions. Even in jurisdictions where a separate license agreement is not initially needed, franchisors will often include an express provision
in the master franchise agreement reserving the right to enter into direct license 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 license 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 license the franchisor's intellectual property to the sub-franchisees on behalf of the franchisor.

**SEVERAL SUB-FRANCHISORS IN THE SAME TERRITORY**

If the master franchise agreement does not grant the sub-franchisor exclusive territorial rights, a certain number of consequences will follow of which the franchisor, the sub-franchisor and the sub-franchisees should be aware.

One of these consequences is the existence of competition among sub-franchisors for qualified sub-franchisees. If there are a limited number of qualified sub-franchisees, this competition may lead sub-franchisors to accept prospective sub-franchisees who are not qualified, especially if there is an unrealistic development schedule. The competition among sub-franchisors may also cause over-saturation of the market by sub-franchisees. This over-saturation may give rise to encroachment claims and to unnecessary business failures.

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 will 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 will without doubt be affected by this state of affairs, with the result that legal claims may 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 will 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 will be reduced or will disappear for both the franchisor the and 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 arise, 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 as a result of their competing rights.
CHAPTER 7

RIGHTS AND OBLIGATIONS OF 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 is a question of commercial maturity, of style and of bargaining power. Local custom will also be of relevance in this connection, but 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 hopes might be raised that realistically the franchisor will not be able to meet.

Similarly, it is a question of style and structure of the agreement whether franchisor’s obligations are dealt with in only one of its clauses, 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 however be mandatory rules of law on contract forms that require that all the obligations of the parties have to be laid down 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 consider each of them carefully with a view to deciding whether or not it is appropriate that they be included in the master franchise agreement.

DUTIES OF INFORMATION

1. PRE-CONTRACTUAL INFORMATION

In a master franchise relationship the pre-contractual disclosure, that is the disclosure of information prior to the conclusion of the contract, is not as important as in a sub-franchise relationship or a simple unit franchise relationship. This is recognised by 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”, but which states that the Code of Ethics “shall not apply to the relationship between the franchisor and its master franchisees”. This would appear to be justified as the business experience and financial background of the sub-franchisor, who usually is a business person or a business entity, 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.

2. **Initial Information**

Once the master franchise agreement has been signed, the franchisor should provide the sub-franchisor with all information that will allow it to adapt the foreign franchise system to the conditions in 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. The franchisor should provide this information independently of whether it is an express requirement of the agreement. It is however clear that it is in the best interest of the franchisor to provide the sub-franchisor with all the information it needs to start successfully and to run the master franchise operation in the host country. The information that concerns the franchise system and its functioning is usually contained in what in effect is the most important part of the franchise, the know-how,¹ and in the operation manuals.²

Other information that the sub-franchisor usually needs and which the agreement could expressly indicate as being a franchisor's duty to provide, includes:

- the technical characteristics, or chemical composition, of products that are to be adapted, or that require authorisation by the authorities of the host country, for it to be possible to use them
- information on the economic and legal conditions of the local market with which the sub-franchisor might not be familiar. The franchisor will often have gathered this information before entering into negotiations with the sub-franchisor.

3. **Ongoing Information**

The agreement will normally include an ongoing obligation of the franchisor to regularly provide the sub-franchisor with information about events in the (possibly worldwide) network as well as about developments of, and improvements to, the system that are of importance to the sub-franchisor. Such ongoing information is usually supplied with the updating of the manuals, when improvements are made to the know-how and whenever changes to the system are introduced.³

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¹ See Chapter 13 "Rights protected by Contract".
² See Chapter 15 "Manuals".
³ See Chapter 14 "System Changes".
TRAINING

To a great extent the transfer of information occurs during the initial and ongoing training of the sub-franchisor by the franchisor. Proper initial training is a fundamental condition for the success of any franchise operation. The initial training and handing over of the manuals ensures the transfer of the franchisor's know-how, but in addition to acquiring the knowledge necessary to operate the franchise, the sub-franchisor must also be trained to act as "franchisor" in its own country.

The franchisor's training obligations are usually dealt with in a separate section of the agreement, a distinction being drawn between initial training and ongoing training.

1. 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 and thereby enable the sub-franchisor, or a representative or employee of the sub-franchisor, to run a franchise unit, at least as a pilot operation. More importantly, the initial training should also give the sub-franchisor all basic elements necessary for the establishment and administration of a franchise network, including what is required for the marketing and sale of the sub-franchise units and the actual running of the network. 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 as a result of the experience of many years, but the fundamental differences between running a company-owned network and running a franchise network composed of independent franchisees must be made clear. The initial training should permit the sub-franchisor to train its future sub-franchisees or those of its dependants that are responsible for the training of sub-franchisees.

Where appropriate, or where required by the particularities of a system, the franchisor should teach specific skills, such as for example the use of a particular computer software or the handling of sophisticated machines, and these skills should be transmitted in the manner that is the most appropriate for the case at hand, alternatives including "on the job training" and the use of experienced and specialised trainers. The typical elements of high-level management training, as adapted to the particular conditions of the individual franchise system, should form part of the training.

Training may be provided to the sub-franchisor personally, to delegated managers or to other representatives of the sub-franchisor. There is no rule, but the franchisor should make sure that the training is given to the person(s) responsible for the actual running of the master franchise operation.

The initial training of the sub-franchisees is a fundamental condition for the successful operation of a franchise network. It also involves quite substantial investments on the part of the sub-franchisor and its importance should therefore be reflected in the franchise
agreement. The franchisor should stress the importance of this obligation by clearly indicating how long it will last (normally at least a few weeks) as well as its component parts. The costs of the training is usually 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. The training will normally take place in the franchisor’s home country, with the consequence that such additional expenses can be substantial. This makes it even more important that the franchisor fulfils its training obligations properly. The franchisor will usually also give the training in its own language. It should therefore either choose only sub-franchisors who speak its language, which should be the rule as it would be unwise for the franchisor to select sub-franchisors who do not speak its language, or indeed for sub-franchisors to accept to become sub-franchisors when they do not speak the language of the franchisor and cannot read the original documentation, or it should provide and pay for interpretation facilities. It does not seem appropriate for the sub-franchisor to have to pay for interpretation.

2. **ONGOING TRAINING**

Additional training programmes for the sub-franchisor and/or its representatives should be conducted 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. They should therefore be held at least once a year. As these additional training programmes in most instances are held on the premises of the franchisor, a regular contact between the franchisor’s employees and the sub-franchisors and their management is possible. The master franchise agreement should clearly state any such ongoing training obligations of the franchisor, what they involve and the financial commitments of each of the parties.

In addition to the specified training obligations, the franchisor may offer optional supplementary training programmes (initial or ongoing), so as to ensure a regular flow of information and the steady improvement of the skills of the sub-franchisor and of its representatives and/or employees.

3. **CONSEQUENCES OF UNSUCCESSFUL TRAINING**

It is possible that the franchisor during the initial or ongoing training programme comes to the realisation 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 successfully complete 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. It is possible to make provision for such occurrences in the agreement itself, and to provide for a reimbursement of the training fees, wholly or more often partially, and even of the initial franchise fee. 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 placed in the franchise. It is however better by far for both parties if they end the relationship at this early stage, when the human and financial investments are still limited. Doing so may save both of them from much greater disappointments and also possibly from substantial financial losses in the future.

ASSISTANCE AND OTHER SERVICES

The most complete information and the best initial training 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 common for the franchisor to undertake 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 for 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".4

1. 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 usually included in the initial franchise fee and is therefore not paid for separately by the sub-franchisor. It may occur that the franchisor requests to be reimbursed for the cost of the travel expenses and accommodation of its personnel. The duration of the initial assistance may vary from a few days to several weeks. In rare cases it might even last for several months. The extent of the assistance and of the costs involved will largely depend on the 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 help only as regards the technical aspects of the implementation of the system, but not as regards other operational issues. On the other hand, where the foreign cultural elements that are imported through the franchise system bring with them commercial tools of importance to the host country, it might be even more crucial that personnel from the franchisor's headquarters assist to implement the culturally foreign elements. This would ensure that they are transmitted in the correct manner.

Again, there is no fixed rule by which the extent of the franchisor's initial assistance is determined. This is usually the result of lengthy negotiations. It mainly depends on the complexity of the franchise system, on the business experience of the sub-franchisor and on the economic environment of the host country. It will also vary depending on the

4 See also Chapter 10 "Advertising and the Control of the Advertising".
individual franchise system, on whether it is a service franchise or a product franchise and on whether the contractual goods and equipment are mainly supplied by the franchisor or are obtained from local sources. As the franchisor usually prescribes standards for the quality of the services to be provided and the goods to be sold to the customers, it will 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, the sales techniques that should be adopted and public relations and advertising. Important written material on these points is usually contained in the manuals. In its own long-term interest, the franchisor should give as much initial assistance as it reasonably can afford within the framework of the initial franchise fee.

2. **ONGOING ASSISTANCE**

For the duration of the agreement, the franchisor will usually continue to provide ongoing advice and assistance on all management, operational and technical issues. It is advisable for the franchisor to institute a "hot-line" for its sub-franchisors, so as to ensure that any needed assistance is provided quickly and efficiently. Such ongoing advice, whether it is offered by telephone or by correspondence, should be free of additional charges and instead be included in the ongoing fees. To be included in the franchise fee are 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.

So as to ensure that quality standards are maintained, the franchisor will often visit the sub-franchisor and its operations in the host country. Where the franchisor inspects the outlets of the sub-franchisees, these visits would be considered as part of the regular quality/service/safety and cleanliness inspections that the sub-franchisor would normally be under an obligation 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. The 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 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. The franchisor should therefore as often as required make experienced members of its international team available to the sub-

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5 See Chapter 6 "Financial Matters".
franchisor. While the fees for such services should cover the costs incurred by the franchisor, it is questionable whether they should be an additional source of profit for the franchisor. Where such optional services are offered, the fees and costs involved should be clearly indicated in the annexes to the agreement or in the manuals.

3. **ASSISTANCE TO THE SUB-FRANCHISOR**

It is unusual, but not excluded, that provision is made in a 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, it should be limited to the initial phase or, for short periods, to crisis situations. Where a crisis situation lasts too long, the question that will normally arise is whether the agreement should be terminated or whether the sub-franchisor’s territory or exclusivity should be reduced.\(^6\)

**SUPPLY OF GOODS**

In a given franchise network the franchisor may supply the goods that are to be sold. It may supply all the goods, only some or possibly none, indicating instead a supplier that it considers to be dependable or with which it has an agreement. Also in the case of service franchises the franchisor may wish to be the exclusive supplier of ingredients or products that it considers indispensable for the rendering of the service. In a number of networks the franchisor will further wish to supply the initial equipment for the franchise outlets. In other cases the franchisor will only set minimum quality standards that the members of the network, sub-franchisor and sub-franchisees alike, are under an obligation to conform to. It is natural that if the franchisor manufactures the goods itself, it will wish to be the only supplier, but even in other cases the franchisor may, to the extent permitted by the applicable competition laws, provide in the agreement that it is to be the exclusive supplier of the goods, or of most of the goods, to be sold in the franchise outlets or to be used when services are rendered. In all such cases, the franchisor should undertake to make available to the sub-franchisor, against payment, all the goods necessary for the refurbishing of the sub-franchisees. It is advisable for the franchisor to charge competitive prices, also so as not to be accused of anti-competitive practices. Similarly, the franchisor should ensure that the goods it supplies do not infringe the industrial or intellectual property rights of third parties. It should of course also bear the normal product liability risk (possibly limiting it with respect to certain risks).\(^7\)

In many cases the franchisor will determine only the range of products or services to be offered by the sub-franchisees or to be used by the sub-franchisees when they render the services, and the quality standards for such goods and services. In these cases, what the franchisor determines should be stated clearly and in detail. With respect to industrial

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\(^6\) See Chapter 18 "Remedies for Non-Performance".

\(^7\) See Chapters 11 "Supply of Products and Services" and 17 "Insurance and Indemnification".
goods the franchisor should supply a list of the specific products or of the objective quality criteria. Within the limits permitted by applicable competition laws it should provide lists of approved or recommended suppliers. With respect to products obtained locally, the franchisor should establish and communicate the criteria to be applied with respect to quality and also help the sub-franchisor to identify the sources of supply. The franchisor should assist the sub-franchisor to negotiate favourable supply conditions with approved or recommended suppliers, especially when they are located outside the contract territory. The franchisor should also regularly supervise whether the goods purchased by the sub-franchisor, and at times also by the sub-franchisees, comply with the quality standards and with applicable safety standards. In the interest of the entire franchise network the franchisor should not only be entitled, but even be obliged, to make every effort to have products that are not of the required quality or are defective withdrawn from the supply list of the network.

OTHER OBLIGATIONS OF THE FRANCHISOR

The franchisor is in most cases obliged to supply the sub-franchisor with an original of the manual or manuals transmitting the franchisor's know-how immediately upon signature of the master franchise agreement or upon the payment of the initial franchise fee or of a part thereof. This manual will usually include an original set of management and technical documents, as well as standard forms that are to be used in the franchise network. In this case the manual is usually the one that should be used by the sub-franchisor and transmitted by the sub-franchisor to the sub-franchisees. It will in most cases have to be adapted to local conditions and translated into the local language and the sub-franchisor will be under an obligation to have this done. It is unusual for the franchisor to supply a manual setting out how the sub-franchisor should run the business as sub-franchisor rather than as the operator of a unit, this know-how being generally transmitted by training only.

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. This fund can also be used to develop promotional and advertising programmes, including standard advertisements, films, videos, brochures and any other material that may serve to promote the network. 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.

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

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8 See Chapter 15.
9 See Chapters 12 “Rights created by Statute” and 14 “Rights protected by Contract”. 
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, access being provided to the sub-franchisor and its sub-franchisees (for example in the car rental or hotel business); and
- the seeking of supply and/or service contracts with government agencies and other public institutions or major customers, with access to the supplies or services thus obtained being offered to the sub-franchisor and its sub-franchisees, possibly against payment of additional fees.

REMEDIES FOR NON-PERFORMANCE BY FRANCHISOR

It is 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. Non-performance by the franchisor, 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 that justifies termination.

The termination of a master franchise agreement will lead to considerable practical difficulties and possibly also to dramatic consequences for the sub-franchisees. A sub-franchisor will therefore hesitate to terminate the master franchise agreement in cases of non-performance by the franchisor, unless it is the only possible solution. This might be the case, for instance, in the case of non-performance of the initial training or where the manuals are not supplied. The agreements will usually provide for less dramatic solutions for a certain number of cases, such as a temporary remittal of the obligation placed upon the sub-franchisor and its sub-franchisees to purchase certain goods only from the franchisor or, in cases where the franchisor does not proceed against trademark infringements, the right of the sub-franchisor to proceed in the franchisor's place. Another possibility is the temporary reduction of the ongoing franchise fees or of the advertising fees, although there are difficulties in establishing precise and reliable parameters to calculate any such reduction. A percentage scale for the non-performance of certain main obligations may however be established.
RIGHTS OF THE FRANCHISOR

A clear distinction between rights and obligations is not always possible. Thus, the controlling of the network by the franchisor may be considered both an obligation, as it may be considered the duty of the franchisor to safeguard the network’s reputation by ensuring that quality standards are maintained, and a right, in that the franchisor retains the right to control the performance of the sub-franchisors in the agreement.

Examples of rights that the franchisor might retain over and above the normal rights/obligations specified in the agreement, are the right to approve the locations for the outlets in the host country, the right to approve prospective sub-franchisees, the right to appoint a director to the Board of Directors or to receive fees directly from the sub-franchisees as opposed to passing though the sub-franchisor and the right to deal directly with the sub-franchisees irrespective of the 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, with questions of liability for the franchisor arising as a consequence.\textsuperscript{10}

\textsuperscript{10} See Chapter 6 "The Tripartite Relationship of Master Franchise Agreements."
CHAPTER 8

RIGHTS AND 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 be viably 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 for example be detailed obligations relating to the speed with 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 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 can be achieved within the scope of the resources that it is prepared, or can afford, to commit to the project.

