

**UNIDROIT**

International Institute for the Unification of Private Law

**GUIDE TO  
INTERNATIONAL  
MASTER FRANCHISE  
ARRANGEMENTS**

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## **FOREWORD**

The International Institute for the Unification of Private Law (Unidroit) is pleased to offer this Guide to International Master Franchise Arrangements to the international legal and business communities. By doing so, it aims to make a contribution to an understanding of this important business method, which, firmly established in a number of market economies, is spreading into and assuming an ever greater role also in an increasing number of countries with mixed or State economies.

International franchising is in fact playing an ever greater role in introducing commercial know-how into countries with developing economies or with economies in transition. Such micro-economic reform complements the large scale international economic and financial changes being brought about by the rapid spread of globalised commercial and industrial development. International franchising is playing a vital role in ensuring the productive transfer of technology and enhanced levels of foreign investment that are so important to developing and emerging economies.

This publication is the outcome of the work of the Study Group on Franchising set up by the Governing Council of Unidroit in 1993. Supported by a group of franchising advisors from national and international non-governmental organisations and staff of the Institute's Secretariat, the Study Group was able to bring its work to fruition in 1998, when it submitted the Guide to the Governing Council of the Institute with the request that it authorise the publication thereof. That the Governing Council was able to endorse the publication of the Guide with enthusiasm is due to the high quality of the work of all those involved. We express gratitude and pay tribute to the members of the Study Group and the advisers for sharing their expertise, for their constant efforts and for the enthusiasm with which they approached their task. We also wish to thank the other practising

lawyers, judges, civil servants and academics from different legal cultures and backgrounds who made contributions during the various stages of the project.

Particular recognition needs to be afforded the contribution of Committee X, the International Franchising Committee of the International Bar Association, without whose close collaboration in the form of the active participation of a number of its prominent members in the work of the Study Group, this Guide would not have been completed.

All of those involved wish to acknowledge the particular role played by Ms Lena Peters who held the whole project together and contributed so much to researching, to the writing of the drafts and the final editing of the publication.

Finally, the Governing Council of the Institute was heartened by reports of the interested anticipation in the publication of the Guide shown by the franchising community in so many countries. It is with satisfaction that we announce that translations into the major languages of the world are in preparation and will be made available to the international community at the earliest opportunity.

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Secretary-General *a.i.*

Luigi Ferrari Bravo  
President

Rome, August 1998

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# EXECUTIVE SUMMARY

The *Unidroit Guide to International Master Franchise Arrangements* offers a comprehensive examination of the whole life of this type of arrangement, from the negotiation and drafting of the master franchise agreement and other associated agreements to the end of the relationship. It deals principally with the positions of the parties directly involved, i.e. the franchisor and the sub-franchisor but, in instances where it is considered to be of particular importance, the positions of others affected, such as sub-franchisees, are covered.

In order to place master franchise agreements in context, the Guide examines the differences between franchise agreements and other types of distribution and representation agreements (Chapter 1). The Guide takes into account the fact that franchising may not always be the vehicle most suited to a particular business under consideration. The parties, in particular the franchisor, must consequently contemplate the possibility that other ways of doing business may answer their purposes better than franchising. The Guide therefore considers the factors that should be taken into consideration by the parties when they decide upon the vehicle most appropriate for their business (Chapter 1). It also reviews the essential characteristics of unit franchising, which in the vast majority of cases takes the form of business format franchising (Annex 1), briefly examines the different forms of franchising that are available to the parties, the methods normally used to franchise internationally, and what is necessary to internationalise domestic franchise systems (Chapter 1).

Of fundamental importance in a master franchise relationship are the rights that are granted to the sub-franchisor. Chapter 2 examines the different assets that belong to the franchisor and to which the sub-franchisor is granted rights, including trademarks and other intellectual property rights

(examined more extensively in Chapters 10 and 11). It also examines the three-tier structure of master franchise arrangements and the relationship between and among the parties involved (franchisor, sub-franchisor and sub-franchisee). The normal lack of a direct relationship between the franchisor and the sub-franchisee is illustrated, with indications being given of a few exceptional occasions on which such a direct relationship may be contemplated. The advantages and disadvantages respectively of short and long terms of duration of the master franchise agreement and the conditions that are often imposed by the franchisor for the renewal of the agreement are considered in Chapter 3.

Essential to any description of franchising is what financial arrangements and payments are to be made by the sub-franchisor in return for the rights granted. This financial compensation is normally in the form of initial and/or continuing fees. Chapter 4 deals with the different sources of income of the franchisor and the sub-franchisor, with the calculation of payments and the procedures adopted for the execution of these payments, as well as with the fiscal implications thereof. The payments that sub-franchisors and sub-franchisees may be required to make into especially set up advertising funds are dealt with in Chapter 8, in connection with the general examination of the issues raised by advertising.

In a master franchise relationship each of the parties naturally has obligations and rights vis-à-vis the other. The rights of one party will often mirror the obligations of the other. Thus, for example, the right of the franchisor to receive payment for the rights it has granted the sub-franchisor the right to use, corresponds to the obligation of the sub-franchisor to pay for the rights it has been granted the right to use. What is perceived essentially as a right, may be both a right and an obligation. Thus, for instance, the right of the franchisor to control the quality of the performance of the sub-franchisor or franchisee may at the same time be an obligation, as the franchisor may be considered to

have an implied duty towards the members of the network, who pay for the right to participate in the network, to ensure that quality standards are maintained by all the members. These questions are examined in Chapters 5 and 6, which deal with the role of the franchisor and sub-franchisor respectively. The sub-franchise agreement, which links the sub-franchisor and the sub-franchisee, is also briefly examined (Chapter 7).

In many cases the franchisor will supply the sub-franchisor, or even the sub-franchisees, with particular equipment required for the franchised business (such as machinery with unique characteristics), with the products that the franchise units are to sell, or ingredients or parts thereof, and/or with services that the sub-franchisor, or in some cases even the sub-franchisees, require to run the business. Such services may include, for example, a centralised booking system for a hotel franchise, or training in, and assistance with, the accounting of the business.

Intellectual property rights are essential to the franchise arrangement, both the intellectual property rights that are protected by legislation and those that are not (know-how in particular). Trademarks and copyright are dealt with in Chapter 10, whereas know-how and trade secrets are discussed in Chapter 11.

A master franchise arrangement, in particular an international master franchise arrangement, is intended to last over time. Its term, in many cases renewable, often extending for twenty years or more in consideration of the substantial investments and efforts necessary to establish and develop a franchise system in a foreign country. Circumstances however change over time, and to maintain its viability the franchise system must be able to adapt to the changing circumstances. In many respects this necessity to adapt the system mirrors the need to adapt it to the requirements of a foreign country when the system is first introduced there. The changes introduced also need to be reflected in the agreements themselves. Chapter 12 examines the circumstances in which change may be necessary

and the techniques that are used to effect the changes required, including modifications to the agreement and to the manuals.

In the course of the master franchise relationship either of the parties may find itself in a position in which a sale, assignment or transfer of its rights in the franchise is necessary. This is the case, for example, with an internal restructuring of the business or if the party wishes to terminate the relationship. Furthermore, in the case of the death of a party, that party's heirs may wish to terminate the relationship. Chapter 13 examines the issues raised by the sale, assignment or transfer of the agreement before its term has come to an end.

Part of the attractiveness of franchising is the possibility it offers all the members of the network to identify with the trade name and/or trademark of the franchisor. From the franchisor's point of view certain risks are however inherent in this system. A consumer may, for example, identify the sub-franchisee with which it comes into contact with the franchisor and may consequently consider the franchisor liable for any failing on the part of the sub-franchisee. The possibility that the franchisor may be held vicariously liable for acts or omissions on the part of the sub-franchisors and sub-franchisees of its network therefore needs to be taken into serious consideration and is examined in Chapter 14, together with the issues raised by requirements that the sub-franchisor, and sub-franchisees, take out insurance.

As is the case with other types of agreement, the parties to a master franchise agreement may not always perform their obligations. A number of remedies are available in such cases, the most drastic of which is termination. Chapter 15 examines the different remedies that are available, both those short of termination and termination, and Chapter 16 considers the end of the master franchise relationship and its consequences, independently of whether it has come to an end as a result of wilful termination or because the term of the agreement has expired. A problematic issue considered in this connection is the fate of the sub-franchise agreements, considering that the rights

granted under sub-franchise agreements are derived directly from the master franchise agreement.

It is of considerable importance to determine what law is to apply to an international agreement. This determination is made by the parties themselves when they enter into the relationship, or, failing such a determination by the parties, by the court seized of a dispute arising out of their agreement. To make this determination courts will in such cases apply the conflict of laws rules of their jurisdiction. Similarly, the forum in which any disputes should be decided also needs to be determined. This may be either a court of a relevant State or an international arbitrator. Alternatively, less binding forms of dispute resolution such as negotiation, mediation or conciliation may be used, possibly as a first step in the dispute resolution procedure. If the parties decide that State courts are to determine the dispute, then they may also agree on the courts of a particular jurisdiction to hear any dispute. The importance and desirability of choosing both the applicable law and the form of dispute resolution are examined in Chapter 17, as are the implications of the different options available.

In addition to the clauses that relate specifically to the franchise business, franchise agreements contain a number of clauses that are commonly used in agreements generally. Examples of such clauses are examined in Chapter 18.

A franchise arrangement may be structured in many different ways and many different agreements may form part of the arrangement. These agreements may concern matters that in some arrangements are regulated in the master franchise agreement itself, such as the duty of confidentiality, or other particular issues that more clearly are the subject of separate agreements, such as the licensing of software. Examples of such ancillary documents are examined in Chapter 19.

As is clear from the list in Annex 2, franchising is a way of doing business. It is not a business in itself. As a consequence whatever licences or permits particular State authorities require

for the carrying on of a particular trade must also be obtained by the sub-franchisor in addition to settling the master franchising arrangements. Examples of such regulatory requirements are given in Chapter 20.

The Annexes to the Guide attempt to sketch in some additional relevant material to place international master franchising in the broader economic, social and legal contexts. The advantages and disadvantages of franchising for the franchisor and the franchisee are illustrated in Annex 1. Annex 2 examines the relevance of franchising to the political economy of a country by outlining the advantages it provides in terms of employment opportunities, through reduced failure rates, especially for small business, and that in many instances compare favourably with those of traditional businesses, and by easing the way for new operators into a market economy in developing countries and economies in transition.

Annex 3 sets out briefly first the different branches of law that are relevant to franchising, even if they do not apply exclusively to franchising, and continues with an examination of the legislation that exists in a number of countries and that is specific to franchising, ending with a consideration of the voluntary regulations that are adopted by the franchise associations and that normally take the form of codes of ethics.

# INTRODUCTION

In recent years franchising is having an increasingly significant effect on the economy of a growing number of countries. The most famous names of franchising (McDonald's, Holiday Inn, Yves Rocher, Body Shop ) have become household names and are to be seen all over the world. This growth is however not limited to large international chains. Thanks to franchising, indigenous networks are spreading with a rapidity that was unheard of only twenty years ago.

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

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

Although master franchising was selected as the main focus of the *Guide* by reason of its being the method most commonly used in international franchising, a brief description of the other principal methods used in both domestic and international franchising is also provided. It is hoped that by offering an introduction to readers not familiar with this form of business, the *Guide* will be of use to operators, lawyers and others active on

both the international and the domestic scenes. It must however be stressed that the principal purpose of the *Guide* is to assist parties in negotiating and drawing up international master franchise agreements by identifying the legal issues involved in those agreements, discussing possible approaches to the issues and, where appropriate, suggesting solutions which parties may wish to consider. By furnishing comprehensive information the *Guide* aims to assist in placing the parties on the same level where no previous knowledge or experience would otherwise have placed one of them at a disadvantage. It should therefore contribute to enabling the parties to deal with the issues that arise with greater confidence.

The *Unidroit Guide to International Master Franchise Arrangements* is the first publication of its kind issued by Unidroit. It confirms the intention of the organisation to expand its activities to cover also alternative approaches to the unification of law in addition to the more traditional approach of preparing and adopting prescriptive legal norms in the form of international conventions.

The most obvious reason for the introduction of legislation is the need to come to terms with problems that have arisen in practice. This is particularly the case where no specific legislation is in place and the legislation of general application is inadequate or unable to solve the particular problem that has arisen. If the problem concerned has cross-border implications, it will often lead to a proposal for the preparation of an international regulatory instrument being put forward in the inter-governmental organisation most suitable for this purpose.

In 1985, when the subject of franchising was first proposed for inclusion in the Work Programme of the Institute, franchising was only just beginning to spread across the Atlantic. At the time, it had already developed to a full-blown industry in North America: in Canada, where the proposal originated, in 1984 retail sales from franchise outlets amounted to approximately 45% of total Canadian retail sales. It is in the nature of things human that

nothing develops without problems and franchising is no exception. There had been instances of sharp practices by some franchisors and this had given rise to a concern that such practices might escape control and eventually appear and spread in international franchise transactions. A proposal was therefore put forward for an international regulatory instrument to be prepared and it was felt that Unidroit, which at the time was engaged in the preparation of what in 1988 were to become the *Unidroit Conventions on International Financial Leasing and International Factoring*, was considered to be the organisation most suited for this purpose.

A first, preliminary stage of the project involved the preparation of reports analysing the phenomenon as such, the information gathered by means of a survey conducted by the circulating of a questionnaire to Governments, professional circles and recognised experts in the field, as well as the provisions used in franchise agreements, and the monitoring of both national and international developments in franchising and franchise legislation.

At its 72<sup>nd</sup> 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, in particular the disclosure of information between the parties before and after the conclusion of a franchise agreement and the effects of the termination 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, to indicate the form of any instrument or instruments which might be envisaged.

As concerns domestic franchising, the Study Group concentrated on the question of disclosure, examining the experience of countries that have, or have attempted, some

form of regulation in this area, the role of franchise associations and the importance of the codes of ethics adopted by those associations. The Study Group did not reach any final conclusion as regards domestic franchising and decided that it would come back to it at a later stage. It consequently recommended to the Council that for the time being consideration of any action on domestic franchising be postponed.

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

The findings of the Group 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. This view found confirmation in the existence of a great variety of franchise agreements and in the numerous different options open to parties entering into franchise agreements, as the consequence of regulating any of the issues that arise by an international convention would be to tie the hands of the parties by suggesting that the issue at hand ought to be dealt with in one specific way only, and this would be of little service to the business community.

Furthermore, although nothing would actually prevent the elaboration of an international convention, the subject-matters examined would require a considerable number of mandatory provisions, which would lead to a lack of flexibility that might in the end hamper the development of the franchising industry. The stringent nature of international conventions would moreover not permit the adaptations that a State might consider to be an

essential condition for its adoption of the convention. The combination of the mandatory nature of the provisions and the binding nature of the convention would not augur well for the adoption of a convention by the different nations of the world. The utility of such an instrument might therefore seriously be questioned.

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

A more feasible instrument might in this case be a model law, a major advantage of model laws being their flexibility, which permits national legislators to make the modifications that they consider to be imperative. It is therefore possible for the experts entrusted with the preparation of a model law to include provisions that they deem to be the most appropriate solutions to the problems addressed, even if in the end not all States that decide to take inspiration from the model law will include all its provisions in their national laws. The price to pay for this greater flexibility is of course less uniformity, as a number of provisions will differ from country to country. While the possibility of adopting a model law might be considered for domestic franchising, it was however felt that it would be less suitable for international franchising, in particular considering the methods normally adopted in cross-border franchising.

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

standards among the members of the professional associations concerned, their effectiveness varies and is often disputed even if courts have been known to refer to them as standards of conduct.

Another type of instrument that was briefly considered as a possibility was that of the model contract. The majority of the Group however did not feel that such an instrument would be suitable for master franchising. Furthermore, the *International Chamber of Commerce* in Paris was already preparing a model franchise contract for international, direct unit franchises and the Study Group therefore decided to exclude the model contract from the options open for consideration.

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

The Group felt that the guide approach would present several advantages for a subject such as franchising. In the first place it could illustrate the problems that might arise in connection with issues that had already been regulated in one way or another by national legislation, but which were of particular importance in the context of franchising (such as intellectual property). It could also illustrate the advantages and disadvantages of the different options open to operators and alert readers to the different hurdles that they might find on their path. This would clearly not be possible if an instrument such as an international convention were opted for. Furthermore, a guide could be prepared in a relatively short period of time, which was not the case for an instrument such as a convention for which a

totally different procedure would be required. A guide could be launched on the market upon completion and could consequently be immediately available to operators, whereas an international convention would require adoption by a sufficient number of States for it to enter into force, followed by the preparation of implementing legislation, all of which might take a long time. If the purpose of the international instrument to be adopted was to reach out quickly to the franchising community, then an instrument such as a guide was the most appropriate. The Group consequently recommended to the Governing Council of Unidroit that work on a guide to international master franchise arrangements be undertaken.

The Governing Council of the Institute endorsed this recommendation at its 74<sup>th</sup> session in March, 1995, and requested that work on the guide advance as rapidly as possible. This volume is the outcome of the labours of the Study Group.

# CHAPTER 1

## FUNDAMENTAL CONCEPTS AND ELEMENTS

### A. MASTER FRANCHISE AGREEMENTS AND OTHER COMMERCIAL VEHICLES

There is no doubt that master franchise agreements are the type of agreement most common in international franchising. The realisation of this fact brought the Unidroit Study Group to recommend, and the Governing Council of Unidroit to accept, that master franchise arrangements should be the form of franchising primarily to be dealt with in this Guide.<sup>1</sup>

#### *I. MASTER FRANCHISE AGREEMENTS*

In master franchise agreements the franchisor grants another person, the sub-franchisor,<sup>2</sup> the right, which in most cases will be exclusive, to grant franchises to sub-franchisees within a certain territory (such as a country) and/or to open franchise outlets itself.<sup>3</sup> 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 initial fee, which may take any one of a variety of different forms, 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.<sup>4</sup> It

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1 See Annex I for a general description of franchising.

2 Often also called the "master franchisee".

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

4 See Chapter 4 "Financial Matters".

should be noted that the use of master franchise agreements is not limited to international franchising and that they may also be used in the domestic franchising context.

In master franchise arrangements essentially two agreements are involved: an international agreement between the franchisor and the sub-franchisor (the master franchise agreement), and a domestic franchise agreement between the sub-franchisor and each of the sub-franchisees (the sub-franchise agreement). There is in most cases no direct relationship between the franchisor and the sub-franchisees, although in some countries intellectual property legislation will make a direct link necessary for matters concerning those particular rights.<sup>5</sup> The sub-franchisor assumes the right to licence the sub-franchisees as the franchisor in the territory and undertakes the duties of a franchisor to the sub-franchisees. The sub-franchisor is responsible for the enforcement of the sub-franchise agreements and for the general development and operation of the network in the country or territory it has been given the right to develop. It is the duty of the sub-franchisor to intervene if a sub-franchisee does not fulfil its obligations. In cases where there are no contractual relationships between the franchisor and the sub-franchisees the franchisor will normally not be able to intervene directly to ensure compliance by the sub-franchisees, but it will be able to sue the sub-franchisor for non-performance if the latter does not fulfil its obligation to enforce the sub-franchise agreements as laid down in the master franchise agreement.<sup>6</sup>

### **a) Principal Benefits of Master Franchising**

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

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 foreign operation itself, although the investment required, in both staffing and financial

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<sup>5</sup> See Chapter 10 "Intellectual Property".

<sup>6</sup> There are however franchisors who reserve the right to intervene against defaulting sub-franchisees - see Chapter 2, cit. For an examination of remedies short of termination, see Chapter 15 "Remedies for Non-Performance".

terms, may turn out to be more substantial than many franchisors estimate before they enter into the agreement.

Furthermore, the country of the franchisor and that of the sub-franchisor will in all likelihood differ considerably as to culture, customs and traditions, legislation, language and religion, not to speak of social and economic organisation. It is therefore of considerable advantage to the franchisor if it is able to rely on an individual or entity that will be familiar with the country concerned, that will know how the local bureaucracy works, what is necessary to fulfil all the legal requirements, and that will be able to advise the franchisor on the modifications that are necessary to adapt the system to the local conditions. Furthermore, the geographic distance between the country of the franchisor and that in which it intends to expand its network might be such that it would be difficult for the franchisor to control the performance of the unit operators. The economic and logistic burdens involved may in fact be such that it would not be economically viable for the franchisor to enforce the terms of the unit agreements. The contribution of a local sub-franchisor that is able to step into the franchisor's shoes in the country concerned, is therefore of the utmost importance. The franchisor will normally undertake to provide the sub-franchisor with a number of services,<sup>7</sup> but thereafter the sub-franchisor will, depending on the system, to a large extent have prime responsibility for the running of the operation. Even so, the role played by the franchisor should not be underestimated.

A major advantage of franchising in general is the fact that the franchisee has the benefit of investing in a well-known and tested business concept. To a certain extent this is true also as regards international master franchising, although how well-known a particular franchise system is in the country of the sub-franchisor will vary considerably. The most famous franchises are known in a large number of countries all over the world. Others are less well-known, or are known in fewer countries, but are solid franchises that have every chance of success. For the sub-franchisor they are therefore well worth investing in, even if a considerable investment in time and effort will be needed to make the system known. The technical know-how that accompanies a franchise might also be of considerable interest to a sub-franchisor. It

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<sup>7</sup> See Chapter 5 "The Role of the Franchisor".

should however be noted, that sub-franchisors are often large commercial entities with substantial funds and technical know-how of their own. Sub-franchisors in fact need to be large, as the amount of investment that they will be required to make to develop the network will be of major importance. It is not unusual for the sub-franchisor to be larger than the franchisor.

## **b) Common Problems associated with Master Franchising**

The three main areas with which franchisors have expressed dissatisfaction are the limited control of the franchisor over the franchise network, the problems associated with the terminating of the master franchise agreement and the sharing of the income derived from the fees.

### **i) Limited control of Franchisor over Franchise Network**

By entrusting the establishment, supervision and control of its franchise network and its trademarks to a sub-franchisor, the franchisor has to a large extent handed over the control of its franchise system, including its trademarks, to the sub-franchisor. This diminished control on the part of the franchisor is a direct result of the fact that typically there is no direct contractual relationship between the franchisor and the sub-franchisees. The franchisor is thus obliged to rely on the sub-franchisor to enforce the sub-franchise agreements and to ensure that its rights, such as intellectual property rights, are not infringed upon.<sup>8</sup> As the sub-franchisor has as great an interest as the franchisor in the proper functioning of the network and the protection of the intellectual property, the franchisor will usually be able to rely on the sub-franchisor to act in case of intellectual property infringement or malfunctioning of the network. Problems however arise where the sub-franchisor does not perform its obligations as it should.

Legally the franchisor has the right to enforce the provisions of the master franchise agreement that require the sub-franchisor to properly establish, supervise and control the franchise system and its trademarks. It is however a right that is most difficult to enforce from a practical point of view. In certain situations direct

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<sup>8</sup> See Chapters 2 and 10 cit.

contractual relationships are exceptionally created between the franchisor and the sub-franchisees, by, for example, making the franchisor a party to the sub-franchise agreement. 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. Although a carefully structured arrangement between the franchisor, sub-franchisor and sub-franchisees and carefully prepared master and sub-franchise agreements can alleviate the problems of diminished control, the nature of master franchising makes it impossible to avoid these problems entirely.<sup>9</sup>

While the franchisor may feel that it has too limited a control over the operations of the sub-franchisor, the sub-franchisor might feel that the franchisor has retained rather too much control. This is understandable, considering that the sub-franchisor is an entrepreneur in its own right, with considerable experience and professional knowledge of the territory with which it has been entrusted.

## **ii) Problems with Terminating Master Franchise Agreements**

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

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<sup>9</sup> On remedies for non-performance, see Chapter 15.

defects of the master franchise arrangement. The consequences need to be considered in detail at the time of the negotiations.<sup>10</sup> If realistically there are problems in terminating the master franchise agreement, the converse is also true, in that the sub-franchisor has no guarantee that the agreement will always be renewed. Considering the substantial investments necessary on the part of the sub-franchisor, this uncertainty represents one of the drawbacks to be taken into consideration at the time of evaluating the franchise.<sup>11</sup>

### **iii) Sharing of Income derived from Fees**

The financial return of the franchisor is likely to be considerably lower in master franchising than in direct unit franchising and development arrangements. This will to some extent be offset by the fewer costs incurred by the franchisor. A feature of master franchising is the sharing of the income derived from the initial franchise fees and the continuing royalty fees between the franchisor and the sub-franchisor. This may give rise to the question whether the revenue from these fees is sufficient for both the franchisor and the sub-franchisor. Although typically the fees are split in a proportion that favours the sub-franchisor, the doubt nevertheless remains whether the revenue left in the hands of the sub-franchisor is sufficient to support the type of organisation that a sub-franchisor is required to build in order to ensure the proper establishment and supervision of the franchise network.

The question is just as relevant for franchisors who typically receive the smaller portion of the fees paid by the sub-franchisees. This has led franchisors to question whether the revenue they receive is sufficient compensation for their continuing efforts to provide support to the sub-franchisor and for the inherent risks involved in international franchising. In the past many franchisors assumed that, once the master franchise agreement had been entered into and the sub-franchisor had been properly trained in all aspects of the franchise system, the sub-franchisor would be solely responsible for the network, without the franchisor having to intervene. What experience has shown over the years, is that the continued involvement of the franchisor in the host 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 host country with the consequence that the continuing costs of

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<sup>10</sup> See below, Section B.IV.

<sup>11</sup> See Chapters 3 "Term of the Agreement and Conditions of Renewal" and 16 "The End of the Relationship and its Consequences".

supporting the franchise system in the host country remain significant. The royalties that will be earned by a franchisor in the initial three to five year period during which the franchise system is being established may therefore not compensate it for its continued efforts in assisting the sub-franchisor in establishing the franchise system in the host country.

## ***II. FRANCHISE AGREEMENTS AND OTHER AGREEMENTS***

Franchise agreements contain numerous elements that may cause them to be identified with other types of agreement, particularly in countries where there is no legislation that specifically regulates franchising. In a number of countries, 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 reality, however, although franchise agreements are often identified with agency, distribution or licence agreements, and although elements of these types of agreement are present in franchising, there are substantial differences between them.

### **a) Commercial Agency Agreements**

The type of agency that is relevant when franchise agreements are compared with other types of agreement is that of commercial agency.

The figure of the commercial agent was developed in the civil law tradition and was introduced into the law of the then 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*.<sup>12</sup> Although certain differences exist between the different civil law systems, the essence of the civil law concept may be considered to have been 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.<sup>13</sup>

Traditionally, the commercial agent was unknown to the common law which consequently did not provide for any specific regulation of this type of

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<sup>12</sup> 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 considers questions relating to the remuneration of the agent and to the conclusion and termination of the contract.

<sup>13</sup> Cf. Article 1(2).

representative. The common law concept of “agent” is in fact to all intents and purposes the same as that of the general agent under the civil law systems. The figure of the commercial agent was consequently introduced into the European common law systems by the European Directive. It should perhaps be observed that, despite the unifying force of the European Directive, considerable differences still exist in this field between the national legal systems.

In franchising on the other hand, the franchisor and the franchisee are two independent businesspersons who invest and risk their own funds. Franchisor and franchisee are not liable for each other’s acts or omissions. Franchise agreements in fact often contain a provision expressly stating 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 unit indicating that that place of business is a franchise and is not owned by the franchisor.

### **b) Distribution Agreements**

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

Distribution agreements may be either general or exclusive. If they are general, the distributor may carry a range of products in respect of which it has been granted distribution rights, it may even have competing or conflicting product lines supplied by different suppliers. Furthermore, the supplier may have several distributors in the same area. Exclusive distribution arrangements grant the distributor the exclusive right to sell the products in a specified area, the supplier undertaking not to supply other distributors in that area. This will not necessarily prevent the distributor from carrying a range of other products. There are in fact a range of possible exclusivity arrangements that may be considered.

In franchise agreements there is instead in most cases an exclusivity clause which provides that the franchisee is to market only the products of the franchisor. The vendor and purchaser relationship may also be present in a franchise relationship, but will in most cases be a mere feature of the broader franchise arrangement, which will include also the licensing of the trademark and system of the franchisor and the providing of certain services by the franchisor to the franchisee, such as training and continued assistance.

### **c) Licence Agreements**

A licence may be defined as a contractual arrangement pursuant to which a party (licensor) grants another party (licensee) the right to use the licensor's patents, know-how, trademarks and/or other intellectual property rights 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 property, the main characteristics are similar.

Licence agreements may be non-exclusive or 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 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 may also undertake not to use the intellectual property itself. An exclusive licence may be granted for a specific territory, for example a particular country, or may be more general in character. In essence the difference between a licence and a franchise is that a licensor controls the manner in which the licensee uses the licensor's patents, know-how and/or trademarks, but has no control over the business format or the manner in which the licensee carries on its business, whereas a franchisor exercises detailed control also over the manner in which the franchisee operates its unit.

### **d) Transfer of Technology Agreements**

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

## ***III. METHODS TO FRANCHISE INTERNATIONALLY***

There are essentially two main ways to franchise internationally: directly<sup>14</sup> or through master franchise arrangements.<sup>15</sup>

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<sup>14</sup> See below.

<sup>15</sup> For a general description of master franchise arrangements, see above, page 5 ff.

These classic methods used by franchisors for international expansion may however not be appropriate in every situation, other methods of distribution being better suited under certain circumstances. Examples of such other methods include "bare bones" license agreements, scaled down versions of master franchise agreements and "hybrid franchise/license" agreements.

Generally speaking, a "bare bones" license agreement is a limited license agreement by which the franchisor grants the franchisee/licensee a license (that may or may not be exclusive) to use the franchise system, and in some circumstances the trade marks, in the foreign country. Apart from the initial training to be provided to the franchisee/licensee, the franchisor will not be required to provide any additional training or assistance and will, to all intents and purposes, be free of any additional obligations.

In a "scaled down" version of a master franchise agreement 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 are excluded.

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.

Joint ventures are also used in international franchising, often as a means to solve problems of funding but also as a means of ensuring that the franchisor is sharing in the risk. They are therefore not used alone, but in conjunction with development agreements or master franchise agreements in particular. 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 units and to grant sub-franchises in the same manner as a normal sub-franchisor. Alternatively, the joint venture may enter into a development agreement with the franchisor and thus become a developer.

One of the most important advantages to be gained by using a joint venture in franchising is the financial contribution that the franchisor is able to make to the operation as a whole. It is a system that is particularly suitable in countries where funding is scarce, but where other pre-conditions necessary to the growth of franchising are present (small businesses or people with savings that they are in a position to invest in a sub-franchise, for example).

Whatever the method a franchisor chooses to develop the franchise system, whether direct franchising or master franchising, in combination or not in combination with a joint venture, it will need to consider whether or not, as a corporate entity, it will engage in the franchising activity directly from its head

office or from a branch, or whether it will do so by means of a subsidiary. It should perhaps be recalled that a subsidiary is a separate legal entity whereas a branch is not. Whether the franchisor decides to set up a branch office or a subsidiary will often depend upon tax and general management considerations. In either case the body concerned, subsidiary or branch office, acts as franchisor for the purpose of granting franchises.

### **a) Direct franchising**

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

#### **1) *Unit Franchising***

In unit franchising the franchisor itself grants franchises to individual franchisees in the foreign country. In this case there is an international agreement to which the franchisor and the franchisee are parties. This form of franchising is not used frequently in international franchising, unless it is between countries that are geographically and culturally close to each other. In most cases the agreements concerned will relate to businesses involving considerable financial investments, such as hotel franchises.

#### **2) *Development Agreements***

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

#### ***IV. AREA REPRESENTATION AGREEMENTS***

Although area representation agreements are sometimes used in international franchising, and are sometimes presented as master franchise agreements or development agreements, 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 units.

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

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

### ***I. FACTORS TO CONSIDER WHEN DETERMINING THE MOST APPROPRIATE VEHICLE***

An entrepreneur who has decided to expand abroad must determine which commercial vehicle is the most appropriate for its type of business and for the achieving of its objectives. Similarly, the prospective local partner of an entrepreneur must evaluate the type of business it is able to set up as well as the type of relationship it wishes to establish with the foreign partner. A number of factors may 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.

#### **a) Objective Factors**

##### ***1) The Market***

Of fundamental importance in the choice of a vehicle is the condition of the market that the system is intending to enter. The factors that should be considered include the type of economy of the host country, 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, the availability of alternative sources of know-how and well-known marks that may make the franchisor's system less of a unique commodity and, last but not least, the general attitude of the local authorities.

In an international situation the franchisor may have to rely on its local partner to provide an assessment of the local market and of

the potential development of the franchise in that particular market.

## **2) *Cultural Considerations***

A number of cultural factors need to be considered in an assessment of the different commercial vehicles available. For example, if there is no entrepreneurial tradition in the host country, then the most suitable vehicle might be one that permits the foreign entrepreneur to exercise greater control over the operations and that ensures that the local operators are adequately trained and are able to function effectively.

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

## **3) *The Legal Environment***

The legal environment in the host country is of considerable importance in determining which vehicle is the most appropriate. For franchising to function there must be in place a general legislation on commercial contracts, an adequate company law, 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.

## **b) Subjective Factors**

### ***1) The Nature of the Business***

Of fundamental importance in the selection of the most appropriate vehicle is the nature of the business itself. What is suitable must be determined on a case by case basis.

In determining whether or not franchising is the most appropriate vehicle for a particular business, a number of subjective factors should be considered and assessed. First and foremost the business concept must 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. Furthermore, the financial returns on the operation of the franchised unit must be sufficient to enable the franchisee to obtain a reasonable return on the assets employed in the business, to earn a reasonable income and to pay the franchisor a reasonable fee for the services the latter supplies. The income generated by the franchisor from the operation of the franchise must in turn be sufficient to cover the franchisor's overhead costs and to permit it to earn a reasonable profit.

### ***2) Economic Circumstances Affecting the Choice of a Vehicle***

It is in the nature of master 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 property rights must be faced. 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 cost-effective.

### ***3) The Experience of the Parties***

The experience of the parties is of importance in a number of respects. If the parent company is considered first, it may be observed that there is a considerable difference between running a chain of wholly-owned outlets and

running a network of units by means of a master franchise arrangement. If the prospective franchisor has no experience in franchising, it is probably advisable for it to proceed step by step, beginning with 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 a development agreement or direct unit franchising. If a franchisor has no experience in master franchising, it is advisable for it to acquire this experience in its own country before attempting to use master franchising abroad.

Previous experience with franchising is less important for the prospective sub-franchisor than for the franchisor. It would however be important for the prospective sub-franchisor or developer to have business experience, as the running of networks of businesses, particularly as large as master franchise or development networks, requires ability and professional knowledge.

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

#### **4) *The Division of Responsibilities and Revenue***

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

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

vehicle to adopt will also reflect any shifts in responsibility and in the collection of revenue.

#### **5) *Control***

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

#### **6) *The Risk Factor***

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

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

Most of the risk factors involved are not unique to franchising, although there are those that may be considered to have particular relevance for this form of business. While it is true that risk is reduced because the franchisee uses a method that is tested and that has proved to be successful, it is also true that if there is too rigid a requirement of observance of the franchisor's blue-print, this might prevent the sub-franchisor from introducing changes to the system that are essential to ensuring that the franchise is successful in that particular country, or might unduly delay the introduction of modifications that have become necessary due to changes in circumstances. Specific terms of franchise agreements, such as the exclusive supply of products, are also to be included among the risk factors, as although they might offer certain guarantees at the beginning of the relationship (in the case of the exclusive supply of products they for example guarantee supplies), they might subsequently prevent the sub-franchisor from adopting an alternative that is more convenient to what is offered by the franchisor.

**i) Risk Factors to be considered by the Franchisor**

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

*(a) External Risk Factors*

Examples of external risk factors are the political situation in the prospective host country, 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.

*(b) Internal Risk Factors*

Internal risk factors include the organisational arrangements of the domestic operation of the franchisor and the financial and human resources available to it. If, for instance, the franchisor's system does not already have an office or unit able to handle the administration, training and control necessary in a master franchise arrangement, and which is also able to adapt its structure to the needs of the host country or countries, the franchisor will need to devote additional financial resources to the establishing of such an office or unit. The risk is that, if such factors are not taken into account, the international activities may create a heavy drain on the financial and staff resources of the franchisor,

thereby harming the domestic operations of the franchisor and ultimately also jeopardising its international activities.

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

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

***II. THE SELECTION OF A SUB-FRANCHISOR***

The selection of a competent sub-franchisor is of essence in master franchise arrangements. The master franchise relationship is one which is to last over time. It involves considerable investment on the part of both franchisor and sub-franchisor, often considerably more than first estimated, and it would be both difficult and expensive to correct any mistakes that are made by an incompetent sub-franchisor. The effects of selecting the wrong partner in terms both of the possible discrediting of the franchise system and of the loss of investment could therefore be devastating.