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 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.

The issues of the viability of the system and the lack of knowledge of the franchisor’s name are often 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 operation is to ascertain whether the business that is franchised is viable and to judge how successful it may be in the territory concerned. 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 also 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 franchisor’s know how as “resulting from experience and testing”, which is another way of describing the practical experience that pilot operations provide.

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 undertake:

- to come to an agreement with the franchisor on sub-franchisee qualification criteria 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;

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1 Article 1(3)(f).
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 the sub-franchisor should immediately initiate legal proceedings. There are other methods short of legal proceedings that are employed by 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, support, persuading the sub-franchisee to improve performances and an attempt to persuade the sub-franchisee to sell its business so that another can take its place in the network;

contracts need to be drafted in such a manner that the sub-franchisor is provided with sufficient scope to handle the network in a flexible manner, which at the same time ensures that the franchisor’s property rights are kept secure;

the sub-franchise agreement will 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;

the franchisor will have registered its trademarks in the territory and will be most concerned that their integrity is properly maintained in accordance with the law, as well as that potential infringers are dealt with;

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 marketplace 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;
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 able 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 based upon knowledge acquired from experience in supporting the franchisees.

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 and to provide the same range of services and support in that territory as the franchisor is able to provide 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 written material written in its own language that will need to be adapted and translated for use within the territory. It is normally provided 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 otherwise would 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 different languages with the many sub-franchisors who will be established in a number of 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 which 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 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 default in such obligations by the sub-franchisees. Vis-à-vis the sub-franchisees the sub-franchisor may however have to warrant that it effectively has the right to grant the rights that it is granting 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 the responsible franchisor. Indeed if the sub-franchisor operates effectively, they would not regard anyone else as being the franchisor.
CHAPTER 9

THE UNIT SUB-FRANCHISE AGREEMENT

International master franchise arrangements are normally not executed in the form of a three-party agreement. The usual three-tier structure is normally achieved by two separate agreements. The standard question for every franchisor is how much freedom it wishes, or is obliged, to give to the sub-franchisor with respect to the drafting of the unit or sub-franchise agreement to be used in the host country.

It is characteristic of franchising that the franchisor aims at achieving a more or less identical reproduction of its proven concept by the all the franchisees. It is therefore natural that it will use all means available to it, including contractual arrangements, to achieve this objective. In contractual terms the simplest way is for it to use a uniform unit franchise agreement. In a domestic context this will normally not pose any problems, unless the country concerned is a federal State with legal requirements that vary from one state or province to the other.

The use of a single standard unit or sub-franchise agreement becomes more difficult when a franchisor leaves its home country and decides to use master franchise arrangements to spread its franchise system to other countries, in particular if considerable cultural differences are involved. The franchisor’s ultimate objective is however always to reproduce its proven concept. It is not possible for the franchisor to risk having the sub-franchisors run systems which, although they are conducted under its trademark, are not identical with the system it has developed in its country of origin, as this may damage its reputation in its own country. Nor would it be able to justify the sometimes substantial franchise fees that it charges, if it only licenses an idea and a trademark. The franchise fee would find justification only in the licensing of a fully structured system which can be, indeed must be, reproduced following the instructions of the franchisor and with the franchisor’s assistance.

Immediately after the selection of a partner who is suited to being a sub-franchisor, the second most important issue for the franchisor is to ensure that it retains a sufficient influence on the sub-franchisees and their operations, despite the fact that it will normally not have any direct contractual relationship with them, so as to maintain the overall uniformity of the franchise system. A very important tool to achieve this is the unit or sub-franchise agreement with respect to which a franchisor basically has two options:

- the franchisor may impose its usual standard franchise agreement on the sub-franchisor and require strict compliance with all its stipulations unless they are in contradiction with mandatory laws or cultural customs of the host country, with the
sub-franchisor 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 form 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 the financial solidity of the sub-franchisor;
- the complexity of the system;
- the trust the franchisor has 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.

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.

**First Option: Strict 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 be exactly the same as the model agreement they have provided, which usually is the standard form they normally use in their own countries. In such cases the sub-franchisor will usually be placed under an obligation to translate the foreign model agreement into the local language at its own expense. In order to attain strict compliance with the original model agreement, the franchisor will usually add the following obligations:

- the sub-franchisor may not use the translated version without the franchisor’s prior written approval of the translation;
- 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 model sub-franchise agreement as 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 sub-franchisees meet the then current admission criteria of the franchisor with respect to

◊ personal qualifications,
◊ related business experience, and
◊ financial solidity.

The franchisor might even require that it be sent a copy of each sub-franchise agreement, with information on the prospective sub-franchisee's qualifications, and reserve the right to approve or not to approve each prospective sub-franchisee.

From a franchisor's point of view, the simplest way to ensure that its business concept is spread in a uniform manner is to impose both the use of its original unit franchise agreement and strict compliance with its contract terms. Although it might be fully justified that a franchisor request that its sub-franchisor's sub-franchisees meet certain admission criteria and fulfil all the terms of the sub-franchise agreements, a number of other typical requests might not always be justified in an international context.

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. A situation where the sub-franchisor has to struggle to obtain the franchisor's consent for each modification it considers appropriate, or even necessary, to meet the local requirements should be avoided, first and foremost because a confrontational relationship does not augur well for the collaboration between the parties, and secondly because the initial legal costs of the sub-franchisor would be considerably increased. A franchisor who chooses this method should 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 unit franchise agreement and to later modify the adapted agreement without the consent of the franchisor. The sub-franchisor should provide information justifying the adaptations or modifications it proposes so as to ensure that the agreement conforms to the laws, customs and commercial practices of the host country.

The admission criteria the franchisor applies in its country of origin may not be appropriate in the host country, with the consequence that their unaltered application might be of considerable hindrance to the development of the franchise system. The admission criteria that the sub-franchisor applies should be reasonable, appropriate for the system and for the host country, as well as acceptable to the franchisor.
In some cases it might be feasible for a franchisor to approve each prospective sub-franchisee in a foreign country in addition to approving the individual sub-franchise agreements. 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 receiving copies of all sub-franchise agreements executed for control purposes, but even in this case the franchisor should consider whether, under the applicable law, such a procedure could create a risk of liability.

Other reasons may speak against too much interference on the part of the franchisor with respect to the sub-franchisor’s freedom in drafting a model sub-franchise agreement. From an economic point of view, for example, it might not be necessary, it might further encroach on the independence of the sub-franchisor and it might be an impediment to the conclusion of the master franchise agreement and subsequently even to the conclusion of sub-franchise agreements.

When the tasks are divided between the parties, what should also be borne in mind is the reason for which the franchisor has decided to spread 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 and use its own personnel in this foreign market, but decided to leave this to a sub-franchisor. As it is the sub-franchisor who mainly bears the 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.

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

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

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

- a general description of the franchise system in a preamble;
- the precise scope of the rights granted;
- (where applicable) a description of the territory for which the agreement applies;
♦ 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 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 and the provisions of the franchise agreement and the manual(s);
♦ (minimum) insurance rules, indemnity;
♦ promotion, advertising issues;
♦ confidentiality;
♦ non-performance of the agreement by the franchisee and possibly by the sub-franchisor;
♦ assignment rules (including assignment to the franchisor);
♦ duration, renewal and termination of the agreement; and
♦ jurisdiction issues (arbitration, mediation, conciliation).

The relative liberty of the sub-franchisor does not mean that the franchisor may not 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 also prescribe the use of certain key provisions, and may also require certain specific wording for these 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;
♦ in certain cases, 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 the 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.

It is necessary for the sub-franchise agreements to contain a provision on what will occur if the master franchise agreement comes to an end as a result of the expiration of its term, or because it is terminated. The franchisor will probably require that all the sub-franchise agreements the sub-franchisor has concluded automatically terminate in either of these cases, and that 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 succeed to the sub-franchisor's rights and obligations. The franchisor will usually prefer the last of these alternatives.¹ Whatever the choice of the franchisor, or whatever the franchisor can agree upon with the sub-franchisor, the model 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 laws.

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 sub-franchise agreement proposed by the franchisor in its view risk infringing local laws and to discuss possible solutions with the franchisor. A reasonable franchisor should be open to such a discussion. The franchisor should in fact require the sub-franchisor to ensure that the 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 to facilitate the expansion of the network in the host country by means of a model 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 again could mean that the franchisor will

¹ See Chapters 18 "Remedies for Non-Performance" and 19 "The End of the Relationship and its Consequences".
insist on imposing specific "mandatory" contract clauses in some countries while accepting less rigid contractual arrangements in others, or at least a less rigid enforcement of the mandatory clauses by the sub-franchisor.

**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 normal means provided for in the host country's legal system, in case of necessity by termination of the sub-franchise agreement.

Every single instance of non-performance of a sub-franchise agreement cannot be considered a material breach of the master franchise agreement. Where, however, the non-performance is material, particularly where this non-performance 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 (for example 30 days), such events may be considered to constitute a material breach of the master franchise agreement.

As a franchisor may not wish to terminate a master franchise agreement in case of only a single or a few instances of non-performance of the sub-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. Only in very serious cases 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 were to start to enforce their contractual rights, to stop paying the royalties or simply to continue conducting the 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 inform all the sub-franchisees of the address of the franchisor to which they may address their complaints. It would be in the best interest of the network as whole for the franchisor to take the complaints it receives from its sub-franchisees seriously, and to make every effort to ensure that its sub-franchisor complies with the sub-franchise agreements.

**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. 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 many suggestions and requests to which the sub-franchisor and the franchisor should respond. It is for this reason that the franchisor should oblige its sub-franchisors to entertain an intense exchange of views and experiences with its sub-franchisees and also 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 to the sub-franchisor to obtain this prior approval. The sub-franchise agreement should in any event provide rules on how improvements made by sub-franchisees should 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 different options open are that such improvements are entirely transferred to the franchisor (with or without compensation); that they are licensed to the sub-franchisor or to the franchisor, with or without exclusive rights being granted, but that ownership is 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, as well as to offer them an appropriate compensation, will encourage sub-franchisees to come forward with their ideas.\(^3\)

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\(^2\) See Chapter 14 “System Changes”.
\(^3\) See Chapter 14 “System Changes”.
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 reasonable cost and if arbitration awards can be easily enforced.

Choice of law is usually not an issue for sub-franchise agreements, as they are generally concluded between parties operating on the same national territory. There are however cases in which a sub-franchisor might have sub-franchisees in several countries. In this situation, which resembles that of a franchisor with sub-franchisors in different countries, the sub-franchisor might wish to apply its own law to all its sub-franchise agreements. The most appropriate solution is however that the law of the country of each sub-franchisee governs that particular sub-franchise agreement, even if this involves certain practical difficulties for the sub-franchisor. In a number of jurisdictions the application of the local law might even be mandatory. It is in any event advisable to adjust the choice of law to the choice of forum.
CHAPTER 10

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 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. 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 no less important in an international context, in which, however, advertising does raise an additional set of issues.

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 secondly, the protection in other countries of the proprietary marks used in the franchise system. In striving to standardise the image of the system that is projected to prospective customers, franchisors and 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.

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 franchisees, whether it will instead merely approve all the advertising materials used by the franchisees, or whether it will provide guidelines or standards that the franchisees 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. Franchisees will moreover resist such stringent control on the part of the franchisor. In practice a majority of franchisors and franchisees will agree on either the franchisor approving the advertising
materials, or the franchisor providing guidelines or standards that the franchisees are expected to follow in developing their own local advertising materials.

1. **Approving All Materials**

   If the franchisor is to approve all the advertising materials used by the franchisees, 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 franchisees 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 franchisees 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 franchisees 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.

2. **Providing Advertising Guidelines or Standards**

   A franchisor who provides guidelines or standards to assist foreign franchisees 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 franchisees will be required to prepare periodic marketing plans;
   - if franchisees are required to prepare marketing plans, whether such plans must be submitted to the franchisor; and
   - if franchisees 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 marketing plans will normally indicate the objectives that the parties hope to meet, only very rarely are they actually followed. Prudent franchisors and franchisees 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.

3. **Master Franchising Contrasted**

   The methods of controlling advertising in other countries described above 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.

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 franchisees, or whether the franchisor will provide its franchisees with advertising materials in its own language and then require the franchisees to have the materials translated. If the franchisees 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 franchisees with translated advertising and promotional materials, as those who require the franchisees 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 franchisees 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 franchisees, as well as any sub-contractors to whom the franchisees 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 franchisee's country.

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 franchisee should bear full financial responsibility for advertising in its territory, that the franchisee 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 master franchising, the sub-franchisor will take the place of the franchisor in these options.

In the case of either of the last two alternatives the parties should decide the purposes for which the contributions of the franchisees may or may not be used by the franchisor and the manner in which the franchisor will be accountable to the franchisees for the actual expenditures made. In the case of either of the first two alternatives the parties should clarify whether the franchisee's expenditures on local advertising will be credited toward the amount(s) the franchisee 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 franchisee 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.

Finally, it should be noted that the laws of some countries will impose a withholding tax on advertising fees paid by a local franchisee 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.

**Advertising Alternatives**

1. **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.

   (i) **Agreement Terms**

   Franchisors that require foreign franchisees 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 franchisees 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 franchisee to the fund and that any specific advertising for which the fund is used will benefit any particular contributing franchisee.

(ii) 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.

(iii) Other Contributions

In addition to the 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) 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 franchisees to achieve economies of scale through the co-ordination of advertising and promotion efforts. A second advantage is that participating franchisees 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 franchisee.

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.

In cases where there are more than one sub-franchisor, the consequences of this fact should be carefully considered also in terms of the division of responsibility, and of the apportionment of the fees, between them.
CHAPTER 11

SUPPLY OF PRODUCTS AND SERVICES

For a franchise network to function properly, it is necessary for the franchisees to have an adequate supply of the products and services that are essential to maintain the integrity and quality standards not only of each unit, but of the franchise system as a whole. An essential element in determining the success of a franchise network, is a proper identification of the franchisor’s role in the supply of the products and services, so that the franchisor will be able to exercise an appropriate control while the franchisees at the same time are offered an adequate and efficient access to such products and services.

Franchising in its many forms ultimately always involves the distribution of products or services through the unit franchises. As the franchisee distributes products or services in accordance with the methods, procedures, specifications and formulae that comprise the system that the franchisor has developed, it should come as no surprise that the franchisor will often provide to franchisees with products or services as an integral part of the franchise system.

The unit franchisees will generally need two different kinds of products or services for their operations. First, they will need the products, or component parts of the products or services, that are distinctive for the franchise system and that might present some proprietary characteristics. Secondly, franchisees need a wide variety of other products or services of a general nature that are essential to the conduct of their operations.

The supplying by the franchisor of products that are unique to the franchised system may offer a number of advantages to both the franchisor and the franchisee. First, the maintenance of the necessary quality standards may be assured if the 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 franchised system as a whole, which is of course a key factor in the success of a franchise system. The franchisor furthermore has a duty to control the quality of the products or services that bear its trademarks, both to maintain the enforceability of the trademarks and to maintain the standards that form an essential part of the franchised system. Secondly, if the 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 may also expect to realise an additional profit from the products or services it provides the franchisees with.

It should be observed that in many countries the manner in which goods or services are provided for distribution, particularly where one of the parties is contractually bound to make such purchases from the other, is regulated by law.
NATURE OF PRODUCTS OR SERVICES SUPPLIED

The franchisor might supply almost any of the products or services 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 unique to that particular franchise system. The reason they are often 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. These products are often those actually sold by the unit franchisees. Examples of such products include food items, petroleum products and equipment parts.

The products or services supplied may on the other hand form an integral part of the franchise system and as such 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 standards of quality that identify the system. Examples of such products may be proprietary operating software, packaging supplies and special equipment.

The products supplied may at times be products which, although generally necessary for the conduct of the franchisee's operations, are not unique to the franchise system. Such products may normally be readily obtained by unit franchisees from independent suppliers, but the franchisor might be in a special position to ensure that they are available at a competitive price. Examples include office or outlet premises, financing, advertising aids, book-keeping services, 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 or services there is usually little need for the franchisor to supply them, although the franchisor may wish to do so as a related business activity.

METHODS OF SUPPLY

There are a variety of arrangements that the franchisor may consider for the provision of products or services to its franchisees. The franchisor may provide such products or services directly and may require the franchisees to purchase what they require directly from it. In the case of master franchising the franchisor may authorise the sub-franchisor to supply the products or services. The franchisor may also designate certain approved suppliers, who may or may not be affiliated with the franchisor either because the franchisor owns the supplier or as a result of an agreement between them. The franchisor may or may
not attempt to receive a payment or commission from any independent suppliers that it approves as suppliers of the designated 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 that are nominated by a franchisee. The approval of each supplier will usually depend on the fulfilment of certain conditions that are intended to ensure both the quality and 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 charge for the products or services that it supplies directly, with the price generating an additional profit or possibly merely helping to defray the costs of supplying the products or services concerned. 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 them. 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.  

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 of the parties in determining the method that should be adopted for the supplying of products by the franchisor. First, 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 that the unit franchises in the system use. 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 will 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 have provisions providing for the purchase of products from specified sources, such as the franchisor, the sub-franchisor, or any independent suppliers the sub-franchisor, or in some cases the franchisor, has approved.

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

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See Chapter 5 "Financial Matters".
initially of the 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 its initial needs 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.

In general both the franchisor and the sub-franchisor will prefer the unique products or services to be supplied from within the territory, in view of the extra costs associated with the transportation of the products involved from the location of the franchisor in one country to that of the unit franchisees in another, considering also the tax and other complications that might arise when the products cross the borders of the country of destination and the need to adapt the products to the requirements of the law or the market conditions of the territory.

The franchisor and 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 and which 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 essential services or products that comprise the heart of the franchise system to the unit franchisees in the territory. The manufacturing agreement concluded between the parties would in this case provide for the eventual transfer of the technology necessary to manufacture the products in question, 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 the 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 that 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 will reach an agreement on the payment of royalties.

**Regulation of Supply Relationships**

In many countries the extent to which a party may impose restrictions on the other party regarding that party's purchases of needed products is regulated by law. Thus, for example, in the United States, when certain requirements are imposed on a distributor, (such as the payment for the right to distribute the products), when significant controls are imposed by the supplier and the use of one or more trademarks is required, the distribution relationship will come within the definition of a franchise under federal law as well as under the laws of many states. In this case the legislation that is applicable to franchise relationships would be applicable also to the distributorship. The legislation that is applicable to franchising contains provisions which specifically regulates the extent to which franchisees may be required to purchase products or services from the franchisor or from other designated suppliers. The antitrust laws of the United States also restrict the extent to which a franchisor may condition or tie the purchase of certain products to the right to purchase other products. The purpose of this legislation is to generally ensure that the restriction of sources of supply is fair and may be justified from a business point of view.

Similarly, in the European Union Article 85 of the Treaty of Rome\(^2\) generally prohibits agreements that restrict sources of supply\(^3\) unless certain economic benefits can be shown to result from this restriction.\(^4\) 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”,\(^5\) 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”,\(^6\) 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.\(^7\)

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\(^2\) *Treaty Establishing the European Economic Community*, signed in Rome, 25 March 1957.

\(^3\) Article 85(1)(c).

\(^4\) Article 85(3).


\(^6\) Article 3(1)(b).

\(^7\) Article 3(1).
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.

**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 goods or services between the two parties. 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 to ensure the maintenance of quality standards. For example, in a hotel franchise system, hotels within the system might use products and services that are entirely available from independent suppliers.

When certain products or services 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 provide 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 actual franchise agreements because of their relatively simplicity and because they are such an integral part of the conduct of the franchising 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 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 a considerable number of 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 provision of
technical assistance and the payment of royalties. When the goods are sold by the franchisor, the supply agreement is actually 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. 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.\(^8\)

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 by the legislation applicable to the transfer of technology or by any other applicable legislation of that country.

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 control the sources of the products in question in any way.

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, size of the supplier and the ability of the supplier to monitor, control and test the quality of the products it supplies.

\(^8\) See Chapter 22 "Ancillary Documents".
CHAPTER 12

RIGHTS CREATED BY STATUTE

In most countries of the world there are certain rights that are created by government legislation and which 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.\(^1\) 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 licence 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. As regards copyright, in certain countries a party may be entitled to copyright protection merely as a result of its having created the work in question, whereas in other countries registration might be necessary. It should also be noted that numerous countries are signatories to the international conventions that deal with intellectual property.

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. The manner in which 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 which involves the grant of such a sub-license by the sub-franchisor may not be possible.

\(^1\) See Chapter 13 "Rights protected by Contract"

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;

♦ 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.
**Infringement of the Franchisor's Trademarks**

Master franchise agreements will generally deal with the consequences of infringement, or threatened infringement, or piracy of any of the franchisor's trademarks by third parties, as well as with how such incidents should be dealt with. The options that are available to the parties 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 parties 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.

**Infringement Proceedings Taken by a Third Party Against the Sub-Franchisor**

The question of infringement proceedings taken against the sub-franchisor by a third party 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 party 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 key 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 rights it is granting, is debatable. This is an important question, 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. The situation will vary from country to country.

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 un-budgeted expenses incurred as a result of the need to change the signs of all franchise outlets owned by the sub-franchisor and by the sub-franchisees, as well as in modifying or substituting 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.

**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 are similar to those previously discussed as regards infringement proceedings.

**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. Even in countries without a registered user system, there may nevertheless be a need for franchise agreements to be registered with the appropriate authorities in view of the type of relationship involved.

**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-license the franchisor's trademark to sub-
franchisees. In certain countries trademark legislation may not permit a sub-franchisor to sub-license 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 as a 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.
CHAPTER 13

RIGHTS PROTECTED BY CONTRACT

In a franchise agreement the franchisee is licensed to use the intangible assets that comprise the method of doing business that is being franchised.\(^1\) These intangible assets may be classified under one of two basic categories of intellectual property rights: those protected by statute (trademarks, patents and copyright, for instance)\(^2\) and those that are protected by the terms of the contracts (know-how). The term "know-how" is however often used as a collective term, to comprise the total of the intangible assets and of the knowledge gained by the owner of these assets. A distinction should therefore be drawn between the different concepts that might included under the term “know-how”.

**Know-How, Trade Secrets and Confidential or Undisclosed Information**

A first distinction should be drawn between know-how and what are known as trade secrets. 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 from competitors.

A characteristic of "knowledge" or "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 of the enterprise. The number of people who legitimately acquire knowledge of the secrets thereby increases. With the increase in number of people with knowledge of the secrets the risk that these people may disclose the secrets to other persons who may use them in their own entrepreneurial activities also increases, as does the risk that those who have acquired the knowledge legitimately may use it in their own business once the relationship with the owner of the secrets has ended.

In order to protect trade secrets it is necessary for persons who acquire knowledge thereof to be bound not to disclose them to other people. This is achieved by means of the 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 which

\(^1\) See Chapter 3 “Nature and Extent of the Grant of Rights”.
\(^2\) See Chapter 12 “Rights protected by Statute”. 
competes with that of the owner of the secrets. This is normally provided for in what are known as non-competition clauses or agreements.

"Know-how" as a concept was developed by the business community which first used the term in common parlance and subsequently in legal drafting. Know-how has come to be considered a category of its own, with the consequence that attempts to regulate it have been made in some legislatures. The business community itself has also attempted to provide a form of voluntary regulation, as well as to distinguish between the assignment and the licensing of know-how.

The body of information that is encompassed by the term "know-how" may relate to the most diverse objects. It may include, for example, inventions that, although patentable, have not been patented, or inventions that cannot be patented, such as computer software, formulas, product testing and quality control techniques. This does not exclude that other forms of protection may exist, such as copyright for computer software.

A first category of know-how is what are known as "technical secrets", which include any technical knowledge that is to provide solutions to technical problems that are encountered in industrial activity.

Know-how also includes "commercial secrets", which may be defined as rules of behaviour derived from the experience gained in the management of an enterprise and pertaining to the specific trade sector or organisation concerned.

Two elements may however be considered to be necessary for a commercial secret to receive protection. First, the fact that the knowledge provides the owner of the enterprise with a competitive advantage that it did not have before; and secondly, that for a competing enterprise to obtain this knowledge, it would be obliged to make investments. A third element that at times is considered necessary for protection is the efforts made by the owner to maintain secrecy. It should however be observed that the nature of commercial know-how is such that it may not be able to claim the same level of protection as that enjoyed by industrial know-how and technical secrets.

In a number of jurisdictions no distinction is drawn between "know-how" and "trade secrets". In the common law countries, for example, the definitions of the two often coincide. The fundamental elements of both are in this case that the formula, device or compilation of information concerned is used in the business of the owner, offers the owner a competitive advantage over competitors and is secret.

In a number of common law jurisdictions a further distinction that is made is that between "trade secrets" and "confidential information". Where such a distinction is made, the confidential information is often considered to be inherently short-lived in nature and would thus cover, for example, short-term plans. Confidential information is therefore less
protected than trade secrets, particularly from the point of view of the duration of the confidentiality and non-competition provisions of the agreements.

In civil law countries no legislative definition of the terms “trade secrets” and “know-how” is generally to be found, although references to both are often scattered among statutes that deal with a number of different matters.

In general, three different views may be considered to exist on the relationship between know-how and trade secrets. According to the first, know-how is a broader concept than trade secrets; according to the second, know-how is instead a narrower concept; and according to the third, know-how is identical to trade secrets.

Specific provisions on the protection of “undisclosed information” are included 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. To be noted, is the fact that the TRIPs Agreement refers neither to “trade secrets” nor to “know-how”. The agreement does not limit the possible contents of protected information in any manner, it merely 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”.³

KNOW-HOW AND THE TRANSFER OF TECHNOLOGY

In numerous countries legislation that has been adopted in particular for the transfer of technology, but also for other purposes, will use the words “know-how” or will include “secret”, “technical”, and/or “commercial knowledge” within their definition of “technology”.

In the European Union know-how is defined by Article 10(1) of Regulation No. 240/96 as “a body of technical information that is secret, substantial and identified in any appropriate form”⁴. The regulation that specifically refers to franchising, Regulation No. 4087/88, also refers to know-how, although in this case it is commercial and not technical know-how that is considered. In the context of franchising know-how is thus defined as “a

³ Article 39(2).
package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified" (Article 1(3)(f)).

**CLASSIFICATIONS AND DISTINCTIONS**

1. **KNOW-HOW THAT IS PROTECTABLE AND KNOW-HOW THAT IS NOT PROTECTABLE**

   A distinction is often drawn between know-how that is protectable and know-how that is not protectable. In this case the know-how that can be protected is that which corresponds to the definitions given above, whereas that which cannot be protected is instead generally know industrial technology or business techniques. It should however be observed that there are jurisdictions in which the parties may legally agree that the obligation to pay royalties for the right to use the know-how will last indefinitely, even if the know-how no longer is secret and therefore cannot be protected against third parties.

2. **KNOW-HOW THAT IS PROPRIETARY AND KNOW-HOW THAT IS NON-PROPRIETARY**

   A further distinction may be drawn between proprietary and non-proprietary know-how. In the case of proprietary know-how the owner is given the right to prevent others from using the know-how concerned, as it is either patented or covered by copyright or secret. In most cases this know-how is however to be identified with specific intellectual or industrial property, the uses of which, and the rights to which, are regulated by statute. In a franchising situation most of the know-how is non-proprietary in nature, in that it is not protected by statute and may be legally copied by others who are not licensed. The value of this non-proprietary know-how lies in the fact that it has been developed into a system and that it is combined with other know-how to form a unique combination which identifies the franchise system. In this connection it should be observed that a question of some importance in international master franchise agreements is whether or not, and the extent to which, the sub-franchisor must warrant that it has the right to dispose of the non-proprietary know-how it possesses.

3. **KNOW-HOW THAT IS SECRET AND KNOW-HOW THAT IS GENERALLY AVAILABLE**

   A distinction is sometimes drawn between "secret" and "generally available" know-how, or between the secret know-how and know-how which, though not secret, can nevertheless be acquired only with difficulty and by exerting considerable efforts. The classification of know-how as being "generally available" may be questionable, in that once information has come into the public domain it will have lost the specific economic value that forms the basis of its legal protection. Secrecy, in other words, is an essential feature of both know-how and trade secrets.

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5 See Chapter 3 cff.
SECRECY OF KNOW-HOW

For it to be possible to protect the know-how, it is fundamental that it is secret. This requirement of secrecy is one that is recurrent in the international instruments adopted. This is the case, for example, of the TRIPs Agreement, Article 39 of which requires the “secrecy” of the undisclosed information. It is also true of the European Regulations on technology transfer and franchise agreements, which, although the know-how referred to is technical in the first and commercial in the second, both require that the know-how in question must be “secret”.

According to the European franchising regulation know-how is “secret” when it is not generally known or easily accessible. Article 39 of the TRIPs Agreement instead 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 in question. The absolute secrecy of the information is however not necessary, as it is sufficient that the information is not easily or readily accessible. The transfer 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.

Neither the Regulation nor the TRIPs Agreement require the secrecy to be absolute, in the sense that only the owner has any knowledge of the information. 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.

FURTHER REQUIREMENTS FOR THE PROTECTION OF KNOW-HOW

1. EUROPEAN UNION RULES: KNOW-HOW MUST BE SUBSTANTIAL AND IDENTIFIED

For the franchisor’s know-how to qualify for the Block Exemption Regulation on franchising, the know-how must be “substantial” and “identified” in addition to being secret. 6 Know-how is considered to be substantial when it “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; 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.”7 The information that constitutes the know-how must in other words not be commonplace and must have economic value for the running of the franchisee’s business, even if it does

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6 Article 1(3)(f).
7 Article 1(3)(h).
not concern the commercial activity of the franchisee as a whole, but only some aspects thereof.

The know-how is identified if it is "described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality". It should be observed that the description of the know-how can be set out either in the franchise agreement or in a separate document, or be recorded in any other appropriate form. In fact, the communication of know-how can take place not only by the delivery of documents (paper-based or in any other form, including electronic documents), it can also be communicated orally, or by means of direct technical assistance or training. The need to identify know-how does not imply that the franchising agreement must be in a written form.

Worthy of note, is the fact that the "identification" of know-how is also required in common-law countries for the enforcement of contractual clauses that protect know-how.

2. THE TRIPS AGREEMENT: KNOW-HOW MUST HAVE COMMERCIAL VALUE AND BE THE OBJECT OF REASONABLE EFFORTS TO MAINTAIN ITS SECURITY

The TRIPS Agreement indicates that for it to be protected, the undisclosed information must "have a commercial value because it is secret". 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.

In addition, the person lawfully in control of the information is required to take "reasonable steps under the circumstances, [...] to keep it secret". It should be observed that the obligation to take reasonable steps is 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 may be considered to be "secret", courts in common law countries have applied the so-called "test of reasonableness" to the measures of protection. The general principle that is embodied in 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.