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

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

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

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

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

### ***IV. NEGOTIATING INTERNATIONAL AGREEMENTS***

Unit franchise agreements are at times identified with contracts of adhesion as franchisors tend to use standard agreements throughout their systems. The situation is different with master franchise agreements as these 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, national differences in terms of language, culture, traditions, religion, law, and economic and social development will be such as to make modifications to the franchise system

imperative if it is to be successful in the country of the sub-franchisor. A standard contract that has been tailor-made for use in one country is therefore unlikely to be suitable for another country. The importance of the negotiation process, in the course of which all the necessary modifications are agreed upon, is therefore considerably enhanced in the case of master franchise agreements, particularly in that of international master franchise arrangements.

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

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. In the case of franchising pre-contractual disclosure is of particular importance. This involves the franchisor supplying the prospective franchisee with information that will permit it to have at its disposal all the elements necessary to evaluate the franchise it is proposing to acquire. This duty is closely linked with the duty of good faith and fair dealing. It is regulated in a number of countries, although with a varying amount of detail,<sup>16</sup> whereas in others it may be deemed to be implied. Although disclosure is usually considered only from the point of view of the information that the franchisor has to provide, it is equally important that the sub-franchisor or franchisee provides the franchisor with the information that it needs to evaluate the prospective sub-franchisor or franchisee. The disclosure should therefore be mutual. Furthermore, for the benefit of the relationship it would be preferable for this exchange of information to become a regular feature of the relationship between the parties.

Whether or not pre-contractual disclosure is as important in a master franchise relationship as in a sub-franchise relationship or a simple unit franchise relationship is disputed. In many cases the sub-franchisor is, or belongs to, a substantially larger economic unit than the franchisor itself. In any event it will invariably have considerable business experience. It may therefore be assumed that the prospective sub-franchisor has taken all the necessary pre-contractual measures and has sought information on the franchisor 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 might be bound by any mandatory disclosure laws that might exist in the country concerned as these may apply also to master franchise relationships.

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<sup>16</sup> See Annex 3 to this Guide.

## V. *DRAFTING INTERNATIONAL FRANCHISE AGREEMENTS*

The master franchise relationship is often regulated by a number of documents in addition to the main master franchise agreement. These may include a manual for the sub-franchisor, an operations manual that the sub-franchisor is to provide the sub-franchisees with regarding the operation of the unit, reports and records to be furnished to the sub-franchisee, advertising guidelines, separate agreements regarding the licensing of the intellectual property and any other licence agreements.<sup>17</sup> In a number of countries these and similar issues are dealt with in the framework of the main master franchise agreement, whereas in others they will instead form the subject-matter of one or more separate agreements. The technique adopted will to a large extent depend upon the drafting techniques traditional in the country or countries concerned.<sup>18</sup>

In the case of international franchise agreements, as in that of any other international agreement, the question of the language and style in which the agreement should be drafted will be a matter of importance.<sup>19</sup> It is however not uncommon for franchisors to be reluctant to accept that their contracts may differ depending on the country in which they are operating. Franchisors will often prefer that with which they are familiar, be it the language of the agreements, the format in which the agreements are couched or the law that is to apply to them.<sup>20</sup> This is understandable, considering that franchisors operating internationally will often be active in a number of different countries and that their contracts would therefore need to be written in a considerable number of different languages and styles. This would naturally make it difficult for the franchisor and the franchisor's lawyers to maintain control over the operations. Regrettably, they do not always realise the considerable number of problems that they might run into if they insist on applying their own law, language and contract format. 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.

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

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17 For a number of collateral agreements, see Chapter 19 "Ancillary Documents".

18 See Chapter 19 "Ancillary Documents".

19 See Sections (a) and (b) below.

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

and the sub-franchisees, will instead conform to local requirements. Alternatively, the franchisor may draft the sub-franchise agreement in the first instance and have it reviewed by local counsel to ensure that it complies with local needs. It should however be pointed out that there is no clear-cut solution and that the situation in each country should be examined with the assistance of local counsel.

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

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

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

It may appear to be logical or normal for the sub-franchisor, 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, even if franchisors increasingly require a knowledge of their language to facilitate relations. Nor, if the sub-franchisor or its officers do 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 for all documentation, including manuals, to be also in the language of the sub-franchisor, so as to avoid misunderstandings or allegations of misrepresentation. The responsibility for the translation of the documentation may vary from case to case. In many instances it will be the sub-franchisor who will be required first to translate the documentation at its own expense and then to submit it back to the franchisor. In case

of discrepancy the franchisor's document will normally govern, on condition that this is enforceable in the country of the sub-franchisor.

The language requirements applicable to collateral or ancillary agreements will vary depending on the country and the type of agreement. Thus, for instance, 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 have 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 units. 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 that language. Furthermore, it might be necessary to vary the contents of the manual to take local requirements into account. A close collaboration between the franchisor and the sub-franchisor, who is usually best placed to determine the modifications that must be made to the manual to conform to local requirements, is therefore essential. Questions of copyright (who is to own the copyright to the modified manual) and of costs (who should pay for the translation and also for publishing or duplication) are best determined in the agreement between the franchisor and the sub-franchisor.

Changes in signage, menus, labelling, or advertising may be necessary in some markets but not in others as a result of

differences in language. It is also often necessary to translate and adapt the trademarks to the local market.

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

## **b) Drafting Technique**

The style in which contracts are drafted varies from family of legal systems to family of legal systems, sometimes even between countries within a family of legal systems, as a result of the specific requirements of each. These requirements are often the result of the historical development of the legal system concerned. Thus, the legal systems that, for example, are derived from, or have been 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 contracts is related to the way in which the legislation is drafted and to the procedure adopted by the courts in adjudicating disputes.

### **1) *Civil Law Legal Systems***

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

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

As a large number of issues are regulated by the legislative instruments, there is less need for the contracts to enter into great detail except where the parties feel that a certain amount of detail is necessary or desirable. This may particularly be the case where the parties want to give a precise indication of their agreed will to any court that may come to analyse the agreement in the future. This may be of considerable importance as courts will in some jurisdictions have the power to interpret contracts and to modify the terms of the agreement if they are considered to be 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 provisions of the codes will apply. Clearly, the mandatory provisions of the codes will always apply no matter what is laid down in the contract.

## ***2) The Common Law Legal Systems***

What first strikes a lawyer educated in the civil law tradition 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 has created a need for contracts to be extremely detailed so as to cover every possible contingency.

### **c) Drafting Alternatives**

A number of different drafting alternatives are possible. Which is the most suitable will depend on the jurisdiction in which the contract is to be implemented. The main alternatives are firstly, a comprehensive contract in the common law style, covering every

possible condition and event; secondly a written document containing references to other documents, such as ancillary 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 ancillary 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 may be written with a certain amount of detail, or may be extremely short, referring simply to the type of arbitration to be resorted to in case of dispute (for example, ICC arbitration).

## ***VI. INTERNATIONALISING THE FRANCHISE SYSTEM***

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

(a) the language of the documentation and of the agreement;<sup>21</sup>

(b) currency issues: the agreement should specify the currency in which payments are to be made. Special provisions may be required if the host country has currency restriction laws in place;<sup>22</sup>

(c) 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. 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;<sup>23</sup>

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21 See the discussion on language above, page 16 ff.

22 See Chapter 4.

23 See Chapter 4.

(d) 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;<sup>24</sup>

(e) cultural differences: many franchise systems adapt to differences in the cultures or tastes of different countries by developing country-specific products, flavours, or formulations;

(f) 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;<sup>25</sup>

(g) 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;<sup>26</sup> and

(h) 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.<sup>27</sup>

## ***VII. SUBSEQUENT CHANGES***

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

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24 See Chapter 10.

25 See Chapter 9.

26 See Annex 3.

27 See Chapter 17.

system in the course of the relationship as well as at the beginning, when the system is first adapted to local conditions.<sup>28</sup> 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. 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 franchisees in exchange for the introduction of the modifications.

Whether or not a proposed modification will be considered to be reasonable, or even feasible, will in part be conditioned by the cost of introducing it. 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 of whether or not the modification should be implemented throughout the system world-wide and, if this is to be the case, 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 change. This is the case when, for example, local suppliers are not able to comply with new product specifications.

Many changes introduced in a domestic franchise network may 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.

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<sup>28</sup> See Chapter 12 "System Changes".

## CHAPTER 2

# NATURE AND EXTENT OF RIGHTS GRANTED AND RELATIONSHIP OF THE PARTIES

The granting of the right to use the franchisor's franchise system is the cornerstone of the relationship between the franchisor and the franchisee. In master franchising the three-tier structure of the arrangement makes it necessary for both the master franchise agreement and each of the sub-franchise agreements to include a provision granting the rights concerned. These provisions are fundamentally similar, even if that of the master franchise agreement will, in addition to specifying the rights that the sub-franchisor itself is granted, delimit the rights that the sub-franchisor is authorised to grant the sub-franchisees.

The grant provision grants the sub-franchisor the right to expand the franchise system in the manner and within the limits provided for in the provision itself. It licences the sub-franchisor to use the specified assets of the franchisor. 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), and know-how. The grant provision thus typically defines:

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

## **A. WHAT IS GRANTED**

The franchisor will typically provide a sub-franchisor with know-how concerning the business, with a trademark licence and with any other intellectual property rights that are involved in the type of business concerned.<sup>1</sup> 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 the trademarks. The system includes all aspects of the business system that the franchisor has set up, including all the know-how that comprises the franchised business method and all the identifying characteristics. The trademarks are the words and symbols that identify the franchise system and distinguish it from others.

### ***I. SYSTEM***

The definition of the system will usually briefly describe the business that is the subject of the franchise, whereas the full details will normally be contained in an operations manual that gives instructions on the proper operation of the franchise; management techniques such as inventory controls, record keeping, personnel practices and purchasing; characteristics of the products; marketing or advertising methods; as well as whatever other aspects of the business are considered to form part of the system that the sub-franchisor is called upon to develop.<sup>2</sup> The definition will normally include:

- ◆ a description of the nature of the business, including the methods, procedures and techniques of operation, quality assurance techniques, distinctive and standardised designs for products, premises or facilities;
- ◆ a reference to the know-how that comprises the system;
- ◆ a reference to the trademarks, logos, trade names, trade dress and other identifying characteristics of the system;
- ◆ a description of key aspects of the business method that make it unique; and

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<sup>1</sup> See Chapters 10 "Intellectual Property" and 11 "Know-How and Trade Secrets".

<sup>2</sup> See Chapter 5, Section C "Manuals".

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

Depending on the nature of the franchise, the know-how transmitted 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. Most franchise systems adopt the business format approach, which involves virtually all aspects of doing business that might be important for the success of the franchise.<sup>3</sup> The know-how thus represents the ensemble of experience gained by the franchisor in the course of its activity as entrepreneur and as franchisor. It is this experience that the franchisor has used to develop procedures and methods that are effective for its type of business. The single elements of the know-how may not be unique, what is unique is instead the manner in which the different elements are combined and used. The single elements of this commercial know-how are therefore not protected, nor is it possible to protect them as they are freely accessible to all. It is only where the know-how is secret that it is possible to protect it and to proceed against anyone who has acquired the know-how by illegitimate means.

In a majority of franchise systems the know-how acquires great value by having been developed into a system which is identified by the distinguishing trademarks and by other proprietary assets. This value is further enhanced by the increasing number of uniform franchised units which contribute to the creation of the strong image and goodwill associated with a franchise system, particularly if it is large.

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

## ***II. TRADEMARKS***

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<sup>3</sup> See Annex 1, Section B "Business Format Franchising".

The franchisor will invariably own trademarks, or in some cases also service marks, that are associated with the system. The grant will include the rights to use, and if possible to sub-licence the use of, these trademarks.<sup>4</sup> In some countries it may be possible within the framework of trademark law to protect what is called "trade dress". Trade dress is the overall appearance of the franchised operations. This may also be protectable under unfair competition laws or, in common law countries, by passing off actions.

### ***III. OTHER INTELLECTUAL PROPERTY RIGHTS***

There are other intellectual property rights that may be involved, of which the principal one is copyright. Copyright extends to a wide range of material that may be used within a franchise system. Examples would include menu cards, advertising materials, operations manuals and software.<sup>5</sup> Specific design or other design rights that might be capable of registration may also be available. Where a patented product is involved, consideration may have to be given to whether a licence to exploit it is necessary.

## **B. HOW THE LICENSED ASSETS MAY BE USED**

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

When the master franchise agreement grants the sub-franchisor the right to develop and operate its own franchise units, the franchisor and the sub-franchisor may conclude a separate unit franchise agreement for each of those units. In this

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<sup>4</sup> See, in particular, Chapter 10, Section A, Sub-Section VI "Sub-Licensing of Trademark".

<sup>5</sup> See Chapter 10, *cit.*

case the master franchise agreement will be able to focus on the sub-franchisor's role as sub-franchisor, without having to include clauses that relate to the opening and operation of the single units.

A disadvantage of requiring separate unit franchise agreements is that each unit agreement is an international agreement and will therefore be subject to any regulations and requirements applicable to international licence agreements in the countries concerned. Compliance with such regulations and requirements is often time-consuming and expensive. On the other hand, separate unit franchise agreements can provide sub-franchisors with a flexibility and independence that will enable them to operate much more efficiently in the area they are to develop. Whether or not a separate unit franchise agreement should be required must be decided on a case-by-case basis.

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).<sup>6</sup> In such cases the sub-franchisor 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.

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.

### **C. WHERE THE RIGHTS MAY BE EMPLOYED**

The geographic territory in which the sub-franchisor may engage in the franchised business is defined in the grant clause.

The franchisor has an interest in limiting the territory to a size which can realistically be developed and managed by the sub-

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<sup>6</sup> See Chapter 6, Section A "Pilot Operations".

franchisor. If the territory is too large, parts of it will not be properly developed because the sub-franchisor will not have the personnel or financial resources necessary to do so.

The sub-franchisor often insists on a territory that is larger than its current resources can support, as it wishes to be able in the future to capitalise on the success of its experiences. This desire is often tempered by the franchisor's expectation of a large initial up-front payment for the expanded territory.

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

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

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

#### **D. EXCLUSIVITY V. NON-EXCLUSIVITY**

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

In this connection it is naturally particularly important for the sub-franchisor to be aware of any limitations in its right to use the trademarks or the franchise system, as these form the essence of the franchise. Furthermore, if the sub-franchisor is granted any type of territorial protection, it is important for the conditions of such protection to be clearly set out. It might moreover be useful if the agreement were to deal expressly with a number of rights that the franchisor may reserve for itself and that

often become points of contention. These include:

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

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

The grant clause will specify the extent to which the rights granted to the sub-franchisor are to be considered exclusive. Exclusivity can mean different things. It can mean that the sub-franchisor is granted the exclusive right to franchise in the territory, which would not exclude the franchisor from operating its own outlets, but it can also mean that the franchisor is excluded from doing just that. There are three basic categories of persons other than the sub-franchisor who may be granted the right to use some or all of the licensed assets in the licensed territory: the franchisor itself; other sub-franchisors or unit franchisees; and other persons who may be authorised to use some of the licensed assets in the territory, but not as part of a franchised business. Agreement has to be reached on what the exclusivity will relate to, on whether it will prevent the franchisor from using or exploiting other marketing methods, such as the setting up of competing networks.

As indicated above, the franchisor may propose reserving the right to sell certain products associated with the franchise system through third persons not operating within the franchise network. A certain product may, for example, be offered through retail outlets such as supermarkets or the shop around the corner, or by means such as catalogue and Internet sales. The franchisor may hope to increase its market penetration by providing for product distribution by these, and many other, alternative means. This may cause problems for the sub-franchisor and sub-franchisees, in that while the total quantity of franchised products sold in their territory might increase, the sales made through the franchised units may actually be reduced as a result of the alternative methods.

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

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

### **E. THE THREE-TIERED STRUCTURE OF MASTER FRANCHISE ARRANGEMENTS**

The granting of rights is further complicated by the realities of master franchising. The three tiers of master franchise arrangements are logically inter-dependent, anything that affects one level also affects the other two. In structuring the

master franchise relationship, the franchisor and sub-franchisor will therefore need to have regard also to the needs of the sub-franchisees.

The scope of the rights granted 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. The extent of freedom a sub-franchisor will have when converting a system for its own needs is one of the controversial points.

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 agreement and system standards serve as the basic elements in the sub-franchise relationship in the foreign country. Under the typical international master franchise agreement, the franchisor will provide the sub-franchisor with copies of its domestic franchise agreement and systems standards manual. The sub-franchisor will be required to convert the franchise agreement into a form sub-franchise agreement that is appropriate for its sub-franchisees, to make sure that the documents meet local legal requirements, to modify the documents so as to make them consistent with local custom and to translate them into the local language.

The master franchise agreement may also provide that the franchisor's prior consent or approval must be obtained regarding various matters relating to the sub-franchisor's relationship with its sub-franchisees, to the terms of each sub-franchise agreement and/or relating to the sub-franchisees' operation of the local sub-franchised units.<sup>7</sup> The master franchise agreement may, for example, require that the sub-franchisor obtain the franchisor's approval of each prospective sub-

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<sup>7</sup> See Chapter 5 "The Role of the Franchisor".

franchisee and of each transfer of the sub-franchised business to a new sub-franchisee. The master franchise agreement may further require the franchisor's approval of the terms of each sub-franchise agreement, especially if there are deviations from the standard form agreement previously approved by the franchisor. The sub-franchisee's site selection, site plans and drawings and mark usage are other areas for which the master franchise agreement may require the franchisor's approval.

It may however not be practical for the franchisor to control these aspects of a sub-franchise in another country, even if it does control such matters in relation to its domestic franchisees. This may be due to the administrative costs, time delays and/or cultural differences involved. There may furthermore be liability implications, as the nature of the relationship between the franchisor and the sub-franchisor may be considered to have changed if the franchisor retains such extensive rights of control. The two might in other words no longer be considered to be two independent entrepreneurs, but two branches of the same entity. It will therefore in all probability be more practical for the franchisor to leave these approval responsibilities to the sub-franchisor. If, however, the franchisor does not wish to grant full discretion to the sub-franchisor in this regard, it may in the master franchise agreement establish minimum criteria to be used by the sub-franchisor. Alternatively, the franchisor may retain responsibility for the approval process, but provide in the master franchise agreement that it may delegate such responsibility to the sub-franchisor in writing once the sub-franchisor has demonstrated its ability to exercise such discretion to the satisfaction of the franchisor. If the franchisor insists on retaining approval responsibility for some matters relating to the sub-franchised business, the franchisor and sub-franchisor should establish the procedures of the approval process in such a manner that the sub-franchised business is not unduly hampered. It may, for example, be appropriate if certain matters submitted to the franchisor for approval are deemed to have been approved if the franchisor does not object within a certain specified period of time after submission.

Master franchise agreements will usually require the sub-franchisor to comply with all regulatory requirements applicable to the offering and sale of franchises in the host country.<sup>8</sup> 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.

The master franchise agreement may require the sub-franchisor to grant franchises to prospective sub-franchisees identified by the franchisor. If development requirements are imposed on the sub-franchisor, then the master franchise agreement should indicate whether sub-franchisees identified by the franchisor are to be additional to those identified by the sub-franchisor, or whether they should be understood as forming part of the number required of the sub-franchisor by the development schedule.

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

If a franchisor intends to benefit from certain provisions in the sub-franchise agreements, it should consider requiring that it be expressly recognised as a third party beneficiary under the agreements, if this is permissible under the applicable law. Thus, for example, the indemnification provisions in the sub-franchise agreements may be drafted so as to expressly include the franchisor as a beneficiary of the indemnity, and the insurance provisions may also require the franchisor to be named as an additional insured in the sub-franchisee's insurance policies.<sup>9</sup>

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<sup>8</sup> See Chapter 20 "Regulatory Requirements".

<sup>9</sup> See Chapter 14 "Vicarious Liability, Indemnification and Insurance".

## F. DIRECT CONTRACTUAL RELATIONS

Although under the typical master franchise arrangement there is no direct contractual relationship between a franchisor and a sub-franchisee, there may 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.

The laws of some jurisdictions may, for example, not offer sufficient protection to franchisors who transfer technology or other intellectual property unless there is a direct contractual relationship between the owner of the intellectual property (the franchisor) and the user (the sub-franchisee). Other jurisdictions may not recognise the sub-licensing of intellectual property rights, which is a key element in master franchise arrangements. In those jurisdictions the franchisor will usually insist on establishing a direct contractual relationship with the sub-franchisees, even if only in relation to those particular rights.

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 enforcement of intellectual property rights. A direct contractual relationship between the franchisor and the sub-franchisees may, however, be considered even when it is not necessary for the protection of the franchisor's intellectual property, as this would increase the franchisor's ability itself to control the sub-franchisees and to enforce the provisions of the sub-franchise agreements, thus reducing its need to rely on the sub-franchisor to do so. This may be especially important in jurisdictions that do not recognise a third party beneficiary's right to enforce a contract for its benefit. Direct contractual relationships may also have the result that the franchisor will to some extent be involved in local operational matters and that it will provide some support and assistance directly to the sub-franchisees. It should however be pointed out that the consequences of direct contractual relationships may also include the endangering of the independent status of the parties and consequently an increased risk of legal liability for the

franchisor, both as to claims by sub-franchisees for non-performance and as to local legal matters affecting the sub-franchised businesses.

In the case of master franchise arrangements, direct contractual relationships are commonly created in either one of two ways. Firstly, the parties may combine the master franchise agreement and the sub-franchise agreement into a single, tripartite franchise agreement between the franchisor, the sub-franchisor and the sub-franchisee, under which the franchisor grants the sub-franchisor the right to sell and service the sub-franchisee, the sub-franchisor sells a sub-franchise to the sub-franchisee and the franchisor directly licences the sub-franchisee to use the intellectual property concerned. In this case a separate tripartite agreement will be necessary for each sub-franchise granted.

Secondly, and more commonly, the franchisor and the sub-franchisee enter into a licence agreement under which the franchisor grants the sub-franchisee a licence to use the intellectual property in connection with the operation of the sub-franchised business. This licence agreement is separate from the master franchise agreement between the franchisor and the sub-franchisor and from the sub-franchise agreement between the sub-franchisor and the sub-franchisee. In this case the sub-franchisee is required to execute the licence agreement as a condition for entering into the sub-franchise agreement with the sub-franchisor and both agreements typically include cross-default provisions.

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. In these cases the sub-franchisor will perform the services necessary to licence the franchisor's intellectual property to the sub-franchisees on behalf of the franchisor.

Even in jurisdictions where a separate licence agreement is not initially needed, franchisors will often include an express provision in the master franchise agreement reserving the right to

enter into direct licence agreements with the sub-franchisees if they determine that the lack of direct contractual relations presents a risk to their intellectual property. In such cases this option should be reflected in the sub-franchise agreement.

The direct relationship between the franchisor and the sub-franchisees may in some cases extend beyond what is necessary for the protection of trademark rights, in that franchisors may at times retain the right to inspect the premises of each sub-franchised unit, as well as each unit's accounting books and records.

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

## **CHAPTER 3**

# **TERM OF THE AGREEMENT AND CONDITIONS OF RENEWAL**

### **A. LENGTH OF THE TERM OF THE AGREEMENT**

Lengthy initial terms of duration are common in the case of master franchise agreements. Terms of twenty years or more are not unknown, nor are options granting the sub-franchisor the right to renew the master franchise agreement for a further term of twenty years. Successive options to renew the agreement for twenty years each may also be provided for.

In a number of countries the maximum or minimum terms of agreements are fixed by law or by judicial precedent and any such limitation will naturally apply also to master franchise agreements. In others, a limitation of the term of a franchise agreement which may result from any other applicable legislation, may apply also to master franchise agreements. A limitation in rights must at times be added to this limitation in duration, in that at the end of the term of the master franchise agreement it may not always be possible for the franchisor to protect its know-how, as this may be deemed to have become the property of the sub-franchisor.

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

#### ***I. LONG TERMS***

An argument in favour of lengthy terms for master franchise agreements is the fact that central to the master franchise arrangement is the granting of the right to sub-franchise to the sub-franchisor. Insofar as the expiration of the term of the master

franchise agreement may by operation of law result in the termination of the sub-franchise agreements, expiration will impact directly not only on the relationship between the franchisor and the sub-franchisor, but also on the future of all sub-franchisees, none of whom is a party to the master franchise agreement. It should also be pointed out that it is generally accepted good practice for an adequately long term to be granted, so as to enable the sub-franchisor to get a return on its investment and to motivate the sub-franchisor to develop the territory fully. The considerable investment that is required of the sub-franchisor in establishing the franchise network would thus argue against applying shorter terms to master franchise agreements.

In addition, in a number of countries, especially developing countries, in which approval of agreements by the competent authorities is required, long-term arrangements may be viewed favourably by those authorities and may indeed result in tax concessions.

## ***II. SHORT TERMS***

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

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.

## **B. CONDITIONS OF RENEWAL**

The renewal of the term of the master franchise agreement, if renewal is possible, is typically subject to the fulfilment of certain conditions. These

conditions include a number or all of the following:

(a) that the sub-franchisor is not in default of a material obligation at the time of renewal, independently of whether or not such default has been cured, and that the sub-franchisor substantially observed and performed its obligations during the term of the master franchise agreement;

(b) that the sub-franchisor does not have any monetary default at the time of renewal;

(c) that the sub-franchisor sign a general release of any claims that it may have against the franchisor; and

(d) that the sub-franchisor inform the franchisor of its intention to renew the agreement in the prescribed manner and within a set period of time prior to the expiration of the term of the master franchise agreement.

A condition for the renewal of a domestic franchise agreement will often be that the franchisee accept to enter into the franchise agreement of the franchisor that is current at the time of renewal. More than a renewal of the agreement, it will in other words be a matter of entering in to a new agreement, even if the franchisee may be granted a certain preferential treatment, in that it may not have to pay a second initial fee. Franchisors who base themselves on their domestic experience may therefore not only insist that the term of the master franchise be of short duration, they may also insist that the sub-franchisor be given the right to renew the agreement for an additional term or terms only on condition that it enter into the franchisor's then current form of international master franchise agreement. In an international situation, however, the agreement current at the time of renewal will almost by definition not be the agreement then offered in that particular territory, as it is unlikely that there will be more than one master franchise arrangement in any territory, but will be the agreement offered somewhere else in the world.

While there are considerable advantages in requiring the adoption of the agreement current at the time of renewal in terms of maintaining the uniformity of a franchise system, this may

create certain problems in the case of international franchise agreements. Rights are granted to sub-franchisees on the basis of the first contract and this makes it difficult to adopt another agreement in case of renewal. 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 may therefore impact on existing unit franchise agreements. International master franchise agreements are furthermore typically negotiated, with the consequence that it might not be realistic to require that the sub-franchisor upon renewal enter into the franchisor's then current form of international master franchise agreement.

There are furthermore situations in which particular provisions are certain to remain unchanged, such as those relating to the continuing fees or the territory. What is increasingly common internationally is, in fact, the giving of guarantees that certain fundamental items will not be changed under any circumstance.

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 the sub-franchisees to maintain, renovate and remodel the individual franchise premises they operate. Although these conditions are sometimes included in the master franchise agreement, a number of them, for example the obligation referring to maintenance and renovations, are best left to each individual unit sub-franchise agreement.

### **C. NEGOTIATIONS FOR RENEWAL OF THE AGREEMENT**

The remark that customs vary from country to country and from region to region may be considered commonplace, but it is nevertheless relevant. It is therefore important to remember that what is considered to be a good custom in a particular cultural setting may not be appropriate in another. This applies also to the

type of provisions that are included in agreements, not the least to those relating to the negotiations for the renewal of the agreement.

# CHAPTER 4

## FINANCIAL MATTERS

### A. WHAT PROVIDES INCOME?

In the final analysis the franchisor, sub-franchisor and sub-franchisees derive income from the sales generated by the franchised units. This income will ultimately have to be shared between all the levels in the system according to their respective contributions and costs. The difference between the income, or selling price of the products and/or services, and the costs constitutes the profits.

Franchise fees, whichever way they are to be calculated, can only be paid if the franchised units are successful. If it is estimated that the profitability of the units to be established in a prospective host country or market would not be sufficient, the question immediately arises of whether the franchise operator would be able to succeed in that market place without substantial restructuring, or even whether it would succeed at all. It cannot be assumed that margins and profitability will necessarily be the same in each and every market, particularly in view of the large number of potentially variable factors that are involved, such as, for example, product costs, rental and other costs and the existence of competing products and services that affect the pricing structure.

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.

### B. THE SOURCES OF INCOME OF THE FRANCHISOR

#### *I. INITIAL MASTER FRANCHISE FEES*

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

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 may result in a breakdown of the relationship or in the re-negotiation of the financial provisions. It is sensible to make the effort to agree on a realistic financial structure in the initial negotiations.

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

- ◆ the actual cost to the franchisor of dealing with the sub-franchisor: training, offering assistance in the setting up of the sub-franchisor's business and working to prove that the concept works within the host country;
- ◆ the cost and time it would take the sub-franchisor to acquire the requisite know-how and skills to operate and franchise a similar business in its territory;
- ◆ the value of the territory as estimated by the franchisor: franchisors tend to calculate the value of a territory by comparing the population numbers of that territory with those of a similar sized area in their own country and by relating the population numbers to what they earned as initial franchise fees for the area in their own country. There is a difference that must be taken into account in making this comparison and that is the fact that in many countries the franchisor's name will be less well known than in those in which it has already established a network. There will therefore be no guarantee that the franchisor's concept and system will operate to the same level of effectiveness.

Consequently, there is a risk that such comparisons by franchisors may not produce realistic and economically sound results;

- ◆ the estimated total amount of initial franchise fees that the sub-franchisor can charge its sub-franchisees in the prospective host country; and
- ◆ the fact that the franchisor has developed a system in its own country that has proved to be successful. This has a value, as the experience thus gained should enable the franchisor to swiftly produce an effective business system within the host country. The means to accomplish this are pilot testing and the introduction of any specific variations that may be advisable.

Franchisors based in countries where high initial fees are charged to franchisees tend to have high expectations as to the value of a territory and the estimated total amount of initial franchise fees that they may charge. They may therefore ask for more than may be realistic in the prospective host country.

It is important to emphasise that there are no precise guidelines laying down what fees should be. All fees are negotiated. The different methods used to calculate fees 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. It may be observed that as it is the sub-franchisor who is in the best position to make a realistic evaluation of the financial possibilities of the system in the territory it has been given the right to develop, it is on the sub-franchisor that the heaviest burden is placed to ensure that the fees it is required to pay are realistic.

Tax considerations and legal issues come into play when the decision of how to structure the fees is taken. There are many innovative ways in which to structure the fees. For example, some franchisors may credit all or part of the initial master franchise fees as prepayment of unit fees. In other words, as each unit is opened the payment which would otherwise be due is reduced by the franchisor applying a "credit" from the amount paid as an initial master franchise fee. Local laws should be taken into careful consideration as they very often have an impact on levels of payment, they may indeed govern the basis upon which

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

## ***II. CONTINUING FRANCHISE FEES***

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

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

chisor's income from the continuing franchise fees it receives from its sub-franchisees. Every prospective sub-franchisor should prepare a business plan. It is essential for the sub-franchisor carefully to prepare cash-flow and profit forecasts as part of this business plan, so that it is in a position fully to appreciate the impact of the payment of continuing franchise fees on its profitability.

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

- ◆ fees related to numbers of products sold;
- ◆ fees calculated as a percentage of purchases as opposed to sales;
- ◆ fixed fees;
- ◆ sliding scales where, for example, there is a charge of X% up to a certain level and thereafter an increasing or decreasing percentage;
- ◆ a fixed minimum fee coupled with fees based upon a percentage of gross income;
- ◆ and
- ◆ a fixed maximum fee above which the continuing fees will not rise.

There are franchisors who supply products to sub-franchisors for onward sale to sub-franchisees. These sub-franchisees will charge a mark up on the sale of the products to the consumers. In a significant number of cases there will also be a continuing franchise fee to pay in addition to the product mark up.

### **C. THE SOURCES OF INCOME AVAILABLE TO SUB-FRANCHISORS**

The ability of the sub-franchisor to make payments to the franchisor will depend upon two factors: the income it is able to generate from its sub-franchisees and that which it is able to generate from the units it operates itself. This income represents the gross income of the sub-franchisor and it is out of this gross income that the sub-franchisor will be required to finance its

activities as “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 labour. So as to permit the sub-franchisor to gain sufficient experience in the operation of units and with a view to rendering them as profitable as possible, master franchise agreements will often require sub-franchisors to open units themselves before they sub-franchise.

A sub-franchisor will be able to obtain its income from the sources listed below.

### ***I. INITIAL AND CONTINUING FEES***

- (i) by charging sub-franchisees an initial fee on entering into the franchise agreement. This fee may be presented to the sub-franchisee in a number of different ways:
  - ◆ it may be a fee for joining the franchise network; or
  - ◆ 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;
- (ii) by receiving on-going income from the sub-franchisee’s activities:
  - ◆ by making a profit on the sale to the sub-franchisee of the products that are sold by the sub-franchisee in the course of its business, or that are used by the sub-franchisee in the provision of services to its customers;
  - ◆ by charging a continuing franchise fee 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. For a variety of reasons franchisors may furthermore wish to establish the payment of the continuing fees on a sliding scale. It should be observed that although there may be some royalty element in these continuing fees, it is not correct to describe them as royalties, as they invariably are paid in return for services. Royalties are instead normally regarded as passive income for the use of a

property right, for instance for the use of copyright material or trademarks. In view of the fact that payment of royalties is likely to be treated differently by tax authorities from payments for services, this source of income needs to be carefully considered and dealt with appropriately in the contractual documents. Whether or not these payments are subject to withholding tax should also be examined;

- ◆ in some franchise systems the continuing franchise fees may be lump sum payments, such as a fixed amount in the local currency, which are not related to 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 the financial compensation it receives in return decreasing in value. Furthermore, its income will not increase as sub-franchisees become more successful and increase their gross incomes and it will find it difficult to expand and improve the range of services that it provides.<sup>1</sup>

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

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

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<sup>1</sup> See Chapter 9 "Supply of Equipment, Products and Services".

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

## ***II. PRODUCT MARK UPS***

Mark ups may be defined as an increase in the sales price of the products which is made by adding overhead expenses and a certain margin of profit to the costs. Manufacturers and wholesalers will normally charge on the basis of mark ups and in many instances the franchisor and/or the sub-franchisor have the role of manufacturer and/or wholesaler. The franchisor, whether manufacturer or wholesaler, may thus "mark up" the products to provide an income. The sub-franchisor will in turn mark up the price at which it sells the products to the sub-franchisees and the sub-franchisees may mark up the product for resale to the consumer, in order to provide the necessary gross margins that are the foundation of the sub-franchisee's profitable activities. It is the possibility of variation in the mark ups made by the franchisor and the sub-franchisor which can have an impact on the financial capabilities of the sub-franchisee. The same applies to other equipment that is necessary for the operation of the franchise and is supplied by the franchisor. It is therefore necessary to ensure that the sub-franchisee is protected against unreasonable price increases that would affect its ability to operate with sufficient profitability to meet all its commitments and to earn enough for itself.

In the context of the sale of products and mark ups the possibility of a conflict with competition law regulations should be considered, as the applicable competition law may limit the right of the franchisor to require that specific products be acquired. If this right is limited, also the possibility of gaining on mark ups might be affected.

In the early days of a franchise system the initial fee payments provide a significant proportion of the franchisor's income. This proportion may gradually be reduced, as the

network grows and as the continuing franchise fees paid by a growing number of franchisees produces an increasingly significant flow of income. This occurs because the volume of initial fees is related to the number of units that are opened and as the network grows the rate at which units are opened tends to slow down.

In 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.

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

### ***III. 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 it will supply 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. Here again, competition law aspects need to be considered.

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

franchisor or the sub-franchisor arrange to receive these payments for their benefit, they should not make a secret of it but should disclose it to the sub-franchisees. Any operative franchise disclosure law, as well as applicable competition law, should be examined in this context to determine whether or not such a relationship is covered by this legislation. In addition to offering these benefits, manufacturers and suppliers will sometimes contribute to advertising, marketing and promotional activities, both nationally and at the different points of sale.<sup>2</sup>

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 a service.

#### **D. CALCULATION OF PAYMENTS AND PROCEDURES**

The method adopted for the actual making of the payment of continuing fees should be in line with the way in which the sub-franchisor deals with its sub-franchisees. If, for example, the sub-franchisees pay their fees by the tenth day of every month, an obligation placed on the sub-franchisor to make payments at the same time and in respect of the same period would be impossible for it to meet. A sub-franchisor will need the time to collect the information and the funds to enable it to make the required reports and accounting to the franchisor. The payment periods and accounting periods at both levels must take this essentially practical issue into account.

Another issue that frequently arises is whether the sub-franchisor should be obliged to pay franchise fees to the franchisor even if it has not been paid by its sub-franchisees. This is an issue for negotiation between the parties, but the franchisor may be reluctant to share the sub-franchisor's credit risks. It is usual for a provision to be included in the contract requiring the sub-franchisor to ensure that sub-franchisees observe and

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<sup>2</sup> See Chapter 8 "Advertising and the Control of Advertising".

perform the terms of the 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-franchisor properly supervising its 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, it will probably not be submitting returns of sales, which in turn will make it impossible to know what should be remitted. It is therefore important to deal with these issues in the agreement.