WARRANTIES BY SUB-FRANCHISOR AND BY FRANCHISOR

Know-how in a strict sense is intellectual and industrial property that is not offered the protection of legislation, that is protected only by the terms of the agreement between the

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8 Article 1(3)(i).
9 Article 39(2)(b).
parties. A consequence of this is that there are no public registers in which rights of ownership to the 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, and for the sub-franchisees to know that the sub-franchisor has been granted the rights it is transmitting to them. The question therefore arises of the extent to which the sub-franchisor should warrant that it has been given the rights that it is granting sub-franchisees and 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.

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

As is the case with other assets, know-how may be the subject of an "assignment". In this case the owner of the know-how transmits it to a third party together with the actual ownership of the know-how. In its capacity as new owner, the third party 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 which binds the assignor until the know-how becomes public knowledge.

It is also possible to licence the know-how. In this case the owner of the know-how grants a third party 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.

Licences are not always required to be in writing, although in some jurisdictions the statutes that concern the transfer of technology might require the written form. It should furthermore be observed that the requirement of “identification” of know-how which exists in a number of jurisdictions only concerns the performance of the obligation to communicate the know-how to the licensee and does not affect the validity of an unwritten licence agreement.

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.

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.

**Third Party Acquisition of Knowledge of the Know-How**

A situation that needs to be considered is that in which a third party acquires knowledge of the know-how, irrespective of the manner in which it acquires this knowledge, 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.

**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 by communicating the commercial know-how together with the granting of the necessary intellectual and industrial property licences to the franchisee and by subsequently ensuring that it is correctly implemented, the franchisor ensures that the members of its network conduct the business in a uniform manner.

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

**The Transfer of Know-How in Franchise Agreements**

In a franchise relationship the franchisor transmits its know-how to the franchisee. It is naturally of considerable importance for the franchisor to ensure that the know-how is correctly used by the franchisee 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 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. Copyright thus becomes an important means to protect the franchisor's know-how.

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 regular courses and/or meetings. Needless to say, it is the franchisor's responsibility to communicate the know-how to the franchisee throughout the relationship.

**COMMUNICATION AND PROTECTION OF KNOW-HOW IN INTERNATIONAL FRANCHISE AGREEMENTS**

In a master franchise situation the franchisor transmits its know-how to the sub-franchisor who then in turn transmits 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 developed subsequently.

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

The sub-franchisor may be held contractually liable for any non-performance 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 constitute non-performance 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 concluded 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 non-performance of the obligation not to disclose the know-how on the part of the sub-franchisees, the sub-franchisor may furthermore be held liable if it fails to take the appropriate measures to remedy this non-performance, such as for example to file suit.
CLAUSES IN 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. 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 the franchise agreements.

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

Confidentiality Clauses

A clause that is normally inserted in the franchise agreement, the purpose of which is to protect the know-how and any other confidential information that the franchisor provides the sub-franchisor and the sub-franchisees with, is the confidentiality clause. This clause will normally provide that the franchisee is not to disclose the know-how of the franchisor to third parties. In this case the third parties clearly do not include those to whom the franchisee must disclose the information if it is 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 franchisee itself, it may be extended also to all staff members and employees of the franchisee. 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 franchisee to be sufficient. Generally speaking, clauses protecting the know-how may legitimately be imposed on employees or former employees in all industrialised countries.

Grant-Back Clauses

Grant-back clauses might also be inserted into the franchise agreement. In accordance with these clauses the franchisee is required to communicate any experience gained in exploiting the franchise to the franchisor and to grant the franchisor, and other franchisees 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 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.
Field of Use Restrictions

"Field of use restrictions" are contractual clauses that oblige the 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 franchisee does not use the know-how of the franchisor to set up an activity in competition with the franchisor.

The 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.

2. Clause used to protect the Know-How after the Agreement has come to an end

Many of the restrictions applied for the duration of the agreement may continue to apply after it has come to an end.

In the case of the duty of confidentiality, the observance of this duty after the main franchise agreement has come to an end cannot be imposed on the franchisee if the know-how has become generally known or easily accessible. It must be observed, 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 licensees or franchisees of the network actually has acquired knowledge of the know-how is not sufficient to release the 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 franchisee who has made the know-how generally known despite the duty of confidentiality.

The franchisee will often develop its own know-how in the process of conducting the business. In this case, if the know-how has been developed completely independently by the franchisee, it would not be possible to prevent the franchisee from using the know-how it has developed for its 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.

Another common post-term restriction is the obligation placed upon the 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 franchisee exploited the franchise, it may be held to this obligation for a reasonable period of time after the agreement has come to an end.
LEGAL REMEDIES

1. PROTECTION UNDER CRIMINAL LAW

In civil law countries trade secrets are generally afforded protection under criminal law by the inclusion of specific provisions in the Penal Code, or by the inclusion of general provisions in the laws on unfair competition. A detailed listing of different types of wrongful acts is also included in the legislation.

In most of the common law countries there are provisions under criminal law against the disclosures of secrets, even if these are scattered in a variety of special laws.

In both systems the addressees of these criminal law rules are in the first instance those who work with the owner in the running of a business. In some jurisdictions liability for the crime of disclosing secrets is extended to third parties. These will include instigators or accomplices, that is first and foremost those who acquire the knowledge from the persons to whom the prohibition of disclosing secrets is primarily addressed.

2. PROTECTION IN TORT (UNFAIR COMPETITION)

In civil law countries provisions on unfair competition may be found either in a special statute or in a single general provision of the Civil Code. In some countries no specific provision has been enacted and unfair competition is instead banned by the general rules on non-contractual, or tort, liability.

In the common law countries courts interpret the tort of breach of confidence so as to include the protection of trade secrets.

In spite of these differences the ultimate results arrived at in individual cases by the courts of the different countries are very similar.

The first paragraph of Article 39 of the TRIPs Agreement states that the protection of undisclosed information is granted by Members "[i]n the course of ensuring effective protection against unfair competition as provided in Article 10bis of the Paris Convention (1967)." It is foreseeable that when the Agreement is implemented in national legislation, violations of secrets will be considered to be acts of unfair competition and will therefore be subject to the corresponding remedies.

The scope of protection of trade secrets under national laws is quite broad, and includes not only discoveries, scientific inventions and industrial applications, but also methods of production, lists of clients, sales practices, commercial know-how, and inventions that cannot be patented.
From the point of view of unfair competition, trade secrets run the risk of being stolen in two ways, namely by spying or by their abusive use by someone who has previously legitimately acquired knowledge of them. While spying always constitutes unfair competition, protection against abusive use is in some countries granted only if the owner of the trade secret has suffered damage.

3. PROTECTION IN CONTRACT

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. If they form the only subject matter of the agreement and are not an ancillary restraint, they will however normally need to be limited as to duration, geographic area and field of activity. No limits as to duration are instead required if the restrictions constitute ancillary restraints. In this case the restriction may extend for the entire duration of the main agreement.

Contractual clauses for the protection of trade secrets may be included in both licensing and sub-licensing 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.
CHAPTER 14

SYSTEM CHANGES

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, uncompetitive.

1. 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 however 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 both 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.
2. **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 at 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 redesigning 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).
3. **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 facilitate change in the franchise system. Sub-franchisors located in countries different from their franchisor may implement changes, or may petition the franchisor to implement changes, based on their different perception of local market conditions.

4. **Internationalising the Franchise System**

In international franchising the franchise system might need to be modified not only after a period of time to accommodate changes in circumstances, but also at the very beginning of the relationship so as to adapt the system 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 the conditions of the host country. In this connection the following factors are among those that must be considered:

(a) **Language**: the language used in the franchisor’s domestic market may differ from the language of host country. In all likelihood the franchise agreement and the other ancillary agreements, well as the operations manuals and any other communications, will need to be translated into the local language. Considering the fact that minor differences will inevitably exist between the versions, a decision should also be taken as to which language version should be the governing version in case of dispute;

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

(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 technology or know-how in the country;

(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;

(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;

(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;

(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;

(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.

**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.
1. **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 franchisee'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 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.

2. **FRANCHISOR-DRIVEN CHANGES**

Franchisors will often decide to modify their franchise system when they estimate that such changes will improve their 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 are able to do so more effectively than their 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 form of units it originally contemplated. 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 franchisee.

(d) **facility upgrade**: a franchisor’s ability to retain or regain its competitive position may well depend upon its ability to require its 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.

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.

1. 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 would 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.

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 the principle of force majeure and that 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.

2. **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 generally prohibit both the discriminatory treatment of franchisees and a 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.

**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 franchisee and changes in the scope of the franchisor’s activities.

1. **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 simply being somewhere in the city. A 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 are likely to change over time. In many cases, territorial rights will be granted to a franchisee on condition that it satisfies 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 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.

(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.

2. **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 to 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.

3. **CHANGES IN THE OBLIGATIONS OF THE FRANCHISEE**

(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. Once the system reaches a critical mass and becomes widespread,
regional and national advertising programmes may however well become the preferred advertising vehicle of the franchisor. 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.

(b) **Higher standards of performance**: in addition to the imposition of evolving obligations on the franchisee, the standards of performance of the franchisee may also be adjusted in the course of the agreement. For some types of performance standards it might be feasible to set forth those standards, as well as any changes that are to be made to the standards, 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 set forth 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.

4. **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 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 franchisees.

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 to the franchise system. In some cases it is instead the changed circumstances of
the franchisee that will dictate change, for example when the training requirements become different or less or the 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, for example, 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.

**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.

1. *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 which is current at the time of renewal. As indicated above,¹ such a condition may however not be realistic in the case of an international master franchise agreement which will be negotiated in any event. 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.

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¹ See Chapter 4 "Term of Agreement and Conditions of Renewal".
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.

2. **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 commonly set on sliding scales, in other words they rise or fall depending on the sales made by the franchisee. Another example would be the revocation of the franchisee's exclusivity in the territory it has 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 franchisees approve them. Franchisees who employ this form of democracy tend to reserve this procedure for modifications that would require a substantial capital investment by franchisees or that would be considered a major change to the system.

3. **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 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 the franchisee to comply with changes that are communicated to the franchisee by means less formal than an amendment of the operations manual, such as for example bulletins, policy statements, notices and similar communications.

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 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 unanticipated obligations upon franchisees, 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.

4. *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 franchisee has requested. These circumstances often arise on the following occasions:

(a) **franchisee's desire to expand**: the franchisee 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 franchisee agrees to introduce the modifications it proposes;

(b) **franchisee's desire to extend term**: the franchisee 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 franchisee agrees to introduce the modifications proposed by the franchisor;

(c) **franchisee's desire to transfer**: the transfer of a franchise to another franchisee will usually require the prior consent of the franchisor under the terms of the franchise agreement. A franchisee'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;

(d) **when franchisee is in default**: if the franchisee 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 franchisee agree to introduce the modifications it proposes as a condition for not proceeding against the franchisee for non-performance;

(e) **franchisor develops new product or service which it is not contractually obliged to make available to franchisee**: if the franchisees consider the new products or services developed by the franchisor to be desirable, the franchisor might grant them the right
to offer these new products or services in exchange for their introduction of the proposed changes. Franchisors may however in this case expose themselves to charges of discriminatory treatment of franchisees. Any differences in treatment of the franchisees must therefore be based on reasonable criteria. Care should also be taken not to withhold such opportunities from a franchisee if to do so would have a negative effect on the viability of the franchisee's operation.

5. **CORRECTIVE AND ENFORCEMENT MECHANISMS**

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, franchisee shortcomings. These measures are generally self-executing (which tends to reduce confrontation between the franchisor and the franchisee) 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 franchisee's exclusive territory or the elimination of the franchisee'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 franchisees for failing to conform to the required standards could be the loss of the franchisee's right to renew the agreement, or the loss of the franchisee'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.

6. **OTHER DRAFTING TECHNIQUES**

(a) **Reservation of rights**: the section of the franchise agreement that lists the rights granted to the franchisee should specifically identify not only the rights being granted to the franchisee, but also any exclusions from, or limitations of, those rights. Independently of whether or not it is necessary from the point of view of the interpretation of the agreement, a franchisor may wish to indicate whether it reserves all rights not expressly granted to the franchisee. This will also assist the franchisee in determining the exact extent of the rights it is being granted.

The agreement should expressly identify any limitations of the franchisee's right to use the trademarks or the franchise system. The agreement may for example state that the franchisee has the right to use the marks only at a single, identified location. If the franchisee is granted any type of territorial protection, the conditions of such protection should be clearly set out.

It might furthermore be useful if the agreement were to deal expressly with those rights that often become a point of contention. These points 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 franchise agreement that expressly permits the franchisor to implement such changes is more likely than a more generally formulated franchise 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 however be considered in this connection. The franchisor might also wish to exercise care so as to ensure that the 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.

"Escape" clauses: franchise agreements will sometimes include provisions that enable the franchisor to extract itself from an untenable franchise relationship or from any elements of the relationship that have become untenable. Certain of these clauses will relate only to specific provisions of the franchise agreement. The franchise agreement might, for example, reserve a right for the franchisor to scale down a non-competition covenant to a level at which it would be legally enforceable. Another type of clause might permit the franchisor to cease selling products to the franchisees if and when alternative sources of supply have become available to them at competitive prices. A fundamental clause of this nature is a buy-back provision that grants the franchisor the option to buy the franchise from the franchisee at a pre-determined price, either at any time during the term of the agreement or at other specified times. A variation of this concept is a right of first refusal, in which case the franchisor has an option to buy the franchise on the same terms as those on which the franchisee has proposed to transfer the franchise to a third party.

7. Making Changes More Palatable

Franchisors have a number of devices at their disposal to make changes in the franchise system more palatable to franchisees. 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 franchisees 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 franchisees to introduce the changes required is the setting up of a sinking fund, that requires the franchisees 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 franchisee. This “required savings programme” ensures that franchisees 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 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 of the franchise, the approval of a request for the transfer of the franchise to another franchisee, waiving the right to proceed against the franchisee for non-performance and providing the franchisee with 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 franchisees 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:** 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.

**Changes of particular significance in the international context**

It is often necessary to adapt the franchise system to operate in foreign markets. Changes to the system that may be especially pertinent in international franchising include the following:
1. **Different Vehicles**

In international franchise relationships the role of the sub-franchisor may influence the vehicle that is chosen to effect changes in the franchise system. 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.

2. **Cost Factors**

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 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.

3. **Practical Differences**

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.

4. **Language**

Differences in language often play a role in the modification of franchise systems. 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, as well as to translate the operations manual. The franchise agreement should furthermore specify the language version that is to govern the interpretation of the agreement, as well as the language of notices and other communications between the parties.

5. **Culture**

Cultural differences may also determine the need to change the franchise system in some, but not all, markets. This need might originate in, for example, dietary requirements
of the local religion, in different ingredient preferences or in different consumer tastes. Many franchise systems develop new products, flavours, or formulations to satisfy consumer preferences in foreign markets. Whether formally or informally, in such circumstances the views of the franchisees are frequently sought, as they will have a greater knowledge of the local market.
CHAPTER 15

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. The franchisor should therefore provide the sub-franchisor with a copy of the manuals prior to it executing the master franchise agreement or, at least, 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.

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 includes 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.

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 franchisee complies with the franchise system. It is however important that all changes to the franchise system are reasonable, 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 franchisee could obviously not have foreseen when it signed the franchise agreement.
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 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.

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. However, any changes to the franchise system that individually or collectively result in a change to the nature or general orientation of the franchise system, that would constitute 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) changes that the sub-franchisor is required to make in order to comply with the laws of the country in which the master franchise agreement is to be implemented should not require the 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. The manuals are owned by the franchisor who lends them to the sub-franchisor who in turn lends them to the sub-franchisees; 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. To the extent that such know-how constitutes an improvement made by the sub-franchisor, such an acknowledgement may, however, in some jurisdictions be viewed as constituting a grant back license. It may therefore be illegal under local law, or may in effect constitute a practice which will prevent the agreement from passing a review process. 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 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 reflect these differences in adaptations of their franchise systems. It should be noted that 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 initiated by the franchisor itself that it 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 franchisor’s request, however, the franchisor must recognise that it may be difficult for the sub-franchisor to insist that its sub-franchisees adopt all such changes. Depending on the nature, degree and costs of such changes, the sub-franchisor should furthermore be given the right to test-market these changes 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 such changes.

The negotiations between the franchisor and the sub-franchisor relating to changes that the sub-franchisor will be permitted to make to the franchise system tend to place a strain on the negotiations as a whole, as many franchisors treat all aspects of their franchise system as a sacred trust, the provisions of which are to be totally respected and which are not to be changed or otherwise tampered with under any circumstances. In international franchising, however, especially where the customs, cultures, habits, tastes, laws, language and commercial practices of the foreign country are different from those of the franchisor's country, the franchisor should not only have an open mind to the need to adapt and make changes to its franchise system, it should actively encourage such changes and adaptations.

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 franchise agreement and must be dealt with in the agreement itself.
CHAPTER 16

INSURANCE AND INDEMNIFICATION

Any franchise agreement, whether national or international, should include provisions dealing with insurance and indemnification. The provision, or provisions, concerned have to take into account the rules relating to liability as well as any practices that might exist in the host country in the field of insurance. Wherever possible, the provisions should not only specify the general obligations of the parties, but 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, for example, problems with, or claims and actions brought by, third parties. The chapter does not deal with the liability of either party for the performance or non-performance of its contractual obligations.

INSURANCE

In sub-franchise and master franchise agreements of North American, European or Australian origin it is usual to provide the sub-franchisor with an obligation to take out insurance for property and third party liability risks. 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". The imposition of a vague obligation of this nature does not help to establish a rational and workable contractual relationship.

On the basis of its experience in its country of origin and in other countries, the franchisor should indicate clearly what risks should be insured as well as 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 it is not usual to take out an insurance cover for third party liability risks or in which an insurance cover is very expensive. As, however, there is always a certain risk that third parties, such as clients of the sub-franchisees, may bring an action directly against the franchisor, either in its home territory or in the host country, and as this risk may even increase in the future, the franchisor and the sub-franchisor should endeavour to find a way to insure such risks. 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.
Insurance clauses that are commonly included in master franchise agreements 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 also for product liability. This minimum coverage would need to be adjusted to the risks and practice prevailing in the host country. From time to time the franchisor, together with the sub-franchisor, should review and, where necessary, adapt the minimum amounts of the insurance coverage.

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, where applicable indicating also the adapted amounts. This evidence must usually be provided every year, either automatically or only at a specific request of the franchisor.

The franchisor usually requires the sub-franchisor's insurer to be a well-reputed insurer acceptable to it. The franchisor usually also 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 countries and to recover the additional insurance premium through the franchise fees.

Unless this is not permitted by law or not available on the market, the franchisor will usually also require that the insurance taken out by the sub-franchisor be a primary insurance which is payable notwithstanding the existence of other insurances and the waiving of subrogation. The franchisor will also usually require that the policies provide that the franchisor must receive notice of cancellation within a specific period, for example thirty days, 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 will usually 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 this case the sub-franchisor would be obliged to reimburse the franchisor for all costs and expenses it has incurred in taking out the insurance coverage.
For all cases in which the franchisor considers a sufficient insurance coverage to be an imperative for a sub-franchisor, it should also prescribe and ensure that corresponding insurance policies are provided for in the sub-franchise agreements and that consequently the sub-franchisees maintain such insurance policies and pay their insurance premiums in a timely fashion. The sub-franchise agreements should also contain detailed insurance provisions corresponding to the clauses dealing with the same issues in the master franchise agreement. 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. The franchisor might even require that, whenever it is admissible and possible in the host country, the franchisor and its directors and officers be named as co-insured persons in the policies of the sub-franchisees.

As it is not very practical for the franchisor to provide that it can itself take out insurance policies in the name and at the expense of the sub-franchisees, the sub-franchise agreement may provide for such a mechanism with the sub-franchisor instead being authorised to take out insurance policies in the name and at the expense of the sub-franchisees. The franchisor should nevertheless make every effort to ensure that the sub-franchisor uses its rights in this regard should this be necessary.

INDEMNIFICATION

It is usual for a sub-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 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. This responsibility includes also an obligation to indemnify the franchisor, and where necessary its directors, officers and other licensees, for any loss, damage, cost or expense (including court costs and reasonable legal fees) that they may have incurred and that arises out of any claim, action, administrative inquiry or investigation concerning the sub-franchisor’s operation of the business, or that arises out of the defence against any such claim, action, administrative inquiry or investigation. 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, or in the loss of benefits that may be had as a result of the 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.

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 operation of the business under the master franchise agreement, and this should be stated in the master franchise agreement itself. This will include any claim or action attributable to the conduct of the franchisor’s directors, officers, employees, agents, representatives, affiliates, shareholders or partners. This responsibility of the franchisor should be limited to any operative measures that have been taken, or that have an effect, in the sub-franchisor’s territory. It should include the indemnification of the sub-franchisor and, where necessary, of its directors and officers, as well as of any of its sub-franchisees and of their directors and officers, for any loss, damage, cost or expense (including court costs and reasonable legal fees) that arises out of any claim, action, administrative inquiry or investigation concerning the franchisor’s operation of the business, or that arises out of the defence against any such claim, action, administrative inquiry or investigation, independently of the reason for which they were made, whether product liability, the infringement of third parties’ intellectual property rights or any other reason.

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 within a short period of time (for example five days) of any liability claim brought, and 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.

The sub-franchise agreement should lay down rules specifying when the franchisor or the sub-franchisor are entitled, or under what circumstances they are obliged, to undertake or assume the defence of any such claim, action, inquiry or investigation, at whose risk and expense such a defence should be undertaken and when they should make a settlement. 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 should always be entitled to choose whether or not it should itself assume the defence against the third party’s claim, if this is permitted by the procedural laws of the host country. As far as the franchisor’s intellectual property or other rights are concerned, the situation will vary from country to country as 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, for example, the sub-franchisor to do so. Where the necessity of such a defence is the result of the way in which the sub-franchisor has operated 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 reached.

The responsibilities mentioned above will always all 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. Nor do they fall upon any other person who

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1 See Chapter 12 "Rights created by Statute".
might stand behind the contractual party, unless claims arise as a result of any tortious acts on its part. Such a person may however be personally liable if, in the master franchise agreement or in an ancillary agreement, it has taken over a personal guarantee for the contractual party’s obligations.
CHAPTER 17

SALE, ASSIGNMENT OR TRANSFER OF RIGHTS

The possibility that the franchisor or the franchisee might need to transfer its rights under the franchise agreement to third parties also in the course 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, although they will in all probability wish to have the possibility to transfer their own rights. It is therefore important that the franchisor and the franchisee consider the circumstances in which they might wish to transfer their rights under the franchise agreement to another party in the course of the franchise 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 franchise agreement was entered into. Both the franchisor and the franchisee 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. Franchise agreements will therefore usually contain provisions governing the transfer of rights.

A party to a franchise agreement may wish to transfer its interests in the franchise 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. 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 franchise agreement, usually a franchisee, because of disability or death. Assignment provisions must somehow address the issues that arise in these circumstances. Although the franchisee must have some rights to transfer its interests in these case, 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.

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 party. When a party wishes to transfer its interests for reasons of this kind, the other party will often be highly 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.

The reason a franchisor may wish to restrict the franchisee’s right to transfer its interests is to prevent an assignment of the franchisee’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 franchisee and of its belief that the franchisee is well suited and committed to making the relationship successful. It is understandably hesitant to allow for the possibility of another franchisee whose ability or commitment is unknown taking the place of the first. If the quality of the franchisee is the primary factor in deciding to enter into the agreement initially, 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 franchise agreement. It will prefer a new franchisee that has the ability and the desire to aggressively pursue the franchising opportunity. The qualities that permit a franchisee to pursue the franchising opportunity are often difficult to determine and are at least to a certain extent a matter of subjective judgement.

The reasons for which a franchisee would like to have the right to restrict transfers of the franchisor’s interests and obligations in the franchise agreement are similar to those for
which the franchisor would like to restrict transfers of the franchisee'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 regard. First, a franchisor is likely to have many different franchisees in its system. To make the franchisor's transfer of rights subject to the consent of all of its franchisees 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.

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

Most contracts describe what constitutes a restricted transfer. Any direct transfer or assignment of the franchisee's interests will be covered, as will usually also any pledge or mortgage of the franchisee'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 franchise as an assignment or transfer of the franchisee'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 franchisee within any three year time period may for example be considered as a transfer that is subject to restrictions.

The 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 franchisee has the qualities that are deemed to be necessary to be a good franchisee. Examples of the kinds of conditions that are imposed are:

- the franchisee must be in compliance in all respects with the 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 franchisee. This condition may contain elaborate detail, making reference to, for example, the prospective franchisee'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 franchisees or 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 franchisee of a transfer fee which serves as a partial reimbursement of the expenses incurred by the franchisor in its review of the proposed transfer;

the execution of a new 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 franchisor may wish to be able prevent the proposed transfer by retaining the right to acquire the franchisee'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 franchisee 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 franchisee's interests, then the transfer to the proposed transferee might be subject to the satisfaction of conditions of the kind described above.

The franchisee 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 franchisee may furthermore seek to impose the application 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 franchisee may be subject to different rules or procedures than a transfer that is completely voluntary.
CHAPTER 18

REMEDIES FOR NON-PERFORMANCE

The non-performance of a master franchise agreement may relate to two main areas: the development right and its exercise as defined in the provisions relating thereto and the sub-franchisor’s functions 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 is at risk if anything happens that can adversely affect its interests. The sub-franchisor is the custodian of those interests 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 standards, but it should also provide for remedies should the sub-franchisor fail to ensure that these quality 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.

REMEDIES SHORT OF TERMINATION

A number of possible remedies are normally provided for in the agreement, the most drastic of which is termination. Although in master franchise agreements provisions are to be found permitting termination by either the franchisor or the sub-franchisor for non-performance by the other party, in general the provisions that deal with the right of the franchisor to terminate will be far more detailed than those dealing with the right of the sub-franchisor to terminate.

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

There tends to be far less of a dialogue between franchisor and sub-franchisor than there is between franchisor and franchisee. This means that by the time it is discovered by the franchisor, the contractual misconduct may be more entrenched in the case of master franchising than would be the case in unit franchising. If, therefore, the franchisor does not keep in touch with developments in the territory managed and developed by the sub-
franchisor, it will find it more difficult to restore performance to a level it will find compatible with its system requirements, given that the sub-franchisor will have developed what the franchisor considers to be bad habits. A sub-franchisor who has not had the problems drawn to its attention will be resistant to the franchisor’s complaints because of the trouble and disruption it will cause for compliance to be achieved. Furthermore, the possibility cannot be ruled out that a sub-franchisor substantially left to its own devices will develop methods of its own that are not compatible with the franchisor’s system, methods and reputation.

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 standards restored. The overall possibility that the arrangement can be terminated, and the great cost to both parties at which this would 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 to remove the threat. 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 sales growth.

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

- to consider selling the business to a well financed third party;
- 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 unless 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 which fall short of termination but which involve legal proceeding 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.

The development right will in all probability carry with it territorial exclusivity and will state in the development schedule how many sub-franchises have to be established and within what time frame.¹

The agreement may 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 a lot of new circumstances could arise over which the parties have no control and which would 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, although this may cause practical problems;
- 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);

¹ See Chapter 1 "Fundamental Concepts and Elements".
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 this is not common).

In some cases 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.

**Termination of Development Right**

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 that 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. 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 many of the problems outlined above will arise particularly with regard to re-location and renewal issues.

It should be pointed out that the termination of the development right may not necessarily result in the termination of the other provisions in the agreement.

**TERMINATION BY 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; and
- those relating to a failure to comply with any other provisions of the agreement.

A provision is frequently to be found permitting 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 be regarded as not so "material of substantial" by a sub-franchisor and 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 default" is to be used, then it should be clearly defined. An example of a definition of "material default" would 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 may be as long as 30 or 60 days, although in the case of sums of money that
have not been paid, this default is likely to be treated more seriously, with a shorter period of notice. 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 does raise a number of issues, as one of the perceived weaknesses of master franchising for a franchisor is the need to delegate the enforcement of quality controls to the sub-franchisor.

Failure by a sub-franchisor to ensure that the 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.

**Termination by the Sub-Franchisor**

In practice it is rare to find provisions that entitle a sub-franchisor to terminate for the default 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 that it can act swiftly to pursue the remedies necessary to preserve its trade name, trademarks, service marks and the goodwill associated with them, 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.

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 deems 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 provisions
that deal with the failure to supply goods that would enable the sub-franchisor to obtain goods of comparable quality elsewhere.2

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 goes bankrupt. These include turning the agreement into a bare-bones licence agreement and buying the trademarks of the system for use in its country.

It should also be borne in mind that either party may dispute the validity of any termination of the master franchise agreement, whether or not it was terminated by notice in accordance with its terms. 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 or not the sub-franchisor 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 allow the sub-franchisor to do that, 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. 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 by 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 party who will provide the ongoing service.

In practical terms, however unfair it may seem, very few sub-franchisees 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.

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2 See Chapter 11 "Supply of Products and Services".
CHAPTER 19

THE END OF THE RELATIONSHIP AND ITS CONSEQUENCES

The master franchise relationship may end as a result of the expiration of the term of the agreement or of any renewals, or it may end if one of the parties exercises its right to terminate the agreement as a result of a non-performance by the other party that has not been remedied. In any event, the end of the relationship gives rise to some of the most difficult issues of master franchising because of the many parties and the many other relationships that are affected by the agreement coming to an end.

It is likely that the sub-franchisor will have developed the franchise system well during the term of the master franchise agreement, establishing and operating many franchised units. Many of these units may be owned and operated by the sub-franchisor and many others may be owned and operated by sub-franchisees. The establishment of every one of these units will have involved a substantial commitment of time as well as investment in tangible assets. Each single unit has in some way had its future linked to the franchisor and the franchise system through the sub-franchisor. This link has been broken by the expiration of the master franchise agreement. The fate of every unit must be determined and the question therefore arises of how they will each relate to the franchisor, whether they will continue to operate as a part of the franchise system or whether they will cease to be identified as a part thereof. Each unit’s history will differ from that of the others in terms of its length of participation, the quality of its performance and the attitude of its owners towards the system and towards continuing participation. Every one of the many parties will be in a situation, and will view the ending of the agreement and its potential consequences from a perspective, which is different from that of others. For the sake of the franchise system and of each of its participants, the divergent interests of all the affected parties must somehow be reconciled so that the disruption in operations is minimised.

The franchisor, the creator of the system, has the preservation of the system as its primary concern and will endeavour to minimise any shock that comes with the removal of a key party. It must find another party (itself or a third party) to provide the functions that have hitherto been provided by the sub-franchisor. The franchisor will want to act quickly to keep the desirable units in the system and, where appropriate, to remove the undesirable units. The franchisor will also want to be sure that the departing sub-franchisor honours all the obligations it has incurred during the term of the agreement and that it promptly de-identifies itself from the franchise system.

The sub-franchisor will want to extricate itself from the franchise system in a manner that recognises the value of the network of franchise units that it has built up. It will want the separation to occur without loss of reputation.
Each of the unit franchisees will evaluate what is happening with a fair amount of scrutiny and doubt. Those that have been successful and have benefited from identifying with the system will probably seek to maintain their place within it, whereas those that do not see a net benefit accruing from remaining in the system may regard the ending of the master franchise relationship as an opportunity to break away.