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

The franchisor will invariably stipulate the currency in which payment is to be made. Franchisors usually prefer payment in their own currency, although a third currency will sometimes be agreed upon. It is necessary to establish in the agreement a date for conversion and it is also sensible to identify which bank's quoted rate will be used for conversion on the date of payment, as well as who should bear the cost of the conversion and of the transfer. The agreement should also establish the alternative action to be taken if the currency conversion cannot take place as a result of exchange controls. In view of the long-term nature of master franchise agreements, provisions are often inserted into the agreement to allow for the possibility that exchange controls

may be introduced in the future. A drastic solution which is at times envisaged in agreements is a reservation of the right to terminate on the part of the franchisor if currency restrictions are imposed and payments cannot be made. Where exchange control permission is required it should be ascertained whether it is the franchisor or the sub-franchisor who has the responsibility to make the application. In any event, both parties should agree to co-operate in any application that is to be made.

## **E. FISCAL CONSIDERATIONS**

The agreement should deal with the way in which payments will be treated and characterised for tax purposes in both the franchisor's country and the host country. It is by no means certain that the initial fee will be regarded as free of withholding tax by the taxation authorities of the country of payment. The franchisor could therefore find that the initial fee is subject to withholding tax. Furthermore, the definition of "royalty payments" should be examined. Any double taxation treaty should be taken into consideration to ensure that the franchisor may, if it so wishes, receive payments free of withholding tax. The agreement should enable the franchisor to obtain the benefit of any double taxation treaty by ensuring that the evidence of payment in the host country is provided in the form required for the relief to be claimed. Any applicable double taxation treaty should be examined for its full effect on the fiscal consequences of the transaction and on the way in which it is structured. Franchisees should seek to avoid being liable for the payment of tax more than once for any one 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 a business activity of the franchisor in that country.

Some franchisors insert what are known as "grossing-up" provisions in their contracts. These provide that if tax is deductible, effectively it has to be borne by the sub-franchisor who must increase its payment to the franchisor so that the franchisor receives net the amount it would have received had there been

no tax deduction. The effect of such provisions is to increase the level of fees payable by the sub-franchisor, as it is effectively paying the franchisor's tax liability on the payments that are remitted to it. This cost is not recoverable from the franchise network. The sub-franchisor should check its projections and cash-flow forecasts if it feels obliged to accept such a provision, so as to ensure that the additional burden does not make the financial proposition unacceptable.

Finally, it should be noted that the laws of some countries will impose a withholding tax on advertising fees paid by a sub-franchisor to a foreign franchisor. In such cases the franchisor will experience no serious consequences when, as often occurs, the laws of the country in which the franchisor is receiving such remittances provide for a foreign tax credit for the amount of the foreign withholding. There will only be a problem if the franchisor is not able to obtain a tax credit in its own country. If it is unable to do so, the effect will be to reduce the funds available for advertising expenditure.<sup>3</sup>

It should also be noted that some of the payments may be regarded as capital and others as revenue for tax purposes and their separate identification may assist in dealings with the tax authorities.

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<sup>3</sup> See Chapter 8, Section C "Financial Considerations", which includes the treatment of advertising fees or contributions.

## CHAPTER 5

### THE ROLE OF THE FRANCHISOR

In a master franchise relationship it is the sub-franchisor that is mainly responsible for both the introduction of the franchise system into the host country and the subsequent development of the franchise network. The role of the franchisor in this process should however not be underestimated.

Although the sub-franchisor is an experienced entrepreneur in its own right, it is not necessarily experienced in the particular business of the franchise. Moreover, the marketing techniques and other know-how used in the franchise have been developed and tested by the franchisor. For the sub-franchisor to be able to operate effectively, it is therefore necessary for the franchisor to transmit to the sub-franchisor the know-how it has acquired, often as a result of many years' experience, and to assist it in introducing and developing the franchise system. In other words, the franchisor has a number of obligations to fulfil *vis-à-vis* the sub-franchisor and through the sub-franchisor to the network. On the other hand, the sub-franchisor also has obligations *vis-à-vis* the franchisor and the network, in that it must follow the operating techniques and methods established by the franchisor, and it must ensure that its sub-franchisees do the same. There is thus a natural tension between the parties, on the one hand in relation to the extent of the franchisor's obligations and the corresponding rights of the sub-franchisor and, on the other, in relation to the sub-franchisor's obligations and the corresponding rights of the franchisor.

This tension begins with the system itself and with the right or duty to adapt the system to local requirements. A franchisor very naturally considers its system to be unique and wishes it to be used and applied with as few modifications as possible. The franchisor also has a natural tendency to believe that all the elements of its system are self-evident and that its manual and

training courses are so well prepared that the sub-franchisor will not need all that much help to introduce and use the system properly in the host country. The sub-franchisor, on the other hand, just as naturally wishes to have as much freedom as possible to adapt the system to the requirements of the territory it has to develop. It also very understandably wishes to receive a substantial amount of initial and ongoing assistance from the franchisor. These contrasting interests have to be balanced in the negotiations between the parties. The franchisor must be certain that it is able perform what it undertakes to do and the sub-franchisor must ensure that it receives the minimum of what it needs to be successful.

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

Master franchise agreements will list the obligations of the franchisor. Whether they contain a short list of a few basic obligations, or a detailed enumeration of all conceivable duties

that a franchisor might undertake, will ultimately depend on contract drafting style,<sup>1</sup> on the commercial maturity of the system and on the bargaining power of the parties, even if a standard contract prepared by the franchisor will often form the basis of the negotiations. Local customs and laws will also be of relevance in this connection. It may however be observed that parties are well advised to avoid using a wording that is so vague that it is not possible to understand what the precise duties of the franchisor are, or to make long lists in an attempt to be exhaustive, as this might give rise to hopes that realistically the franchisor will not be able to meet.

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

## **A. OBLIGATION TO PROVIDE INFORMATION**

### ***I. INITIAL INFORMATION***

Once the master franchise agreement has been signed, the franchisor typically provides the sub-franchisor with all the information regarding the franchise system that it might need to adapt it to the conditions of the local market and to start the business. The sub-franchisor will itself have the knowledge of local requirements necessary for an evaluation of what modifications are advisable. In this respect the experience it gains at the pilot operation stage will be of considerable importance. In particular, the franchisor should provide the information that the sub-franchisor is required to transmit to its potential sub-franchisees, either to comply with legal requirements or for business reasons. The information that concerns the franchise system and its

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<sup>1</sup> On the question of drafting style, see Chapter 1, Section B, Sub-Section V "Drafting International Franchise Agreements", in particular *lit.* (b) "Drafting Technique".

operation is usually transmitted by means of initial training<sup>2</sup> and operations manuals.<sup>3</sup>

Other information that the sub-franchisor usually needs, and that some agreements might expressly indicate as it being a duty of the franchisor to provide, includes:

- ◆ the technical characteristics or chemical composition of products that are to be imported into the host country and that may have to be adapted if any required permits are to be obtained, or the importation or use of which may require authorisation and/or registration by the local authorities. It is naturally important to ensure that such products can be sold in the host country and it should be clear whose duty it is to obtain approval or registration of the products concerned;
- ◆ information on the economic and legal conditions of the local market. The franchisor will often have gathered this information before entering into negotiations with the sub-franchisor. It will include information relating to the subject-matter of the franchise, the availability of raw material and the legal requirements that affect the capacity to sell the franchise.

## ***II. ONGOING INFORMATION***

The agreement will normally include an ongoing obligation of the franchisor to regularly provide the sub-franchisor with information on relevant developments of, and improvements to, the system, <sup>4</sup> as well as on events in the (possibly world-wide) network. Whenever improvements are made to the system, or modifications are made to the know-how, information in relation thereto will be transmitted in the form of an up-dating of the manuals. Modern means of communication, such as electronic mail, may also be used to transmit information, in particular information that relates to events in the network.

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<sup>2</sup> See below, Section B "Training".

<sup>3</sup> See below, Section C "Manuals".

<sup>4</sup> See Chapter 12 "System Changes".

## B. TRAINING

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

### I. INITIAL TRAINING

Ideally, the initial training and the studying of the manuals should permit the sub-franchisor to acquire all the elements of the franchise system, in particular the franchisor's know-how,<sup>5</sup> that will enable it to run a franchise unit. More importantly, the initial training should give the sub-franchisor all the basic elements necessary for the establishment and administration of a franchise network, including what is required for the marketing and sale of the sub-franchise units and the actual running of the network, i.e. all that is necessary for it to be able to act as "franchisor" in its own country. Where appropriate, the franchisor should furthermore teach specific skills, such as, for example, the use of a particular computer software or the handling of sophisticated machines. The providing of this initial training is not an easy task. Many franchisors therefore require sub-franchisors to attend the training courses that they offer in their own country and training school. It should however be observed that the level of tuition offered by franchisors will vary. In any event, in the relatively short period of time that the initial training lasts, the sub-franchisor will not be able to acquire all the skills and know-how that the franchisor has developed and that are the result of the experience of many years. It would therefore be advisable for this know-how to be written down in a "sub-franchisor's manual".<sup>6</sup> The initial training should also enable the sub-franchisor to train its future sub-franchisees. In this connection consideration should be

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<sup>5</sup> See Chapter 11 "Know-How and Trade Secrets".

<sup>6</sup> See below, Section C, *cit.*

given to whether the franchisor should teach the sub-franchisor how to establish training facilities.

Training may be provided to the sub-franchisor in person, to delegated managers or to any other representatives of the sub-franchisor that are responsible for the actual running of the master franchise operation. The franchisor may also undertake to train the sub-franchisees and may require that this training take place at its training facilities.

The initial training of the sub-franchisor, and subsequently of the sub-franchisees, is a fundamental condition for the successful operation of a franchise network. Its importance should therefore be reflected in the master franchise agreement, which should clearly indicate how long this training will last, where it will take place, in what language it will be conducted and what its component parts will be. The possibility of introducing changes in this respect, for example a change in the venue of a course, should be provided for. In this connection it should be observed that, depending on the franchise, the initial training may extend for a certain period of time after the beginning of the operations. The contract should also state clearly who is to bear the costs involved: in most cases the initial training will be covered by the initial franchise fee, but the cost of travel, accommodation and other expenses related to the training are usually to be borne by the sub-franchisor. In view of the fact that the initial training is the basis for the future activities of the sub-franchisor, it is advisable for the franchisor to ensure that language barriers do not obstruct the success of the training. This is equally important where the franchisor undertakes to train the sub-franchisees.

## ***II. ONGOING TRAINING***

In most cases it is advisable for additional training programmes for the sub-franchisor and/or its representatives to be held regularly in the course of the relationship. The purpose of such ongoing training programmes is to keep the sub-franchisor up to date with developments of, and improvements to, the franchise system. As these additional training programmes in most instances are held on the premises or at the training facilities of

the franchisor, they permit a regular contact between the employees of the franchisor and the sub-franchisors and their management. It is advisable for the master franchise agreement to state clearly the length of the ongoing training programmes, what they involve and the financial commitments of each of the parties. Depending on the nature of the franchise involved, these additional training programmes may be optional or compulsory.

### ***III. OBLIGATIONS THAT ARISE AS A RESULT OF UNSUCCESSFUL TRAINING***

In the case of domestic franchising in particular, it is possible that the franchisor during the initial, or even during the ongoing, training comes to realise that a person following the training course is unsuited to the tasks he or she is being trained for. In such cases the wise course would be for the franchisor first of all to inform the person concerned of the conclusion it has reached, and then to terminate the contractual relationship. A franchisor who wishes to have the possibility to take such a decision is however well advised to make this clear in the agreement itself. In this connection the possibility of a partial or full reimbursement of the fees paid for the training, and/or even of the initial franchise fee, might be considered. A situation of this nature is less likely to arise in a master franchise situation, where the sub-franchisor is selected only if the franchisor is satisfied that it has the necessary qualities to operate effectively as a sub-franchisor.

## **C. MANUALS**

### ***I. FRANCHISE UNIT MANUALS AND SUB-FRANCHISOR MANUALS***

In most franchise systems, especially in business format franchise arrangements, the know-how and other intellectual property rights are 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.

They may also contain a further provision to the effect that all the provisions of the manuals are to be deemed to form an integral part of the master franchise agreement, as if the manuals had actually been incorporated into the agreement itself. Consequently, one of the franchisor's principal obligations is usually to hand over a copy of the manuals to the sub-franchisor upon or soon after the execution of the master franchise agreement. It is also usually appropriate to provide the sub-franchisor with an opportunity to examine the contents of the manuals prior to the execution of the agreement, although in this case the information the sub-franchisor obtains should be considered to be confidential. If the sub-franchisor does not have an opportunity to examine the contents of the manuals, or at least their table of contents, courts in certain jurisdictions may conclude that the sub-franchisor is not bound by their provisions as it was not familiar with them prior to the execution of the agreement.

In most cases the manuals that are provided by the franchisor will relate to the management of the unit franchises and will describe the workings of the franchise system. In the case of master franchising, however, the sub-franchisor does not operate only 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 it needs to operate as a franchisor. The means adopted by franchisors to provide sub-franchisors with this information include the provision of a manual which details the obligations that are to be assumed by the sub-franchisor in its capacity as "franchisor". This manual will also provide information on the nature of the relationship between a franchisor and a franchisee.

As the manuals contain all the know-how associated with the franchisor's system, the franchisor will need to be able to control the use of the manuals in order to protect its know-how. To this end, it is recommended that the manuals remain the property of the franchisor and that they only be "lent" by the franchisor to the sub-franchisor, as opposed to being "provided". If the manuals are only lent, the sub-franchisor will be required to return

all copies of the manuals in its possession to the franchisor when the agreement comes to an end.

It should however be observed that in practice only few franchisors operating in the international market place 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 the occasion of the periodic visits the sub-franchisor makes to the franchisor's centre of operations or the franchisor makes to that of the sub-franchisor.

In relation to manuals, an important question is who should be responsible for translating them into the local language and consequently who should pay for the expenses associated therewith. This is a matter of negotiation between the parties to the international master franchise agreement and is best dealt with in the agreement itself.<sup>7</sup>

## ***II. ADAPTATIONS AND CHANGES***

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

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<sup>7</sup> On the question of the translation of the manuals and other documentation, see Chapter 1, Section B, Sub-Section V, *lit.* (a) "Language of the Agreement and of the Other Documents".

- (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 introduce changes that it thinks will improve the franchise system;
- (b) where prior written approval on the part of the franchisor is required for the implementation of a change, this approval should not be unreasonably withheld. The right of the franchisor to protect the core of its system is however universally recognised and as a consequence the franchisor should have a broad authority to reject proposed changes. Any changes to the franchise system that would individually or collectively result in a fundamental change, or that would have a generally negative impact on the operation of the franchise system in a neighbouring country, should be subject to the prior approval of the franchisor;
- (c) the sub-franchisor should be permitted to make any changes that are required to comply with the laws of the host country without the prior consent of the franchisor. The franchisor should nevertheless be advised of such changes prior to their implementation, as the proposed change might lead the franchisor to reconsider its policy with respect to franchising in that country;
- (d) all permitted changes to the franchise system should be reflected in the manuals; and
- (e) all changes to the franchise system, whether initiated by the franchisor or the sub-franchisor, as well as any know-how associated with such changes, should be acknowledged by the sub-franchisor as being the sole and exclusive property of the franchisor and as being a constituent part of the system that is being franchised. If such an acknowledgement concerns an improvement made by the sub-franchisor, it may be viewed in some jurisdictions as constituting a grant back licence and this may be illegal.<sup>8</sup> Under such circumstances it is usual to include a provision

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<sup>8</sup> Cf. European Community competition law.

by which the sub-franchisor grants the franchisor a perpetual, world-wide, royalty free licence 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.

#### **D. ASSISTANCE AND OTHER SERVICES**

The most complete information and the best of initial training courses may not be sufficient to place a new sub-franchisor in a position where it is able to offer the new franchise operation a perfect start. It is therefore not uncommon for the franchisor to give initial, and subsequently ongoing advice on the adaptation of the system to the conditions of the host country, the setting up of the management and operational structures of the sub-franchisor, the logistics of the future network, 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".<sup>9</sup>

##### ***I. INITIAL ASSISTANCE***

Up until the opening of the first pilot operation, and possibly for some time beyond that, the franchisor's management and operational assistance will usually be provided by experienced staff from the franchisor's headquarters. This initial assistance is normally included in the initial franchise fee and is therefore not paid for separately by the sub-franchisor. It may occur that the franchisor requests reimbursement for the cost of the travel expenses and accommodation of its staff. The extent and duration of the assistance will largely depend upon the amount charged as an initial franchise fee, but the distance in geographic and even cultural terms from the location of the franchisor's headquarters will also be of relevance in this regard. Conditions may be so different that the franchisor's staff may be able to offer substantial help only as regards the technical

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<sup>9</sup> See also Chapter 8 "Advertising and the Control of the Advertising".

aspects of the implementation of the system, but will be able to offer little as regards other operational issues. On the other hand, where the culturally foreign elements of the franchise system introduce commercial tools that are new to the host country, it might even be crucial that staff from the franchisor's headquarters assist in the implementation of those culturally foreign elements.

There is no fixed rule for the determination of the extent of the franchisor's initial assistance. It is usually the result of lengthy negotiations and will depend mainly on the complexity of the franchise system, the economic environment of the host country, the business experience of the sub-franchisor and the extent to which the franchisor wishes to control the adaptation of the franchise system. It will also vary depending on whether the individual system is a service franchise or a product franchise and on whether the contractual goods and equipment are supplied mainly by the franchisor or are obtained from local sources. As the franchisor normally prescribes standards for the quality of the services and/or the goods, it will usually, and to the greatest extent possible, provide advice with respect to 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, the handling and hiring of staff, book-keeping and reporting, including the forms that should be used, the sales techniques that should be adopted and public relations and advertising activities. Important written material on these points is usually contained in the manuals. It is in the long-term interest of the franchisor and the system that the franchisor give as much initial assistance as it reasonably can afford within the framework of the initial franchise fee. It is however also possible for specific services to be provided against additional payments.

## ***II. ONGOING ASSISTANCE***

For the whole duration of the agreement the franchisor may provide advice and assistance on a range of management, operational and technical issues. It may be observed that under certain jurisdictions the continuing provision of commercial or

technical assistance during the life of the agreement is a mandatory element of any franchise agreement. In some cases a "hot-line" for the sub-franchisors will be instituted, so as to ensure that any assistance needed is provided quickly and efficiently. In most cases such ongoing advice, whether it is offered by telephone or by correspondence, is not paid for separately, but is instead covered by the ongoing franchise fees.<sup>10</sup> Also included in the continuing franchise fees may be 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 meetings of the sub-franchisors of the system, for example by geographic region. Travel expenses are normally not included.

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

The sub-franchisor may find it most cost effective to pay for the franchisor's staff to provide any additional services it might need, rather than to consult outside advisers. The franchisor's staff will have long-standing and world-wide experience on how to sell franchises, how to run successful public relations and advertising campaigns, how to optimise the sale of the franchised goods and services and how to adapt the system rapidly to changing economic conditions. It may therefore be advisable for the franchisor to make experienced members of its international team available to the sub-franchisor by arrangement. Where such optional services are offered, the fees and costs involved should

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<sup>10</sup> See Chapter 4 "Financial Matters".

be clearly indicated and this is often done in the annexes to the agreement or in the manuals.

### ***III. ASSISTANCE TO THE SUB-FRANCHISEES***

It is unusual, but not excluded, that provision may be made in the master franchise agreement for the franchisor to provide direct assistance to the sub-franchisees. Considering that this is in contradiction with the master franchise concept, such assistance should probably be limited to the initial phase or, for short periods, to crisis situations. Where a crisis situation lasts too long, the question will normally arise whether the agreement should be terminated or whether limitations should be made to the sub-franchisor's territory or other exclusive rights.<sup>11-</sup>

## **E. OTHER OBLIGATIONS OF THE FRANCHISOR**

### ***I. SUPPLY OF GOODS***

The franchisor may undertake to supply goods to the sub-franchisor and the sub-franchisees of the network. It may do so not only where it wishes to impose an exclusive purchase obligation in favour of its own or other specific products or initial equipment, but also where it wishes to ensure that the goods are of a certain standard. Where it does take on such a commitment, the sales conditions and any limitations in the franchisor's liability should be clearly stipulated in the agreement.<sup>12</sup>

### ***II. PROMOTION***

The franchisor will usually undertake to promote the franchise network internationally. For this purpose an international advertising fund will in most cases be established, to which all the sub-franchisors will contribute advertising fees.<sup>13</sup>

### ***III. PROTECTION OF TRADEMARKS***

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<sup>11</sup> See Chapter 15 "Remedies for Non-Performance".

<sup>12</sup> See Chapter 9 "Supply of Equipment, Products and Services".

<sup>13</sup> For more details, see Chapter 8, *cit.*

Another important obligation of the franchisor is the maintenance and protection of the trademarks and other intellectual property rights, know-how included, that it licenses to the sub-franchisor.<sup>14</sup>

#### ***IV. OTHER SPECIAL OBLIGATIONS***

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

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

#### **F. RIGHTS OF THE FRANCHISOR**

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

There are also other rights that the franchisor might wish to retain over and above the normal rights/obligations specified in the agreement, such as, for example, the right to approve the location of the outlets in the host country, the right to approve

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<sup>14</sup> See Chapters 10 "Intellectual Property" and 11, *cit.*

prospective sub-franchisees, the right to appoint a director to the Board of Directors of the sub-franchisor or to receive fees directly from the sub-franchisees as opposed to passing through the sub-franchisor, and the right to deal directly with the sub-franchisees irrespective of any decision taken by the sub-franchisor. A certain caution should however be exercised, in that rights of this nature might be considered to change the nature of the relationship between the parties, giving rise to a risk of vicarious liability for the franchisor.<sup>15</sup>

Moreover, as indicated above, the franchisor may in the master franchise agreement retain the right to make periodic inspections of the units and to offer the sub-franchisor periodic consultations with regard to the operation of the units. The retention of such rights on the part of the franchisor might be accompanied by the power to sanction non-performing sub-franchisees.

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<sup>15</sup> See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

# **CHAPTER 6**

## **THE ROLE OF THE SUB-FRANCHISOR**

For the franchisor and the sub-franchisees of a network the sub-franchisor is the effective franchisor for the system in the host country. The sub-franchisor has responsibilities to both franchisor and sub-franchisees. To the franchisor the sub-franchisor is its "presence" in the host country. The franchisor will therefore expect the sub-franchisor to run the system as it would itself. To the sub-franchisees the sub-franchisor is their franchisor and they will therefore expect the sub-franchisor to behave towards them as a responsible franchisor. Indeed, if the sub-franchisor operates effectively, the sub-franchisees will not regard anyone else as being the 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 the franchise network in the host country. The sub-franchisor will be required to contribute to ensuring that the franchisor's system can viably be operated in the host country. It will be required to introduce the system into the host country, to develop the franchise network and to provide the full range of the franchisor's services to the sub-franchisees.

### **A. PILOT OPERATIONS**

The foreign franchise system is frequently unknown in the host country and the success it will encounter is therefore uncertain. The issues of the viability of the system and the lack of knowledge of the franchisor's name may be approached by requiring the sub-franchisor to establish one or more pilot operations. It should

be noted, however, that frequently it is the franchisor itself that establishes the pilot operations. The purpose of pilot operations is to ascertain whether the business that is franchised is viable and to judge how successful it may be in the host country. The performance of the pilot operations will also enable the franchisor's system to be adjusted to take account of the experience gained. The pilot operations will furthermore assist in the marketing of sub-franchises, as the ability to demonstrate success in operation is a vital sales aid. In some countries the codes of ethics of franchise associations may require pilot operations to be set up. The European Commission Regulation 4087/88 on the application of Article 85(3) of the Treaty of Rome to categories of franchise agreements defines the franchisor's know how as "resulting from experience and testing",<sup>1</sup> which is another way of describing the practical experience that pilot operations provide.

The experience gained in the pilot operations will assist the sub-franchisor in identifying the legal and regulatory requirements that are applicable in the host country to the operation of the franchise business. It might be advisable to reflect some of these requirements in amendments to the operations manuals. Furthermore, the experience gained in conducting pilot operations may 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 acquired with the pilot operations will furthermore enable the sub-franchisor, in supporting the sub-franchisees, to provide the right level of advice.

## **B. DEVELOPMENT SCHEDULE**

The franchisor will invariably impose a number of obligations on the sub-franchisor in order to ensure the orderly and realistic development of the territory. Detailed obligations will, for example, be imposed in relation to the speed at which sub-

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<sup>1</sup> Article 1(3)(f).

franchised units are to be opened. Such obligations will normally be specified in what is known as a development schedule.

A development schedule that sets out the required annual and cumulative rates of growth of the network in the host country (usually measured by number of units, but on occasion measured by volume) is a common feature of master franchise agreements. Without it, the franchisor would not be confident that the sub-franchisor is committed to what it would regard as the proper exploitation of the territory. Franchisors attach great importance to the development schedule, particularly where exclusive rights are granted, because it protects them 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 the operational units, the master franchise option may lose some of its attractions to the franchisor. On the other hand, the sub-franchisor must be satisfied that the development schedule proposed by the franchisor can be achieved within the scope of the resources that it is prepared, or can afford, to commit to the project. These two factors, the annual rate of growth in number of units and the cumulative rate of growth, will normally be the subject of extensive discussion and negotiation.

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 franchise 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.

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 prospective sub-franchisors prepare a business plan as a part of the process of deciding whether or not to enter into a master franchise agreement. Such a 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 decision about whether or not to enter into the agreement, nor will it be able to estimate the level of resources that it would need to commit to the establishment of the business. In this context note should be taken of the existence of an increasing number of different forms of franchising and of the fact that diverse forms are increasingly being used within the same franchise system. This may affect the development schedule agreed by the parties, as it may result, for example, in a mixture of larger and smaller units being set up.

As observed above, in many cases it will be necessary to introduce to the host country an unknown name and an untried system. This may be particularly problematic if the sub-franchisor does not feel confident in accepting a commitment to a development schedule that is proposed, as it is uncertain that it 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 if the business is successful, it is unlikely that the sub-franchisor will not wish to expand it to the full. It is however important for both parties that the sub-franchisor is obliged to expand sufficiently to ensure that it achieves a critical mass of sub-franchisees, as this will enable it to

make the maximum use of its resources and thereby to arrive at the achievement of effective growth.

In establishing the development schedule there is a factor which, experience shows, may need to be discussed. There are businesses which over the years have rationalised their approach by centralising some or all of the production functions, and have established satellite outlets rather than full service operational units.<sup>2</sup> This approach is often the result either of the need to use capital more effectively in order to enable the business to compete, or of the cost of the capital equipment requirements, as these are increasingly technology based and tend to change very rapidly.

### **C. RENEWAL OF DEVELOPMENT SCHEDULES**

The debate about development schedules does not necessarily end when the contract is executed, because the agreement may incorporate the right for the sub-franchisor to renew or extend the contract upon its expiration.<sup>3</sup> There is one school of thought that holds that the master franchise agreement should be a long-term arrangement where the sub-franchisor, provided it is not in default under the development schedule, has unlimited rights of renewal. There are also situations in which what may be terminated is the right to develop new units. In such cases the master franchise agreement would remain in effect as regards the existing unit franchise agreements until these come to an end. Alternatively, the sub-franchisor might lose the exclusive right to develop new units.

The terms upon which renewal may be granted will undoubtedly involve the establishment of a continuing development schedule of one kind or another. Even if the parties are agreed that full market exploitation has taken place, the sub-franchisor will probably be faced with a demand from the

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<sup>2</sup> This is the case in some fast food franchises which have centralised the preparation and cooking functions.

<sup>3</sup> See Chapter 3 "Term of the Agreement and Conditions of Renewal".

franchisor that what exists be maintained and that any sub-franchisees who exit the network be replaced.

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

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

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

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

#### **D. OPERATIONAL OBLIGATIONS**

As the sub-franchisor is entrusted with the responsibility for "protecting" the integrity of the licensed rights of the franchisor within the host country, the parties may be expected to discuss provisions in the master franchise agreement under which the sub-franchisor would be asked to undertake a number of obligations:

- ◆ to come to an agreement with the franchisor on sub-franchisee qualification criteria and to observe them, so as to ensure that the sub-franchisees are of the right calibre;
- ◆ to train sub-franchisees following the training courses and procedures established by the franchisor;
- ◆ 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 differences in law and business practice.

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

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

The contractual provisions that provide for these methods need to be drafted in such a way that the sub-franchisor is offered sufficient scope to handle the network in a flexible manner, while at the same time ensuring that the franchisor's property rights are kept secure;

- ◆ to ensure that the sub-franchisees do what they should and to enforce the sub-franchise agreement;
- ◆ in general to fulfil its obligations as franchisor under the master franchise agreement.

The sub-franchise agreement will inevitably need to impose upon the sub-franchisee a number of financial and reporting obligations. These will include reporting sales figures, so that franchise fees can be calculated and verified, and providing financial information and accounts relating to its business. The payments that will be made to the sub-franchisor and the reports upon which they are calculated will in turn form the basis for the payments by the sub-franchisor to the franchisor. The sub-franchisor will therefore be required to ensure that the sub-franchisees comply with their obligations to provide the required

reports and to make prompt payment of their financial commitments. The sub-franchisor will also be required to verify the accuracy of the financial information it receives and of the payments made by the sub-franchisees.<sup>4</sup>

The sub-franchisor will have the prime responsibility in the host country for ensuring that trademark laws are complied with and for supervising that the sub-franchisees use the marks in a proper manner consistent with legal requirements.<sup>5</sup> The sub-franchisor will also be expected to monitor the market place in the host country, with a view to identifying any possible infringements of the trademarks. The franchisor will 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 the proceedings effectively. In a number of jurisdictions trademark law might actually require licensees to be involved in any such proceedings.

As far as intellectual property rights other than trademarks are concerned, in its role of custodian of those rights the sub-franchisor will itself need to undertake to preserve them. Important elements of these intellectual property rights are the know-how and other confidential information that the franchisor has to make available to the sub-franchisor and through the sub-franchisor to the sub-franchisees. In passing on the 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 on the know-how to the sub-franchisees and will therefore be required to impose obligations on the sub-franchisees, in compliance with which they are required to keep the franchisor's know-how confidential. The sub-franchisor will also

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

5 See Chapter 10 "Intellectual Property".

be required to enforce any breach of such obligations by the sub-franchisees.<sup>6</sup>

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 for franchisors to specify key posts that the sub-franchisor must create, such as, for example, general manager, operations manager, or finance manager. Those who fill these key positions may be required to follow a franchisor-approved training course. Alternatively, the sub-franchisor may be required to fill these posts only with people who have been trained and approved by the franchisor.

The agreement will also contain a provision or provisions detailing how advertising and promotional activities are to be conducted and at whose expense.<sup>7</sup>

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, an organisation that provides the same range of services and support in the host country as the franchisor provides in its own country.<sup>8</sup>

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6 See Chapters 10, *cit.*, and 11 "Know-How and Trade Secrets".

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

8 See Chapter 5, Sections B "Training" and D "Assistance and other Services".

## E. LANGUAGE ISSUES

Most franchisors find it administratively essential and cost effective to be able to communicate with their sub-franchisors in the franchisor's language.<sup>9</sup> Consequently, the franchisor will invariably provide the sub-franchisor with material written in the franchisor's language and this material will need to be adapted and translated for use within the host country. Although it is typically expected that the sub-franchisor should undertake the preparation of translations at its own expense, the franchisor will need to have the copyright to the translation vested in it, as it would otherwise lose control of its know-how.

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 with the sub-franchisors in the different countries in the local languages. It is therefore 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.

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<sup>9</sup> On the question of language, see Chapter 1, Section B, Sub-Section V, *lit.* (a) "Language of the Agreement and of the Other Documents".

# CHAPTER 7

## THE SUB-FRANCHISE AGREEMENT

International master franchise arrangements are normally not executed in the form of a three-party agreement. The three-tier structure is usually achieved by two separate agreements: the master franchise agreement between the franchisor and the sub-franchisor and the sub-franchise agreement between the sub-franchisor and the sub-franchisee.<sup>1</sup> It is thus normally the sub-franchisor who selects the future sub-franchisees of the network and who enters into a sub-franchise agreement with each of them. There are however also cases in which the franchisor identifies prospective sub-franchisees and requires the sub-franchisor to enter into sub-franchise agreements with the persons or entities identified.<sup>2</sup> The point at issue is the extent to which the franchisor is able to influence, or even to control, the selection of the sub-franchisees and the drafting of the sub-franchise agreements.

It is characteristic of franchising that the franchisor, by means of the sub-franchisor and the sub-franchisees, attempts to reproduce in the host country a business concept that has proved to be successful in its home country. It is natural for the franchisor to want the reproduction to remain as close to the original as possible. The reasons for this include not only the fact that the franchise network that is set up uses trademarks that belong to, and are identifiable with, the franchisor and the fact that a system that has already proved to be successful will have

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<sup>1</sup> See, in general, Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

<sup>2</sup> See Chapter 2, Section E "The Three-Tiered Structure of Master Franchise Arrangements".

greater chances of success, but also the fact that the staff members of the franchisor who are entrusted with the operations will be familiar with the structure of the franchise system wherever the network is located, which may be of considerable importance if the franchisor were ever to have to take over the running of a network.

The master franchise agreement and the sub-franchise agreements are to be included among the tools that are of importance in aiding the franchisor to achieve a reproduction of its franchise concept. Thus, the master franchise agreement may impose an obligation on the sub-franchisor to use standard sub-franchise agreements that are more or less identical with the standard form unit franchise agreement that the franchisor uses in its own country, the difference being that it has been translated into the language of the host country.

In many instances, however, it is neither possible nor appropriate, for legal, economic, cultural or other reasons, merely to translate the franchisor's standard form unit agreement. The agreement must of needs be adapted to local requirements. These adaptations of the agreement will reflect the changes to the system that are required in order to introduce it into the host country. It is clear that it will not be possible for the franchisor to accept changes to its system that will modify the nature of the relationship between the parties. The franchisor will therefore not be able to accept that only the trademark and/or trade dress remain identical with those of the original system, as the relationship would no longer be recognisable as being a franchise. It may however nevertheless need to permit substantial modifications to be made to the system to ensure its success in the host country. As the franchisor needs to be able to control what changes are introduced in order to protect its rights, it will also need to have a certain control over the drafting of the sub-franchise agreements, the only question being the extent of this control.

A franchisor will therefore basically have two options available to it:

- ◆ the franchisor may oblige the sub-franchisor to use its standard unit franchise agreement and may require compliance with all its stipulations unless they conflict with mandatory laws, customs or business practices of the host country, the sub-franchisor essentially being responsible only for the translation of the agreement and of the annexed documents; or
- ◆ the franchisor may provide a basic structure for the agreement, including a number of mandatory provisions, but leave the actual drafting of the standard form sub-franchise agreement to the sub-franchisor.

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

- ◆ the maturity of the system and the experience of the franchisor;
- ◆ the business experience and financial solidity of the sub-franchisor;
- ◆ the complexity of the system;
- ◆ the confidence 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.

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

As indicated above, many franchisors prefer the terms of the standard form agreement that is to be used in the host country to be exactly the same as those of the standard form agreement they have provided. In such cases it will normally be the sub-franchisor who will be obliged, at its own expense, to secure the

translation of the foreign form agreement into the local language. In order to ensure an absolute correspondence of the translation with the original form agreement, the franchisor will commonly add the following obligations to the master franchise agreement:

- ◆ any alterations or amendments that the sub-franchisor wishes to make must be approved by the franchisor;
- ◆ the sub-franchisor may not use the translated version without the franchisor's prior written approval;
- ◆ the sub-franchisor must undertake not to alter or amend the translated version without prior consultation with, and the written consent of, the franchisor;
- ◆ the sub-franchisor must undertake that each of its future sub-franchisees will execute the standard form sub-franchise agreement agreed upon;
- ◆ the sub-franchisor must undertake 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;<sup>3</sup> and
- ◆ the sub-franchisor must undertake that all its sub-franchisees meet the then current admission criteria with respect to
  - ◇ personal qualifications,
  - ◇ related business experience, and
  - ◇ financial solidity.

A franchisor who chooses this first option should consider that the mere imposition of a translated version of the original unit franchise agreement may contravene mandatory legal rules and/or business practices and/or cultural customs of the host country. The franchisor should therefore show flexibility with respect to the sub-franchisor's requests for adaptation of the sub-franchise agreement. This does not mean that the sub-franchisor should be entirely free to adapt the sub-franchise agreement, and subsequently to modify the adapted agreement, without the consent of the franchisor. Even when the sub-franchisor proposes adaptations or amendments that it judges to be necessary for

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<sup>3</sup> See Chapter 6 "The Role of the Sub-Franchisor".

the agreement to conform to the laws, customs and business practices of the host country, it should provide the franchisor with information justifying the adaptations or amendments it proposes. Furthermore, the franchisor might be well advised to come to an agreement with the sub-franchisor as to the sub-franchisee qualification criteria, as the criteria that the franchisor applies in its country of origin may not be appropriate in the host country, they may in fact hinder the development of the franchise system.<sup>4</sup> If the franchisor wishes to impose certain admission criteria on the sub-franchisor, then these should be reasonable, appropriate for the system and for the host country, as well as acceptable to the sub-franchisor.<sup>5</sup>

There are franchisors who wish to approve the individual sub-franchise agreements, whereas others instead only request a copy for control purposes. There are however franchisors that extend their control beyond the agreement to the franchisees themselves and therefore provide that they should approve each prospective sub-franchisee. In some cases it might be feasible for the franchisor to retain the right to approve the agreement and/or the sub-franchisee, but in most cases the franchisor will probably not be in a position to exercise any such rights. Cumbersome approval procedures of this nature may in fact be an obstacle to the dynamic development of a system in the host country. They might furthermore involve an unwelcome risk of liability for the franchisor.