Renewal as a Possible Consequence of the Relationship Coming to an End

Although the emphasis of this chapter is on the consequences of the ending of the master franchise relationship, it should be noted that when the master franchise agreement comes to an end as a result of the expiration of the agreement, the parties are often well advised to renew their relationship by renewing the same agreement or by executing a modified version of it. If the parties have worked together reasonably well during the term of the agreement and if they are able to redefine their relationship on a mutually acceptable basis, then the advantages of a renewal are significant. The disruption of breaking off relations, the enormous costs of the separation and of the establishment of new relationships can then be avoided. The renewal must of course be negotiated and the parties should provide in the initial agreement for a substantial period prior to the date of expiration in which to negotiate a satisfactory renewal agreement.

It should be observed that a master franchise agreement will often provide for a number of automatic renewals of the agreement if certain basic conditions are met.¹

The End of the Relationship

If the relationship is not to continue, then the complex issues that arise when the agreement comes to an end must be dealt with. The parties may usefully deal with a number of those issues as part of the negotiation of the master franchise agreement. The master franchise agreement may end as a result of termination following one or more instances of non-performance by one of the parties that have not been remedied, or it may end simply as a result of the failure to renew the agreement upon the expiration of its term. The issues that must be addressed will be the same in both cases. The resolution of those issues may however be easier when the agreement ends as a result of expiration, than when the master licence is terminated as a result of non-performance by one of the parties. When the agreement expires simply because its term has come to an end, the implication is that the parties had a good, or at the very least an adequate, relationship. In any event their relationship will have been better than if one of the parties had not performed its obligations. The parties might therefore expect to sever ties in a more co-operative manner. Even in this situation, however, the fact that the parties are not continuing the relationship implies that the relationship was less than adequate in the eyes of at least one of the

¹ See Chapter 4 "Term of the Agreement and Conditions of Renewal".
parties, as the parties would normally seek to renew a relationship that has been good and mutually beneficial. In any event, a separation of ways is bound to be both costly and complex.

An awareness of the fact that many complex issues will be involved in the ending of the relationship, that many different relationships will be affected and that the relations may be less than cordial, will prompt the parties to anticipate the possibility of termination of the master franchise relationship by addressing some of the consequences in advance, as well as by providing an outline of procedures to be followed in order to move into a new situation that is beneficial to all affected parties. Negotiating these provisions on the eve of entering into a relationship is at times awkward and difficult. Developing such a procedure is indeed akin to negotiating a prenuptial agreement in anticipation of divorce just prior to a marriage. Separation is far from the minds of the parties when they are full of enthusiasm and hope at the prospect of working together. A desire to consider the subject of the end of the agreement is occasionally interpreted by the other party as an indication of distrust or uncertainty of the relationship when it is about to be formally established. Nevertheless, the parties must recognise that circumstances change, personnel change, attitudes change and financial situations change. Such changes may result in situations in which it is in the interest of either or both parties to terminate the relationship. A plan for orderly separation may be both useful and beneficial to the parties when the circumstances dictate a termination of the relationship. A careful exit strategy may actually give the parties a sense of comfort and security in the knowledge that a plan for fairness and order will govern to minimise disappointment at the separation of ways.

Although it is wise to develop procedures to deal with the end of the master franchise agreement, the parties must be careful not to attempt to cover the situation in too much detail, as it is not possible to foresee the exact circumstances under which the agreement will come to an end. The provisions must be sufficiently flexible to permit the ending of the agreement to be structured so as to fit the circumstances. It is possible that if they are too detailed the provisions will not be suitable for the circumstances that exist when the agreement does come to an end. If the provisions that have been developed cannot be applied in a practical manner, then the parties will be thrust into a situation in which the provisions governing the end of the relationship will be of little help. They will then have to negotiate the entire separation as if no planning had been done.

Each of the relationships that will be affected by the agreement coming to an end should be addressed in the documents that govern that relationship. The master franchise agreement, each of the unit agreements and any collateral documents (for example supply agreements and advertising agreements) are the ones that will be affected. Each agreement should acknowledge the possibility of the master franchise relationship coming to an end, indicate the consequences of such an event and set out procedures that the parties will be under an obligation to follow so as to acquire the desired post agreement status. The franchisor should have the possibility to require that each party that is affected
by the agreement coming to an end comply with the obligations imposed upon it, even if the franchisor is not a party to the agreement or relationship affected.

**Consequences of the End of the Relationship for the Sub-franchisor**

With the expiration of the master franchise agreement a number of issues must be addressed. These include:

- the ending of the sub-franchisor’s role and activities as sub-franchisor;
- the substitution of another party to provide the sub-franchisor functions previously performed by the sub-franchisor;
- whether to terminate or continue any relationships that the sub-franchisor has as a supplier of goods or services to the unit franchisees in the territory; and
- the future of the franchised units in the territory, including the units that are owned or operated by the sub-franchisor.

Each of these issues may be addressed separately, as they may be subject to different considerations and treatment. The overall effects must however be co-ordinated, since the treatment of each of these issues will have an impact on the others.

The easiest issue to address is perhaps the ending of the sub-franchisor’s functions as sub-franchisor, as distinguished from the ending of the sub-franchisor’s status as an operator of franchised units in the licensed territory. The steps that should be taken in this regard would not be controversial. The master franchise agreement should provide for the immediate cessation of all activities authorised under the master franchise agreement and require the full performance of all obligations that each of the parties has incurred vis-à-vis the other up to the time of the ending of the relationship. The sub-franchisor should be required to cease all activities it conducts as sub-franchisor, to cease all use of the trademarks of the system, to cease all use of any trade name that is associated with the system and to remove any reference to it in public listings such as business or phone publications. It might be helpful to require that an announcement be issued and sent to specified parties. The sub-franchisor should have no interest in continuing its sub-franchising activities after the agreement has come to an end.

The agreement should also 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 subject of the franchise. The franchisor will not look favourably upon 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. It may accept that the trademarks and identifying characteristics of the franchise system must remain the exclusive property of the franchisor, but it may resist being barred from using what it has learned. It must protect its right to continue to use the substantial assets that it has invested in the course of its franchise. What, for example, would a hotel franchisee be able do with a number of hotels that it has developed if it is barred from employing them as hotels? If it cannot use the assets for their original intended purpose, it must at least have the right to sell them at a fair price.

The content of a non-competition clause must be negotiated and the laws of the territory examined to determine the extent to which the non-competition clause may be enforced. The laws of most jurisdictions specifically restrict the extent to which covenants not to compete after the agreement has come to an end can be enforced. In some jurisdictions any post term covenants are prohibited.

The second issue to be addressed is perhaps the one that is the most important for both the franchisor and the sub-franchisee, namely the nomination of a qualified party to assume all the functions that were previously performed by the sub-franchisor. These functions are fundamentally the same as those performed by a franchisor, as 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 for available supplies and services for unit franchisees;
- the co-ordination of advertising efforts;
- the policing of the system within the territory to ensure compliance by each sub-franchisee of its obligations, to maintain uniformity among the unit operations and to identify possible infringements of the system’s intellectual properties by others in the territory; and
- the collection of royalties and other payments due from unit franchisees.

It is obvious that the continuation of these functions with a minimum of disruption is vital to maintaining a healthy system within the territory.

There are fundamentally two possible choices for a substitute party to take the place of the sub-franchisor: the franchisor itself or a third party. It would generally make more sense for the franchisor to assume these functions as it is thoroughly familiar with them and with the franchised system it has created. The only difference between the franchise
system as devised by the franchisor and as run by the sub-franchisor may be in the special adjustments that have been made in light of the special characteristics, business practices, and consumer habits of the market that comprises the licensed territory. It might be difficult or impossible to find a third party who is qualified or interested in buying into these roles without prior experience. Accordingly, the franchisor and the sub-franchisor may device procedures for the nomination of a new sub-franchisor by focusing on the possibility that the party that will take the sub-franchisor’s place will indeed be the franchisor.

If the system has grown to any appreciable size, the sub-franchisor will in all probability have developed a reasonably large organisation to perform the functions it should perform in its capacity as sub-franchisor. That organisation may have quite a large office, a well trained staff of employees, physical assets, established systems and procedures and valuable market information. In short, it may be a valuable going concern. The most effective solution may therefore be for the sub-franchisor to sell its sub-franchising operation to the franchisor.

The franchisor may prefer to have the option to acquire the assets of the sub-franchisor. The sub-franchisor in turn may want the option to require the franchisor to purchase these assets. Even if neither of these possibilities is provided for in the agreement, the franchisor may in practice find that it has the option to purchase the assets as the sub-franchisor may have difficulties in finding a use, or a purchaser, for them. Assuming on the other hand that the acquisition of these assets by the franchisor is provided for, then the parties will probably want to have a mechanism for determining a fair purchase price to be paid by the franchisor. Alternatively, the parties may simply allow for a negotiated price, providing instead for a procedure to arbitrate a fair price if the negotiations fail. The franchisor will want the right to thoroughly investigate the operations, books and records of the sub-franchisor, just as any other prospective purchaser of the business would.

So as to facilitate the transfer of the assets that the sub-franchisor uses in its activity as sub-franchisor when the agreement comes to an end, the sub-franchisor might conduct its sub-franchising activities from an entity which is separate from that which owns or operates the sub-franchisor’s own units.

An acquisition of this nature is very similar to the acquisition of any other business. These transactions take an enormous amount of time and delays are common. Should the transaction not be completed by the specific date of the expiration of the term of the master franchise agreement, then it may be advisable for the sub-franchisor to be required to continue to perform its functions until the transfer is complete. This may be done by means of operating covenants such as are normally required of the seller of a business that is to be closed.
The master franchise agreement should also address what happens to any ancillary agreements that exist and that relate to the territory of the master franchise. The sub-franchisor may, for example, be a party to special supply relationships that have been established. It may thus have arranged for the supply of products that are sold by the unit franchisees, for the supply of materials that are used by the unit franchisees, or for the supply of services that are needed by the unit franchisees. It is not always necessary for the sub-franchisor to discontinue these activities after its sub-franchise relationship has come to an end, but this possibility should be considered. The franchisor would not normally want the sub-franchisor to continue these activities if it has not performed its basic obligations under the master franchise agreement. The ancillary agreements may be treated in the same manner as the sub-franchisor’s operations, that is to say they might be purchased by the franchisor, or the sub-franchisor may simply be required to comply with the requirements imposed on any supplier of products to units in the system.

Finally, the fate of the units operated directly by the sub-franchisor must be determined. The franchisor and the sub-franchisee may prefer these units to be purchased either by the franchisor or by third parties so as to completely remove the sub-franchisor from any association with the network. It is however not possible to know whether this will be the case when the master franchise relationship is entered into. Accordingly, it is common practice simply to allow the franchised units that are owned by the sub-franchisor to continue to operate after the master franchise relationship has come to an end. This is facilitated by the fact that each unit operated by the sub-franchisor is the subject of a separate unit franchise agreement between the sub-franchisor and the franchisor. Alternatively, each unit may be owned by a legal entity that is separate from the sub-franchisor and a separate unit franchise agreement entered into between the sub-franchisor and the new entity that is owned by the sub-franchisor.

The effects on the sub-franchisor of the agreement coming to an end, independently of whether it comes to an end as a result of the expiration of the agreement or because of termination for non-performance, may thus be summarised as follows: the sub-franchisor will

- lose future development right;
- have to cease to operate 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;
not use the system know-how or confidential information in the future;

- have to de-identify all premises;

- cease the use of all materials bearing the franchisor's trademarks, trade names or indicating an association between the franchisor and the sub-franchisor;

- 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 transfer to the franchisor the benefit of all sub-franchise agreements;

- for a limited period of time not conduct any business which competes with the franchisor's type of business; and

- in some cases grant the franchisor an option to acquire certain of its assets.

Provisions of the local laws may well affect a number of these consequences. This will be the case with, for example,

- intellectual property laws which 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;
  - the possibility that if the master franchise agreement is terminated, sub-franchise agreements also terminate unless the contracts 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

- 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.

**Consequences of the Relationship Coming to an End for Franchised Units within the Territory**

The ending of the master franchise agreement will affect not only the units that are owned and operated by the sub-franchisor, it will affect all the units that the sub-franchisor has sub-franchised to others. The future of these units must be considered in the master
franchise agreement as well as in each unit sub-franchise agreement. There are basically two approaches that may be taken:

- the agreements may provide that all unit agreements end at the same time as the master franchise agreement; or
- the agreements may provide that each unit agreement will continue until the expiration of its own term and that the sub-franchisor’s interests in each unit agreement are to be assigned to the franchisor or its designee.

It is particularly important to provide for these consequence in a way that is fully enforceable vis-à-vis each of the unit franchisees.

The first approach brings about a clean break with each unit and in effect gives the franchisor the option to renew or discontinue the relationship with every one of them. The franchisor is in other words given the option to renew the relationship with each single unit franchisee. Although this approach has been adopted with some frequency, the advantages to the franchisor are offset by a number of serious disadvantages. First, such a provision discourages the appointment of new sub-franchisees in the later years of the master franchise agreement term. The sub-franchisor and the potential sub-franchisees will be hesitant to enter into a sub-franchise relationship knowing that the agreement may be automatically terminated after a very short period of time, too soon in fact to allow the parties to properly reap the benefit of the unit franchise that is being established. This prospect may have a dampening effect even if the franchisor and the sub-franchisor eventually agree on a renewal of their relationship. The parties will as a result have suffered a self imposed setback in the development of units in the territory. It is of course possible for the parties to recognise this possibility and to negotiate a renewal long before the date at which the agreement is to come to an end, but negative effects are unavoidable even then. Second, the franchisor will have the overwhelming task of evaluating and negotiating a renewal with each single unit franchisee with whom it wishes to continue the relationship and at the same time of completing the termination of the units that it does not wish to renew. Third, experience has shown that the unit franchisees become independent when the master franchise relationship comes to an end. A simultaneous ending of the master franchise agreement and the unit agreements may motivate the unit franchisees to join forces and to establish a new system that is completely separate and independent and that competes with the franchised system. The approach of having all unit agreements end simultaneously will therefore present serious disadvantages for all parties concerned.

In the case of the second approach, the unit agreements should continue to be operative in accordance with their terms, including the date for the ending of the relationship, and should also provide for the assignment of the sub-franchisor’s interests (rights and obligations) to the franchisor or to a third party. If the assignee is a third party, the effect will be to restore the sub-franchisor/sub-franchisee relationship. If the agreements are instead assigned to the franchisor, then the relationship will become a typical
franchisor/franchisee relationship, except that the agreements are international franchise agreements. Any requirements to file and obtain approval from the authorities of the jurisdiction concerned will apply once the agreement has become an international one. To avoid this problem, the franchisor may establish a wholly-owned subsidiary within the territory to replace the sub-franchisor.

This treatment of the unit franchisees has many advantages. First, the existing state of affairs of each unit is essentially preserved with a minimum of effort. The sub-franchisor's interests are simply assigned to a new party (the franchisor or its subsidiary or a third party). The expiration of each unit agreement is, staggered according to when it was entered into so that each expiration has a minimum impact on the system. This approach tends to eliminate the effects of the period towards the end of the term of the master franchise agreement during which the sub-franchisor and potential sub-franchisees are normally hesitant to enter into unit agreements. Each unit franchisee will be able to realise the full benefit of a full term of the unit agreement. The unit franchisees may moreover see less of an opportunity to break away from the system, especially the ones who are realising benefits from being a part of it. For the sub-franchisor, this approach preserves and allows for the recognition of the substantial stream of income and goodwill that it has established.

In order to accomplish this, it is important that each unit agreement provide for the assignment of the sub-franchisor's interests. For this reason it is useful if the franchisor is given a copy of each unit franchise agreement at the time it is entered into. The master franchise agreement should also require that all records relating to each assigned franchise be transferred to the franchisor. The sub-franchisor will want to have a provision in the master franchise agreement whereby the franchisor agrees to fully perform the obligations of the sub-franchisor and perhaps to indemnify the sub-franchisor for any liabilities that arise after the assignment. The master franchise agreement may provide for a notice to be given jointly by the franchisor and the sub-franchisor to each unit sub-franchisee.