What should perhaps be borne in mind, is that if a franchisor has decided to expand its system via master franchising, the main reason is invariably that the franchisor could not, or did not want to, invest its own financial means or use its own staff in the foreign market concerned and therefore decided to leave this to a sub-franchisor. As it is the sub-franchisor who bears the main financial risk for the development of the system in the host country, it would appear to be reasonable to transfer responsibility to the sub-franchisor at all possible levels, including the drafting of the sub-franchise agreements.

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<sup>4</sup> See Chapter 6, Section D "Operational Obligations".

<sup>5</sup> See Chapter 6, *cit.*

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

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

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

- ◆ a general description of the franchise system;
- ◆ an indication of the precise scope of the rights granted in the sub-franchise agreement;
- ◆ a description of the territory for which the agreement applies (where applicable);
- ◆ lists of the sub-franchisor's and the sub-franchisee's rights and obligations;
- ◆ training provisions relating to both initial and ongoing training, with indications of the duration, location and component parts of the training;
- ◆ provisions relating to the supervision of sub-franchisees in general and quality control in particular;
- ◆ provisions requiring a regular exchange of experience among the members of the network, including by the organisation of meetings of sub-franchisees and by other means of ongoing communication (which might include the setting up of a council of sub-franchisees);
- ◆ provisions relating to the protection and control of the use of the trademarks, know-how and other intellectual property rights, including a general statement that the system, trademarks and other intellectual property rights belong to the franchisor;

- ◆ provisions relating to the implementation of system changes;
- ◆ provisions relating to both initial and ongoing franchise fees;
- ◆ provisions containing rules on reporting, on the making of payments and relating to control rights;
- ◆ provisions requiring compliance with local laws, the terms of the franchise agreement and the manual(s);
- ◆ provisions requiring (minimum) insurance, and relating to indemnity;
- ◆ provisions relating to promotion and advertising issues;
- ◆ in-term and post-term confidentiality and non-competition covenants;
- ◆ assignment rules;
- ◆ provisions relating to the non-performance of the agreement by the sub-franchisee and possibly by the sub-franchisor;
- ◆ provisions regarding the duration, renewal and termination of the agreement (including assignment to the franchisor); and
- ◆ provisions dealing with jurisdiction issues (including arbitration, mediation and conciliation).

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

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

In addition, the other requirements indicated above in relation to the first option might also be included in the master franchise agreement.

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

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

The parties are well advised to include in the sub-franchise agreements one or more provisions illustrating what will occur when the master franchise agreement comes to an end as a result of the expiration of its term or because it is terminated.<sup>6</sup> It may be recalled that the alternatives include the automatic termination of the sub-franchise agreements, the assignment of the sub-franchise agreements to the franchisor, and the franchisor exercising an option to select the sub-franchisees it wishes to continue relations with.<sup>7</sup> It goes without saying that both parties to the master franchise agreement should carefully consider whether the solution adopted is viable under local conditions.

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<sup>6</sup> See Chapters 15 "Remedies for Non-Performance" and 16 "The End of the Relationship and its Consequences".

<sup>7</sup> See Chapters 15 and 16, *cit.*

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

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

It should be observed that negotiations in which the sub-franchisor has to struggle to obtain the franchisor's consent for each and every modification it considers to be necessary or appropriate in order to meet local requirements will very soon lead to a confrontational relationship. This does not augur well for the collaboration between the parties and also considerably increases the initial legal costs of both parties.

### **D. ENFORCEMENT OF THE SUB-FRANCHISE AGREEMENT**

It is one thing to oblige a sub-franchisor to use a specific contract form 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 and trust the sub-franchisor to enforce the obligations of the sub-franchisees under the sub-franchise agreements.<sup>8</sup>

Although a franchisor will generally have the possibility to terminate a master franchise agreement for breach if the sub-franchisor does not enforce the sub-franchise agreements, it may have recourse to other remedies short of termination. These include, for example, claiming monetary compensation from the sub-franchisor. The latter may of course in turn claim compensation from the defaulting sub-franchisees.

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 stop paying the royalties, or simply to conduct business outside the franchise system, the sub-franchisor's network might quickly fall apart. As this would damage the franchisor's reputation throughout, and not only in that particular country, it would appear to be advisable for the franchisor to oblige its sub-franchisors to provide all their sub-franchisees with an address of the franchisor to which they may address their complaints. It would be in the best interest of the network as a whole for the franchisor to take the complaints of the sub-franchisees seriously and to make every effort to ensure that the sub-franchisor complies with the sub-franchise agreements.

## **E. COMMUNICATION WITH AND SYSTEM IMPROVEMENTS PROPOSED BY SUB-FRANCHISEES**

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<sup>8</sup> See Chapters 6, 15 and 16, *cit.*, for a full discussion of this issue.

Improvements to the system are proposed not only by the franchisor and the sub-franchisor, but also by the sub-franchisees.<sup>9</sup> Sub-franchisees are close to the consumers and they are therefore the first to realise what improvements might be required by the market. They will therefore usually submit suggestions and requests to which the sub-franchisor and the franchisor should respond. It is for this reason that the franchisor would be well advised to oblige its sub-franchisors to ensure that there is constant communication, and an intense exchange of views and experiences, with the sub-franchisees. It would also be advisable for the sub-franchisor to organise regular meetings of the sub-franchisees of the network. The sub-franchisor should encourage its sub-franchisees to come forward with proposals for improvement, but it should also ensure that they do not implement them without the prior approval of the franchisor. It will fall upon the sub-franchisor to obtain this prior approval. It would furthermore be advisable for the sub-franchise agreement to contain rules on how improvements suggested by sub-franchisees are to be integrated into the franchise system. Needless to say, these rules must comply with the legislation of the country concerned and the solutions will therefore differ from country to country. The options available are firstly, that such improvements are entirely transferred to the franchisor (with or without compensation), and, secondly, that they are licensed to the sub-franchisor or to the franchisor, with or without exclusivity being granted but with ownership being retained by the sub-franchisee. Permitting the sub-franchisees to retain the ownership of the improvements they have devised and which have been introduced into the entire franchise system will encourage sub-franchisees to come forward with their ideas. The offering of appropriate compensation or the instituting of a system for the rewarding of such initiatives would also be an incentive.<sup>10</sup>

## **F. CHOICE OF FORUM AND CHOICE OF LAW**

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<sup>9</sup> See Chapter 12 "System Changes".

<sup>10</sup> See Chapter 12, *cit.*

Choice of law is usually not an issue for sub-franchise agreements, as these are typically concluded between parties operating on the same national territory. There are however cases in which a sub-franchisor has sub-franchisees in several countries, or in several states of a federal State. In these cases it is highly likely that different laws will apply. This situation resembles that of a franchisor with sub-franchisors in different countries. When a sub-franchisor selects the law that it proposes should apply, it might therefore take into consideration the same elements as a franchisor in an international situation.<sup>11</sup> It is in any event advisable to adjust the choice of law and choice of forum to the situation.

The franchisor will usually not influence the sub-franchisor's policy in relation to the choice of forum clause of the sub-franchise agreements. 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 national court system. It is however not a foregone conclusion 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, after having given due consideration to all the different possibilities, mediation included. In countries where franchising is a relatively unknown business method and where national courts may have difficulties in dealing with franchise issues, arbitration might be the better alternative, if it is available at a reasonable cost and if arbitral awards can be easily enforced.

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<sup>11</sup> See Chapter 17 "Applicable Law and Dispute Resolution".

## **CHAPTER 8**

# **ADVERTISING AND THE CONTROL OF ADVERTISING**

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

The value and importance of advertising and promotion in the building up of the goodwill and public image of a system cannot be denied. Franchisors and franchisees therefore share an interest in maintaining a degree of standardisation of advertising and promotional programmes. This is equally important in both the domestic and the international contexts, even if it does raise an additional set of issues in the latter. The first of these issues is likely to relate to the process of "building up from scratch". What is required in this process will vary from country to country and will depend on social and economic conditions. In a number of countries, for example, it may be necessary to create consumer awareness where little or none existed before. In such cases the franchisor and sub-franchisor must come to a clear understanding as to who will bear the burden of doing so, in terms of human as well as financial resources. A prospective sub-franchisor should normally be prepared to accept the obligation to introduce the franchise system into the country, unless the franchisor has specifically indicated that it is prepared to do so.

As the costs involved might far exceed any benefit that the franchisor could derive from the network in the country concerned, the franchisor might in fact not be willing to undertake this task.

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

In striving to standardise the image of the system that is projected to prospective customers, sub-franchisors and sub-franchisees seek to preserve and cultivate the goodwill of the franchise system with the public, as well as to structure the system in such a manner that similar advertising rights are granted, and similar advertising obligations are imposed, wherever the system is developed. When they protect their proprietary marks in foreign markets, franchisors will need to protect their rights also as regards the translation of the marks into the local language.<sup>1</sup> The inclusion in international franchise agreements of provisions such as the

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<sup>1</sup> See below, Section B "Translations". On intellectual property rights in general, see Chapters 10 "Intellectual Property" and 11 "Know-How and Trade Secrets".

ones described below may be of assistance in achieving these objectives.

## **A. APPROVAL AND USE OF ADVERTISING MATERIALS**

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 typically retain control by deciding at a general level how international advertising should be conducted. In determining the extent to which the franchisor will control the manner in which the system is advertised abroad, important considerations are whether the franchisor will itself provide all the advertising materials used by the sub-franchisor and the sub-franchisees, whether it will instead merely approve the advertising materials used by them, or whether it will provide guidelines or standards that they will be required to follow in developing their own local advertising materials.

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

### ***I. APPROVING ALL MATERIALS***

If the franchisor is to approve all the advertising materials used by the sub-franchisors, a decision will need to be taken as to whether the franchisor should have pre-approval rights or post-approval rights. In the case of pre-approval rights the sub-franchisors will be required to submit all the advertising materials they develop to the franchisor for approval prior to their use. Any

such material will be subject to review and to renewed approval by the franchisor at specified intervals. Alternatively, a franchisor may require foreign sub-franchisors to submit all the advertising materials they develop within a certain period of time after they begin to use such materials. This latter type of requirement is normally accompanied by a provision in the agreement that permits the franchisor to reject any submitted materials and that requires sub-franchisors to cease using any disapproved materials immediately. In either case, submissions are ordinarily made in both the local language and in the language of the franchisor. It is frequently provided that the franchisor's rejection is subject to a deadline: if the franchisor has not reacted within a specified period of time, approval is assumed.

## ***II. PROVIDING ADVERTISING GUIDELINES OR STANDARDS***

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

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

In addition, the parties should bear in mind that, while marketing plans normally indicate the objectives that the parties hope to meet, only very rarely are these objectives fully achieved. Prudent franchisors and sub-franchisors therefore 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 assessed.

## **B. TRANSLATIONS**

A second major decision that should be taken in the initial stages of a franchise system's expansion abroad concerns when and how 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 the sub-franchisor, or whether the franchisor will provide the sub-franchisor with advertising materials in its own language and then require the sub-franchisor to have the materials translated. If the sub-franchisor is required to provide for the translation of the materials, a decision should be taken as to who should pay for the translation.<sup>2</sup>

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

Franchisors who require sub-franchisors to translate materials would be well advised 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 franchisor 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 would also be well advised to require sub-franchisors, as well as any sub-contractors to whom the sub-franchisors have entrusted the translations, to execute agreements granting all proprietary rights in the translations to the franchisor. In such cases an agreement to this effect should be concluded prior to the translation of the materials.

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<sup>2</sup> See Chapter 1, Section B, Sub-Section V, *lit.* (a) "Language of the Agreement and of the Other Documents" and Chapter 6, Section E "Language Issues".

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

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

## **C. FINANCIAL CONSIDERATIONS**

### ***I. SOURCES OF REVENUE FOR ADVERTISING EXPENDITURE***

The revenue which is available for expenditure on advertising is usually, but not exclusively, generated from the operation of the franchise units by the sub-franchisees. The usual range of sources of such revenue include:

- ◆ a sum of money that the sub-franchisor is required to pay and that is calculated as a percentage of the sub-franchisee's gross income rather in the same way as the continuing franchise fee is calculated. The sums received from the sub-franchisees are spent on advertising and promotion;
- ◆ the continuing franchise fees, in that the franchisor or sub-franchisor includes the advertising expense within the continuing franchise fee and undertakes to spend not less than a minimum percentage of such fees on advertising and promotion;
- ◆ other sources, in that the franchisor or the sub-franchisor undertakes to engage in advertising and promotion to the extent it thinks fit without collecting a contribution or allocating a fixed sum for the purpose. An example of this approach is when the franchisor or sub-franchisor is a manufacturer who is already a substantial advertiser on its

own account and the members of the network will inevitably benefit from its advertising activities.<sup>3</sup>

## ***II. SHARING OF COSTS***

Once the means have been determined by which the objectives of the global standardisation of the image of the franchise network and the protection abroad of the proprietary marks used with the system are to be achieved, the final major issue for the parties to consider is who should bear the cost of advertising.

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

Where the sub-franchisor makes a contribution to the funds available to the franchisor, the parties should decide the purposes for which the contributions of the sub-franchisors may or may not be used by the franchisor and the manner in which the franchisor will be accountable to the sub-franchisors for the actual expenditures made. Where the sub-franchisor instead is wholly responsible for the advertising the parties should clarify whether the sub-franchisor's expenditures on local advertising will be credited towards the amount(s) the sub-franchisor is required to spend on other advertising activities (such as, for example, contributions to a regional advertising fund) and whether, and if so by what means, the franchisor is to verify that the sub-franchisor has spent the required amount on local advertising. This second matter may be significantly more difficult to enforce for a franchisor whose system has expanded abroad than is the case in purely domestic franchising.

With reference to the above discussion on the relationship between franchisor and sub-franchisor, it should be observed that

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<sup>3</sup> For advertising fee rebates, see Chapter 4 "Financial Matters".

a parallel set of issues must be confronted in the context of the relationship between the sub-franchisor and the sub-franchisees and that these issues must be addressed in the sub-franchise agreement.

### ***III. 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 advertising funds. These advertising funds may be specific to a region or administrative territory within a country, national, supra-national (that is, covering a geographic region comprising more than one country, for example the European Union), or international, including within their ambit a number of different countries not necessarily within the same region. Advertising funds are most frequently and most successfully implemented when the areas that comprise a franchise territory have highly differentiated markets and/or are geographically distant.

It should be observed that where international advertising funds are established, 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.

#### **(a) Agreement Terms**

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

advertising for which the fund is used will benefit any particular contributing sub-franchisor.

### **(b) Setting Up**

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

### **(c) Other Contributions**

In addition to the sub-franchisor and sub-franchisees themselves, the manufacturers and the suppliers of the network may also contribute to the advertising, marketing and promotional activities of the network, both at a national level and as regards each separate unit.<sup>4</sup>

### **(d) Advantages**

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

### **(e) Problems**

It should be noted that there may be a fiscal problem when funds paid into an advertising fund in one year are not spent

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<sup>4</sup> See the discussion in Chapter 4, *cit.*

until the following year, as for fiscal purposes these funds are normally to be considered to be the property of either one of the parties. In view of the above, it is important for the parties to state explicitly to whom the funds belong.

#### **D. THE IMPACT OF MASTER FRANCHISING**

Master franchising provides the franchisor with an opportunity to delegate a significant amount of decision-making to others intimately involved with the international expansion of the franchise system. Furthermore, it tends to facilitate the setting up of funds 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 an advertising fund, at the very least for the sub-franchisor's own franchised units. Independently of whether a sub-franchisor is required to set up an advertising fund only for its own units, or for its own units as well as for those 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 concern the network as a whole and for which the franchisor will bear the main responsibility, the advertising at a regional or national level for which the sub-franchisor will be responsible (also by reason of its knowledge of the local market and of its capability to adapt any programmes or materials to local requirements) and the local advertising for which the sub-franchisee will bear responsibility. The different levels of permission that are necessary will need to be considered and determined. Thus, for example, the question of whether the local advertising devised by the sub-franchisee will require the

approval of both sub-franchisor and franchisor, or whether the approval of the sub-franchisor alone will be sufficient, will need to be examined by the parties.

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

## **CHAPTER 9**

# **SUPPLY OF EQUIPMENT, PRODUCTS AND SERVICES**

Franchising, whatever the form adopted, will invariably involve the distribution of products or services through the unit franchisees. The franchisor will often require key products or services to meet certain well defined specifications and standards. For a franchise network to function properly, and in order to maintain the integrity and quality standards of each unit as well as the uniformity of the franchise system as a whole, it is necessary for the franchisees to have both an adequate supply of these products and access to the services. A proper identification of the sources of supply of the products and services is essential, at times indeed decisive, for the success of most franchise networks. It is only an efficient source of supply that will enable the franchisor to exercise an appropriate control over what is supplied, and at the same time assure that the sub-franchisees have an adequate and efficient access to the products and services they need.

In order to ensure that quality standards are properly maintained, the franchisor will often require that these key products or services are obtained from suppliers that it has approved. In the international context it is for natural reasons more difficult for the franchisor to approve local suppliers. Any indication of a local supplier will therefore typically be left to the local sub-franchisor. Alternatively, the franchisor may arrange to supply products or services to the sub-franchisees either directly or, more likely, through the sub-franchisor.

The sub-franchisees will generally need two different kinds of products or services. Firstly, they will need the products or services, or component parts thereof, that are distinctive of the franchise system and that might be protected by intellectual property laws. These products or services are typically those that are offered for

sale to the customers of the sub-franchisees. Secondly, they will need a wide variety of other products and services, as well as equipment, that are essential to the conduct of their operations. These products, services and items of equipment are used by the sub-franchisees themselves and are not resold to their customers.

The supply by the franchisor, either directly or through the sub-franchisor, of products or services that are unique to the franchised system may offer a number of advantages. Firstly, the maintenance of the necessary quality standards may be assured if the items are supplied by the franchisor, as opposed to their being supplied by an independent contractor. The resulting uniformity in the products or services offered is important for the maintaining of the integrity of the franchise system as a whole. The franchisor (and also the sub-franchisor) has a duty to control the quality of the products or services that bear its trademarks, in order to maintain both the enforceability of the trademarks and the standards that form an essential part of the franchise system. Secondly, if the franchisor 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 expect to realise an additional profit from the products, services or equipment it provides the sub-franchisees with.

The supplying of these products and services may however be cumbersome, inconvenient and expensive for the franchisor, in particular considering the fact that the franchisor and the sub-franchisors and sub-franchisees of its system are often located at great distances from each other. Moreover, questions of fairness may be raised because of the lack of independence of the parties. It is therefore more likely that it will be the sub-franchisor that will be entrusted with the task of providing the required products or services.

It should be observed that in many countries the manner in which products or services are provided, particularly where one of the parties is contractually bound to make such purchases from the other, is regulated by law. These regulations generally seek to ensure that the purchases are made under competitive conditions and that the purchaser is treated fairly.

## **A. NATURE OF PRODUCTS OR SERVICES SUPPLIED**

As indicated above, the products or services supplied may be of two different categories. In the first instance they may be products or services that are identified with the trademarks of the system and that are offered to the customers of the sub-franchisees. Such products or services are an attribute of the system and are often unique to that particular franchise system. The reason they are unique is either that the franchisor will use a proprietary method for their manufacture or performance, or that they have characteristics that are available only within that franchise system. Examples of products of this nature include food items, petroleum products and equipment parts.

On the other hand, equipment, products or services may be supplied that form an integral part of the franchise system and that as such give the members of the network a competitive advantage. In other words, the members of the network use the equipment, products or services for the operation of the units. 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 sub-franchisees are conducted in accordance with the quality standards that identify the system. Examples of such products and services include proprietary operating software and connected services of software experts, packaging supplies, fixtures, signage and special equipment.

The equipment, products or services concerned may at times not be unique to the franchise system, even if they are generally necessary for the conducting of the franchisee's operation. Although the sub-franchisees may normally obtain such products or services from independent suppliers, the franchisor or sub-franchisor might be in a special position to ensure that they are available at a competitive price. Examples include financing, advertising aids, book-keeping services, commercially available operating software, equipment, supplies, ingredients or component parts and training. The franchisor may provide these products and services either by sale, or pursuant to lease or rental

agreements. In view of the general availability of these products and services there is usually little need for the franchisor to supply them. The franchisor or sub-franchisor may however wish to do so as a related business activity.

## **B. SOURCES OF SUPPLY**

There are a variety of arrangements that the franchisor may consider for the provision of equipment, products or services to sub-franchisees located abroad. As indicated above, the franchisor may provide such equipment, products or services directly to the sub-franchisees and may require that they purchase what they need directly from it. Alternatively, the franchisor may authorise or require the sub-franchisor to supply the equipment, products or services. The franchisor, or the sub-franchisor if so authorised or required under the master franchise agreement, may also designate certain approved suppliers. It is possible that such suppliers may be affiliated with the franchisor or sub-franchisor, either because they are owned by the franchisor or sub-franchisor, or as a result of an agreement between them. On the other hand, they may be completely independent and may simply produce and supply the designated products. The franchisor may or may not attempt to receive a payment or commission from any independent supplier that it designates as approved supplier.<sup>1</sup>

Many franchisors develop approved supplier programmes that lay down specifications for important equipment, products or services and that identify the suppliers that are authorised to supply those items of equipment, products or services to the sub-franchisees of the network. Such programmes may also include a procedure for the approval of suppliers proposed either by the sub-franchisor or by a sub-franchisee. The approval of the suppliers will usually depend on their fulfilling certain conditions that are intended to ensure both the quality and the availability of the equipment, products or services.

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<sup>1</sup> On this last point, see Chapter 4, Section C, Sub-Section III "Payments from Producers or Suppliers".

Whatever the method selected for the supplying of the needed equipment, products or services, it is possible for the franchisor to derive additional economic benefit therefrom. The franchisor may, for example, charge the sub-franchisees directly for the equipment, products or services that it supplies, thus generating an additional profit. When the equipment, products or services are provided by the sub-franchisor or by other independent suppliers, the franchisor may receive royalties or consulting fees from these parties. In these cases it is necessary to consider the fairness of the overall compensation that the franchisor receives from all sources, including the revenues generated from the franchising operations themselves, from the licensing or transfer of supporting technology and from the direct supply of equipment, products or services.<sup>2</sup>

### **C. FRANCHISOR/SUB-FRANCHISOR RELATIONSHIP**

The relationship between a franchisor in one country and a sub-franchisor in another has some unique characteristics that may influence the approach adopted by the parties in determining the method that should be followed for the supplying of equipment, products or services by the franchisor. The sub-franchisor, in its capacity as sub-franchisor, does not deal with the public directly, nor does it operate units that use the same equipment, products or services as the unit franchises in the system. The provisions of a master franchise agreement that relate to the supplying of equipment, products or services will therefore be different from the supply provisions contained in a standard sub-franchise agreement.

As the franchise system is new to the host country when the first sub-franchisor is granted exclusive territorial rights, a number of products or services that are unique to the system may not be available in that territory. The sub-franchisor may therefore wish to be assured of the initial supply of equipment, products or services that are essential to providing the franchise system with its unique characteristics. In this situation the franchisor may also wish to supply the sub-franchisor with what it needs initially, so as to

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<sup>2</sup> See Chapter 4 "Financial Matters".

ensure that the quality of the equipment, products or services is maintained. 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 if the franchisor is the sole supplier of the products needed for the franchise and, for example 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.

The franchisor and the sub-franchisor will normally prefer the products or services unique to the system to be supplied from sources within the host country, rather than from sources located abroad, also in view of the extra costs involved in transportation as a result of the distance between the establishments of the franchisor in one country and those of the sub-franchisees in another. In the case of products the costs of transportation might be substantial. Tax and other complications might furthermore arise when the products cross the borders of the country of destination. There might in addition be a need to adapt the products to the requirements of the local law or to local market conditions.<sup>3</sup>

The franchisor and the sub-franchisor may therefore conclude a detailed agreement governing the manufacture of the essential products in the host country. This agreement will often be separate from the main franchise agreement and may provide for an initial period during which the franchisor will supply the products to the sub-franchisor, or even to the sub-franchisees, after which, when the number of sub-franchisees has reached a certain level, the sub-franchisor will take over the supply of the products. The agreement between the parties that licenses the manufacture of the products would in this case provide for the eventual transfer of the technology necessary, for the applicability of quality standards and for the payment of royalties. It would also contain any other provisions that might normally appear in a technical assistance agreement relating to the manufacture of products.

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3 See Chapter 20 "Regulatory Requirements".

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

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

#### **D. REGULATION OF SUPPLY RELATIONSHIPS**

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

products or services. Other countries may regulate these arrangements under technology transfer laws.

In the United States, the tying arrangement is regulated as a matter of antitrust law. It is therefore illegal for a franchisor to require the purchase of one or more products ("tied products") as a condition for selling other products when the franchisor has sufficient power to force the sale of the tied products. There may also be a case of a "tied product" when the franchisor sells the products and receives a commission or other compensation for the sale of the tied product. Such tying practices may be justified by the necessity to ensure the protection of trade secrets or the maintenance of unique quality requirements, as well as by other important business reasons. In order to avoid the reaches of prohibitions on tying arrangements, franchisors often use approved supplier programmes. Other practices deemed to violate the duty of good faith and fair dealing, such as price discrimination between franchisees and other distributors and the offering of kickbacks by a supplier to the franchisor, are also proscribed.<sup>4</sup>

Similarly, in the European Union, Article 85 of the Treaty of Rome<sup>5</sup> contains a general prohibition of agreements that restrict sources of supply,<sup>6</sup> unless certain economic benefits can be shown to result from this restriction.<sup>7</sup> 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",<sup>8</sup> or "to sell, or use in the course of the provision of services, goods

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4 See also Chapter 4, *cit.*

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

6 Article 85(1)(c).

7 Article 85(3).

8 Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements, in OJ EEC L 359/46 of 28 December 1988, Article 3(1)(a).

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"<sup>9</sup>, 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.<sup>10</sup>

In Japan, under the Anti-Monopoly Act unjust tyings and abuses of a dominant position are illegal as constituting unfair trade practices.<sup>11</sup> In 1983 the Fair Trade Commission issued a guideline on the applicability of the Anti-Monopoly Act to franchise agreements. This guideline provides for a two-fold standard. Firstly, the franchise agreement as a whole may be considered to be invalid on grounds of abuse of a dominant position on the part of the franchisor, unless the restrictions contained in it only apply to the franchisees for as long as is necessary for the operation of the franchise system. Secondly, the single provisions may be held to be invalid. Factors such as the franchisor's position, the extent to which the franchisee is restricted in its activities and the number of franchisees in the system are also taken into account.

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

## **E. CONTRACTUAL PROVISIONS**

In the course of the negotiations, when the relationship between the franchisor and the sub-franchisor is defined, an issue that the parties should address is clearly the provision of essential equipment, products or services. This might not be necessary if the equipment, products or services essential to the operation of the franchised units are generally available within the prospective

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<sup>9</sup> Article 3(1)(b).

<sup>10</sup> Article 3(1).

<sup>11</sup> Act concerning the Prohibition of Private Monopoly and Maintenance of Fair Trade, Law No. 54 of 1947, Article 19.

host country, although in this case provision is best made for the maintenance of quality standards. For example, in a hotel franchise system the hotels within the system might use equipment, products and services that are entirely available from independent suppliers.

In the case of certain specific equipment, products or services, the parties may however wish to define the circumstances under which they are to be furnished to the franchise units and to indicate which of the supply 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 sub-franchise agreements. For example, a hotel franchise agreement may require the sub-franchisees of the network to participate in the system-wide reservation system and may establish that a fee is to be charged for such participation. Or it may establish that all the sub-franchisees are obliged to participate in a common advertising programme administered by the franchisor or by the sub-franchisor. These items are normally covered in the franchise agreements themselves, rather than in the ancillary documents, because of their relative simplicity and because they are such an integral part of the franchise operations.

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

It may be appropriate for the parties to conclude a separate supply agreement when numerous items are to be supplied, or when there are a considerable number of important issues that

relate to the supplying of those items. A separate agreement would permit the parties to deal with all the issues properly. These issues include, for example:

- ◆ the adaptation of product specifications to the needs or requirements of the host country;
- ◆ the manner in which the products should be manufactured within the host country;
- ◆ the manner in which the quality is to be assured;
- ◆ the measures to ensure adequate supplies; and
- ◆ the provision of technical assistance, trademark usage and the payment of royalties.

It should be observed that when products are sold by the franchisor, the supply agreement is in actual fact an agreement for the sale of goods and will include terms dealing with exclusivity, product specifications, pricing, payments, delivery, warranties, non-performance and termination. It may in such instances be appropriate to provide for the franchisor/vendor to retain title in the products until payment is made.

Similarly, appropriate provision should be made either in the master franchise agreement or in a separate supply agreement if the sub-franchisor is to be the supplier of the equipment, products or services.

If there is a separate agreement, the parties should consider the interplay between this separate agreement and the master franchise agreement, so as to ensure that the two are consistent and to take account of the implications of a possible termination of the master franchise agreement. The franchisor may, for instance, not want a sub-franchisor whose agreement has been terminated to continue as a supplier to the franchise system.

Finally, the applicability of the legislation of both the country of the franchisor and of that of the sub-franchisor, including the applicability of the *United Nations Convention on Contracts for the International Sale of Goods*, must be taken into account when a supply agreement of this nature is entered into.<sup>12</sup>

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<sup>12</sup> See Chapter 19 "Ancillary Documents".

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

The franchisor may not wish to enter into questions of the direct or indirect supply of the required equipment, 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. Finally, a franchisor may simply reserve the right to insist that certain specified minimum quality standards are maintained, without indicating that it will in any way control the sources of supply.

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

# CHAPTER 10

## INTELLECTUAL PROPERTY

In most countries of the world there are certain rights that are created by legislation and that the owners are entitled to use to the exclusion of all other parties. Any other party who wishes to make use of such rights is consequently obliged to obtain a licence 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 agreement between the parties.<sup>1</sup> Collectively these rights are known as intellectual 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 in an operations manual. Most countries have specific legislation for trademarks and for copyright. Although franchisors will sometimes own also patents and other industrial property rights that they will licence to franchisees as necessary, these rights will typically be the subject of licence arrangements, under which a licensee is granted the right to manufacture a product by making use of the licensor's patents and other intellectual property rights<sup>2</sup> and to distribute such products under the licensor's trademark.

### A. TRADEMARKS

The use of a trademark is an essential element of a franchise system. The manner in which a franchisor obtains the registration of a trademark from the appropriate government authority and subsequently maintains it, will vary from country to country. How a

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<sup>1</sup> See Chapter 11 "Know-How and Trade Secrets".

<sup>2</sup> For the purpose of this Guide the term "intellectual property" includes also what is known as "industrial property".

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 typical 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. It should, however, be observed that in certain countries the sub-licensing of a trademark is not permitted and that in these countries a master franchise arrangement that involves the grant of such a sub-licence by the sub-franchisor will not be possible. In these cases an arrangement by which the franchisor licences the trademark directly to the sub-franchisee will have to be provided for.<sup>3</sup>

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

In most countries trademark legislation will provide that for the owner of a trademark to licence the use of its 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 typically include provisions such as the following:

- ◆ a provision by which the use of the trademark by the sub-franchisor is restricted to use in accordance with the franchise system and in accordance with the standards and specifications contained in the operations manual, which is the property of the franchisor and is 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. If the sub-franchisor is

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<sup>3</sup> See Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties".

permitted to use the trademark as part of its corporate or trade name, then the manner in which the sub-franchisor may use the trademark should be specified. 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 general provision specifying the manner in which the trademark may be used also by sub-franchisees. 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 the manner in which the trademark is used and displayed by the sub-franchisees, as well as the manner in which services associated with the trademark are performed. The provision will also impose an obligation on the sub-franchisor to enforce compliance with the required use of the trademarks, as well as with the standards and specifications established by the franchisor.

The sub-franchise agreement between the sub-franchisor and the sub-franchisees will contain corresponding provisions.

It should be noted that there may be cases in which a trademark cannot realistically be used in the prospective host country. This may be due to, for example, the fact that in the local language an offensive meaning attaches to the trademark, or that there already exists in that country a mark which is similar to that of the franchise and with which there consequently is a risk of confusion. In such cases the franchisor might decide to modify the trademark and to register the modified trademark.

## ***II. INFRINGEMENT BY NON-AUTHORISED THIRD PARTIES OF ANY OF THE FRANCHISOR'S TRADEMARKS***

Master franchise agreements will typically address the consequences of infringement or threatened infringement of any of the franchisor's trademarks by third parties, and how such incidents should be dealt with. It should be noted that the registration of a trademark typically grants the owner the exclusive right to use the trademark in association with the goods

and/or services listed in the registration. The right of the registered trademark owner is deemed to be infringed by any person who sells, distributes, or advertises goods and/or services in association with a confusingly similar trademark. Similarly, a trademark owner may sometimes be permitted to bring an action for infringement, for what in common law countries is known as "passing off", or for unfair competition, or may have recourse to any other similar remedy that may be available, against a person who, in the ordinary course of business, employs a mark which causes, or is likely to cause, confusion between the goods, services or business of that person and those of the trademark owner. This right of the owner may at times be conferred upon another who has been granted rights by the owner, such as, in the case of franchising, the sub-franchisor.

The options that are available to the parties to the master franchise agreement in cases of infringement or passing off will typically include the following:

- ◆ the franchisor may retain the exclusive right, at its discretion, to decide whether or not to institute an infringement action against third parties for the unauthorised use of the trademark. The different elements to be considered by the franchisor in this connection include the cost of infringement proceedings and the possibility that such proceedings, if unsuccessful, may make it possible for others to infringe upon its trademark;
- ◆ the sub-franchisor may be authorised to institute an infringement action in certain circumstances specified in the master franchise agreement if the franchisor elects not to do so. If this is the case, then the manner in which the sub-franchisor is authorised to prosecute and to settle any such proceedings should be dealt with; and
- ◆ the parties may 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 and the allocation of any monetary awards that might be obtained.

### ***III. 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 typically dealt with in the agreement from the point of view of the 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 significant 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 consequently the extent to which the sub-franchisor can be expected to warrant that it has the right to grant its sub-franchisees the sub-licence to use the trademarks, is an important issue, not the least because of the consequences the reply is likely to have for the possible liability of the franchisor and the sub-franchisor respectively.

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

the master franchise agreement, but also in the sub-franchise agreements.

#### ***IV. UNREGISTERED TRADEMARKS***

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

#### ***V. REGISTERED USER AGREEMENTS***

Many countries with a legal system inspired by the system which existed under traditional 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 for the quality of the products or services to be offered, provides for its right to inspect the production of such products or the performance of such services and indicates the duration of the so-called permitted use. It should be borne in mind that, in view of the type of relationship involved, there may be a need for franchise agreements to be registered with the appropriate authorities even if the country concerned does not have a registered user system.

#### ***VI. SUB-LICENSING OF TRADEMARK***

As indicated above, in certain countries trademark legislation may not permit a sub-franchisor to sub-licence a trademark, as only the owner of a trademark may license its use to others. In these countries the structure of the master franchise relationship will be a cause of considerable concern.

In such circumstances one option available to the parties is 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 and a trademark licence agreement between the franchisor and the sub-franchisee covering the use of the trademark by the sub-franchisee.<sup>4</sup>

Another option is 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.

In connection with the above two options, it should however be observed that the owner of a trademark is usually required by law to supervise both the manner in which the products and services in respect of which the trademark has been registered are produced and marketed, and the manner in which the quality of the products and services bearing the trademark is maintained. As the franchisor is normally not in a position to perform such supervisory functions in the host country, and as in addition to its legal obligations it also needs to ensure that the distinctiveness of the trademark is maintained, it is obliged in one way or another to transfer this burden or obligation to the sub-franchisor. Furthermore, it must be recalled that frequently the franchisor chooses the master franchise vehicle precisely so as not to have to deal directly with the sub-franchisees. By entering into a direct contractual relationship with the sub-franchisees, even if only for the limited purpose of protecting its intellectual property rights, the franchisor will have defeated its objectives.

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<sup>4</sup> On the different options available, see also Chapter 2, Section F "Direct Contractual Relations".

The fact that the franchisor enters into licence agreements directly with the sub-franchisees, or becomes a party to the unit franchise agreement, would in fact seem to invite sub-franchisees to look beyond the sub-franchisor for help and supervision and to encourage them 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. In addition, the use of an agreement pursuant to which the franchisor bypasses the sub-franchisor and licenses the right to use the trademark directly to sub-franchisees may result in a risk of third party liability claims against the franchisor. There may be a similar risk also in the case of three-party agreements.

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. If this option is chosen, then provisions dealing with this relationship 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. The obligations of the parties in this connection should be specified. In addition, as indicated above, any registered user agreement that may be required by law should normally 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. It should however be observed that the option of the franchisor appointing the sub-franchisor as its agent will not shield the franchisor from potential third party liability claims, especially where such claims are a result of the use of the trademark.

## ***VII. THE INTERNATIONAL REGULATION OF TRADEMARKS***

It should be noted that many countries of the world are signatories to the international conventions that deal with trademarks, the most important of which are considered in the following sub-sections.

### (a) The Paris Convention

Most industrialised nations are Contracting Parties to the *1883 Paris Convention for the Protection of Industrial Property*<sup>5</sup> and as such are members of the *Paris Union*.<sup>6</sup> The Paris Convention deals with industrial property, which is defined as covering patents, utility models, industrial designs, trademarks, service marks, trade names, indications of source or appellations of origin and the repression of unfair competition.<sup>7</sup>

The provisions of most interest in the franchising context are those that require each country party to the Paris Convention to grant nationals of the other member countries the same treatment as that it grants its own nationals (the “national treatment” principle).<sup>8</sup> No requirement as to domicile or establishment in the country where protection is claimed may be imposed upon nationals of member countries as a condition for their benefiting from an industrial property right.<sup>9</sup> The same treatment is extended also to nationals of countries that are not party to the Paris Convention if they are domiciled in a member country or if they have a “real and effective” commercial establishment in such a country.<sup>10</sup>

One of the most practical benefits of the Convention is the “right of priority” pursuant to which, on the basis of a regular application for an industrial property right filed in one of the member countries, an applicant may, within a specified period

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<sup>5</sup> 1883 Paris Convention for the Protection of Industrial Property, revised at Brussels (1900), Washington (1911), The Hague (1925), London (1934), Lisbon (1958) and Stockholm (1967) and amended in 1979.

<sup>6</sup> As at 22 June, 1998, the Paris Convention had 149 Contracting States.

<sup>7</sup> Article 1(2). Trademarks are dealt with in Articles 5C(1), (2) and (3) and 6 *bis*.

<sup>8</sup> Article 2(1).

<sup>9</sup> Article 2(2).

<sup>10</sup> Article 3.

of time, apply for protection in all the other member countries. These later applications will then be regarded as if they had been filed on the same day as the first application and will therefore enjoy a priority status with respect to all applications relating to the same item filed after the date of the first application. They also enjoy a priority status with respect to all acts accomplished after that date which would normally be apt to destroy the rights of the applicant. In the case of trademarks the period of time within which the subsequent applications must be made is six months.<sup>11</sup>

## **(b) Madrid Agreement**

Of the contracting parties to the *1891 Madrid Agreement Concerning the International Registration of Marks*,<sup>12</sup> mention may be made of France, Germany, Egypt, Italy, China, the Russian Federation, Spain and Switzerland. Major countries not signatories to the agreement include the United States and Canada. The contracting parties to this Agreement and to the *1989 Protocol Relating to the Madrid Agreement concerning the International Registration of Marks* form the *Madrid Union*.<sup>13</sup>

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

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<sup>11</sup> See Article 4.

<sup>12</sup> Madrid Agreement Concerning the International Registration of Marks of 14 April, 1891, revised at Brussels (1900), Washington (1911), The Hague (1925), London (1934), Nice (1957) and Stockholm (1967) and amended in 1979 and 1989 Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks (Madrid Protocol)

<sup>13</sup> As at 25 May, 1998, the Madrid Agreement had 48 Contracting Parties and the Madrid Protocol 31. In total 56 States form the Madrid Union.

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

“[...] the country of the [...] Union where the applicant has a real and effective industrial or commercial establishment; if he has no such establishment in a country of the [...] Union, the country of the [...] Union where he has his domicile; if he has no domicile within the [...] Union but is a national of a country of the [...] Union, the country of which he is a national”.<sup>14</sup>

Applications for international registration are made to the industrial property office of the country of origin and it is this office that will forward the application to the *International Bureau of the World Intellectual Property Organization (WIPO)*, after checking and certifying that the mark as reproduced in the application for international registration is entered in the national trademark register in the name of the applicant and that the goods and/or services listed in the international application are covered by the national registration. It should be noted that international registration has effect only in those countries for which protection has been explicitly requested.<sup>15</sup> The application is then circulated to the other member States whose local trademark offices have twelve months within which to review and accept or reject the application based on local requirements. Accordingly, an applicant may obtain trademark registration in several countries by means of a single application, although it should be borne in mind that the international registration has no effect in the country of origin, that the trademark is protected in that country under the national registration that constitutes the basis for the international registration.

The agreement has been criticised because for a period of five years from the date of the international registration the protection resulting from the international registration remains

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<sup>14</sup> Article 1(3) of the Madrid Agreement.

<sup>15</sup> Article 3<sup>ter</sup>(1) of the Madrid Agreement.

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

The regime of the Madrid Agreement was modified by the *Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks*,<sup>16</sup> which was adopted to make the Madrid system acceptable to more countries. The main changes introduced by the Madrid Protocol may be summarised as follows:<sup>17</sup>

- ◆ the Protocol allows international registrations, at the option of the applicant, to be based on national applications (and not only on national registrations);<sup>18</sup>
- ◆ the Protocol, at the option of the Contracting Parties, allows eighteen months as opposed to twelve for refusals, and an even longer period in case of oppositions;<sup>19</sup>
- ◆ the Protocol allows the transformation of a failed international registration (failed, for example, because of a central attack) into national or regional applications in each designated Contracting Party. Such applications will

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<sup>16</sup> Madrid, 28 June, 1989.

<sup>17</sup> See World Intellectual Property Organization (ed.), *Introduction to Intellectual Property - Theory and Practice*, London/The Hague/Boston, 1997, p. 416.

<sup>18</sup> Article 2(1)(i).

<sup>19</sup> Article 5(2)(b) to (d).

have the filing date and, where applicable, the priority date of the international registration.<sup>20</sup>

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

A second main purpose of the Madrid Protocol is indicated as being the establishment of a link between the Madrid system and the regional trademark system of the European Communities, with the consequence that a Madrid registration could be based on a Community application or registration and that the European Communities could be designated in a Madrid registration.<sup>21</sup> This would be possible as a result of the provision in the Madrid Protocol in accordance with which not only States, but also certain intergovernmental organisations, such as the European Communities, can become party to the Protocol.<sup>22</sup>

### **(c) The European Community Trademark<sup>23</sup>**

The European Community trademark system is devised to provide a single registration covering all Community member States. The national systems of trademark protection are however not abolished by the adoption of the Community trademark system. The member States are free to maintain their own national legislation on trademark protection for their national territory. The main features of the national legislations have been harmonised by *Council Directive 89/104/EEC of 21 December 1988*.<sup>24</sup> A European trademark office has been

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<sup>20</sup> Article 9 *quinquies*.

<sup>21</sup> See Article 2 of the Protocol.

<sup>22</sup> Article 14(1)(b).

<sup>23</sup> Council Regulation (EC) No 40/94 of 20 December 1993 on the Community trademark, in OJ EEC L 11/1 of 14 January 1994.

<sup>24</sup> First Council Directive 89/104 of 21 December 1988 to approximate the laws of the Member States relating to trade marks, in OJ EEC L 40/1 of 11 February 1989.

established in Alicante, with applications lodged with the office being accepted as of 1 January, 1996. Harmonisation of the trademark registration process will clearly facilitate the entrance into the European Union of franchisors wishing to export their franchise system into the European Union and will serve to reduce barriers to trade between member States.

## **B. COPYRIGHT**

Copyright protects original literary, artistic and scientific works. In the franchising context copyright will thus mainly concern operations manuals, forms or modules, advertising materials or certain decorating materials. In most jurisdictions, copyright arises immediately upon creation. There is in other words no requirement to register a particular work in order to obtain enforceable rights. Typically, copyright subsists for the life of the author of the particular work concerned, plus an additional fifty or seventy years.

Registration is however possible in a number of countries. In these cases registration creates a presumption as to the fact that copyright in the work exists and as to the ownership of that copyright. Furthermore, it constitutes notice to the world at large that copyright exists, which may be important in assessing legal remedies.

It is often stated that copyright provides the owner with a package of rights, including the right to produce, reproduce, perform or publish the work, or any substantial part thereof, in any material form. It is important to bear in mind that copyright does not protect ideas, but only the manner in which those ideas are expressed. A work of copyright is, for example, infringed if a person without the permission of the owner produces a work that is substantially similar to the original or a deceptive imitation thereof. Master franchise agreements will typically deal with the consequences of piracy of copyright.

It is also important to note that if an author is a citizen of a country that is a contracting party to an international convention, that author will be able to obtain the same protection in the other contracting States of that convention as in his or her own

country. In this connection the provisions of the *1886 Berne Convention for the Protection of Literary and Artistic Works*,<sup>25</sup> the *Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs)*<sup>26</sup> and regional regulations such as those of the European Communities should be taken into consideration.

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<sup>25</sup> 1886 Berne Convention for the Protection of Literary and Artistic Works, completed at Paris (1896), revised at Berlin (1908), completed at Berne (1914), revised at Rome (1928), at Brussels (1948), at Stockholm (1967) and at Paris (1971) and amended in 1979 (the Berne Union).

<sup>26</sup> Marrakesh 1994, contained in an Annex to the Agreement Establishing the World Trade Organization.

# CHAPTER 11

## KNOW-HOW AND TRADE SECRETS

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

The term “know-how” generally refers to the body of professional knowledge that is acquired by persons engaging in a specific activity and that is distinctive of that activity. This knowledge is usually a combination of factual information concerning the activity and the experience gained in its exercise. Depending on the nature of the activity, the know-how may be technical or commercial. What is required for a body of knowledge to qualify as know-how will vary from field of activity to field of activity and from country to country, although a growing consensus may be seen in the adoption of similar definitions at supra-national and international level.<sup>1</sup> This is a recent development. Traditionally, the protection of know-how was not regulated legislatively and its protection was, and to a great extent still is, entrusted to the terms of the agreement between the owner of the know-how and the person that is being granted the right to use it. Know-how is therefore a special proprietary right which, contrary to what is the case with patents, trademarks and copyright, cannot be protected against the world at large. It is perhaps not surprising, considering the nature of know-how, that there are no public registers in which rights of ownership to know-how may be recorded or from which they may be ascertained. Notwithstanding this lack of legislative

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<sup>1</sup> See below, Section B “Know-How, Trade Secrets and Confidential or Undisclosed Information”.

regulation and protection, know-how is normally included among the intellectual property rights.<sup>2</sup>

Commercial know-how is an essential element of franchising. It is of fundamental importance to all the parties involved in the franchise arrangement. It is of importance first of all to the franchisor, as it is the know-how that it has built up over the years, in its activity as entrepreneur and above all as franchisor, that, together with its other intellectual property assets, is distinctive of its franchise system and that will give all the members of the network an advantage over their competitors. The communication of this know-how, together with the granting of the necessary intellectual and industrial property licences, will form the basis upon which the members of the network conduct their business. That they do so in a uniform manner is ensured by the supervisory functions of the franchisor and, in the case of master franchising, of the sub-franchisor.

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

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

“Know-how” is not the only expression used in business terminology and legal drafting to designate a distinctive body of professional knowledge. Expressions such as “trade secrets” and “confidential” or “undisclosed information” are also used. Although legal writers will distinguish between these concepts, the distinctions are so slight, that for the purposes of this Guide the expression “know-how” will include also trade secrets and confidential or undisclosed information.

The development of the knowledge that forms the know-how requires an investment on the part of the enterprise. The incentive

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2 See Chapter 10 “Intellectual Property”.

for such an investment is the profitability of the product or service developed and/or the advantage gained over competitors. This advantage will continue to exist as long as the secrecy of the knowledge is successfully protected.

A characteristic of know-how is that it is necessary for the owner of the enterprise to disclose it to, for example, its employees or collaborators, for it to be possible for them to use the know-how in the ordinary course of business. It is therefore a high risk asset, as the more it is exploited, the greater the risk that its secrecy will be lost.

In order to protect the know-how, it is therefore necessary for the persons who acquire knowledge thereof to be placed under an obligation not to disclose it to other people. This is achieved by means of confidentiality clauses or agreements. Furthermore, they must be bound not to make use of the know-how they have acquired to engage in a business activity that competes with that of the owner of the secrets. This is normally provided for in what are known as "non-competition clauses" or "covenants not to compete".<sup>3</sup>

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

"Know-how" is defined indirectly in Article 39(2) of 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. This provision, which deals with undisclosed information, indicates three conditions which undisclosed information must satisfy in order to qualify for protection: "[n]atural and legal persons shall have the possibility of preventing information lawfully within their control from being

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<sup>3</sup> See pp. 140 and 142 below.

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". A definition of know-how which is similar to that of undisclosed information contained in Article 39(2) TRIPs, is that contained in the European Union Block Exemption Regulation for franchising.<sup>4</sup> The domestic legislation of some countries also contains similar definitions. It should be noted that the adoption of, or accession to, the TRIPs Agreement will lead to know-how being offered similar protection in a large number of jurisdictions. The parties to a master franchise agreement are therefore well advised to ensure that what they call "know-how" qualifies for protection under the TRIPs Agreement. The requirements of Article 39(2) may be analysed as follows:

### ***I. SECRECY OF KNOW-HOW***

The requirement of secrecy is one that is recurrent in the international instruments adopted. This is the case also with the TRIPs Agreement, which in fact provides a definition of secrecy when it states in Article 39(2) that, for the undisclosed information to be secret, it must not, as a body or in the precise configuration and assembly of its components, be "generally known among or readily accessible to persons within the circles that normally deal

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<sup>4</sup> Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements, in OJ EEC L 359/46 of 28 December, 1988, Article 1(3)(f): "'know-how" means a package of non-patented practical information, resulting from experience and testing by the franchisor, which is secret, substantial and identified".

with the kind of information in question”.<sup>5</sup> This definition makes it clear that the absolute secrecy of the information is not necessary, as it is sufficient for the information not to be readily accessible to those who normally deal with the information in question.

## ***II. COMMERCIAL VALUE***

Article 39(2) TRIPs furthermore states that for the undisclosed information to be protected, it must have “a commercial value because it is secret”.<sup>6</sup> The information concerned is therefore only information the commercial 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 be lost.

## ***III. STEPS TO SAFEGUARD THE SECRET***

In addition, the person lawfully in control of the information is required to take “reasonable steps under the circumstances, [...] to keep it secret”.<sup>7</sup> The obligation to take reasonable steps is thus placed not only on the owner of the information, but also on whoever else 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 many jurisdictions courts have applied the so-called “test of reasonableness” to the measures of protection adopted in order to assess what information should be considered to be “secret”. The philosophy underlying this test is that it is not possible to claim protection against violations of “secret” information if the behaviour of the owner or of the person controlling the information is not compatible with an intention to keep it secret.

## **C. WARRANTIES BY SUB-FRANCHISOR AND BY FRANCHISOR**

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5 Article 39(2)(a)

6 Article 39(2)(b).

7 Article 39(2)(c).

It is of considerable importance for the sub-franchisor to be certain that the franchisor is the real owner of the know-how of the franchise system and for the sub-franchisees to know that the sub-franchisor really has been granted the rights it is transmitting to them. In the absence of public registries of know-how ownership rights, the questions therefore arise of firstly, the extent to which the franchisor should be required to warrant that it is the owner of the rights that it is granting the sub-franchisor or the franchisee and, secondly, the extent to which the sub-franchisor should be required to warrant that it has been given the rights that it is granting sub-franchisees. The replies to these questions will vary from country to country.

#### **D. THE DIFFERENCE BETWEEN "ASSIGNMENT" AND "LICENSING" OF KNOW-HOW**

The owner of the know-how can dispose of it in either one of two ways: by assigning it to another person, or by licensing its use. In the case of assignment the owner of the know-how will transmit both the know-how and the ownership of the know-how to another person. In its capacity as the new owner, this other person will be subject to no limitations as to how it may use or dispose of the know-how, whereas the previous owner will no longer be able to exploit it. The legal effect of the assignment contract is usually strengthened by means of a non-competition clause that binds the assignor until the know-how becomes public knowledge.

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

Although not all legal systems require licences to be set forth in writing, it may be assumed that in the case of international

franchise agreements all the conditions governing the licensing of the know-how will be set forth in writing.

The duration of a know-how licence cannot extend beyond the moment in time at 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 products or fields of activity (the so-called "field of use restrictions"). In this case the licensor will retain the right to exploit the know-how, directly or through other licensees, for other products or in other fields of activity. In the case of franchising the know-how may in most cases be used only for the exploitation of the franchise formula.

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

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

A situation that may occur is that of a third party acquiring knowledge of the know-how without the franchisor, or a person authorised by the franchisor, having transmitted this knowledge. The possibility that such a situation might occur needs to be considered by the parties, irrespective of the manner in which the third party may acquire the knowledge and of whether or not it acquires it in good faith, as a number of important questions would arise in such an event. One of the questions that would arise is whether or not the sub-franchisor, and the sub-franchisees, would still be bound by the confidentiality agreement with respect to the know-how, notwithstanding the fact that it no longer is secret. The situation will vary from jurisdiction to jurisdiction. In some jurisdictions they would still be bound,

whereas in others they would not, as the obligation of confidentiality would cease to exist as soon as the information covered by it no longer is secret. Parties are therefore well advised to devote special attention in the drafting of their agreement to the consequences of the know-how becoming public knowledge through no fault of their own.

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

In a master franchise relationship it is naturally of considerable importance to the franchisor that its know-how is used correctly by the sub-franchisor and the sub-franchisees and that the secrecy of the know-how is fully protected. In addition, the franchisor will need to ensure that it retains the right to exploit the know-how itself and to transmit it to other sub-franchisors or franchisees.

In practice, the know-how will normally be communicated by means of the operations manual<sup>8</sup> and by means of the initial and on-going training provided by the franchisor.<sup>9</sup> In a master franchise situation, the obligation to transmit know-how refers not only to the know-how that is available at the beginning of the relationship, but also to that subsequently developed during the life-time of the agreement.

Over time, the techniques adopted by the franchise system will be up-dated to take into account the experience gained in the exercise of the franchise, as well as the development of new techniques and other improvements. The means by which the up-dated techniques are communicated to the members of the network are typically new releases or other up-dating of the operations manual and the organising by the franchisor of

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8 This manual will normally be covered by copyright protection - see Chapter 10, Section B "Copyright". See also Chapter 5, Section C "Manuals".

9 See Chapter 5, Section B "Training".

periodical additional training programmes and/or meetings.<sup>10</sup> Needless to say, it is the franchisor's responsibility to keep the sub-franchisor abreast with the development of the know-how of the franchise system throughout the relationship. The sub-franchisor, on the other hand, must undertake the obligation to attend and/or to have its staff and sub-franchisees attend any such courses and meetings.

### **G. PROTECTION OF KNOW-HOW IN INTERNATIONAL FRANCHISE ARRANGEMENTS**

The main problem in master franchising, which requires the know-how to be transmitted to a series of successive users, is preventing the know-how from being disclosed by the sub-franchisees at the end of the line, as the statutory rules that protect trade secrets in the country of the sub-franchisees may not be sufficient to grant effective protection, also in view of the fact that the sub-franchisees have no direct contractual relationship with the franchisor. Contractual protection of know-how may however be ensured by the inclusion of appropriate clauses in both the master franchise agreement and the sub-franchise agreements.

It should be noted that the sub-franchisor may be held contractually liable for any breach of the obligation not to disclose the know-how on the part of its sub-franchisees, their employees or collaborators. In such cases the sub-franchisor may also be held liable if it fails to take the appropriate measures to remedy this breach, such as for example if it fails to file suit. The disclosure of know-how by sub-franchisees may furthermore be considered to amount to breach of the sub-franchisor's obligation to select the sub-franchisees with care, although it is possible that the sub-franchisor will not be held liable if the franchisor has retained the right to approve the agreements to be stipulated between the sub-franchisor and the sub-fran-

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<sup>10</sup> See Chapter 5 "The Role of the Franchisor"

chisees.<sup>11</sup> For the sub-franchisor to be held liable in such a case a specific clause would need to be inserted into the master franchise agreement.

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

Although know-how may be afforded protection by means of statutory rules that address other issues, such as criminal law rules or rules applicable in tort to acts of unfair competition, this limited statutory protection is insufficient for an asset of the nature of know-how. Clauses suitable to ensure the protection of the know-how, both for the duration of the agreement and for the time after it has come to an end, must therefore be included in every franchise agreement.

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

#### **(a) Confidentiality Clauses**

The master franchise agreement and the sub-franchise agreements will normally include a confidentiality clause aimed at protecting both the franchisor's know-how and any other confidential information that the sub-franchisor and the sub-franchisees are provided with. By means of such clauses the sub-franchisor and sub-franchisee undertake not to disclose the franchisor's know-how to third parties. In this case the third parties clearly do not include those to whom the information must be disclosed in order to ensure the proper functioning of the business, for example employees or other collaborators.

Such employees or collaborators may however find that the duty of confidentiality that binds their employer, independently of whether they are employed by the sub-franchisor or a sub-franchisee, may be extended also to them. Alternatively, the

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<sup>11</sup> On the question of prior approval of sub-franchisees by the franchisor, see Chapter 2, Section E "The Three-Tiered Structure of Master Franchise Arrangements".

franchisor might require a specific confidentiality agreement to be concluded between those persons and itself, so as to make them directly responsible to it, as it might not consider their obligations towards their employer to be sufficient. Generally speaking, in all industrialised countries clauses protecting the know-how may legitimately be imposed on employees or former employees.

Worthy of note, is the fact that the scope of a confidentiality clause is not necessarily limited to technical and/or commercial know-how that qualifies for protection. It may also cover other information, or even component parts of the know-how, that normally would not qualify for statutory protection, always provided that this information was not generally known and that it was therefore not already in the possession of the recipient, and assuming that this information, in combination with the other elements that form the know-how, is an essential element of the know-how. A declaration by the sub-franchisor or sub-franchisee indicating what he or she knew, or ignored, up until the time of the signature of the master franchise or sub-franchise agreement is therefore sometimes required in order to assist in the delimitation of the know-how that is protected.

An obligation of confidentiality does not come to an end with the expiration of the agreement, it will normally last until the information has become public. It should however be observed that in some jurisdictions this obligation will continue to bind the party that has assumed it even when the know-how, through no fault of any of the parties involved, has become public knowledge during the term of the agreement.<sup>12</sup>

Finally, it should be noted that contractual restrictions on the use of confidential information do not normally require specific compensation to be offered to the party that is restricted in its activities.

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<sup>12</sup> See also Section E "Third Party Acquisition of Knowledge of the Know-How", above.

## **(b) Non-Competition Clauses**

Another clause usually included in both master franchise and sub-franchise agreements is the non-competition clause. The main purpose of this clause is to protect the know-how and to avoid a dilution of the image of the franchise network. The validity of such a clause may be limited in some jurisdictions, in particular as regards territorial restrictions of competition. However, even if it may not always be possible to enforce such a clause in respect of territories that are not part of the franchisor's actual or potential market, its presence in the agreement will ensure that the sub-franchisor or sub-franchisee is not able to use the franchisor's know-how without permission. The validity of a non-competition clause will typically extend for the whole duration of the agreement.<sup>13</sup> Should the sub-franchisor at the time the master franchise agreement is signed already be engaged in a competing business, then this fact is best mentioned in the agreement.

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

## **(c) Grant-Back Clauses**

The master franchise and sub-franchise agreements might also include what are known as grant-back clauses. In accordance with these clauses the sub-franchisor, or sub-franchisee, is required to transmit any experience it has gained in the exploitation of the franchise to the franchisor and to grant the franchisor, and the other sub-franchisors and sub-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

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<sup>13</sup> See, however, Sub-Section II, *lit.* (b) "Post-Term Non-Competition Clauses", below.

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

#### **(d) Field of Use Restrictions**

“Field of use restrictions” are contractual clauses that limit the use to which the know-how granted may be put. In the case of a franchise such a clause will oblige the sub-franchisor or sub-franchisee not to use the know-how for purposes other than the managing of the franchised enterprise. It will therefore ensure that the sub-franchisor or sub-franchisee does not use the know-how of the franchisor for an activity without compensating the franchisor as the owner of the know-how and without the franchisor having any control over how its know-how is used.

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

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

#### **(a) Confidentiality Clauses**

In the case of the duty of confidentiality, the observance of this duty after the master franchise or sub-franchise agreement has come to an end cannot be imposed on the sub-franchisor or sub-franchisee if the know-how has become generally known or readily accessible. It must be stressed, however, that the

know-how cannot be considered to have become generally known if it is not known by, or readily accessible to, persons who may use it for business purposes. The mere fact that a person other than the members of the network has actually acquired knowledge of the know-how is not sufficient to release the sub-franchisor or sub-franchisee from the obligation not to disclose the confidential information.

It should be observed that the rule prohibiting the protection of generally available know-how after the agreement has come to an end does not apply when it was the sub-franchisor or sub-franchisee who divulged the know-how notwithstanding the fact that it was under an obligation to keep the information in its possession confidential.

### **(b) Post-Term Non-Competition Clauses**

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

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

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

### **(c) Know-How developed by the Sub-Franchisor and Sub-Franchisee**

The sub-franchisor and sub-franchisees will often develop their own know-how in the process of conducting the business. In this case, if this know-how was developed completely independently by the sub-franchisor or sub-franchisee, it would not be possible to prevent them from using the know-how they have developed for their own purposes after the franchise agreement has come to an end.

### **(d) Field of Use Restrictions**

Field of use restrictions may in general be extended after the end of the agreement.

# CHAPTER 12

## SYSTEM CHANGES

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

The success of a franchise system depends on its ability to evolve and change over time. The franchise relationship must be fluid and adaptable in order to remain viable. If the relationship is too rigid, the franchise system may become obsolete or, at the very least, un-competitive.<sup>1</sup> The franchise agreement provides the framework for the franchise relationship. It is however not possible to draft a franchise agreement, irrespective of whether it is a master franchise or a sub-franchise agreement, that expressly provides for each and every change in circumstance that might occur during the life of the agreement and that might affect the franchise system. It is therefore imperative to ensure that it is possible to adapt first and foremost the franchise system, but also the agreement that regulates the relationship of the parties with respect to that system, to the changed circumstances.

#### *I. THE DIFFERING OBJECTIVES OF THE PARTIES*

The interests of the parties with respect to the adaptation of the franchise system, image and products are however likely to differ. Whereas franchisors will wish to retain the maximum flexibility to implement changes in the franchise system, and will reflect this in appropriate clauses in the agreement, sub-franchisors and sub-franchisees naturally tend to prefer clearly specified obligations that are reflected in an agreement that does not permit change, as they understandably may fear that

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<sup>1</sup> On the need to adapt the franchise system to local requirements before beginning operations, see Chapter 1, Section B, Sub-Section VI "Inter-nationalising the Franchise System".

the franchisor will unilaterally and without limitation increase their obligations and expenditures. Sub-franchisors and sub-franchisees may therefore view changes proposed by the franchisor from the perspective of their adverse effect upon them, rather than from the perspective of the long-term benefit to the system. On the other hand, the franchisor might also hesitate to introduce changes proposed by the sub-franchisor, as it may not be familiar with the conditions that have occasioned the proposals.

In terms of the relations between the parties, the challenge is therefore to create conditions that will enhance the likelihood of their sharing a vision of the desirability of the proposed changes. It is important that all proposed changes to the franchise system are reasonable, or in line with the principle of good faith, both as to the extent of the changes concerned and as to the costs involved in introducing them. The franchisor may otherwise have difficulty in enforcing changes that the sub-franchisor and sub-franchisees could obviously not have foreseen when they signed the master franchise and sub-franchise agreements, and the sub-franchisor may find resistance to its proposals on the part of the franchisee. In terms of drafting, the challenge is to anticipate the need for change and to provide for it in a manner that is tolerable to both parties.

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

The types of changes that will benefit a franchise system are often related to the stage of development that the system has reached. In a franchise system's infancy, a modification of the system is likely to reflect the early experiences of the franchisor and its initial franchisees, and may involve, for example, the adjusting of the inventory or menu items of the system, the introduction of additional trademarks, or the use of different advertising media. Similarly, in international franchising the initial modifications are likely to reflect differences in culture, customs

and laws between the franchisor's country and the prospective host country.

As a franchise system grows and becomes well established, and as the franchisor's formula for success becomes more refined, more substantial changes to a franchise system may be required as a result of, for example, shifting demographics, changing consumer tastes, new technologies, or new competition. In response to these developments, a franchisor may wish to adapt its system in a number of ways, such as:

- ◆ by adding or deleting entire product lines (for example, a restaurant system introducing a hot/cold salad bar or a delivery service);
- ◆ by changing the system's image (for example, by re-designing logos);
- ◆ by increasing advertising and promotional activities (for example, by increasing the payments due to the advertising fund); or
- ◆ by changing operating standards.

In certain cases total changes in direction of the franchise system, or the conversion of franchised units into company-owned units, cannot be excluded, nor can the opening of new chains of units that sell product lines that directly or indirectly compete with those sold by the members of the franchise network.

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

In international arrangements, as in purely domestic arrangements, the franchisor will be the source of most of the changes and modifications to the system which will be incorporated during the lifetime of the agreement. It is not uncommon for modifications introduced as a result of the experience gained in one country to be incorporated into the system and to be implemented also in other countries.

A delicate situation may arise in relation to changes to the franchise system that the franchisor wishes the sub-franchisor to introduce and to have the sub-franchisees apply. In most cases this request on the part of the franchisor will be perfectly legitimate, as

the franchisor is naturally always endeavouring to improve its franchise system. Notwithstanding the legitimacy of the request, however, the franchisor must recognise that it might be difficult for the sub-franchisor to insist that its sub-franchisees adopt all such changes. Hesitations on the part of the sub-franchisor may be explicable by the fact that not all changes might be suitable for all countries. The introduction of changes will furthermore involve a certain expenditure and this is an important factor in the evaluation of the feasibility of introducing the proposed changes. Depending on the nature, degree and costs of the proposed changes, the sub-franchisor should therefore be given the right to test-market them and should only be obliged to introduce them if the results of the test-marketing prove positive. In addition, the possibility of granting the sub-franchisor certain fixed periods of time within which to implement the changes might be considered.

## **B. CIRCUMSTANCES THAT MAKE CHANGE LIKELY OR INEVITABLE**

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

### ***I. EXTERNAL FACTORS***

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

- ◆ demographic change;
- ◆ technological change;
- ◆ changing competitive conditions;
- ◆ changes in the law;
- ◆ changes in sources of supply as a result of changes in the local infrastructure.

### ***II. FRANCHISOR-DRIVEN CHANGES***

Franchisors will often decide to modify their franchise system when they estimate that such changes will improve the system.

The need to introduce modifications may result for a variety of reasons, including:

- ◆ the development of new products and services;
- ◆ the possibility of developing new marketing opportunities by reaching out to new customers and markets;
- ◆ the desire to use new marketing and distribution channels, although care should be exercised not to infringe upon the rights of the sub-franchisor and the sub-franchisees, as the fact that the franchisor retains a right to sell its product or distribute its services through other outlets may reduce the value of the franchise for the sub-franchisor and the sub-franchisees;
- ◆ the obsolescence of the franchise premises in terms of the equipment used and the image they present to customers, which makes a refurbishing of the facilities by the sub-franchisees of the network necessary.

Some changes that are more substantial or that are less urgent are often delayed until the franchise agreement is due to be renewed.

### ***III. SUB-FRANCHISOR INITIATED CHANGES***

As is the case with the initial modifications made to the system, subsequent modifications or improvements may also be introduced following suggestions made by the sub-franchisor or, through the sub-franchisor, by the sub-franchisees. As the owner of the know-how of the franchise system, the franchisor will however retain the right to approve the introduction of modifications or improvements 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. In these cases an issue of importance that should be addressed is that of the ownership of the improvements made.

## **C. THE EFFECT OF LEGAL PRINCIPLES**

A number of generally recognised legal principles will limit the franchisor's ability to modify its franchise system unilaterally. While franchisors might view these limitations as an impediment to their ability to respond effectively to a changing market, franchisees might on the other hand consider them to be a guarantee against arbitrary modifications on the part of the franchisor.

### ***I. CONTRACT LAW ISSUES***

A first observation when questions of contract law are considered, is that the different drafting techniques adopted in the systems belonging to the various legal traditions must be taken into consideration.<sup>2</sup>

The contract should be drafted in such a manner that it reflects the intention of the parties to allow changes to be made to the franchise system in the future. Changes to the system may, however, involve changes to the obligations of the parties, and it is therefore necessary to make provision also for this possibility. Contract clauses to this effect are however necessarily vague, as it is not possible to foresee what changes will be necessary. The question of their enforceability is therefore likely to arise. In general, if the franchise agreement does not show that the parties intended to grant the franchisor the discretion to modify the obligations of the sub-franchisor or the sub-franchisees in relation to a proposed modification to the franchise system, the franchisor might be unable to implement the modification that it wishes to introduce. For this reason, the agreement may 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 other parties to the arrangement. It should however be observed that clauses of this nature would in all likelihood come under close scrutiny from the point of view of their fairness. They might in fact be considered to be unfair contract terms, in that a unilateral right granted to the

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<sup>2</sup> See Chapter 1, Section B, Sub-Section V, *lit.* (b) "Drafting Technique".

franchisor might enable the franchisor to modify the terms of the agreement arbitrarily, thereby increasing the obligations of the sub-franchisor and/or sub-franchisees to a point where negative effects on the franchise units at the end of the line might ensue. The legislation applicable to unfair contract terms therefore needs to be taken into consideration in the drafting of a provision of this nature. It should furthermore be observed that any ambiguities in a contract will be construed against the drafter of the contract, which in the case of franchise agreements normally is the franchisor, although in the international context the contract is more likely to be the product of intense negotiations between the franchisor and the sub-franchisor.

In addition to the express obligations of the parties as laid down in the terms of the agreement, each party will in most countries have an implied duty not to take actions that will prevent the other party from benefiting from the agreement. While this duty may not be used to override the express terms of a contract, the extent to which the parties have expressly covered a subject in their franchise agreement is not always clear. As it is not possible to foresee every type of change that may be necessary, it might be especially difficult to demonstrate that this implied duty is not violated when a franchisor exercises its contractually granted discretion to modify the franchise system and consequently varies the obligations laid down in the agreement itself.

The technique of effecting change by incorporating by reference documents that are modified as a matter of course as the system develops, such as the operations manuals, may furthermore be thwarted by the rigid application of certain principles of contract law. It should however be observed that these rules have been mitigated in most jurisdictions and that a standard of good faith and reasonableness pervades this area of contract law. Consequently, the franchisor will usually be permitted to introduce the modifications it deems necessary when unforeseen difficulties arise in the performance of a contract, or when a proposed modification to a contract conforms to commercial standards of reasonableness. Other legal principles that might come into play in this context are the

principle prohibiting the discriminatory treatment of similarly placed parties and, of course, *force majeure*.

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

A franchise relationship is typically a long-term relationship. It is therefore natural that many aspects are sooner or later likely to require modification. To the greatest extent possible, these aspects should be considered in the franchise agreement itself. Those which most commonly require modification are the nature of the business, its external appearance, changes in the obligations of the sub-franchisee and changes in the scope of the franchisor's activities.

### ***I. THE NATURE OF THE BUSINESS***

#### **(a) Location and Nature of Facility**

As the demographics, traffic patterns, or zoning in the marketplace change over time, it may be desirable to re-locate the premises of unit franchises or to change their nature.

#### **(b) Territorial Rights**

The market considerations that determined the extent of the territorial rights granted to a sub-franchisor or sub-franchisee are likely to change over time, with the result that there may be a need to modify the territorial rights originally granted.

#### **(c) Customers towards which System is directed**

A franchise system's target customer will often change over time.

#### **(d) Products and Services offered**

Market research needs to be conducted periodically to discern changes and trends in the market, to which the system may respond by adding to, deleting from, or improving upon the products and services that are a part of the system.

### **(e) Methods of Marketing and Delivery**

The franchisor must be in a position to take advantage of the new marketing opportunities that become available as a result of the development of new media. Similarly, consumer demand for convenience may be met by making use of alternative channels of distribution, by engaging in combination franchising or by making use of other similar techniques.

## ***II. THE EXTERNAL APPEARANCE***

### **(a) Trademarks/Trade Dress**

The trademarks, logos, or trade dress of the system may be modified in the course of the franchise agreement to introduce a fresh colour scheme or a more modern logo, or because the system has evolved to such an extent that the marks no longer represent the full range of products or services offered by the franchise system. In these cases, as well as when the validity of the marks are in question, the franchisor will be compelled to introduce additional or substitute marks to increase the effectiveness of the system.

### **(b) Renovation**

The renovation of the franchise premises is frequently a precondition for the renewal or transfer of a franchise. Many franchisors also require their franchisees to remodel and upgrade their premises and equipment in the course of the franchise agreement, especially when the agreement is of long duration. Remodelling and upgrading of the franchise premises will typically entail a significant capital investment by the franchisee. Many franchise agreements will therefore provide a level of comfort to franchisees by setting forth standards, or by otherwise limiting the franchisor's discretion in this area. This limitation is often expressed either as a maximum amount of money that a franchisee will be required to invest in the renovation of the premises, as a specific number of renovations that will be required over the term of the franchise agreement, or as a requirement that the renovation bring the franchise unit

into compliance with the franchisor's then current standards for the system. In the context of a master franchise structure the franchisor will want to ensure that these rights and obligations are clearly outlined in the sub-franchise agreement.