It may also be advisable to provide for the immediate assignment to the franchisor of each unit agreement in which the sub-franchisee suffers as a result of one or more instances of non-performance on the part of the sub-franchisor which have not been remedied. This might however not be necessary, as any such non-performance will probably be a basis for the termination of the master franchise agreement in its entirety.

The parties might consider providing that the franchisor will become a party to each unit agreement when it is entered into. This would aid the franchisor in assuming the rights of the sub-franchisor. Most franchisors would however prefer not to do this, as they will be concerned that they might be exposing themselves to potential liability directly to the unit franchisee and also because of the complications that might arise with the unit agreement becoming an international agreement.
The master franchise agreement might allow the franchisor to meet directly with unit franchisees as soon as the fact that the master franchise relationship will end is known but before its end has become effective. This potentially enables the franchisor to minimise the uncertainty and anxiety of the unit franchisees.

There is an obvious and substantial benefit that will be realised by the franchisor if the unit franchisees remain in the system. It is natural for the sub-franchisor to expect to be compensated for the value that it has created for the franchise system over the years. The franchisor might instead take the position that most of the value has been created by the franchise system itself and that the sub-franchisor has bargained for and received its full benefit during the term of the master franchise agreement. In most cases there is no provision for compensating the sub-franchisor for the value that it has created. In any event, the parties must consider the extent to which the sub-franchisor is to be compensated for its efforts in developing the franchise system in the licensed territory. If a certain amount of value is to be recognised, then a method for determining the proper value has to be devised and set forth in the provisions of the master franchise agreement that regulate the end of the relationship.

In the case of termination of the master franchise agreement for non-performance a risk for franchisors and sub-franchisees is that the sub-franchise agreements may terminate automatically by operation of law. Franchisors frequently require the inclusion in the agreement of an option by which the defaulting sub-franchisor is required on termination to assign all or some of its sub-franchise agreements to the franchisor. If the sub-franchise agreements have automatically terminated there will however be nothing to assign.

If, in these circumstances, such an option is included in the master franchise agreement, then that agreement and the sub-franchise agreements should make express provision to ensure that the sub-franchise agreements survive the termination long enough for the franchisor to exercise the option should it wish to do so.

Other questions about the future of the sub-franchisees that arise on termination of the master franchise agreement and that often form the subject of negotiations include:

- whether the franchisor will be obliged to take over the sub-franchises;
- whether the sub-franchisor will be able to make a virtue out of termination and claim payment of a sum of money by way of compensation of the “take-over” of its sub-franchised network;
- whether the franchisor, having terminated the sub-franchisor for good cause, will want to take over what could be a badly run network of disgruntled sub-franchisees who are intent on making difficulties and be faced with the expense of putting the business right, or whether the sub-franchisor, rather than expect compensation, should on the
contrary expect to be liable to the franchisor for the costs of coping with the problems left behind; and

♦ what is to happen to any real estate (including leases), which the sub-franchisor has acquired for leasing or sub-leasing to the sub-franchisees and which may have a capital value that the franchisor cannot afford to pay. A failure to take over the real estate could create difficulties as a result of the integrated structure of the sub-franchise arrangements in these circumstances.

The likelihood is that the franchisor will want to take over the network if only to ensure that the name does not suffer much harm. The problem is that based upon past experience the sub-franchisees are unlikely to be co-operative and will regard themselves as having a strong bargaining position fortified by their belief, which will probably be soundly based, that they have been let down. They will in all probability have suffered from a lack of support which will have made them more independent and will oppose any attempt by the franchisor to introduce discipline into the network by requiring proper compliance with contractual obligations. Many will believe that they can re-brand and continue in the same business without paying fees. Some will continue to operate using the franchisor’s name until the franchisor obtains an order to prevent it, which may take a long time and cost a great deal. It is unlikely that a sub-franchised network developed by a sub-franchisor whose agreement is terminated will welcome the franchisor and accept its authority. It is against this background that the discussions and negotiations about the issues raised by these questions will be conducted.
CHAPTER 20

CHOICE OF LAW

The selection and indication of the law that is to apply to an international franchise agreement, and the selection and indication of a preferred forum for the settlement of disputes, are two important elements that should not be overlooked in the master franchise agreement or left until after all the substantive elements of the agreement between the parties have been settled.

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 the agreement. This indication, together with an indication of a preference for a forum, will lay the foundations for the handling of any disputes that arise under the master franchise agreement. Clear choices on both of these matters will be of great importance in ensuring the effective enforceability of the outcome of any future dispute resolution process.

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.

A master franchise agreement will in general be governed by the laws of a particular State. This law is selected in accordance with the rules of conflict of laws which provide indications of how the governing law should be selected. In this process any applicable international treaty or convention, or other relevant principles of international law, will be taken into account.

The technique used in the choice of a law is rather sophisticated and at times complex. In the case of contracts there are several different rules that are applied to determine what law is applicable. According to one of these rules the law of the 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.

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1 See Chapter 21 "Choice of Forum".
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.

**The Desirability of Making a Choice**

At the beginning of their relationship the parties may not wish to consider the possibility of friction and disputes developing between them. The time spent before the terms of the agreement are finally settled in determining which law is to govern the agreement, or parts of it, will however not be wasted. In practical terms it is the choice made that may determine whether or not particular contractual obligations entered into are enforceable.

In all situations where a choice can be made the ultimate criterion for making a particular choice is enforceability. This may in fact lead to a decision to choose a different legal system to apply to the different agreements that make up the overall master franchise arrangement. The franchisor might, for example, for reasons of effectiveness in managing a world-wide network of sub-franchisors wish to maintain one legal regime to govern its basic core master franchise agreements, but for reasons of efficient enforceability subject the agreements concerning the detailed arrangements, such as the licensing of the intellectual property rights, to the law of the jurisdiction in which the protection will be sought. There should be little argument that the law of the State in which the sub-franchisees carry on the franchised business should be the law governing their relationship with the sub-franchisor.

A substantial measure of uncertainty will remain with respect to the obligations that the parties to an international master franchise agreement have undertaken if they do not specify the applicable law and jurisdiction. What law is to apply will be determined by the courts before which any dispute arises in accordance with the conflict of laws rules applicable to the law of contract in the jurisdiction concerned. In most cases this is likely to be the law of the country in which the sub-franchisor operates the franchised business, but it might be that different laws are found to be applicable to the different component parts of the master franchise package.

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 of 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.

Two further elements that the parties need to bear in mind in making a choice of law is the forum that will be asked to apply the choice made and the fact that a court will in any case be more comfortable in applying the law of its own jurisdiction.

In most of the following commonly occurring situations the above considerations would lead to a choice of the law of the sub-franchisor's jurisdiction being the better choice:

♦ failure of the sub-franchisor to pay fees;
♦ failure of the sub-franchisor to supervise the sub-franchisees;
♦ failure of the sub-franchisor to meet quality control standards;
♦ failure of the sub-franchisor to develop the territory;
♦ trademark or business mark abuse;
♦ sub-franchisor's claims resulting from non-performance on the part of the franchisor;
♦ actions to terminate the master franchise agreement; and
♦ claims against sub-franchisees upon termination of a master franchise agreement. A variety of claims are likely to be made by the franchisor against sub-franchisees, involving both preliminary and permanent judicial orders intended to clarify the position that the franchisor may now have assumed under the agreements between the sub-franchisor and the sub-franchisees as a consequence of its contractual relationship with the sub-franchisor. Any such change in position of the franchisor is made in anticipation of a failure on the part of the sub-franchisor to protect the trade and/or service marks, trade secrets and know-how of the franchisor that are in the hands of sub-franchisees.

Any evaluation of the relative benefits of the different legal systems made prior to the choice of the applicable law is also likely to show that, quite apart from the effect that any choice of law may have on the application of the provisions of the master franchise agreement documents themselves, and therefore on the rights of the parties to it, in any jurisdiction with a sophisticated business law system 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, for example, 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 if an informed judgment is to be made in relation to the law
that is to be applied to the whole master franchise agreement, or to parts of it, so as to identify any difficulties or unacceptable provisions:

- 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.

ENFORCEABILITY OF THE CHOICE MADE

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 and public policy); and
specific statutory provisions directed to franchise agreements, including international master franchise agreements.

THE 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 reasons be different from that applicable to the sub-franchise agreements.

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 a country, or the franchised business is being exploited in a country with an unsophisticated legal system.

Where the forum chosen for dispute resolution is not the judicial system of the country of domicile of the sub-franchisor, but is that of the franchisor instead, this choice may be sufficient reason in practical terms to choose also the law of the jurisdiction where the franchised outlets are located.²

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² See Chapter 21 for a discussion of the considerations concerning the enforceability of foreign judicial and arbitral awards that may influence the choice of forum and for consequential practical reasons lead to the choice of law being the law of that forum state.
CHAPTER 21

CHOICE OF FORUM

The achieving of some degree of certainty in the enforceability of an international master franchise agreement will depend on the parties not only making an effective choice of law,¹ but also on their agreeing on the approach to adopt regarding dispute resolution. This includes their agreeing on the forum in which disputes arising out of, or in connection with, the agreement might be resolved. In this connection parties should consider also the possibility of having recourse to arbitration as opposed to litigation, and the use of mediation and negotiation.

It is in the best interest of the parties to indicate in the master franchise agreement the court(s) in which they intend that disputes should be litigated and, if arbitration is to be resorted to, how any such arbitration of disputes should be conducted, rather than leave these matters to be dealt with once a disagreement has arisen.

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 party 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 party (the judge or arbitrator). This distinguishes these procedures from negotiation and

¹ See Chapter 20 "Choice of Law".
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, then 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. Thus, for example, in Asian societies the contract commonly does not have the authority or importance that it enjoys in European and Anglo-American jurisdictions.

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 many 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 which 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 later 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.\(^2\) 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.

**NEGOTIATION, MEDIATION OR CONCILIATION**

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.

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.

**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.

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\(^2\) 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.
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 the 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 which 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 which governs the contract. Language is a relevant matter, having regard to the language of each of the parties and the language of the contract. 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 which 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.

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 which 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 (Brussels 1968) and its extension to the European Free Trade Association (EFTA) membership in the 1988 Lugano Convention. Articles 17 of those Conventions (Brussels/Lugano/San Sebastian) 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 which 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.

ENFORCEMENT OF A JUDGMENT RENDERED BY A COURT PURSUANT TO A CHOICE OF FORUM
CLAUSE

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 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/San Sebastian 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.

**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, of which 105 States were parties at 27 October 1995; and
• the interests of innocent third parties 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 which 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 bypass arbitration if the other party objects. Courts will generally allow arbitrators a broad scope to decide matters that arguably come within the scope 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 arbitrators are not in general required to state reasons for their decision and 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 prejudgment attachment of assets to secure a claim which 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.

**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 not made any reservations to the obligations of the Convention, or 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 22

ANCILLARY DOCUMENTS

DESCRIPTION OF ANCILLARY DOCUMENTS

The term "ancillary documents" refers to the preliminary agreements, side agreements and addenda that are used in forming and administering a master franchise relationship in addition to the master franchise agreement itself. Ancillary documents tend to be separate agreements for a number of reasons. Some ancillary documents logically precede the master franchise agreement, such as a joint venture agreement. Others logically follow the master franchise agreement, such as a transfer agreement. 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 might be used between the sub-franchisor and a sub-franchisee as are used between a franchisor and sub-franchisor. 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.\(^1\) 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 franchisor will be required to allow the franchisee 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.

**The Purposes of Ancillary Documents**

Franchisors use ancillary documents for a variety of reasons. First, 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.

Second, 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.

Third, 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.

Fourth, 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.

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\(^1\) See Chapter 15 "Manuals".
EXAMPLES OF ANCILLARY DOCUMENTS

The following examples of ancillary documents 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.

1. ANCILLARY DOCUMENTS COMMONLY USED WITH MASTER FRANCHISE AGREEMENTS

(i) Confidentiality Agreement
Confidentiality agreements are used almost universally in international franchising. Their purpose is to bind persons who have not signed the master franchise agreement (for example shareholders, officers and employees of the sub-franchisor and 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 unit franchise agreement. They will therefore usually 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, probably cannot be retrieved.
(ii) Non-Competition Agreement

As is the case with confidentiality agreements, non-competition agreements are separate documents used to bind non-signatories of the master franchise agreement (for example shareholders, officers and employees) to the non-competition covenants found in the master franchise agreement or 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 of the European Union as well as of the individual countries. Problems to enforce these agreements could therefore be encountered under those laws. The agreements most vulnerable to challenge would be those with employees of sub-franchisors or 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 their 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.

(iii) 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 losses it incurs 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.

(iv) 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 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.

(v) 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 regulating 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.

(vi) 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 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 upto 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.

2. Ancillary Documents that May be Required for the Franchised Business

(i) 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 may 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 Contracts for the International Sale of Goods (CISG), should apply, or alternatively that their application should be excluded.

(ii) Equipment Purchase or Lease Agreement

The franchisor may recommend approved suppliers or give equipment specifications to the sub-franchisor if the franchise requires specialised equipment. 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 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 franchise 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.

(iii) 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.

3. **Ancillary Documents Required by the Structure of Certain Transactions**

   (i) **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 the 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 a choice of law and forum to govern the master franchise agreement.
(ii) **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.\(^2\) 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 in turn 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.

(iii) **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-

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\(^2\) See Chapter 1 "Fundamental Concepts and Elements" for a description of the use of joint venture agreements in franchising.
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, expiration of the letter and procedures by which the franchisor may obtain payment.

(iv) 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 simply 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 that 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 franchise context.
4. **Ancillary Documents that may be Required by Local Law**

(i) **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.\(^3\)

(ii) 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 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.

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\(^3\) See Chapter 12 “Rights created by Statute”.
CHAPTER 23

PERMISSION REQUIREMENTS

The operation of any commercial enterprise is subject to a number of preconditions, some of a subjective nature, such as adequate financial means on the part of the entrepreneur or sufficient expertise and know-how, others are objective in character, such as legislative requirements that must be fulfilled.

The legislative requirements in a purely domestic situation may to a certain extent differ from those applicable to an international agreement. In the latter case a number of additional requirements will need to be fulfilled, such as, for example, the obtaining of prior approval of the underlying international trade agreement by 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 trade marks, for instance). 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.

Similarly, any entrepreneur engaged in a business which is international in character must 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 which 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, a franchise operated through a branch or subsidiary, a joint venture or a master franchise agreement, 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, 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 which is applicable in India, for example, should also be carefully considered by each and every entrepreneur.
EXAMPLES OF LICENCES AND PERMITS

The licences and permits required might cover a whole range of different issues, including the following:

♦ prior approval for the setting up or incorporation of branch offices, subsidiaries, joint ventures, holding companies etc.
♦ permits required for foreign elements such as foreign investments
♦ registration in the appropriate registers or as required under the competition act:
  ◦ registration in commercial registers
  ◦ registration of trademarks, trade names, symbols, patents and designs
  ◦ registration in the registers that cover the transfer of technology
♦ work permits for the foreign personnel of the franchisor
♦ registration and obtaining of permits for agents
♦ permits required for the availability of domestic credit
♦ import or export licences and permits required as a result of import or export restrictions
♦ permits for the exportation of the profits and required under the legislation on currency restrictions
♦ permits required for the purchase of real estate
♦ any permits specific to the trade concerned.

1. PRIOR APPROVAL

An example of the requirement of prior approval is that required by transfer of technology laws in certain countries. Where prior approval is required, the agreement must be filed with the competent authorities who 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.