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

#### **(a) New Obligations**

The franchisor must be able to establish and maintain the quality and uniformity of the products or services its network offers, as well as acceptance by the consumers. The franchisor's capacity to do so will often depend upon its ability to adjust the obligations of the sub-franchisor and sub-franchisees, in particular those obligations that deal with advertising fund contributions,<sup>3</sup> new marketing programmes and the like.

#### **(b) Higher Standards of Performance**

In addition to having evolving obligations imposed upon it, the sub-franchisor and/or sub-franchisee may also find that its standards of performance are adjusted in the course of the agreement. For some types of performance standards, such as sales quotas, it might be feasible to state those standards, as well as any changes that are to be made to them, directly in the franchise agreement itself, but most franchise systems will require sub-franchisors and/or sub-franchisees to comply with the standards and procedures specified in the system's operations manuals and the franchise agreement will instead typically reserve to the franchisor the right to update those manuals for the whole duration of the agreement.

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

Not only do the obligations of sub-franchisors and sub-franchisees change in the course of the franchise agreement, the

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<sup>3</sup> On advertising funds, see Chapter 8, Section C, Sub-Section III "Advertising Funds"

franchisor's obligations *vis-à-vis* its sub-franchisors, and through them its sub-franchisees, are also subject to modification as the franchise system evolves. This is particularly true in the case of domestic franchising. 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 sub-franchisors and the network.

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 a particular product to the members of the franchise network. Initially, the franchisor may be the sole source of this product, particularly if the product is not otherwise available or not of the required quality, 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 that product.

## **E. TECHNIQUES FOR EFFECTING CHANGE**

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

### ***I. THE USE OF THE TERM OF THE AGREEMENT***

#### **(a) Expiration of the 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 preferred by a franchisor who foresees

having to introduce more extensive changes to the system or to the terms of its franchise agreement.

### **(b) Renewal of the Agreement**

An almost equally effective opportunity to effect change arises in the context of the renewal of the franchise agreement, assuming that renewal is an option that is provided for.<sup>4</sup>

## ***II. OTHER TECHNIQUES***

In addition to the use of the term as a technique for effecting change, other techniques may be available in the course of drafting.<sup>5</sup> One such techniques which is becoming increasingly important in a time of rapid change is the reservation of rights. This would involve the franchisor reserving the right to market the same or similar products or services through alternative channels of distribution, perhaps at a later time and perhaps in a manner not readily accessible to the sub-franchisor or sub-franchisees (catalogue sales, for instance). While a sub-franchisor or sub-franchisee might be concerned that this could eat up its own sales, it might well realise a net benefit due to the increased exposure of the products or services that it offers to the consuming public. The parties should address this issue, and the methods of satisfying the objectives of each, at the outset.

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

As it is not possible to reflect all operational changes that are required to keep the franchise system up to date in amendments to the master franchise agreement, these operational changes are typically reflected in changes made to the manuals. It should however be noted that the franchisor will have great difficulty

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<sup>4</sup> See Chapter 3 "Term of the Agreement and Conditions of Renewal".

<sup>5</sup> See, generally, the discussion in Chapter 1, Section B, Sub-Sections IV "Negotiating International Agreements" and V "Drafting International Franchise Agreements".

enforcing provisions contained in the manuals that contradict the express terms of the franchise agreement. Moreover, the use of the manuals to implement major changes in the system, to impose significant new and previously unanticipated obligations, or to impose them in a manner that is demonstrably inconsistent with the reasonable expectations of the franchisees, may be problematic or not possible at all. An express acceptance of the new terms might be required in some legal systems.

The franchisor may also modify the system by requiring compliance with changes that are communicated by means less formal than an amendment of the operations manuals, such as, for example, bulletins, policy statements, notices and similar communications.

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

##### **(a) Events occurring outside the System**

An example of a change introduced following an event occurring outside the system would include the payment of an additional advertising fund fee when certain specified actions have been taken by competitors of the system.

##### **(b) Events occurring within the System**

Examples include the revocation of the sub-franchisor's or sub-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) Events occurring as a Consequence of Actions of other Franchisees**

The franchisor may wish to implement certain changes only after a qualified, or absolute, majority of its sub-franchisors approve them.

## ***V. CIRCUMSTANCES THAT MAY PROVIDE APPROPRIATE OPPORTUNITIES TO EFFECT CHANGE***

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

### **(a) Sub-Franchisor's Desire to Expand**

The franchisor, who has no obligation to grant an additional territory or franchise, may elect to do so on condition that the sub-franchisor agrees to introduce the modifications the franchisor proposes and to require its sub-franchisees to comply with them.

### **(b) Sub-Franchisor's Desire to Extend Term**

The franchisor might agree to extend the term of the master franchise agreement, or to renew it, on condition that the sub-franchisor agrees to introduce the modifications it proposes.

### **(c) Sub-Franchisor's Desire to Transfer**

A sub-franchisor's request to transfer some or all of its interest in the franchise to another sub-franchisor 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.<sup>6</sup>

### **(d) Sub-Franchisor in Default**

If the sub-franchisor has not adequately performed the master franchise agreement, or wishes to be excused for a debt it owes the franchisor, the franchisor may request that the sub-

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<sup>6</sup> See the more extensive discussion in Chapter 13 "Sale, Assignment and Transfer".

franchisor agree to introduce the modifications it proposes as a condition for not proceeding against the sub-franchisor for non-performance.

**(e) Franchisor develops New Product or Service which it is not contractually obliged to make available to Sub-Franchisor**

The franchisor might grant the sub-franchisor the right to offer the new product or service it has developed in exchange for the introduction of the proposed changes. Care should be taken not to withhold such opportunities from a sub-franchisor if to do so would have a negative effect on the viability of the sub-franchisor's operation.

***VI. CORRECTIVE AND ENFORCEMENT MECHANISMS***

A franchisor who anticipates and plans for future changes in the system will often include corrective measures in the franchise agreement for cases of, for example, sub-franchisor shortcomings. These measures will in general take effect automatically and will usually result in changes that are less drastic than an actual termination of the relationship. Common examples include the reduction of the sub-franchisor's exclusive territory or the elimination of the sub-franchisor's exclusive right to the territory if it fails to satisfy certain requirements (such as the attainment of a certain sales quota), the loss of the sub-franchisor's right to renew the agreement, or the loss of the sub-franchisor's right to carry all the products or services offered by the franchisor. This way of proceeding might permit the franchisor to facilitate change in the franchise system in a manner that may cause less friction between the parties than would otherwise be the case.

***VII. MAKING CHANGES MORE PALATABLE***

Franchisors have a number of devices at their disposal to make changes in the franchise system more palatable to sub-franchisors. These may play an important role in facilitating the modification of franchise programmes and in preserving a

constructive relationship. Many franchisors will consequently employ these devices even though they have no legal obligation to do so.

#### **(a) Disclosure of Likelihood of Change**

Franchisors may inform sub-franchisors that a modification of the franchise system is likely to occur.

#### **(b) Ensuring the Practicability of effecting the Changes**

An example of a device to ensure that it is possible for the sub-franchisors to introduce the changes required is the setting up of a sinking fund, that requires the sub-franchisors to set aside a specified amount of money each year in anticipation of alterations that will require a significant capital infusion.

#### **(c) Inducements**

The franchisor may be able to encourage its sub-franchisors and sub-franchisees to implement the required changes by offering them certain inducements, such as the granting of a larger, or of an additional, territory, the granting of an extended term or of a renewal, or by making available an additional product or service that the franchisor is not obliged to provide.

#### **(d) Assistance**

The franchisor may be willing to offer, or arrange for, financial benefits (such as the suspension of the payment of continuing fees) or other assistance to those that make the desired modifications.

#### **(e) Limitations upon required Changes**

Sub-franchisors or sub-franchisees may be more sympathetic to requests for modifications if they are aware that such requests will not be open-ended. The franchise agreement or operations manual should therefore specify any limitations in those requests, such as a limitation of the frequency of such

requests, the maximum amount of capital investment that will be required, or the events or conditions that could trigger requests for modifications of the franchise system.

## **CHAPTER 13**

# **SALE, ASSIGNMENT AND TRANSFER**

An eventuality that usually is not contemplated when the master franchise agreement is entered into, is that of the franchisor, or sub-franchisor, having the need to transfer its rights under the agreement to a third party even if the agreement has not come to an end. The importance of the assignment or transfer of rights under master franchise agreements, and of the rules or conditions that regulate such assignments or transfers, not only for the two parties directly affected but for the network as a whole, should however not be underestimated.

Master franchise agreements are almost invariably long-term agreements. In most cases the parties enter into the master franchise relationship with the intention of remaining in the relationship for at least the initial term, if not longer. The selection of a suitable partner is therefore of paramount importance. The parties will spend time and effort identifying a person or enterprise that they feel offers the necessary guarantees for a long-term relationship and that in general answers their requirements. Thus, to a considerable extent, each of the parties will base its decision to enter into a particular 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 a successful development of the franchise system. It is therefore natural for a party to prefer the other not to transfer its rights under the agreement, or for it to wish to see this ability restricted or somehow limited. It is however equally natural for that same party to wish to have the possibility to transfer its own rights. The franchisor and the sub-franchisor should therefore give careful consideration to any circumstances that might arise in the course of the agreement and that might result in a need on their part to transfer or assign their rights under the master franchise

agreement, as well as to the conditions under which they will each consent to an assignment or transfer by the other. The same considerations should be made by the sub-franchisor and the prospective sub-franchisee when they negotiate the terms of the sub-franchise agreement.

The laws of many jurisdictions provide rules governing the transfer or assignment of rights under agreements such as franchise agreements, but the parties may consider these rules to be insufficient in detail. Master franchise and sub-franchise agreements will therefore usually contain provisions governing the transfer of rights. It should be noted that whereas there is usually no reason to limit the rights of the franchisor to transfer or assign its rights,<sup>1</sup> and the master franchise agreement will therefore contain little, if anything, on transfers on the part of the franchisor, there are more reasons to limit the rights of the sub-franchisor and, in a sub-franchise relationship, of the sub-franchisee. The differences in the relationships that exist between the franchisor and sub-franchisor on the one hand and the sub-franchisor and sub-franchisee on the other, however occasion certain differences in the drafting of the provisions of the agreements. Those contained in sub-franchise agreements are in fact likely to be fairly detailed as to the different conditions under which the sub-franchisor will consent to a transfer on the part of the sub-franchisee, whereas international master franchise agreements might merely state that a transfer is not possible without the consent of the franchisor, who however should not withhold its consent unreasonably.

## **A. CIRCUMSTANCES GIVING RISE TO A TRANSFER**

### ***I. INTERNAL RESTRUCTURING***

A party to a franchise agreement, be it a master franchise agreement or a sub-franchise agreement, may wish to transfer its interests or rights in the agreement for a variety of different reasons. It may, for example, simply wish to restructure its interests

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<sup>1</sup> See below, Section C "Transfers of Franchising Interests of Franchisor Seldom Restricted".

internally, while having no intention to alter its ultimate ownership of, participation in, or commitment to the franchise relationship. Internal corporate governance, facilitation of ownership succession and tax considerations are to be found among the reasons for an assignment or transfer of franchise agreement interests to a different legal entity. Changes in the political world may also be the cause of changes of this nature. There may, for example, be situations in emerging economies in which wholly or partially State-owned enterprises that originally received franchises are privatised and this might require special treatment in the agreement. 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.

## ***II. DISABILITY OR DEATH***

It may be necessary to transfer the interests of an individual who is a party to a master franchise agreement as a result of disability or death. Assignment provisions must somehow address the issues that arise in these circumstances, such as under what circumstances the heirs of, or successors to, an individual may be entitled to assume its rights and obligations under the agreement. While this may be relatively uncontroversial in the case of a franchisor, it needs to be dealt with in relation to the death or disability of a sub-franchisor. Although it must be possible to transfer the interests of the sub-franchisor in these cases, it is natural that the franchisor will want to be able to exercise a certain amount of control over who steps into the franchise relationship by virtue of such a transfer. So as to be able to safeguard the network, the franchisor needs to be able to ensure that the transferee is capable of acting as sub-franchisor, that it is a suitable substitute for the original sub-franchisor.

## ***III. INSOLVENCY***

The insolvency of a party may also give rise to a transfer of all or part of its interests in the master franchise agreement. In such cases the laws of the country in which that party resides may dictate how and under what circumstances the transfer is to be made. It should be noted that these insolvency laws may overrule the contractual provisions that the parties have developed. The parties should therefore take care to ensure that their provisions do not conflict with the applicable insolvency laws.

#### ***IV. DESIRE TO TERMINATE THE RELATIONSHIP***

Either party may for financial or other reasons wish to terminate its involvement in the franchise relationship and may therefore decide to transfer its rights. This decision 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 motivated to ensure that the transferee is acceptable to it. Indeed, its concern in this regard will be fully justified. In the case of a transfer by a sub-franchisor, the franchisor may even require that it approve the transfer before it is made and may set forth certain conditions as a prerequisite for the granting of this prior approval. Any conditions of this nature will be designed to give it some assurance that performance of the assumed or transferred obligations will continue with the new party.

#### **B. REASONS TO PREVENT UNRESTRICTED TRANSFERS BY SUB-FRANCHISORS**

The reason a franchisor may wish to restrict the sub-franchisor's right to transfer its interests is to prevent an assignment of the sub-franchisor's interests to a party whose financial standing, ability or reputation is not satisfactory. It would clearly also wish to prevent assignment to a competing business or to a party affiliated with a competing business. A franchise relationship is based on the trust of each of the parties in the other. The

franchisor has entered into the relationship on the basis of its conviction of the quality of the sub-franchisor and of its belief that the sub-franchisor is well suited and committed to making the relationship a success. It is understandably hesitant to allow for the possibility of another sub-franchisor, the ability or commitment of which is unknown to it, taking the place of the first.

The franchisor will require more than an assurance that the new party will comply with the provisions of the master franchise agreement. It will prefer a new sub-franchisor that has the ability and the desire to actively pursue the franchising opportunity. The qualities that permit a sub-franchisor to pursue the franchising opportunity are often difficult to determine and are, at least to a certain extent, a matter of subjective judgment.<sup>2</sup>

### **C. TRANSFERS OF FRANCHISING INTERESTS OF FRANCHISOR SELDOM RESTRICTED**

The reasons for which a sub-franchisor would like to have the right to restrict transfers of the franchisor's interests and obligations in the master franchise agreement are similar to those for which the franchisor would like to restrict transfers of the sub-franchisor's interests. It is however unusual for a master franchise agreement to restrict the franchisor's right to transfer or assign its interests. There are two main reasons for which the franchisor is not restricted in this regard. Firstly, a franchisor is likely to have many different sub-franchisors in its system. To make the franchisor's transfer of rights subject to the consent of all of its sub-franchisors would at the very least create a procedure that is burdensome in the extreme. It might in fact effectively bar the franchisor from assigning its rights. Secondly, restrictions on the franchisor's ability to assign its interests would greatly reduce the marketability of both the franchisor itself and of the franchisor's franchise system, should it wish to sell the franchise business.

Furthermore, as the drafter of the master franchise agreement the franchisor will typically insert a provision allowing it

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<sup>2</sup> See the discussion of the selection of a sub-franchisor in Chapter 1, Section B, Sub-Section II "The Selection of a Sub-Franchisor".

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 is viewed as a very remote possibility. Most franchise agreements will therefore give the franchisor the freedom to transfer its interests as it wishes. Should such a transfer occur, it will often also fully release the franchisor from any further responsibilities to the sub-franchisor, at least to the extent that the franchisor's assignee has assumed the obligations concerned.

## **D. COMMON CONTRACTUAL APPROACHES**

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

### ***I. WHAT CONSTITUTES A TRANSFER***

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

### ***II. CONDITIONS FOR PERMITTING TRANSFER***

The master franchise agreement will often require the written consent of the franchisor for any transaction that constitutes a restricted transfer. The franchisor may be given the sole and

absolute right to grant or withhold its consent, or its consent may be subject to the satisfaction of certain conditions. The conditions that are imposed are usually designed to ensure that the new sub-franchisor has the qualities that are deemed to be necessary in a good sub-franchisor. Examples of the kinds of conditions that are imposed are:

- ◆ the sub-franchisor must be in compliance in all respects with the master franchise agreement;
- ◆ the sub-franchisor must give up and release any claims that it may have against the franchisor at the time of the proposed transfer or assignment;
- ◆ the proposed transferee must demonstrate to the satisfaction of the franchisor that it has the appropriate managerial, financial and business characteristics to become a suitable sub-franchisor. This condition may contain elaborate detail, making reference to, for example, the prospective sub-franchisor's good reputation, net worth, credit rating, ability to actively supervise the operation of the franchised units in the territory, general aptitude and economic and business experience, or it may simply refer to the franchisor's established standards for the appointment of new sub-franchisors. Satisfaction of conditions of this kind will to a certain extent depend on subjective evaluations on the part of the franchisor and sub-franchisor and might lead to differences of opinion between the two;
- ◆ the payment by the transferring sub-franchisor of a transfer fee that serves as a partial reimbursement of the expenses incurred by the franchisor in its review of the proposed transfer;
- ◆ the execution of a new master franchise agreement by the proposed transferee that conforms to the latest version of the 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 sub-franchisor, who may wonder why it should give up rights that it has vis-à-vis the franchisor in order to be permitted 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 while they are still working together. If that is the franchisor's purpose, then the possibility of adopting a more clearly balanced formulation of the provision might be considered.

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 sub-franchisor. A prospective initial sub-franchisor may nevertheless understandably object to subjective standards that give the franchisor excessive discretion in determining whether a proposed transferee is suited to be a good sub-franchisor. The parties may find a compromise by providing that the franchisor's approval of a proposed assignee will not be unreasonably withheld.

The sub-franchisor will of course wish to have the freedom to transfer its interests in the franchise agreement in appropriate circumstances. It should therefore at the very least seek to ensure that the conditions that must be satisfied for it to obtain the franchisor's consent to the transfer are reasonable. The sub-franchisor may furthermore seek to impose the application of standards of reasonableness when the franchisor exercises any discretion that it might have in the actual determination of whether or not the required conditions have been satisfied.

Finally, the conditions imposed for the transfer of interests may differ depending on the circumstances. A transfer caused by the insolvency or bankruptcy of the sub-franchisor will, for example, be subject to different rules or procedures than a transfer that is completely voluntary. In this connection the

special insolvency laws of the countries involved must be examined in order to understand the implications of either of the parties coming under the special requirements of these laws.

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

### ***III. RIGHT OF FIRST REFUSAL***

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

# **CHAPTER 14**

## **VICARIOUS LIABILITY, INDEMNIFICATION AND INSURANCE**

Any franchise agreement, whether national or international, should include provisions dealing with vicarious liability, indemnification and insurance issues. The provision or provisions concerned should be drafted taking into account the legal rules that relate to liability, as well as insurance practices that apply in the host country. Wherever possible, the provisions should specify not only the general obligations of the parties, but also the content and extent of such obligations.

It should be observed that the issues under consideration in this chapter arise as a consequence of problems with, or claims and actions brought by, third parties. The chapter does not deal with the liability of either party to a master franchise agreement for the performance or non-performance of its contractual obligations.

### **A. VICARIOUS LIABILITY**

Suits by plaintiffs attempting to hold the franchisor liable for the acts, omissions or defaults (hereinafter referred to as "defaults") of a member of its network are increasingly a risk factor for franchisors. The general rule is that, in the absence of a legal relationship on which such a claim may be based, for example an allegation that an agency relationship exists, the franchisor is not vicariously liable for the sub-franchisor's, or indeed the sub-franchisees', defaults.

For an agency relationship to give rise to a claim, it must be based on the right of the principal (in this case the franchisor) to control the day-to-day operations of the business of the agent (the sub-franchisor or sub-franchisee). In an agency relationship,

the right to control will extend not only to the day-to-day business, but also to the result of the work and the manner in which the work is accomplished. A claim could also be based upon the proposition that by using the franchisor's name, the sub-franchisor and sub-franchisee are held out to the public as agents of, or indeed as being, the franchisor and that they therefore have ostensible authority to commit the franchisor and to make the franchisor liable for their defaults. It is consequently important for the franchisor to review the way in which such claims may be made under the relevant laws, with a view to eliciting how it might be possible to reduce or eliminate this risk. A common method is to require the sub-franchisee to announce, for example by exhibiting a notice in its unit, that it operates its business under franchise and that it is independent of the franchisor.

The franchise relationship will almost always involve the franchisor imposing a system and method of operation accompanied by controls. The conduct of the sub-franchisee in carrying out its obligations might be perfectly correct and in accordance with the requirements of the franchisor, but still result in damage being suffered by a customer or by a stranger who has no contractual relationship with the sub-franchisee. This could lead to a court finding the franchisor vicariously liable for the acts or omissions of the sub-franchisee. Issues such as whether a duty of care was owed, and whether the loss suffered by the third party was foreseeable, would in such cases be examined by the court. If the customer or stranger concerned realises that the damages would be substantial, that the sub-franchisee is relatively impecunious but that the franchisor has a deep pocket, that customer or stranger might be tempted to sue the franchisor on principal/agency grounds, or on the basis of vicarious liability. Alternatively, the sub-franchisor might be sued for the same motive and on the same grounds.

In order to avoid being held vicariously liable, a franchisor or sub-franchisor might allege that the sub-franchisee had not followed instructions and that it had not performed in accordance with the franchisor's and/or sub-franchisor's requirements. In this case the extent and conduct of the franchisor's or sub-franchisor's method of regulating and

monitoring the sub-franchisee's business would be examined by the court, with a view to determining whether the franchisor or sub-franchisor could escape liability on the grounds that the sub-franchisee had failed to observe the requirements.

A franchisor or sub-franchisor may also be a victim of the sub-franchisee's defaults and the court might need to investigate whether the sub-franchisee had disregarded pressure from the franchisor or sub-franchisor to conform to the requirements of the system. In connection therewith, the court would also need to determine whether the franchisor or sub-franchisor had acted reasonably in the enforcement or non-enforcement of its requirements. This could subject the franchise relationship to stress, as the sub-franchisee might resent what it would regard as over-regulation by the franchisor or sub-franchisor. It might also lead a franchisor or sub-franchisor to the conclusion that, in order to satisfy a court, it must take strict legal enforcement measures, rather than use less formal techniques to persuade the sub-franchisee to comply.

The above considerations point to the need for a franchisor or sub-franchisor to be circumspect, not only with regard to the drafting of franchise agreements, but also in the way in which it conducts the continuing relationship with the sub-franchisees. While a franchisor has an important interest in ensuring that the franchisee adheres to its system for the purposes of achieving consistency and of protecting the goodwill of the trademark or trade name, an excessive control over the sub-franchisee could result in the franchisor and sub-franchisor being exposed to liability for the acts or omissions of the sub-franchisees.

A franchisor or sub-franchisor will therefore need to take care to avoid controlling the sub-franchisees' day-to-day operations. It is unlikely it would want to do so, as that would negate the principles on which franchising is based and might create also other problems.

## **B. INDEMNIFICATION**

### ***I. RESPONSIBILITIES OF THE SUB-FRANCHISOR***

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

On the other hand, the sub-franchisor does not have to hold the franchisor free from liability if actions are brought against the sub-franchisor following accidents that have occurred as a consequence of a legitimate and proper use of the franchise, or if actions are brought against the franchisor as a consequence of the sub-franchisor's use of the trademarks or of the franchise system, if the trademarks or the system were used in conformity with the agreement.

## ***II. RESPONSIBILITIES OF THE FRANCHISOR***

It is natural for the franchisor to assume sole and entire responsibility for any loss, damage, cost or expense (including court costs and reasonable legal fees) that arises out of any claim, action, administrative inquiry or other investigation that relates to its own operation of the business, independently of the

reason for which it was made. Examples of such claims or actions would include product liability claims or claims of infringement of intellectual property rights. It would appear to be appropriate for the master franchise agreement to include a statement relating to the assumption by the franchisor of any such responsibility.

### ***III. DUTY TO INFORM***

It is also usual for each of the parties, the franchisor or the sub-franchisor as the case may be, to be obliged to inform the other promptly or within a specified short period of time of any liability claim brought, of any law suit, proceeding, administrative inquiry or other investigation 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.

### ***IV. RESPONSIBILITY FOR DEFENCE***

It is advisable for the sub-franchise agreement to set out rules specifying when the franchisor or sub-franchisor is entitled, or under what circumstances either of them is obliged, to undertake or assume the defence of any liability claim, action, inquiry or investigation, at whose risk and expense such a defence should be undertaken and the conditions under which a settlement might be made. Often, it will be the party in whose country the action takes place that will assume the primary defence, always providing the other with full information on the progress of the proceedings, but in the final analysis it will depend on whom the liability ultimately will fall, as that person will be likely to want to have the right to assume the primary defence. The franchisor is usually entitled to choose whether or not it should itself assume the defence against the third party's claim, always provided that this is permitted by the procedural laws of the host country. As far as the franchisor's intellectual property rights are concerned, the situation will vary from country to country. In a number of jurisdictions it is only the owner, the franchisor in this case, who has the right to assume their defence, whereas in others it is possible

for an exclusive licensee, such as the sub-franchisor, to do so.<sup>1</sup> Where it is the way the sub-franchisor operates its business that is the cause of the necessity of such a defence, it is natural that it will be the sub-franchisor that will bear the cost and expense of the defence. Whoever assumes the defence, the prior written consent of the other is normally necessary before a settlement can be made.

#### ***V. RESPONSIBILITY OF INDIVIDUALS***

The responsibilities mentioned in Sub-Sections III and IV above will normally fall upon the party who has actually concluded the contract, namely the franchisor or the sub-franchisor, and not upon their directors, officers, shareholders or partners, unless a claim arises as a result of a default of such a person. Directors or other persons may however be personally liable if, in the master franchise agreement or in an ancillary agreement, they have issued a personal guarantee for the contractual party's obligations. This might be the case when the contractual party is a corporate entity.

#### ***VI. LIMITS ON REPRESENTATIONS AND WARRANTIES***

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

#### ***VII. CORRESPONDING INSURANCE COVER***

Finally, it is very important for both the franchisor and the sub-franchisor to examine their own liability insurance policies in detail. It is advisable for them to ensure that these insurance policies cover the extent of their possible liability risks, or at least

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<sup>1</sup> See Chapter 10, Section A, Sub-Section II "Infringement by Non-Authorised Third Parties of any of the Franchisor's Trademarks".

that the indemnification provisions in the contracts they conclude do not go beyond the insurance cover.

### **C. INSURANCE**

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

#### ***I. INSURANCE OBLIGATIONS OF THE SUB-FRANCHISOR***

In master franchise agreements of North American, European or Australian origin a provision is usually found under which the sub-franchisor is under an obligation to take out insurance, in the first instance against third party liability risks but also against property risks. The sub-franchisor is usually obliged to impose a similar obligation on its sub-franchisees. Such contractual clauses may at times only provide for a general obligation to "take out an appropriate insurance policy", leaving it to the sub-franchisor or sub-franchisee to decide what it considers to be "appropriate", but often the cover needed will be specified.

The franchisor and the sub-franchisor would be well advised to discuss the liability risks that exist in the host country, not only under statutory law but also under case law, as well as what insurance coverage is available or usually taken out in that country. There may be countries in which taking out an insurance against third party liability risks is unusual or unheard of, or in which an insurance cover is very expensive or simply not available. In such countries it might also be unusual to go to court with third party liability claims. There is however always a risk that third parties, such as clients of the sub-franchisees, might bring an action directly against the franchisor, either in the host country or in the franchisor's home country where the courts might be used to such claims being brought and where they might even grant substantial sums in compensation. As this risk may increase in the future, franchisors and sub-franchisors have an interest in finding a

way to insure against it. A possibility might be to include the sub-franchisor and the sub-franchisees in the insurance policy of the franchisor, another to find insurance coverage in a foreign insurance market. The latter possibility may, however, be less viable in cases where the host country's foreign exchange laws prohibit or limit the export of money for foreign insurance policies.

## ***II. EXTENT OF INSURANCE OBLIGATIONS***

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

The sub-franchisor may be obliged to provide the franchisor with copies of the insurance policies before initiating the master franchise operation and may thereafter be obliged regularly to provide evidence that such insurance policies are still in force. The provision of such evidence might be automatic at each renewal of the policies, or might be made at specified intervals or only at the specific request of the franchisor.

The franchisor usually requires the insurance coverage to be extended to it and to its directors, officers, shareholders, partners or other licensees wherever the interests of these persons may be affected by the risks covered by the insurance policies. For this to be possible, the insurance practice of the host country must permit such an extension, 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 parties and to

recover the additional insurance premium through the franchise fees.

### ***III. STEPPING IN OF FRANCHISOR***

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

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

### ***IV. INSURANCE OBLIGATIONS OF THE SUB-FRANCHISEES***

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

# CHAPTER 15

## REMEDIES FOR NON-PERFORMANCE

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

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

In addition to having a natural desire to see the franchise system develop in conformity with the development schedule, the franchisor will be concerned to ensure that the sub-franchisor monitor and control the quality and standards of performance of the sub-franchisees. As the sub-franchisees are trading using the franchisor's know-how and systems, the franchisor's assets are at risk if anything happens that can adversely affect its interests and property rights. The sub-franchisor is the custodian of those interests and rights in the territory in respect of which it has been granted the right to develop the franchise system. The agreement should therefore provide for the monitoring and maintenance of quality performance standards,<sup>1</sup> but it should also provide for remedies should the sub-franchisor fail to ensure that these standards are maintained. It is recommended that the default provisions of the agreement, which are those that provide the basis for the remedies, 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.

As is the case with other issues of relevance to a master franchise relationship, regard must be had to the legislation applicable within the host country, as it may impose limitations on

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<sup>1</sup> See Chapter 6 "The Role of the Sub-Franchisor".

the right to terminate a contract or on the payment of compensation. It should also be borne in mind that either party may dispute the validity of any termination of the master franchise agreement by the other, irrespective of whether or not it was terminated in accordance with its terms.

## **A. REMEDIES SHORT OF TERMINATION**

A number of possible remedies are normally provided for in the agreement, the most drastic of which is termination. In master franchise agreements provisions are typically to be found that permit termination by the franchisor for non-performance by the sub-franchisor. There are also cases in which the agreement provides for formal termination by the sub-franchisor for non-performance by the franchisor, but these are in the minority. It should however not be forgotten that in case of breach by the franchisor a sub-franchisor will always have access to the remedies that are normally available for breach of contract. It is sometimes suggested that reciprocity demands that the sub-franchisor should have the same termination rights as the franchisor. The nature of the arrangement and of the rights to be protected are however such as to render that possibility impracticable.

### ***I. REMEDIES AVAILABLE TO THE FRANCHISOR***

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

The relationship between franchisor and sub-franchisor is not as close as that between franchisor and franchisee. The performance at unit level in a master franchise arrangement is delivered by the sub-franchisees. The sub-franchisor's role is to recruit, train and supervise the performance by the sub-franchisees and to provide them with the appropriate range of "franchisor" services.<sup>2</sup>

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<sup>2</sup> See Chapter 6, *cit.*

The franchisor's overall supervisory functions will not normally involve a day to day participation in the activities of the network in the host country.<sup>3</sup> While the franchisor can visit the host country, it will only with difficulty be able to keep up to date with the performance of the network or with any dissatisfaction of the sub-franchisees with the performance of the sub-franchisor. Non-performance on the part of the sub-franchisor will often lead to poor performance on the part of the sub-franchisees. By the time a franchisor discovers the nature and extent of non-performance by the sub-franchisor a great deal of damage may have occurred. The sub-franchisees may, for example, be very unhappy with the poor performance of the sub-franchisor and disillusioned with the franchisor and the system as a consequence. It would be very difficult for the franchisor to recover the confidence of the sub-franchisees in such a situation, or for a new sub-franchisor to take over.

Situations such as those described above may arise if the sub-franchisor has strayed from the franchisor's system and is resistant to the franchisor's attempts to re-impose the necessary discipline to a badly run network, or if the sub-franchisor has reached the conclusion that it knows better than the franchisor how the system should be operated. If the relationship is affected by these problems, then correcting them by direct discussion and persuasion may be difficult. Nevertheless, the franchisor, and indeed the sub-franchisor, will be better off if the issues can be negotiated and the system and standards restored. The overall possibility that the arrangement may be terminated, and a consideration of the great cost to both parties if this should occur, should encourage them to seek an agreed way forward.

In order to avoid termination a means must be found to alleviate the problems that are causing the difficulties. The alternatives the parties should consider in this connection include:

- ◆ 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;

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<sup>3</sup> See Chapter 2, Section E "The Three-Tiered Structure of Master Franchise Arrangements".

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

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

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

Where the sub-franchisor has difficulty meeting its financial commitments to the franchisor, a possible solution is for the franchisor to re-schedule the debt. The franchisor may however not be prepared to reschedule debts at all, or may be prepared to do so only if the prospect exists that adequate capital will be made available, thus ensuring that future payments will be made in full and on time.

Remedies that fall short of termination, but that involve legal proceedings, are unlikely to result in an improvement in working relations, unless they can assist the parties in reaching a mutually satisfactory arrangement. Remedies such as injunctions or specific performance are inappropriate, as a franchisor would not want to have a reluctant sub-franchisor operating merely because the court has issued 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 the non-performance on the part of the sub-franchisor is limited to the non-payment of a debt, the franchisor 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 that the agreement should continue to be performed in other respects.

## ***II. REMEDIES AVAILABLE TO THE SUB-FRANCHISOR***

A number of remedies short of termination are available to the sub-franchisor in the case of non-performance of the

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

## **B. TERMINATION**

### ***I. TERMINATION BY THE FRANCHISOR***

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

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

Some breaches are more likely than others to occur. These include:

- ◆ failure to make payments when due;
- ◆ failure to submit reports;
- ◆ failure to follow procedures for the transfer of the business (which might even include making an unauthorised transfer);

- ◆ failure to observe restrictions on involvement in competitive businesses;
- ◆ failure to respect confidential information and to ensure that also sub-franchisees do so; and
- ◆ failure to ensure a proper use of the trademarks, trade name and franchise system by sub-franchisees.

A provision that is found in master franchise agreements is one which permits a franchisor to terminate in the event of a material or substantial default. Expressions such as "material or substantial default" are often difficult to interpret. What a franchisor regards as a "material or substantial default" may not be regarded as so material or substantial by a sub-franchisor. The parties should agree on what is material or substantial, as they will find that if they do not, the court will decide and how the court will determine a dispute could be open to question. It is important for both parties to know where they stand. If an expression such as "material or substantial default" is used, then it should be clearly defined.

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. The franchisor and sub-franchisor must ascertain whether the law applicable to the agreement (which in this case may be the law of the host country as a matter of public policy) provides special procedures, restrictions of direct or indirect penalties in some form or other which may inhibit the exercise of a contractual right to terminate the contract.

Before termination is resorted to, the sub-franchisor will normally be given a certain period of time to cure the default. The period of time allowed for the cure has to be appropriate for the nature of the breach complained of. In the case of sums of money that have not been paid, the default is likely to be treated more seriously by the franchisor, with a shorter period of time being given to cure the default. Quality control defaults may need a longer period for the default to be put right, as the action to be taken to do so will invariably involve enforcing rights against sub-franchisees. For a number of defaults, however, a short period will be sufficient, such as for example in the case of non-observance of hygiene requirements in fast food operations.

### **Termination of Development Right**

In all probability the development right will carry with it a right to territorial exclusivity and the development schedule will state how many sub-franchises have to be established in that exclusive territory and within what time-frame.<sup>4</sup> The agreement will therefore be expected to deal with the issues that will arise if the requirements of the development schedule are not met.

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. If an agreement is to be reached, both parties will have to consider the various sanctions that may be imposed for a failure to achieve the requirements of the development schedule. The agreement may provide for:

- ◆ the loss by the sub-franchisor of the exclusive territorial rights it has been granted by the franchisor;
- ◆ the keeping of exclusivity for only part of the territory;
- ◆ the reduction of the contractual territory;
- ◆ the payment of a penalty (if legally possible in the territory);
- ◆ the payment of liquidated damages;

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<sup>4</sup> See Chapter 6, Section B "Development Schedule".

- ◆ increases of royalty payments or the loss of the benefit of a reducing sliding scale for the franchise fees (although such a scale is not common);
- ◆ a reduction in the number of sub-franchisees that 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; and
- ◆ 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.

In some cases where there is a failure to perform the development schedule the parties may agree upon a formula that will enable the sub-franchisor to pay what are called "phantom royalties", which may be considered to be a form of liquidated damages, in order to preserve the development rights. Phantom royalties are a sum of money calculated in accordance with a predetermined formula and designed to 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. 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 will again become available to the franchisor. It is also possible that the parties may re-negotiate the development schedule if it becomes apparent that it was unrealistic.

Removing the sub-franchisor's exclusive territorial rights when it has not performed its obligations under the development schedule may not achieve the result that the franchisor and the sub-franchisor seek, as even if the sub-franchisor continues to open further franchise units, it might 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 that operate under the same name, but that might not have the same quality standards. If the first sub-franchisor continues to sell, then 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 when this becomes necessary as a result of demographic changes or because it is not possible to renew a lease. There could furthermore be difficulties over the exercise of rights of renewal, as it will probably not be possible to extend the first sub-franchisor's agreement. Sub-franchisees would not be able to expand their operations. Advertising programmes have to be co-ordinated and the first sub-franchisor may be sufficiently upset at the loss of its rights not to be co-operative. For these essentially practical reasons many franchisors may not wish to agree to an agreement that provides for the termination of the sub-franchisor's rights of exclusivity in cases of non-performance of the development schedule, but may instead insist on termination of the agreement in its entirety.

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

It should be pointed out that the termination of the development right may not necessarily result in the termination of other provisions in the agreement that are not related to that right or its exercise. Thus, for example, the sub-franchisor would still have the right to collect fees for the servicing of existing sub-franchisees.

## ***II. TERMINATION BY THE SUB-FRANCHISOR***

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

If the sub-franchisor considers the franchisor to be failing to provide the services or products it is under an obligation to provide, and considers this failure to have adverse consequences for itself and its sub-franchisees, then the remedy of damages for non-performance of the agreement is available. The sub-franchisor will in any event have to decide whether it wishes to continue with the relationship notwithstanding the non-performance on the part of the franchisor. In reaching a decision, it will need to evaluate whether the reason for the non-performance is temporary and might be remedied in the future. There are in fact often provisions in agreements that deal with the failure or inability of the franchisor to supply goods and that

enable the sub-franchisor to obtain goods of comparable quality elsewhere.<sup>5</sup>

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

A franchisor would have to consider whether it could agree that the sub-franchisor should have that right, bearing in mind that the effect would be to remove an asset which in the case of an insolvency related cause would no longer be available for creditors or its shareholders. Consideration may need to be given to the effect of bankruptcy procedures in the franchisor's jurisdiction, particularly of those procedures that permit continued trading under court supervision with a moratorium on creditors' claims and that prevent termination in accordance with the agreement. Another effect of such a provision could be to eliminate the incentive for the franchisor to resolve its difficulties and 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 franchisors will consider the consequences of termination by a sub-franchisor for non-performance on their part 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

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<sup>5</sup> See Chapter 9 "Supply of Equipment, Products and Services".

on the sub-franchisor to ensure that the franchisor is viable and financially secure. There are many franchisors who offer master franchise opportunities who may find it difficult to satisfy that criterion.

# CHAPTER 16

## THE END OF THE RELATIONSHIP AND ITS CONSEQUENCES

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

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

- ◆ the term of the master franchise agreement may come to an end;
- ◆ the agreement may be terminated by the franchisor in accordance with its terms;<sup>1</sup>
- ◆ the agreement may be terminated by the sub-franchisor in accordance with its terms;<sup>2</sup>
- ◆ the sub-franchisor may exercise a legal remedy to terminate the agreement.

#### I. *THE TERM OF THE AGREEMENT COMES TO AN END*

The circumstances to be considered include:

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

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<sup>1</sup> For a discussion of the ways in which the relationship may be brought to an end, see Chapter 15 "Remedies for Non-Performance".

<sup>2</sup> See Chapter 15, *cit.*

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

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

- ◇ the sub-franchisor decides to exercise the option and the parties enter into an appropriate new agreement.<sup>3</sup>

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<sup>3</sup> See Chapter 3 “Term of the Agreement and Conditions of Renewal”.

## ***II. THE AGREEMENT IS TERMINATED BY THE FRANCHISOR IN ACCORDANCE WITH ITS TERMS***

Where there is lawful termination in accordance with the provisions of the master franchise agreement that deal with termination, the franchisor would expect the full range of consequences listed in Section B, Sub-Section I below to take effect. A sub-franchisor that is not happy with any of those consequences must negotiate alternative solutions when the contract is being established. It is however likely to prove difficult to persuade the franchisor to accept any "watering down" of what it will probably regard as fundamental requirements.

There are two other issues that may arise:

- ◆ franchisors would expect to be able to restrain a sub-franchisor from breach of post term restrictions by court order or injunction. In some countries these remedies are not available, whereas there is usually some form of penalty payment, liquidated damages or other lawful financial constraint to act as a disincentive to a sub-franchisor that is tempted to ignore the contractual requirements;
- ◆ the question of whether the franchisor should be required to make a payment to the sub-franchisor for the transfer of the sub-franchise. The following issues arise:
- ◆ the sub-franchise agreements may be regarded as having come to an end automatically when the master franchise agreement terminates. It is therefore necessary to make provision in both the master franchise and the sub-franchise agreements for an extension of the term of the sub-franchise agreements beyond the end of the master franchise agreement, so as to provide the franchisor with sufficient time to make the correct informed decision about which approach it wishes to adopt with respect to the sub-franchise network;
- ◆ a sub-franchisor who wishes to terminate for any reason, or who wants to sell but cannot find a purchaser, could deliberately breach the contract to force the franchisor to terminate and "buy" the network;

- ◆ the sub-franchise network may be unhappy with the sub-franchisor and this may result in rebellious sub-franchisees who are seeking to break away from the franchise;
- ◆ whether the franchisor in any event will be obliged, or whether it will merely have the option, to take over the sub-franchised network, or whether it should be able to select the sub-franchisees it wants to deal with and to terminate the others;
- ◆ in view of the problems that the franchisor may perceive as possible with a sub-franchised network in these circumstances, whether the franchisor should be able to require the terminated sub-franchisor to compensate it for the additional expense it will incur and for the likely losses of dissatisfied sub-franchisees.

Other provisions dealing with termination would inevitably include the bankruptcy, insolvency or liquidation of the sub-franchisor. It should be remembered that local laws may have an impact on what happens to the sub-franchised networks. These issues therefore require careful consideration when negotiations take place.

### ***III. THE AGREEMENT IS TERMINATED BY THE SUB-FRANCHISOR IN ACCORDANCE WITH ITS TERMS***

It is comparatively rare to find a provision in a master franchise agreement permitting termination by the sub-franchisor for breach by the franchisor. Indeed it is not even common to find a provision in a unit franchise agreement giving the franchisee a right contractually to terminate the agreement. In master franchise agreements the debate regards the inherent injustice in a situation in which the consequences for the sub-franchisor are the same whether or not it or the franchisor is in breach of the agreement. The problem to be confronted, and about which a franchisor needs to be satisfied, is the adequate protection of the franchisor's property assets in the host country if its name and system cease to be issued by the sub-franchisor. The sub-franchisor on the other hand would find it difficult to understand why, when the franchisor is in default, it has to choose between permitting the default to continue or terminating and losing the

right to continue to trade as before. The right to terminate might therefore not give the sub-franchisor the satisfaction it needs, as it might result in a cessation of the right to use the trademarks for the whole sub-franchise network.

#### ***IV. THE SUB-FRANCHISOR EXERCISES A LEGAL REMEDY TO TERMINATE THE AGREEMENT***

The two most common remedies available to a sub-franchisor are a right to terminate the agreement and the possibility to accept a rescission or repudiation by the franchisor. The nature and extent of the remedies may well vary from country to country and the sub-franchisor will need to be aware of these remedies and of the circumstances under which they may be available. In addition to these remedies (as well as usually being a part of them) the sub-franchisor may be able to claim damages for breach of contract. In some countries it may also be possible to ask a court to order the franchisor to perform its obligations.

### **B. CONSEQUENCES OF THE MASTER FRANCHISE RELATIONSHIP COMING TO AN END**

#### ***I. CONSEQUENCES FOR THE SUB-FRANCHISOR***

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

- ◆ that it will lose future development rights;
- ◆ that it will have to cease operating as the “franchisor” of the sub-franchisees in the development area;
- ◆ that it will be required to discontinue the use of the franchisor’s:
  - ◇ trade marks, trade names and other branding;
  - ◇ copyright materials, including the operations manuals that the franchisor has issued to it or that it has in its possession or under its control, all copies of which it will be required to return to the franchisor;

- ◇ all materials bearing the franchisor's trademarks, trade names or indicating an association between the franchisor and the sub-franchisor;
- ◇ systems, know-how and confidential information, which it will also be required not to use in the future;
- ◇ other intellectual property rights, which could be quite wide and include, for example, in the case of fast food, the recipes;
- ◆ that it will have to de-identify any premises it might have;
- ◆ that, at the franchisor's option, it will be required to transfer all sub-franchise agreements to the franchisor;
- ◆ that for a limited period of time it will be required not to conduct any business that competes with the franchisor's type of business; and
- ◆ that it will in some cases be required to sell certain of its assets to the franchisor if the franchisor exercises its option to acquire the assets concerned.

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

- ◆ intellectual property laws will have to be complied with to ensure that the rights that have been exercised are correctly terminated;
- ◆ restraints on the use of systems, know-how and confidential information will be affected by the law applicable to such property rights, but also by competition laws in some countries;
- ◆ the transfer of sub-franchise agreements may be affected by:
  - ◇ local laws regulating who can carry on business in a territory (for example, in some countries it is a requirement that local nationals must own at least 51% of any entity trading in that country);
  - ◇ the possibility that if the master franchise agreement is terminated sub-franchise agreements also terminate, unless the agreements deal with this issue;
- ◆ post-term restraints against competition may be affected by local laws in general application as well as by the application of competition laws;

- ◆ local laws may confer a right on the sub-franchisor to claim compensation; and
- ◆ it is possible that, if the agreement is sought to be terminated for insolvency or other related reasons, there may be laws under which administrators are appointed to preserve assets for creditors and which affect the right to terminate.

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

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

There may also be a range of other agreements between the sub-franchisor and the sub-franchisees.<sup>4</sup> It is important that the way in which each of these ancillary agreements is to be dealt with at the end of the relationship is considered by the parties already at the negotiation stage, although the desired outcome may not be easy to achieve, particularly where the agreements deal with assets (for example leases of real estate) that may have an aggregate value that make "buy outs" too expensive.

An effective operation of the sub-franchise units requires adequate servicing and assistance on the part of the sub-franchisor. In cases of termination or expiration of the term of the master franchise agreement, the risk is that sub-franchisees with agreements expiring after the expiration of the master franchise agreement may be left without proper assistance. In order to avoid this problem, the sub-franchisor may choose not to establish units as the agreement draws to a close. It is nonetheless not to be recommended that the development schedule remain

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<sup>4</sup> See Chapter 19 "Ancillary Documents".

inoperative during the latter part of the term of the master franchise agreement, as franchisors will wish to encourage the establishment of franchise units 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 should remain in force solely with respect to franchise units for which sub-franchise agreements have been entered into prior to such expiration and that the sub-franchisor should lose its right to develop additional franchise units under the master franchise agreement. This would permit the franchisor to itself establish, or to franchise others to establish, new units within the territory concerned.

Each franchise unit 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 sub-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 sub-franchise agreement. Assuming that a sub-franchise agreement, the term of which is ten years, is entered into by the sub-franchisor during the last year of the term of the master franchise agreement, an arrangement such as the one described would have as a consequence that certain provisions of the master franchise agreement would remain in force for a period of between nine and 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.

An alternative is for the expiration of the term of the master franchise agreement to be made to coincide with the expiration of the term of the last of the sub-franchise agreements to expire. In a number of countries a valid reason for adopting such a solution 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.

In the event of termination there may be a claim for damages if the termination procedures do not follow or are not justified by the contractual provisions. The same may be the case if termination is effected by the incorrect application of any legal remedy which may be available under the relevant legal system. The nature and extent of any such claims will depend upon the laws relating to damages in the host country.

## ***II. CONSEQUENCES FOR THE SUB-FRANCHISEE***

In many jurisdictions it would probably be true to say that each individual sub-franchise agreement would automatically terminate if the effect of the expiration of the term of the master franchise agreement or of its termination on the sub-franchise agreements is not dealt with in the master franchise agreement and the sub-franchise agreements. In this case each sub-franchisee would be required:

- ◆ to cease using the franchise system and trademarks; and
- ◆ to remove any decorations or indications identifying the franchise unit as belonging to the franchise network.

The sub-franchisee would probably also be forced to comply with non-competition covenants. The repercussions of the failure to deal with the effects of termination of the master franchise agreement on the sub-franchise agreements would therefore be extremely serious, not only for the franchisor, but also for each sub-franchisee. The drafting of the provisions of the master franchise agreement that relate to the effects of the expiration of its term thus requires careful consideration by both franchisor and sub-franchisor. The impact of such provisions should also be dealt with in each sub-franchise agreement.

Considering the risk of automatic termination of the sub-franchise agreement in case of termination, or expiration of the term, of the master franchise agreement, it is in the interest of the sub-franchisee to obtain an undertaking by the franchisor to the effect that, if or when such an event should 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.

### ***III. ASSIGNMENT OF THE SUB-FRANCHISOR'S RIGHTS IN THE SUB-FRANCHISES***

In consideration of the consequences examined in Sub-Sections II and III above, the only practical alternative in dealing with the effects of termination of master franchise agreements 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 sub-franchise agreement.

The parties should address such questions as whether the franchisor's option to take over the network should refer to the network in its entirety, whether the franchisor should be obliged to accept the assignment of the sub-franchisor's rights under each sub-franchise agreement, whether the franchisor should be allowed to choose the units to be assigned to it and to select the appropriate financial arrangements (if any), or whether it should merely be granted an option to obtain such assignments.

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

Another question of considerable importance 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 sub-franchise agreements to the franchisor. It should be noted that authorities in some jurisdictions might question the validity of such assignments in the absence of financial compensation in one form or another. In such jurisdictions it would therefore be advisable for provision to be made for the compensation of the sub-franchisor by the franchisor following such assignments, so as to avoid the risk of their being declared null and void.

The practical difficulties associated with the enforcement of assignment provisions have made it necessary to put appropriate mechanisms in place. 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 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 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 that the master franchise agreement were to be 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 sub-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 sub-franchise agreement will be assigned to the franchisor. In certain jurisdictions the sub-franchise agreement should therefore include an acknowledgement by the sub-franchisee that the franchisor is a third party beneficiary of such rights.

## **CHAPTER 17**

# **APPLICABLE LAW AND DISPUTE RESOLUTION**

The achieving of a degree of certainty in the enforceability of an international master franchise agreement will to a large extent depend on the parties having chosen the law that is to apply to their relationship and on their agreeing on the approach to be adopted to resolve any disputes that may arise between them. This includes their agreeing on the forum in which disputes might be resolved. In this connection parties should consider at the outset the possibility of having recourse to arbitration as opposed to litigation, as well as the use of mediation, negotiation or conciliation.

These matters are what are usually considered by the parties when they negotiate the traditional choice of forum and choice of law clauses in an international agreement.

### **A. THE DESIRABILITY OF MAKING A CHOICE**

The selection of the law that is to apply to an international agreement within a master franchise arrangement and the reaching of an agreement on the preferred forum for the settlement of disputes are two issues that should not be overlooked in negotiating international master franchise arrangements, or be left until after all the substantive elements of such arrangements between the parties have been settled, or, even less acceptably, until a real disagreement arises.

Decisions on these two issues are closely related and similar considerations apply to both. Indicating the legal regime that is to apply helps clarify at the outset the interpretation that the parties intend should be given to the principal terms of their agreement.

The law chosen will determine much about the actual obligations entered into by the parties. It is relevant to many of

the issues addressed in the other chapters of this Guide and the recurrent references in those chapters to the applicable law give a clear indication of the importance of choosing the law of a particular jurisdiction to apply to the master franchise agreement.

If the parties do not choose the law that is to apply to their agreement, the determination of the laws of which State should govern it will be left to the applicable conflict of laws rules. In this process any applicable international treaty or convention, such as the *European Convention on the Law Applicable to Contractual Obligations*,<sup>1</sup> the *Inter-American Convention on the Law Applicable to International Contracts*<sup>2</sup> and other relevant rules of private international law, will be taken into account.

In many cases this conflict of laws analysis will result in the applicable law being the law of the country in which the sub-franchisor operates the franchised business, but it might also happen that different laws are found to be applicable to the different component parts of the master franchise package.

## **B. APPLICABLE LAW**

### ***I. CHOICE OF APPLICABLE LAW***

The application of the conflict of laws rules of a State to determine which law should apply is rather sophisticated and at times complex. In the case of contracts there are several different rules that are used to determine the applicable law. According to one of these, 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 chosen by the parties. 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.

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<sup>1</sup> Rome, 1980.

<sup>2</sup> Mexico, 1994.

In negotiating the choice of a law to apply to the agreement, each of the parties will tend to press for the choice to fall on the law of its own jurisdiction. There are many possible reasons for this: the familiarity of that legal system to the legal representatives of the parties, the assumption that that particular law will offer advantages, or, in the case of franchisors, because they want the same law to apply to all the master franchise agreements they have in place around the world. Rather than proceed on this largely intuitive basis, the parties would be better served by considering in a systematic way the situations in which disputes are likely to arise and where litigation would most effectively take place for the outcome to be enforceable. It should be borne in mind that a court selected as the forum will, in all probability, be more comfortable in applying the law of its own jurisdiction.

The choice of a particular law will naturally have an effect on the terms of the master franchise agreement, as well as on the way in which they are drafted. In addition, the parties will have to comply with any particular legislation of the jurisdiction in which the franchised business is to be exploited, first and foremost that intended to enforce intellectual property rights, but also that enshrining domestic public policy, such as competition laws and consumer protection and foreign investment laws. Laws such as these are mandatory and are likely to provide that certain of their provisions shall not be overridden by inconsistent contractual terms or by the application of conflict of laws rules. Particular features of the following areas of the substantive law of the relevant jurisdiction need to be closely considered in this regard:

- ◆ public policy;
- ◆ foreign investment law;
- ◆ corporation law and rules set by regulators;
- ◆ competition law/anti-trust/trade practices;
- ◆ intellectual 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 franchise regulation.

If the prospective host country 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.

## ***II. ENFORCEABILITY OF CHOICE***

In a number of countries the parties to an agreement are not permitted to determine the law applicable to their agreement, as legislation exists that either stipulates what the applicable law should be, or otherwise limits the freedom of the parties to make a choice. In most jurisdictions, however, parties are permitted to determine what law they wish to see applied to their agreement, although subject to some specific limitations.

The more common position applies, for example, within the European Union, the United States of America, 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 must have been made in good faith, be legal and must not have been made merely to validate what would otherwise be invalid under what in the

absence of a choice of law would be the law governing the contract (for example attempts to evade mandatory rules of public policy); and

- ◆ any limitations found in specific statutory provisions directed to franchise agreements, including international master franchise agreements.

### ***III. MOST LIKELY OUTCOME***

Unless the prospective host country has no sophisticated system of business law and commercial usage and practice, the parties are most likely to choose the law of the prospective host country, which normally is 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 offer its interests a better protection than the laws of its own jurisdiction, as might be the case if the jurisdiction of the franchisor has strong franchising and consumer protection laws. One reason for the adoption of the law of the jurisdiction of the sub-franchisor also in such cases is the fact that in all likelihood it can be expensive and difficult to enforce the sub-franchisor's rights if the laws of the jurisdiction of the franchisor were chosen.

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 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 however not always be possible. In some international franchise agreements the domicile of neither the franchisor nor the sub-franchisor will be in the

jurisdiction in which the franchised business is to be conducted. The law applicable to the master franchise agreement and to the protection of intellectual property rights may therefore for good reason be different from that applicable to the sub-franchise agreements.

#### ***IV. 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 domestic 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 not only the domestic laws of the country whose law has been selected, but also the uniform international law (treaties, conventions) to which that country is a party and its conflict of laws rules. It should be noted that, whereas it is possible to select the substantive domestic law of a jurisdiction as well as its rules and regulations applicable in the international context, it is not possible to select its conflict of laws rules unless this is specifically permitted.

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 choice of the law that is to apply to the agreement to fall on the law of the country in which the franchise units are located, unless the sub-franchisor is not domiciled in that country, the master franchise agreement covers more than one country, or the franchised business is being exploited in a country with an unsophisticated legal system.

## **C. DISPUTE RESOLUTION**

### ***I. NEGOTIATION, MEDIATION AND CONCILIATION***

In commercial dispute resolution there has in recent years been a move away from litigation and arbitration, with the adoption of other techniques and procedures such as mediation. Use is also being made of more structured negotiations between the parties, partnering arrangements and conciliation. These processes differ from arbitration and litigation because no third party involved is authorised to resolve the dispute by making a binding determination: the third party 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.

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 to develop options for settlement and keeps the negotiations moving on a constructive basis.

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. In addition, they have an important role to play in cases where it would be difficult to enforce a foreign judgment in the country of the defendant.

The *Conciliation Rules* published by the *United Nations Commission on International Trade Law (UNCITRAL)* and the *International Chamber of Commerce (ICC)*<sup>3</sup> are useful guides to parties and their mediators or conciliators in the conducting of such consensual methods of dispute resolution.

By contrast, arbitration and litigation involve a binding determination by a third party (the judge or arbitrator). This distinguishes these procedures from negotiation and mediation. Despite the fact that the jurisdiction of the arbitrator is derived from the original agreement of the parties to refer disputes to arbitration, arbitration is not truly consensual, indeed, it has much of the mandatory character of litigation. In important respects arbitration does however differ from litigation. Arbitrators do not exercise the judicial authority of the State and the composition of the arbitral tribunal is, to a significant extent, determined by the

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<sup>3</sup> The full title of the ICC Rules is *ICC Rules of Arbitration - ICC Rules of Conciliation* as the publication also carries rules relating to arbitration.

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. As concerns litigation, in an international transaction the authority of the court may not be at all clear. If the defendant is not present within the territory of the court, a question of jurisdiction or competence may arise. Moreover, the effectiveness of a judgment outside the country of rendition may also be questionable. Cultural considerations are also of importance in this context.

Parties with different cultural backgrounds may have differing perceptions of the bargain they are striking, they may not understand their contractual obligations in the same way and may attach different significance to the master franchise agreement itself.

Persons of a particular cultural background may have a preference for one form of dispute resolution over another. People from common law countries are, for example, used to an adversarial system of dispute resolution and have until recently tended to regard litigation as usual and acceptable. Persons from some Asian backgrounds have on the other hand traditionally shied away from adversarial confrontation and have sought the resolution of disputes by more consensual and informal means.

In international master franchising transactions it is important for the parties to be proactive and to consider dispute resolution at the initial stage of the formation of their agreement. The agreement itself should contain provisions for dispute resolution and should set out the procedures that the parties agree to follow. If dispute resolution is not dealt with in the agreement, then one of the parties may find that there is no effective way to resolve a dispute when a problem subsequently arises. Alternatively, a party may find itself involved in a form of dispute resolution that is inappropriate or undesirable.

With respect to the actual provisions made in the master franchise agreement, the parties need to consider the possible requirement for injunctive relief and other interim measures in case of non-performance. While both judges and arbitrators may be able to grant interim measures, from the perspective of enforceability the State court systems are normally likely to be more efficient and effective. It is not unusual for the convening of an arbitral tribunal to involve an element of delay. Therefore, if the parties do opt for arbitration, it would 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 reasons of enforceability to exclude certain particular breaches, such as intellectual property infringements, from arbitration and to subject them instead to litigation.<sup>4</sup> 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 appear 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 case of a trademark infringement.

## ***II. LITIGATION***

### **(a) Choice of Forum**

If consensual approaches fail, or if binding orders are considered to be necessary by one or both parties, litigation or arbitration will need to be considered.

From the standpoint of the potential plaintiff international litigation requires a decision on where the action should be instituted. Once the action has been commenced the defendant will have to determine its response. It may participate in the litigation and contest the action, it may stay

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<sup>4</sup> It should be noted that in the case of some matters, notably intellectual and industrial property rights, in many countries it will in any event not be possible to have recourse to arbitration, as this possibility will be excluded by law.

away from the proceedings or it may seek to terminate them. A defendant can seek to terminate proceedings either in the court in which the action has been instituted (by an application to stay the proceedings on grounds of lack of jurisdiction or *forum non conveniens*), or by an application to a court in another State to enjoin the plaintiff from proceeding in the original court.

In selecting the forum of litigation the plaintiff may have a choice of courts available to it. The alternatives include the court in the plaintiff's place of residence, the court in the defendant's place of residence and 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 courts of the selected judicial system possess jurisdiction or competence under their 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 judicial system, then enforcement will be relatively easy, although the plaintiff may wish to avail itself of provisional measures to ensure that the defendant does not transfer those assets. If, however, the defendant does not possess assets in the jurisdiction of the selected court, then the judgment will only be effective if the defendant voluntarily agrees to satisfy it, or if it is enforceable in the courts of another country where the defendant has assets. This will depend on the rules for the enforcement of foreign judgments of the place of enforcement.

Apart from considerations of jurisdiction and enforcement, the plaintiff should also evaluate the comparative costs of litigating in the various forums. This will depend on several matters, including the legal expenses that will be incurred in litigating in the various forums and whether the courts of those

jurisdictions award legal costs to the winning party or whether each party bears its own costs.

Another consideration is convenience. This involves geographic considerations, such as the residences of the parties and of the witnesses likely to be called to give evidence. It also involves legal considerations such as the law that governs the contract. Language is a relevant matter and consideration should be given to the language of each of the parties and to the language of the agreement. Another matter to consider is the time within which an action will be heard and finally determined, both in the court of first instance and, perhaps, in appellate courts. The longer the litigation process, the more expensive it becomes and the greater the delay in resolving the dispute. Yet another consideration is the performance of the court selected, especially in handling commercial matters, and whether it has a reputation for shrewd judgment.

Rather than wait until a dispute arises that requires litigation, the parties should consider whether the master franchise agreement should contain a forum agreement that provides for the submission of disputes to the court system 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 a forum agreement may be included in the main master franchise agreement or in an ancillary agreement.

### **(b) 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 jurisdictions, moreover, legal

doctrines prevail that hold that foreigners should not have more extensive legal rights than nationals and that the remedies available to foreigners should therefore be those obtainable from the local courts.

Legal advisers need to assess how their particular clause will be interpreted when they examine 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 courts of the country concerned (prorogation) and those that remove jurisdiction from those courts (derogation). On the whole, courts would appear to be 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.

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 system 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 last two to three decades a general trend has however developed in the United States, Japan, the European Union and other countries of the OECD, for courts to uphold the freedom of the parties to restrict litigation to a particular jurisdiction as long as the parties make it clear that their chosen jurisdiction is their exclusive choice.

One significant attempt at producing a sensible uniform law solution is the *European Communities Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters*<sup>5</sup> (the *Brussels Convention*), the application of which was extended to the *European Free Trade Association (EFTA)* membership by the *Lugano Convention*.<sup>6</sup> Article 17 of these Conventions provides that where one of the parties to the contract is domiciled in a contracting State, the court system 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 Conventions do not apply to agreements that confer jurisdiction on courts outside the European Union and EFTA contracting States.

It is relevant also to note that when they do 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 the 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;

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<sup>5</sup> Brussels, 1968. The Convention was subsequently modified to permit the accession to the Convention by the States that joined the European Communities after 1968 (Adhesion Conventions of Luxembourg, 1982 and Donostia-San Sebastián, 1989).

<sup>6</sup> Lugano, 1988.

- ◆ *validity of patents, trademarks, designs and models and similar intellectual property rights requiring filing or registration*: jurisdiction of the courts of the State in which the 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.

### **(c) Enforcement of Court Judgments**

The crucial test of a successful choice of forum clause is whether the judgment and orders of the court system 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, particularly if that judgment or order is contrary to strong public policy considerations of that jurisdiction.

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, bilateral treaty obligations between the jurisdictions concerned, or provisions in the form of a recognition of foreign judgments legislation, should be in place in each jurisdiction in which enforcement is sought. This would enable a relatively simple registration system of enforcement to apply to foreign judgments.

Again, the Brussels/Lugano Conventions conveniently in Title III set out recognition and enforcement procedures that are to apply to the enforcement of decisions rendered in one contracting State in all other contracting States.

With respect to decisions rendered by courts of States not parties to these Conventions, separate enforcement proceedings will have to be initiated by bringing an action on the foreign judgment in the jurisdiction in which 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.

In the case of monetary judgments, a third possibility exists in jurisdictions the domestic foreign judgments legislation of which, even without a bilateral treaty, 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.

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 the 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 have foreign judgments legislation providing for enforcement on a reciprocal basis.

### **III. ARBITRATION**

#### **(a) The Arbitration Alternative**

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 Convention on the Recognition and Enforcement of Arbitral Awards*;<sup>7</sup> 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 that favours the recognition of arbitration clauses in international contracts and provides a straightforward method of meeting New York Convention obligations.

The agreement to arbitrate will almost always preclude either party from by-passing arbitration by seeking redress in a court of law. Courts will generally allow arbitrators a broad

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<sup>7</sup> As at 20 June, 1998, 119 States were Contracting Parties to the New York Convention.

scope to decide matters that arguably come within the ambit of their own mandate.

In drafting their clauses the parties should also consider whether, the jurisdiction whose law is chosen permitting, any arbitration is intended to deal not only with causes of action relating to, for example, contract interpretation and non-performance, but also with claims relating to the statutory remedies of the substantive law of the jurisdiction of choice, such as those available under competition, securities, consumer protection and anti-fraud laws. The law in the United States at the federal level appears to admit committing such claims to arbitration in cases of international transactions.

There are in addition a number of issues that are problematic for the parties and that concern the extent to which the assistance of the courts may be resorted to when arbitration has been accepted as the dispute resolution mechanism. It may, for example, be difficult for a party to obtain pre-judgment attachment of assets to secure a claim that is to be presented to arbitrators.

It is moreover unlikely that arbitration proceedings will be significantly cheaper to run than legal proceedings and unfortunately the delays in reaching a result can be almost as great as with litigation.

All of this suggests that in practice negotiation and mediation are likely to be far preferable in resolving disputes that do not threaten to end the master franchise relationship.

When the parties do choose arbitration, they should in their arbitration clause select:

- ◆ an administrative body to have authority over any arbitration conducted, such as the *American Arbitration Association*, the *International Court of Arbitration* of the International Chamber of Commerce, the *London Court of International Arbitration* or the *Australian Centre for International Commercial Arbitration*; and
- ◆ depending on which administrative body is selected, the arbitration rules to be followed. Each of the above-mentioned bodies has its own rules. There are however also the *Arbitration Rules* of the *United Nations*

*Commission on International Trade Law (UNCITRAL)* which may be selected regardless of which administrative body is chosen.

## **(b) 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 number of ratifications or accessions, 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 different 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 master franchise agreement will therefore need to verify whether:

- ◆ the State(s) concerned have made any reservations to the obligations of the Convention and, if they have, what these reservations are;
- ◆ the necessary domestic legislation has been passed to give effect 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 the effects that the grounds on which a court may refuse to enforce an award will have on them. Examples of such grounds include that the subject-matter was not arbitrable according to the law of the country in which the enforcement is sought, and that the recognition or enforcement of the award would be contrary to the public policy of that country.

# **CHAPTER 18**

## **OTHER GENERALLY USED CLAUSES**

In addition to the clauses that relate specifically to the franchise, there are a number of other clauses that may be found in master franchise agreements and that might be of considerable importance. These include:

- ◆ clauses relating to severability;
- ◆ entire agreement clauses;
- ◆ waivers;
- ◆ force majeure and hardship clauses;
- ◆ clauses relating to the nature of the agreement;
- ◆ cumulative rights clauses;
- ◆ notice provisions; and
- ◆ provisions relating to different types of damages.

Consideration should be given to the impact of the relevant law on the effectiveness of each of these provisions.

### **A. CLAUSES RELATING TO SEVERABILITY**

Not surprisingly, it is very important for both franchisor and sub-franchisor that their agreement continue in force for a considerable length of time, not the least because the investments made by both are often considerable. Master franchise agreements may therefore contain clauses providing that if a particular clause, or even part of a clause, becomes unenforceable, invalid or illegal, then the invalidity, illegality or unenforceability of that particular clause or part thereof shall not affect the validity or enforceability of the remainder of the agreement. The invalid or illegal clause, or part thereof, is in other words considered to be severable from the remaining agreement. At times, this severability is conditional upon the remaining agreement not appearing to be distorted or unfair to

one of the parties. There are three possible approaches to invalid or illegal clauses in case of severability:

- ◆ the clause is considered as if it had never been stipulated, or
- ◆ the clause is replaced by another which is valid, legal and enforceable but achieves the objectives of the parties, or
- ◆ the clause is modified and interpreted in such a manner that its purpose may be achieved in all legality.

Similar constructions are resorted to in the case of a gap in the agreement.

As regards partially invalid clauses, the agreements may sometimes indicate that they should be considered to be enforceable to the extent that they are valid.

There are agreements that give a certain discretion to the franchisor, in that they provide that the franchisor may terminate the agreement:

- ◆ if it considers that the exclusion of the particular provision concerned adversely affects its right to receive payment of fees or other remuneration;
- ◆ if the exclusion adversely affects the trademarks, trade name, trade secrets, know-how or methods of the system; or
- ◆ if the franchisor determines that the finding of illegality adversely affects the foundations on which the agreement is based.

The agreements will often list the bodies that may declare the clauses to be invalid, for example domestic courts or Government bodies, the European Court of Justice or the European Commission, and the types of instrument by which this may be done, such as decisions of the courts or Government bodies, an Act of Parliament, domestic legislation, European Community legislation and statutory or other by-laws or regulations.

Agreements 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 particular jurisdiction, but its validity or effect in other jurisdictions should not be affected.

## B. ENTIRE AGREEMENT CLAUSES

So as to safeguard themselves against any surprising claims, franchisors will often include a clause which states that the agreement is the entire agreement between the parties and that it embodies all prior negotiations and/or all prior agreements reached. The degree of detail of such clauses will vary from very short statements to the effect that, for example, oral collateral agreements are not valid, to long descriptions of what is intended. The degree of detail will depend also on the legal drafting technique adopted in the country of the franchisor.<sup>1</sup> In other instances the entire agreement clause may specify that in addition to the main agreements there are also specific agreements between the parties, for example a lease agreement for the premises, or that other documents are annexed, such as general conditions of trade or, in the case of American franchises, the *Franchise Offering Circular*.

At times, certain exceptions will be provided for. Thus, for example, the sub-franchisor's obligation to comply with the specifications that the franchisor determines from time to time will not be affected by the fact that no collateral or oral agreements are considered to be valid.

Other provisions may be linked to the entire agreement clause. Examples of such provisions include an acknowledgement by the sub-franchisor that it has not entered into the agreement as a result of any representations, warranties, inducements or promises and a requirement that if the sub-franchisor thinks that any representations, warranties, inducements or promises have been made, and that they have been instrumental in making it take the decision to enter into the agreement, then it should submit a written statement to the franchisor to this effect, so as to permit the inclusion in the agreement of the contents of the written statement.

## C. WAIVERS

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<sup>1</sup> See Chapter 1, Section B, Sub-Section V, *lit.* (b) "Drafting Technique" on differences in style of legal drafting.

Franchise agreements will often contain clauses waiving liability for the franchisor and/or disclaiming the waiving of any rights of the franchisor. Again, the amount of detail will vary depending on the origin of the contract, those from the common law countries entering into far greater detail.

The waiver of liability will often be in the form of a recognition by the sub-franchisor that the success or otherwise of the business depends on its own efforts and that even if the franchisor and its staff have provided advice and assistance, operations manuals and training courses, the franchisor, its directors and employees will not be liable for any loss or damage suffered by the sub-franchisor. At times this waiver of liability will extend even to loss or damage suffered as a result of the system or of the advice and assistance given. The exception might be if the loss or damage was directly caused by the franchisor's breach of an express provision of the agreement, or by fraud on the part of the franchisor, but even then there might be a limitation in the amount of compensation that the agreement admits.

Disclaimers of the waiving of the rights of the franchisor will take the form of provisions stating that the fact that the franchisor does not exercise its rights or the powers it has been given does not mean that it waives these rights or that it will never be able to exercise them in the future. This will be stated as applying in general as well as for any specific non-performance. In most cases these clauses will not refer to time-limits for the exercise of the rights by the franchisor. On occasion, however, there may be such a reference, even if it only excludes any time-limit at all. 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 another occasion.

In the case of the franchise being sold to a new sub-franchisor, it is possible that the successor sub-franchisor may be required to waive any rights or remedies it might inherit as a result of the franchisor's non-performance of the agreement with the previous sub-franchisor.

In most cases these waiver clauses will only refer to the franchisor, although there are those that refer to non-performances on the part of both the franchisor and the sub-

franchisor and that disclaim any waiver on the part of either party.

#### **D. FORCE MAJEURE AND HARDSHIP**

Contracts will often contain clauses that provide either for the re-negotiation of the agreement in cases of changed circumstances (so-called "hardship clauses") or for a suspension in performance in cases of "*force majeure*". The existence of a veritable *force majeure* situation might in fact be considered a valid reason for a party to be excused from performance indefinitely. The formulation of these clauses in master franchise agreements will follow the formulation of similar clauses in other types of agreement.

It is not always easy to distinguish clearly between events that give rise to a hardship situation and events that are to be considered *force majeure*. An indication might however be the seriousness and the nature of the event. Hardship will often not make performance totally impossible, even if it becomes unduly onerous or difficult (for example an unexpected exorbitant increase in the cost of raw materials) and a re-negotiation of the agreement consequently becomes necessary if the relationship is to be maintained. *Force majeure*, on the other hand, is likely to result in an objective impossibility to perform, even if it is an impossibility that is limited in time (for example a declaration of war). Hardship and *force majeure* clauses will in general concern non-performance on the part of either party.