Requests by the authorities for an amendment of the franchise agreement might not be well received by the franchisor. Franchisors are often reluctant to introduce changes into their agreements and may therefore wish to have the possibility of making an evaluation of 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 if the franchisor in good faith determines that the amendments required are detrimental to its interests, then it may terminate the agreement. It is possible that, in view of the fact that the termination does not depend upon the franchisee’s acts or omissions, the possibility of a reimbursement of the expenses incurred by the franchisee might be provided for in the agreement.
2. **Permits required by the Foreign Elements**

The permits required may be of either national, regional or municipal applicability, depending on what they concern. In an international situation the position of the foreign elements, whether of the foreigners themselves - restrictions in the number of foreigners allowed to sit on the Board of Directors of a company, for example, or permits required for a foreign investment - or of other elements such as the foreign trademark, need to be ascertained. What is required must therefore be carefully considered for each particular case.

3. **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 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, such as the trademark register. Government bodies with which an agreement should be filed, or registered, include, for example, the Fair Trade Commissions that have been set up in a number of countries, the competition authorities and the authorities that look after agreements for the transfer of technology.

The obtaining of prior permits or of registration might be conditioned by the existence of protective guilds in particular industries. The importance of these guilds however does not end with the obtaining of permits. They may also heavily affect the saleability of a franchise as they might limit the market for the foreign franchise network.

4. **Foreign Personnel of the Franchisor**

An important aspect of the franchise agreement is the training and assistance the franchisor offers its franchisees. 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. Franchise agreements will often provide that the obtaining of these permits is an obligation on the part of the franchisee or sub-franchisor.

5. **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, and permits allowing the agent to operate obtained from the appropriate authorities.
6. **PERMITS REQUIRED FOR THE OBTAINING OF DOMESTIC CREDIT**

Franchisees often need to find financing to be able to initiate their activity. In order to obtain the necessary credit from the banking institutions the franchisee might be required to produce not only sufficient guarantees, but also any permits or licences that might be required.

7. **IMPORT AND EXPORT LICENCES AND PERMITS REQUIRED AS A RESULT OF IMPORT OR EXPORT RESTRICTIONS**

Where the franchise involves the export or the import of products or even of items that are to be used in the franchise (raw materials, for example), licences will often be required and will have to be obtained, again in most cases, by the franchisee. 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 of applying for an exemption.

8. **EXPORT OF PROFITS AND CURRENCY RESTRICTIONS**

The export of the profits in the form of royalties and fees will often require special permits from government authorities. This is particularly true of countries that have a shortage of hard currency, as these will often require any profits made 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 franchisee who will be the one to apply for the necessary permits and who will be required to pay any associated taxes.

9. **WITHHOLDING TAXES**

An important point relating to the export of profits is that which concerns the 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 the withholding tax when royalties and other fees are transmitted abroad.¹

10. **REAL ESTATE**

For certain franchises the acquisition of land or premises is necessary. In most cases the franchisee will make the necessary acquisitions and will consequently obtain the necessary building permits or the permits necessary for the allocation of the premises for a specific purpose. There are, however, cases in which the franchisor will make the necessary acquisition so as to subsequently lease the property to the franchisee. In these cases the franchisor will have to obtain the necessary permits, amongst which those required for the acquisition of real estate by a foreigner.

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¹ For a discussion of the financial issues in general, see Chapter 5.
11. 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.

WARRANTIES

Where the franchisee is a corporate body, the franchisee may be required to guarantee that all its directors are holders of the required licences and/or that they will continue to hold the licences. At the same time, the franchisee might be obliged to ensure that, for example, every salesperson it employs is registered as such in the appropriate register.

WHO SHOULD OBTAIN THE PERMITS

A number of the permits or licences listed 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 would be 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 franchisee must be entered as the registered user.²

As the franchisee is an entrepreneur in its own right, it will be subject to the registration requirements usual for its trade. The franchisee 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 to 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 the obtaining of the permits, although the responsibility would fall to both. What would clearly

² For a review of the problems associated with registered user systems and master franchise agreements, see Chapter 13.
fall to 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.

In the case of a master franchise agreement the obtaining of the permits necessary will be a duty shared by the sub-franchisor and the sub-franchisees, each responsible for the aspects which belong to its sphere of competence.

As in an international situation the franchise is to be operated abroad, the obtaining of the majority of the permits will fall to the local franchisee. In most cases the agreement will merely indicate an obligation on the part of the franchisee 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 by the franchisee. 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 franchisee. This will follow from the obligation which is placed on the franchisee 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 contract.
ANNEX

LEGISLATION APPLICABLE TO OR 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 in place, where there exists an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are properly set forth and enforced and where companies can rely on ownership of trademarks and know-how and on confidentiality agreements. This legislation covers elements essential to franchise agreements and which are common to the different types of agreement.

In addition to the above listed essential commercial law, franchise agreements are subject to a considerable number of other laws and regulations. These are essentially of two separate categories, the first of which contains the laws and regulations that are applicable to contracts in general, the second one of which contains those applicable to the specific contract concerned (industry specific laws and regulations, for example).

A specific regulation of franchising exists in only a very few countries. In part, this is due to the complexity of the relationship and to the great number of areas of law which a franchising relationship involves. With the exception of the United States and Russia, the legislation is what is known as disclosure legislation, in that it specifies the information that must be furnished by a franchisor to a prospective franchisee so as to enable the latter to make an informed decision as regards buying the franchise. The European Union regulation of franchising differs yet again, in that it deals only with the competition law aspects. This annex will first consider the general legislation that is applicable to franchising and thereafter briefly review the franchise specific legislation adopted up until December 1996.

GENERAL LEGISLATION

Franchising is a form of business which touches upon a great many different areas of law, the majority of which are regulated in most countries, at times also internationally. These include:

- general contract law;
- commercial law;
- agency law;
- the law regulating other distribution contracts;
- leasing;
- securities;
financial investments;
intellectual and industrial property law;
competition law;
fair trade practices law;
corporate law;
taxation;
ordinary property law;
legislation on consumer protection and products liability;
insurance law;
labour law; and
any laws or regulations specific to the trade sector involved (for example health regulations for food franchises).

To these areas of law must be added in the case of international franchising:

the law regulating the transfer of technology;
legislation regulating foreign investments;
currency control regulations; and
import restrictions and/or quotas.

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.

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 in question with one of agency. The same applies to the law regulating other distribution contracts.

Equipment and premises might be leased and security interests might be involved.

The corporate form the franchisor and the franchisees adopt will also be relevant, particularly for questions of liability and taxation.

Financial investments will be covered by the legislation which regulates these matters specifically.

Intellectual and industrial property law is the basis on which the franchise relationship is constructed and is therefore of fundamental importance. In international relationships the international conventions and other regulations of international origin must be taken into account.
Competition law is highly relevant, particularly in consideration of the terms in the franchise agreements that might be covered by the competition law, as these are often of considerable importance. These are clauses relating to prices, exclusivities, market sharing and the possibility of concerted action between the members of the network. 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.

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 in view of the costs involved.

Ordinary property law will also need to be considered for the assets of the franchise, particularly in the case of termination of the agreement.

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.

Insurance law is relevant as often agreements will require that franchisees take out insurance with the franchisor as beneficiary.

Labour law is highly relevant, particularly where the nature of the relationship between the franchisor and the franchisee is concerned, but also for the rights some franchisors retain to approve the employees of the franchisee.

Furthermore, any laws or regulations specific to the trade sector involved (for example health regulations for food franchises) needs to be carefully considered in each particular case.

To these must be added in the case of international franchising also the law regulating the transfer of technology, as franchising is often covered by the broad definition of technology transfer. In this context the recent European Regulation on technology transfer agreement should be noted.\(^1\) Adopted on 31 January 1996, it replaced the existing regulations on patent and know-how licensing agreements.\(^2\)

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Legislation regulating foreign investments needs to be considered as do the connected currency control regulations, import restrictions and/or quotas and legislation regulating joint ventures.

**Specific Legislation**

Only a very few countries have adopted legislation specifically applicable to franchising. In addition, the European Commission in 1988 adopted a block exemption regulation for categories of franchise agreements, but this regulation only deals with competition law aspects.

**The United States of America**

Franchise legislation in the United States is of two types: the first concerns the relationship between the parties after the franchise has been initiated and this exists only at state level and then only in seventeen states. The other regulates the offer and sale of the franchise and this exists in two forms: at federal level in the form of the 1979 Federal Trade Commission (FTC) Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures\(^3\) and at state level in the form of state legislation, again only in seventeen states, though not necessarily the same ones as those which regulate the relationship. The second of the two types of legislation is known as "disclosure legislation" as it regulates the information with which a franchisor is supposed to supply the prospective franchisee in order to permit it to have all the elements necessary to evaluate the franchise it is proposing to acquire.

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;

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\(^{3}\) (EEC) 556/89 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). 

16 C.F.R. § 436.
financing;
- required personal participation;
- termination, cancellation and renewal provisions;
- statistics on the number of franchisees;
- training;
- site selection; and
- financial reporting, including audited financial statements.4

The North American Securities Administrators Association (NASAA)5 has also adopted a Uniform Franchise Offering Circular (UFOC) which 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.6 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 disclosure information and other information prior to all franchise offerings.7

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 1995.8 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. Until 1983, when a new Securities Act was adopted, the Quebec Securities Act covered franchising by defining "securities" to mean, among other things, "a contract of concession or of franchising under which the concessionaire or the franchisee obtains certain special rights respecting the operation of an undertaking". The new Securities Act does not contain any specific reference to

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5 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.
6 It is reproduced in CCH, Business Franchise Guide, at ¶ 3700.
franchising, although it does cover what it calls "investment contracts", i.e. contracts "whereby a person, having been led to expect profits undertakes to participate in the risk of a venture by a contribution of capital or loan, without having the required knowledge to carry on the venture or without obtaining the right to participate directly in decisions concerning the carrying on of the venture".9 The recent adoption of the New Civil Code in Quebec, which contains a broad definition of contracts of adhesion in its Article 1379, has further raised the question of the applicability of the provisions relating to adhesion contracts to franchise agreements.10 The possibility of introducing legislation in the province of Ontario has also recently been aired, but as yet nothing more specific has been developed.

FRANCE

In Europe, the first country to adopt legislation related 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 environment11 was adopted, the first article of which is relevant for franchising. It is a disclosure law, the details of which were subsequently laid down in government Decree No. 91-337 of 4 April 1991.12

SPAIN

In Spain, provisions relating to franchising were introduced as Article 62 of Law No. 7/1996 relating to the retail trade.13 Also this provision relates mainly to disclosure, although it does provide for a registration requirement. To date, the implementing regulations have not been adopted.

BRAZIL

In Brazil a Law relating to franchising contracts and other measures was adopted on 15 December 1994.14 This law deals mainly with disclosure but contains provisions also on other aspects of franchise agreements, such as royalties and fees.

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9 See CCH, Business Franchise Guide, at ¶ 7040.
14 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.
MEXICO

One country which has introduced provisions regulating franchising in its law on industrial property is Mexico.\textsuperscript{15} 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.\textsuperscript{16}

As is the case with the American disclosure legislation, the laws enacted or proposed in other countries require documents of information to be furnished on:

\begin{itemize}
  \item the franchisor and the directors of the enterprise;
  \item the history of the enterprise;
  \item the legal constitution of the enterprise;
  \item the intellectual property concerned;
  \item financial statements for the two or three preceding years;
  \item lists of other franchisees in the chain;
  \item 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
  \item information on any exclusivities.
\end{itemize}

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 the building up of trust between the parties, which is a prerequisite for the success of the enterprise.

RUSSIA

The legislation adopted in Russia is not a disclosure legislation, 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) and entered into force on 1 March 1996. This Chapter does not actually refer to franchising in the text, but only to "Commercial Concessions". The descriptions of aspects of the relationship the provisions are aiming to regulate are however clearly referred to franchising. The provisions deal with the form and registration of the contract, sub-


\textsuperscript{16} Diario Oficial, 23 November 1994. These Regulations came into effect on 8 December 1994. They are reproduced in the CCH, Business Franchise Guide, at \textsuperscript{\textcopyright} 7215.
concessions, remuneration under the contract of commercial concession, the obligations of the user (i.e. the franchisee), the possibility to limit the rights of the parties to the agreement, the right holder’s (franchisor’s) liability for claims filed against the user, the rights of the user to renew the contract, amendments to the contract, termination, the changing of the parties, consequences of a change in the trade name or trademark and the consequences of the termination the exclusive rights granted in the agreement.

**AUSTRALIA**

A totally different and innovative approach has been taken in Australia, where attempts to legislate have through the years met with opposition from all sectors involved. The result was the appointment by Minister for Small Business and Customs of a *Franchising Task Force*. The outcome of the work of this task force was the development of what is now the *Franchising Code of Practice*.¹⁷ The Code is voluntary and self-regulatory, meaning that franchisors and others who are regulated by the Code can choose whether or not to adhere to it. The Code of Practice applies 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 (i.e. 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 franchisees within which they may terminate the franchise agreement, regulates unconscionable conduct, alternate dispute resolution, and contains the requirement that the franchisees 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 attempts at legislation and the subsequent adoption of a Code of Practice were in fact a response to public disquiet at the lack of competence, judgment and morality amongst the connected group of service providers to investment generally. The outcome in the Code was something which each of the groups brought together in the task force - franchisors, franchisees, service providers, advisers and government officials - saw as being necessary to deal with the deficiencies of the recent past, but also to maintain a practical balance of what realistically business could live with.

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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. 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. The possibility of introducing legislation was again rejected, but the Australian Government in power at that time proposed to establish a Small Business/Trade Practices Unit in the Australian Competition and Consumer Commission to provide an interface between small business and the Commission. This Unit would have as one of its main tasks the monitoring of non-registered franchisors to ensure that appropriate standards of disclosure and conduct were being maintained.

THE EUROPEAN UNION AND FRANCHISING\textsuperscript{19}

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).\textsuperscript{20} 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.\textit{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 (e.g. the know-how), although the provisions must be essential for this purpose. However, certain categories of clauses which limit the franchisee’s activities (e.g. price determination clauses) were not considered acceptable by the Court.

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19 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. Mendelsohn/B. Harris, Franchising and the Block Exemption Regulation, London 1991.
20 Case 161/84 of 28 January 1986.
Following the landmark *Pronuptia* decision, the Commission of the European Communities has rendered five Decisions on franchising cases\(^{21}\) and has adopted a Block Exemption Regulation on franchise agreements.\(^{22}\)

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."\(^{23}\)

The text of the Regulation further gives what 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 franchisee of know-how, - the continuing provision by the franchisor to the franchisee of commercial or technical assistance during the life of the agreement [...]"\(^{24}\). This definition has come to be regarded as an almost standard definition of franchising within the Communities.

\(^{23}\) Recital (5).
\(^{24}\) Article 1(3). The European Franchise Federation 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
The Regulation indicates to which restrictions of competition the exemption shall apply, to which it shall apply notwithstanding the presence of certain obligations, to which it shall apply on certain conditions and to which it shall not apply. 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.

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.

**Voluntary Regulation of Franchising**

A number of franchise associations, both national and international, have adopted Codes of Ethics which 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.

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 "In order to allow prospective Individual Franchisees to enter into 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.

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25 Article 2.
26 Article 3.
27 Article 4.
28 Article 5.
29 Article 6.
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".30 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",31 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".32 The European Code is applicable to the members of the national associations which are members of the EFF.

In addition to the European Code which 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".33 Furthermore, in October 1994 the Italian Franchise Association adopted a regulation integrating the European Code which 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".34 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"35 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".36 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.

30 Clause 3.3.
31 Clause 3.1.
32 Clause 3.2.
33 Clause 2.
34 Section III, Clause 1 para. 2.
35 Section IV, Clause 1 para. 1.
36 Section IV, Clause 1 para. 2.