A definition of hardship that was prepared at international level and is achieving increasing international recognition is that contained in the *Unidroit Principles of International Commercial Contracts*:

"There is a case of hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party's performance has increased or because the value of the performance a party receives has diminished, and

(a) the events occur or become known to the disadvantaged party after the conclusion of the contract;

(b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract;

(c) the events are beyond the control of the disadvantaged party; and

(d) the risk of the events was not assumed by the disadvantaged party".<sup>2</sup>

Similarly, the definition of *force majeure* contained in the *Unidroit Principles* states that:

"(1) Non-performance by a party is excused if that party proves that the non-performance was due to an impediment beyond its control and that it could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

(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) (...)

(4) (...)]".<sup>3</sup>

The purpose of the hardship clause is therefore not to terminate the contract, but to make a re-negotiation of its terms possible. *Force majeure* clauses on the other hand may be considered to be the basis upon which a non-performance may be excused, often permanently, but also temporarily. As the borderline between the two concepts is not always clear, the same event might be considered a case of hardship or alternatively a case of *force majeure*. It is then for the court to decide whether the event constitutes hardship or *force majeure*.

*Force majeure* clauses may be either in the form of general formulae or in the form of lists of events that should be considered to constitute *force majeure*. Examples of the events included in *force majeure* provisions are fire, storm, flood, earthquake, acts of God, explosions, accidents, acts of public enemies, war, insurrection, sabotage, epidemics, transportation embargoes,

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<sup>2</sup> Article 6.2.2.

<sup>3</sup> Article 7.1.7.

delays in transportation, energy or petrol cuts, labour disputes, strikes, non-performance of sub-contractors, acts of any government whether national, municipal or otherwise and judicial action. General formulae may be to the effect that *force majeure* is caused by any contingency beyond the control of the non-performing party, or to the effect that the non-performance is due to a cause or circumstance beyond the reasonable control of the party, or beyond the reasonable ability of the party to control. Often the two approaches will be combined, the provision including a general statement followed by a list of examples.

If the events constituting *force majeure* are limited in time, then the duty to perform the obligation will be suspended only for the duration of the event.

There are also *force majeure* clauses that state that they shall have effect only at the discretion of the franchisor, unless the event renders performance impossible for a longer and continuous period of time.

Other conditions may also be attached to the application of the clause, such as the requirement that the event should not have been caused or exacerbated by the non-performing party.

The relevance of these clauses for master franchise agreements should be considered, in particular as concerns hardship as an excuse for non-performance of the development schedule.

## **E. CLAUSES RELATING TO THE NATURE OF THE AGREEMENT**

The nature of the franchise agreement is often a point of contention. This is also due to the fact that, as there are a considerable number of different types of agreement that are included under the term "franchising", there is no single, generally recognised definition that can be applied. Furthermore, in most countries franchise agreements are not specifically regulated and in several jurisdictions courts will therefore apply legislation written for other types of agreement. They will examine the relationship to determine the legal form to which the agreement has most similarity: an agency agreement, for example, or a licence agreement, or an instalment sales contract, or even a

contract of employment, and apply the legislation that is applicable to that type of agreement.

In an attempt to avoid that the agreement may be considered to be something which to all intents and purposes it is not, the contract may specifically state that it should not be identified with, for example, an agency agreement or a partnership, a joint venture or a contract of employment, or that it does not create a fiduciary relationship between the parties. In most cases it will state clearly that the parties to the agreement are independent contractors. To stress this point it may also state that the franchisor has no control over the employment contracts of the employees of the sub-franchisor, even if in fact this is not always the case.<sup>4</sup>

The contract might furthermore state that the sub-franchisor is in no way authorised to make any contract, agreement, warranty or representation on behalf of the franchisor, and that the sub-franchisor may not create any obligation on the franchisor's behalf. Linked with this is often a provision stating that the sub-franchisor must ensure that franchisees indicate clearly that their units are franchises operated by them.

A statement to the effect that the agreement is not one of agency or employment will not necessarily lead to the desired result, as in some jurisdictions judges will not always accept such a statement off hand, but will look at the contents of the agreement to determine whether or not it is correct. If it is not, the parties may find that the legislation that is applied will be that which applies to the type of agreement that the judge considers to come closest to the real nature of the agreement concerned.

## **F. CUMULATIVE RIGHTS**

In master franchise agreements a clause may be found stating that the rights and duties of the franchisor are cumulative and that the enforcement of any one of these rights or duties shall not preclude the enforcement of any other right or duty. A similar provision regarding the rights and duties of the sub-franchisor may also be found.

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<sup>4</sup> See Annex 3, Section A, Sub-Section XIII "Labour Law".

## G. NOTICE PROVISIONS

The provisions of importance in a master franchise agreement include also the notice provisions. These should specify what constitutes valid notice and what constitutes valid acceptance (for example, a requirement that any such communication be in writing), the manner in which the notice should be delivered and the dead-lines applicable to it.

## H. DAMAGES

The types of damages that may be awarded vary from legal system to legal system. In some legal systems 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, even if they may be subject to judicial control (this is the case, for example, in Germany). Often the amount of compensation will depend on the type of damages admitted. As the concepts vary from one country to another,<sup>5</sup> master franchise agreements may choose to specify exactly for what harm compensation is recoverable (for example, only for the actual harm sustained).

## I. THE PREAMBLE TO THE AGREEMENT

The Preamble to the agreement might also be of importance, although how important it is will to a large extent depend upon the drafting technique adopted. The Preamble is therefore likely to be of greater importance in common law countries than in civil law countries.

In the common law tradition the Preamble is designed to aid the identification of parties and terms. In some cases it is used to identify the basic purpose of the contract or the background to its performance.

The importance of the Preamble in international master franchise agreements may be found in the need to clarify

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<sup>5</sup> The different concepts include: damages for future benefits lost, for lost chances, for lost profits, for losses suffered, "*negatives Vertragsinteresse*", "*positives Vertragsinteresse*", etc.

concepts, rights and duties in view 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, in case of litigation the Preamble may serve as a guide to the interpretation of the contract if it is to be enforced in a country in which franchising is not a well-known form of business, or if the courts and/or arbitrators are not familiar with franchising.

In some jurisdictions the law might require a court to refer to the purpose of the agreement it is interpreting and the Preamble might serve to state precisely this. In a number of civil law countries the Preamble might further refer to the relevant sections of the legislation, civil or commercial code or law, that is applicable.

## **J. IMPLIED OBLIGATIONS**

A certain number of obligations might not be expressly stated, but might be implied, either from the contract or from the law. The extent to which obligations may be implied will vary from legal system to legal system. In general, the civil law systems are more inclined to accept the idea of implied obligations than the common law systems. This is also a consequence of the drafting style adopted. In civil law countries the relevant non-mandatory provisions of the codes will be considered part of the contract unless the parties provide otherwise (clearly the mandatory provisions will always be applicable). It is also possible that obligations might be implied from the contract itself, through an interpretation of its terms. This is the case in particular where the contract is silent on specific points and the court must interpret it to arrive at the will of the parties.

There are also a number of general principles that are considered to apply even if they are not expressly referred to in the contract. An example illustrating this is the principle of good faith. In civil law countries the principle of good faith permeates the whole legal system, parties are expected to deal with each

other in good faith, not only once the contract has been concluded, but also in the pre-contractual stage. Traditionally this is not the case in common law countries, although there is a slow movement towards a recognition of the need to apply the principle of good faith also in the pre-contractual stage, especially in Australia. In the United States the good faith requirement is also becoming more accepted generally, as can be seen in the franchise laws that have been adopted recently and in the proposals for legislation presented to Congress.<sup>6</sup> However, the duty of good faith has often been held by courts not to override express contractual terms.

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<sup>6</sup> See, for example, Section 5(a) of the proposed Federal Fair Franchise Practices Act, H.R. 1717, introduced 25 May 1995 to the United States Congress.

# CHAPTER 19

## ANCILLARY DOCUMENTS

### A. DOCUMENTING OTHER RELATIONSHIPS

A franchisor frequently has relationships with a sub-franchisor, or franchisee, which strictly speaking are not inherent in the franchise relationship itself. In addition to their relationship as franchisor and sub-franchisor or franchisee, the parties may also be, for example:

- ◆ seller and buyer;
- ◆ lender and borrower;
- ◆ landlord and tenant; or
- ◆ principal and agent.

Almost any traditional commercial relationship may in fact exist simultaneously with the franchise relationship. These other relationships, like the franchise itself, will inevitably entail rights and obligations, benefits and burdens. The parties will therefore find it necessary, or desirable, to document their respective obligations.

Where these other obligations are of the type listed above, this will not present major difficulties: loan or lease agreements are after all familiar documents. While the practice may differ depending on the nature of the business, these documents will typically be separate from the franchise agreement, although they may be connected by cross-default provisions or by other techniques.

There are however many other obligations which one party may wish to impose upon the other and which to a great extent form an integral part of the franchise relationship, but which, for one reason or another, may be included in a separate document rather than in the main agreement between the franchisor and the sub-franchisor or franchisee. These separate documents are often referred to as "ancillary documents".

### B. DESCRIPTION OF ANCILLARY DOCUMENTS

The term "ancillary documents" refers to the preliminary agreements, side agreements and addenda that, in addition to the master franchise agreement itself, are used in forming and administering a master franchise relationship. Ancillary documents tend to be separate agreements for a number of reasons. Some ancillary documents logically precede the master franchise agreement, such as joint venture agreements. Others logically follow the master franchise agreement, such as transfer agreements. Many involve parties other than the sub-franchisor. Confidentiality agreements are, for example, usually agreements between the owners of a sub-franchisor (when the sub-franchisor is a corporation), or the employees of the sub-franchisor, and the franchisor. A number of ancillary documents are used only in certain instances, for example financing agreements or letters of credit. 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 simply intended to highlight the terms of the master franchise agreement.

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. However, some ancillary agreements tend to remain separate documents.

Many ancillary documents that are either the same as, or similar to, those used between a franchisor and a sub-franchisor might also be used between a sub-franchisor and a sub-franchisee. This is the case, for example, with confidentiality and non-competition agreements. The franchisor may, in fact, require the sub-franchisor to use these documents with its sub-franchisees. Where the ancillary documents used by the sub-franchisor are similar in substance to those used by the franchisor, there may be differences due to the fact that 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 many cases these issues are dealt with in the main agreement and not in ancillary documents.

In this connection mention should also be made of the franchise manuals. Although manuals are not, and should not be considered to be, agreements themselves, an obligation to adhere to the manuals is usually found in franchise agreements.<sup>1</sup>

### **C. THE PURPOSES OF ANCILLARY DOCUMENTS**

Franchisors use ancillary documents for a variety of reasons. Firstly, by separating out into ancillary documents negotiated terms, one-time-only transactions, or issues not central to a master franchise arrangement, franchisors are able to maintain a basic uniform master franchise agreement that contains all the terms that are to remain consistent from one sub-franchisor to another. This consistency is important to franchisors, sub-franchisors, and sub-franchisees alike, as the value of the franchise will in all likelihood be based on brand recognition and consistency of quality of the product or service offered.

Secondly, ancillary documents are used to bind particular persons to promises to which they would not be bound by the master franchise agreement. Covenants of confidentiality and non-competition, and sometimes covenants against transfers of ownership interests in the sub-franchisor entity, are for example typically included in separate documents to be signed by individuals who did not sign the master franchise agreement, such as shareholders and employees of the sub-franchisor. Enforcing such promises against these individuals may be difficult or impossible if they do not sign separate agreements.

Thirdly, franchisors use ancillary documents to make adjustments if the relationship changes after it is formed, for

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<sup>1</sup> See Chapter 5, Section C "Manuals".

example if the sub-franchisor sells its business or brings in new investors. Changes of this nature will typically not require the execution of a new master franchise agreement, indeed, re-negotiating the agreement is often undesirable. Changes in the franchise relationship may therefore be documented by means of ancillary documents without disturbing the underlying obligations of the parties.

Fourthly, franchisors use ancillary documents to comply with the laws of a particular jurisdiction. Some countries for example require the filing of a registered user agreement for trademark licenses, or a separate trademark licence agreement.

## **D. EXAMPLES OF ANCILLARY DOCUMENTS**

The examples of ancillary documents given below are grouped as follows: the first group includes ancillary documents that often accompany master franchise agreements, the second group includes agreements the use of which depends on the nature of the franchised business, the third group includes ancillary documents the use of which depends on the structure of the transaction, and the fourth group includes documents that may be required by local law.

### ***I. ANCILLARY DOCUMENTS COMMONLY USED WITH MASTER FRANCHISE AGREEMENTS***

#### **(a) Confidentiality Agreements**

Confidentiality agreements are used almost universally in international franchising. Their purpose is to bind persons who have not signed the master or sub-franchise agreements (for example shareholders, officers and/or employees of the sub-franchisor and of the sub-franchisees) to the covenants of confidentiality found in the master franchise agreement or in the sub-franchise agreement. These covenants are critical for the protection of the franchisor's know-how and trade secrets.

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 of confidential information exchanged during the negotiation of the master franchise agreement. If the negotiations do not lead to the conclusion of a master franchise agreement, the parties will still be legally bound not to disclose confidential information about the other or the other's business.

Confidentiality agreements usually contain terms that correspond to the covenants of confidentiality found in the master franchise agreement or in the sub-franchise agreement.<sup>2</sup> They will therefore contain promises that the individual signing the confidentiality agreement will not disclose, disseminate, or misuse confidential information gained through the sub-franchisor's or the sub-franchisee's operations in the franchise system. A confidentiality agreement may also specify certain remedies against an individual who violates the agreement, such as an injunction or damages. Liquidated damages are often the only viable remedy in the case of a violation, either because injunctions or similar forms of relief are not available in the country where the violation occurs, or because the confidential information, once disclosed, in all probability cannot be retrieved.

### **(b) Non-Competition Agreements**

As is the case with confidentiality agreements, non-competition agreements are separate documents used to bind non-signatories of the master or sub-franchise agreements (for example shareholders, officers and/or employees) to the non-competition covenants found in the master franchise agreement or in the sub-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 sub-franchisor or sub-franchisee.

In the case of the member States of the European Union, non-competition agreements will be subject to the competition laws both of the European Union and of the individual countries.

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<sup>2</sup> See Chapter 11, Section H, Sub-Sections I, *lit.* (a) and II, *lit.* (a), dealing with in-term and post-term confidentiality clauses respectively.

Problems could therefore be encountered under these laws in relation to the enforcement of these agreements. The non-competition agreements most easily challenged are those with employees of the sub-franchisors or of the sub-franchisees who might find it difficult to earn a living if bound by non-competition restrictions after their employment has come to an end. This is why in some countries post-term non-competition covenants may lead to mandatory compensation for the duration of the non-compete period.

Non-competition agreements will usually contain terms that correspond to the non-competition covenants found in the master franchise agreement.<sup>3</sup> These include, for example, promises that the individual signing the non-competition agreement will not own an interest in, or otherwise be involved in, businesses similar to the sub-franchisor's business, both during and for a limited period of time after its association with the sub-franchisor. The time period for which the non-competition agreement lasts after the association ends, for example the time period after the employee resigns or the owner transfers its interest in the sub-franchisor, may vary, but one to two years is common. There may be limitations by law with respect to the length and territorial extent of the non-compete covenant.

Non-competition agreements may also specify the remedies for violation. The remedy may either be an injunction or, in countries where injunctions or specific performance are not available remedies, liquidated damages. If the non-competition agreement is between the sub-franchisor and its sub-franchisee, shareholder or employee, the franchisor may insist on a provision giving it the right to enforce the agreement directly if the sub-franchisor fails to do so.

### **(c) Guarantee and Indemnity**

Guarantee and indemnity agreements are designed to protect the franchisor from losses caused by a sub-franchisor's failure to perform under a master franchise agreement.

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<sup>3</sup> See Chapter 11, Section H, Sub-Sections I, *lit.* (b) "Non-Competition Clauses" and II, *lit.* (b) "Post-Term Non-Competition Clauses".

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 or of the operation of the sub-franchisor's business. For example, if the sub-franchisor fails to provide training to its sub-franchisees and the franchisor is forced to provide the training directly, or if a customer sues the franchisor for compensation for an injury suffered at a franchise unit and the franchisor is held vicariously liable, the franchisor might recover its expenses and costs from the shareholders who signed a guarantee and indemnity agreement.<sup>4</sup>

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

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<sup>4</sup> See Chapter 14, Section A "Vicarious Liability".

statutory provisions or notarisation requirements. It is highly desirable for the franchisor to seek the opinion of local counsel in the sub-franchisor's country in relation to the terms of the guarantee and indemnity agreement.

#### **(d) Transfer Agreements**

The master franchise agreement will 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, the conditions of which are usually set out in detail in the master franchise agreement.<sup>5</sup>

#### **(e) Termination Agreements**

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. The termination agreement must in particular regulate the fate of the sub-franchisees.<sup>6</sup>

#### **(f) Release**

By means of release agreements the releasing party renounces any claims that it may have against the other party. The purpose of these agreements is essentially to give the franchisor and the sub-franchisor the opportunity to start again at certain key stages of the relationship, to give the released party the assurance that long-forgotten incidents will not suddenly be brought forth as legal claims. Releases are most often used upon the renewal or transfer of a master franchise

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<sup>5</sup> See Chapter 13, Section D, Sub-Section II "Conditions for Permitting Transfer".

<sup>6</sup> See also Chapter 16 "The End of the Relationship and its Consequences".

agreement, but may also be used upon the agreement's expiration or termination.<sup>7</sup>

The release may be one-sided, in which case it will typically be the sub-franchisor who releases the franchisor, or it may be mutual. The release may apply only to particular claims, or it may be general, with or without exceptions to preserve specific claims. Releases will often include statements to the effect that the party releasing the other has authority to make such promises, acknowledgements that the release will bar any claim subsequently made by the party releasing the other with reference to events occurring up to and including the date of the release, as well as other terms to facilitate enforcement, such as choice of law and forum selection provisions. It is important to note that in some countries releases of certain claims may violate public policy and may therefore not be valid.

## ***II. ANCILLARY DOCUMENTS THAT MAY BE REQUIRED FOR THE FRANCHISED BUSINESS***

### **(a) Supply Agreements**

When the purpose of the franchise is or includes the distribution or the use of products with or without a particular trademark the supply agreement may specify the terms on which the products are sold to the sub-franchisor by the franchisor.<sup>8</sup> 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 impose restraints on trade, they should always be reviewed for consistency with the relevant competition or technology transfer laws of the country in which the agreement will be used.

The parties may decide that certain statutes, conventions, or principles of law, such as for example the United Nations Convention on Contracts for the International Sale of Goods

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<sup>7</sup> See, in relation to transfer, Chapter 13, Section D, Sub-Section II, *cit.*

<sup>8</sup> See Chapter 9, Section E "Contractual Provisions".

(CISG), should apply, or alternatively that their application should be excluded.

### **(b) Equipment Purchase or Lease Agreements**

If the franchise requires specialised equipment the franchisor may recommend approved suppliers or give equipment specifications or may even itself sell or lease such equipment to the sub-franchisor.<sup>9</sup>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.

With the exception of a possible cross-default provision or other link to the master franchise agreement, equipment purchase and lease agreements are likely to be similar to such agreements found outside the franchising context. They will in particular regulate the payment conditions and the passing of ownership in the case of purchase contracts.

### **(c) Software Licence Agreements**

Computer software is increasingly becoming a central element in franchise systems. Software licence agreements set out the terms under which the sub-franchisor may use and sub-licence software developed for the system. The software licence agreement will be between the franchisor and the sub-franchisor if the franchisor owns the software or if it has an exclusive right to use the software. Otherwise the software licence agreement may be between the sub-franchisor and the creator, or vendor, of the software.

A typical software licence agreement defines the scope of the licence 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:

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<sup>9</sup> See Chapter 9, Section C "Franchisor/Sub-Franchisor Relationship".

- ◆ the right (if any) to sub-license the software to others (in the case of master franchising to 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 licence the software user will generally be obliged to remove the software from its computer system, not to retain any copies of the software and to return all user manuals and similar documentation to the franchisor or vendor.

### ***III. ANCILLARY DOCUMENTS REQUIRED BY THE STRUCTURE OF CERTAIN TRANSACTIONS***

#### **(a) Letters of Intent**

In a letter of intent parties who are contemplating entering into a definitive agreement set out their agreement in principle on major issues. It is similar to a "commitment agreement" and may be used in the context of negotiations for master franchise or joint venture agreements. Letters of intent are used most often in relation to transactions that entail large capital expenditures, such as hotels. The letter of intent is used to express the basic terms of the anticipated agreement. Any further negotiations on those terms are thereby reduced to a minimum. A letter of intent may also provide the prospective sub-franchisor with the proof of the intended arrangement that it needs in order to raise money from investors or to borrow money from banks.

The terms of a letter of intent will naturally depend upon the transaction anticipated in the letter. A letter of intent will typically

- ◆ identify the parties and the nature of the transaction;
- ◆ describe any further investigation to be performed by either party;
- ◆ oblige the parties to use best efforts to negotiate a definitive agreement by a certain deadline;
- ◆ allocate responsibility for the expenses that will be incurred in negotiating and drafting the final agreement;
- ◆ prohibit the disclosure of information shared during the negotiations; and
- ◆ oblige the parties to co-ordinate any public announcement of their transaction.

Most importantly, it 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, continuing fees, development obligations, and possibly choice of law and forum.

### **(b) Joint Venture Agreements**

The franchisor and a foreign partner may for a number of reasons find it appropriate 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.<sup>10</sup> The joint venture agreement is then usually set out in a separate document. 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

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<sup>10</sup> See also Chapter 1, Section A, Sub-Section III "Methods to Franchise Internationally".

countries where the laws regulating foreign technical assistance 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 venture agreements often take the form of shareholders agreements or, if the joint venture entity is not a corporation, of an analogous agreement between the owners of the entity. The contents of a joint venture agreement will vary considerably depending on the arrangements between the parties. Generally, however, the agreement will define:

- ◆ the joint venture's juridical form and authorised activities;
- ◆ the capital contributions and in-kind contributions to be provided by each party;
- ◆ the distribution of ownership interests and income between or among the parties;
- ◆ control and decision-making authority (for example the board of directors, or its equivalent, in the host country);
- ◆ the circumstances under which the joint venture will be dissolved, as well as the terms of dissolution; and
- ◆ the procedures for dispute resolution.

In a market where the franchise concept has not been tested, a test phase for the joint venture might also be provided for.

### **(c) Agreements on Methods of Payment**

A master franchise agreement will typically specify the method by which the sub-franchisor is to pay the continuing fees and other amounts owed to the franchisor, for example by wire transfer to a bank account in the franchisor's country.<sup>11</sup> In some circumstances the franchisor might wish to require payment by other methods, such as by letter of credit. A letter of credit is essentially a letter from the financial institution of the sub-franchisor to the franchisor, stating that the sub-franchisor has deposited funds that the franchisor may withdraw upon presentation of certain documents. Letters of credit are often

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<sup>11</sup> See Chapter 4, Section D "Calculation of Payments and Procedures".

used with supply agreements. They are occasionally used to back continuing fee obligations.

#### **(d) Agreements Evidencing Financing Arrangements**

Franchisors rarely 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 or continuing fees and/or by providing start-up inventory or equipment on credit and possibly by taking a security interest in the inventory or equipment being financed. In such cases, and in the rare cases where a franchisor advances funds as a lender, the parties are likely to execute specific agreements for this financing on the part of the franchisor. An arrangement of this kind may have several advantages for the sub-franchisor. The franchisor might charge a lower rate of interest than would other financiers and the franchisor can be expected to be more knowledgeable of, and committed to the ultimate success of, the sub-franchisor's business. Borrowing from the franchisor might also enable the sub-franchisor to avoid burdensome application procedures and more elaborate documentation. On the other hand, a disadvantage for the sub-franchisor is that the debt is likely to be linked to the master franchise agreement, which would not necessarily be the case with financing from an independent source. If the sub-franchisor does not meet its obligations in relation to its debt, it might therefore find that the entire master franchise agreement is jeopardised.

The financing agreement may be as simple as a promissory note if the franchisor is merely deferring the payment of fees. The franchisor may however require the sub-franchisor to provide security for the payment of the debt, or request shareholders or others to guarantee the payment. In this case the financing agreements may include a security agreement, which maintains the franchisor's claim to the property pledged in the event that the sub-franchisor fails to make timely payments, and separate written guarantees. The terms of the

financing agreements are not likely to differ from similar agreements found outside the franchising context.

#### ***IV. ANCILLARY DOCUMENTS THAT MAY BE REQUIRED BY LOCAL LAW***

##### **(a) Trademark Licence Agreement**

Although the trademark licence is generally not contained in a separate agreement, in a number of countries regulatory constraints, such as registration requirements,<sup>12</sup> or tax considerations may at times render this advisable. When separate trademark licence agreements are used, the master franchise agreement will be divided into a trademark licence 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 continuing fees for tax purposes in countries in which different withholding rates are imposed for continuing fees charged for trademarks licences and for technical assistance.

Separate trademark licence agreements contain the conditions and terms that would normally be included in the master franchise agreement in relation to the use of the franchisor's trademarks.<sup>13</sup> The trademark licence will last for the same length of time as the technical assistance agreement. The renewal of the trademark licence agreement is often subject to the renewal of the technical assistance agreement.

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<sup>12</sup> See Chapter 20, Section A, Sub-Section II "Registration in the Appropriate Registers".

<sup>13</sup> See Chapter 10, Section A "Trademarks".

## **(b) Registered User Agreement**

Registered user agreements are agreements that are separate from trademark licence 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.<sup>14</sup> 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 licence agreements, as well as any relating to specific formalities required by local law. Although local law may authorise registered users to enforce their rights to the trademark against third parties 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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<sup>14</sup> See Chapter 10, Section A, Sub-Section V "Registered User Agreements".

# **CHAPTER 20**

## **REGULATORY REQUIREMENTS**

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

The legislative requirements applicable to an international agreement may to a certain extent differ from those relevant in a purely domestic situation. In the former case a number of requirements additional to those applicable to a domestic agreement may need to be fulfilled, such as, for example, the obtaining of prior approval of the underlying international trade agreement by the authorities of the prospective host country and the obtaining of specific licences and permits.

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 (such as registration in the appropriate commercial registers). The permits required may furthermore be of national, regional or municipal applicability, depending on what they concern. Any entrepreneur that begins an activity must make sure that all the necessary permits are obtained and that all legal requirements are met. This is normal sound business practice in all businesses, franchising included.

Any entrepreneur engaged in a business that is international in character must therefore make sure that, in addition to all the requirements applicable to domestic businesses, also those applicable specifically to the international activity concerned have been met. The advice of specialised legal counsel should be sought, not the least because the situation will differ from country to country. The registrations that are required, the permits and licences that must be obtained, and above all who has to obtain them, will furthermore vary depending on the type of

franchise involved, on whether it is a direct franchise or a master franchise, as well as on whether a branch or subsidiary is involved or a joint venture is used, although there are some permits for which responsibility clearly falls to either one party or the other.

The examples given in this chapter are therefore illustrations of what might be required in general terms and not specifically for franchising, but it should be stressed that the list is not exhaustive. Other requirements specific to either a trade or a certain country, such as the sales or value added tax registration that is applicable in some countries, should also be carefully considered.

## **A. EXAMPLES OF LICENCE AND PERMIT REQUIREMENTS**

### ***I. PRIOR APPROVAL***

Prior approval by a Government authority might be required for the setting up or incorporation of, for example, branch offices, subsidiaries, joint ventures and holding companies.

In a number of countries transfer of technology laws might also require prior approval of the agreement concerned. Where prior approval is required, the agreement must be filed with the competent authorities which will examine it and thereafter either grant or refuse approval. Alternatively, the authorities may require certain amendments to be made as a condition for the obtaining of the approval. Following the approval, the agreement may also be required to be registered in the appropriate register.

Requests by the authorities for an amendment to the franchise agreement might not be well received by the franchisor, as it may feel that the amendments requested have a negative effect on its franchise system. To cover also the eventuality that the changes required might prove to be unacceptable to the franchisor, clauses may be found in agreements stating that the franchisor may terminate the agreement if it in good faith determines that the amendments required are detrimental to its interests. In view of the fact that the termination does not depend upon the sub-franchisor's acts or omissions, a reimbursement of the expenses incurred by the sub-franchisor might be provided for in the agreement.

## ***II. REGISTRATION IN THE APPROPRIATE REGISTERS***

The procedure for the prior approval of the trade agreement may end with the actual registration of the agreement. In other instances the obtaining of prior approval by a Government authority is a first step, followed by registration in the commercial register or in any other official register with which the agreement or the business must be registered.

Examples of registration that might be required include:

- ◆ registration in commercial registers of the company or enterprise concerned; and
- ◆ registration of the trademarks, trade names, symbols, patents and designs in the appropriate registers.<sup>1</sup>

Examples of Government authorities with which the agreement should be filed for prior approval and subsequently registered include:

- ◆ the *Fair Trade Commissions* that have been set up in a number of countries;
- ◆ the competition authorities; and
- ◆ the authorities that look after the transfer of technology.

The facility with which an administrative decision is obtained will vary from country to country. It should be noted that the possibility to obtain prior approval or registration might be limited by the adoption in the host country of policies protecting the interests of the national entrepreneurs, particularly the artisans. Protective policies of this nature may heavily affect the saleability of a franchise and might limit the market for the foreign franchise network.

As concerns trademarks, sub-franchisors will normally not be involved with the registration of the trademark as the franchisor will in most cases try to keep the trademark registration in its own name, so as to avoid that the sub-franchisor or anyone else obtain any rights in its trademark.

It should be noted that a growing number of countries are introducing franchise-specific legislation.<sup>2</sup> While most of these do not provide for any registration requirement, they do require

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<sup>1</sup> See Chapter 10 "Intellectual Property".

<sup>2</sup> See Annex 3 "Legislation and Regulations Relevant to Franchising".

specific procedures to be followed. This legislation may be modified from time to time and the parties should therefore make a point of reviewing it regularly, so as to ensure that all current legislative requirements relevant for their activities are met.

### ***III. PERMITS REQUIRED FOR THE FOREIGN ELEMENTS***

In a cross-border situation the position of the foreign elements, whether of the foreigners themselves, for example restrictions in the number of foreigners allowed to sit on the Board of Directors of a company, or of other elements such as the permits required for a foreign investment or the registration requirements applicable to a foreign trademark, need to be ascertained. What is required must therefore be carefully considered in each particular case.

### ***IV. FOREIGN EMPLOYEES OF THE FRANCHISOR***

The training and assistance the franchisor offers its sub-franchisors will often involve the physical presence of employees of the franchisor at the franchise unit or business head office in the host country. For these employees to be able to stay for any length of time in the host country, and for them to be able to operate and work there, they often need to have visas, residence and work permits issued by the authorities of the country concerned. Master franchise agreements will frequently provide that the obtaining of these permits is an obligation that falls upon the sub-franchisor.

### ***V. AGENTS OF THE FRANCHISOR***

If the franchisor operates through an agent, that agent may have to register as such, assuming there is a register for agents in the country concerned. Permits allowing the agent to operate may also have to be obtained from the appropriate authorities.-

### ***VI. IMPORT AND EXPORT LICENCES AND OTHER PERMITS REQUIRED AS A CONSEQUENCE OF IMPORT OR EXPORT RESTRICTIONS***

Licences will often be required when the franchise involves the export or import of products, or the import of items that are to

be used in the franchise (raw materials, for example). It will also be necessary to ensure that these products or items comply with any regulatory requirements (including approvals) and any particular specifications that local regulations may require, such as those applicable to labelling. In most cases the obtaining of these licences and approvals will fall upon the sub-franchisor. The question of quotas and other associated restrictions will need to be considered, as the existence of any such quota may result in the necessity to apply for an exemption.

### ***VII. EXPORT OF PROFITS AND CURRENCY RESTRICTIONS***

The export of profits in the form of continuing fees and other fees will often require special permits from Government authorities. This is particularly true in countries that have a shortage of hard currency, as these will often require profits to be reinvested in the country. These permits will relate to currency restrictions in general, but also to the applicable tax regime. In general terms it will normally be the sub-franchisor that applies for the necessary permits and that will be required to pay any associated taxes.

### ***VIII. WITHHOLDING TAXES***

An important point relating to the export of profits is that which concerns withholding tax. It should be noted that there are countries in which it is necessary to obtain permission from a specified bank for the payment of withholding tax when continuing fees and other fees are transmitted abroad.<sup>3</sup>

### ***IX. TRADE-SPECIFIC REQUIREMENTS***

Each trade requires a certain number of permits specific to that trade. Thus, for example, the food industry requires licences to sell food or alcoholic beverages. Health legislation will set certain standards that must be observed, non-compliance with which might lead to a suspension of the licence. The location

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<sup>3</sup> For a discussion of the financial issues in general, see Chapter 4 "Financial Matters".

chosen for a particular activity may also necessitate a particular permit as a result of, for example, zoning regulations, although in this case the permit necessary will in all likelihood be of municipal character and not of nation-wide application.

## **B. WHO SHOULD OBTAIN THE PERMITS**

In an international master situation the franchise is to be operated abroad. The obtaining of the majority of the permits will therefore fall upon the local sub-franchisor. In most cases the agreement will merely indicate an obligation on the part of the sub-franchisor to obtain any such permits or licences as might be necessary for the operation of the business and to cover the expenses associated with the obtaining of the permits, applicable duties included. In general terms it is logical that the party responsible for the obtaining of any permits should be the local party, the sub-franchisor in the case of master franchising. The sub-franchisor will clearly have the knowledge necessary to determine which permits and registrations are necessary and will know how to proceed to comply with these requirements. It will therefore in most cases fall upon the sub-franchisor to exercise due diligence both in the determination of the requirements and in the compliance with them. It should be noted that the risk of non-compliance may in some cases be that the agreement might be considered void.

There are many instances in which there is no natural candidate for the obtaining of the necessary permits. In such cases the parties should determine in their agreement which one of them should obtain what permit and bear its cost.

A number of the permits or licences listed in Section A above would, however, 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,<sup>4</sup> and the filing for regulatory approval of products.

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<sup>4</sup> For a review of the problems associated with registered user systems and master franchise agreements, see Chapter 10, Section A, Sub-Section V "Registered User Agreements".

Where the franchisor sets up a branch office or subsidiary in the host country, that branch office or subsidiary might be required to be registered in the commercial register. If the franchisor intends to operate through a branch office or a subsidiary, it will fall upon the local directors of the franchisor to obtain all the permits necessary for the conducting of the business.

In the case of a joint venture established by the franchisor together with a local partner, the franchisor will naturally rely on the local partner for assistance in obtaining the permits, although the responsibility would fall to both. The joint venture agreement would in all probability deal with this issue. What would clearly fall upon the franchisor is the obtaining of the permits which may be required for the investment it intends to make, as foreign investments may be subject to a series of conditions.

At times, the existence of the agreement may need to be made conditional upon the obtaining of all the necessary permits. Similarly, the temporary, or permanent, suspension of any permits or licences the possession of which is a prerequisite for the operation of the franchise, may result in the termination of the agreement for breach on the part of the sub-franchisor. This will follow from the obligation that is placed on the sub-franchisor to obtain and maintain in good standing all required permits and licences.

# **ANNEX 1**

## **FRANCHISING: GENERAL NOTIONS**

The complex structure of a master franchise arrangement is not what normally captivates the imagination of the public. The consumer of a product or service has the image projected by the franchise unit in mind when he or she buys a particular product or service. What form of franchising is used for that unit is not something a consumer will normally be aware of. In most cases, however, the franchise a consumer will come across will be a business format franchise.

### **A. DIFFERENT FORMS OF FRANCHISING**

As indicated in Chapter 1, franchising is often divided into industrial franchises, distribution franchises and service franchises. In this case industrial franchises are defined as concerning the manufacturing of goods and as consisting in manufacturing licences based on patents and/or technical know-how combined with trademark licences, distribution franchises are defined as concerning the sale of goods and service franchises are defined as concerning the supplying of services.<sup>1</sup> Other descriptions of franchising divide franchises into product distribution franchises and business format franchises. 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, and a business format franchise is where

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<sup>1</sup> Commission Regulation (EEC) No 4087/88 on the application of Article 85(3) of the Treaty to categories of franchise agreements, in OJ EEC L359/46 of 28 December 1988, Recitals 3 and 4.

the right to use a specific business format is granted.<sup>2</sup> It should perhaps be noted that in many businesses the term “franchising” is used in a generic way, to describe a wide range of licensing transactions that strictly speaking cannot be considered to be franchising.

## **B. BUSINESS FORMAT FRANCHISING**

Most people who hear the word “franchising” will think of businesses such as McDonald’s or Pizza Hut, all of which are business format franchises.

### ***I. BASIC ELEMENTS***

The basic elements of a business format franchise are 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 this 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 will involve the right of the franchisee to use the franchisor’s assets, namely its know-how, in the form of the business and technical methods that are part of its system, its trademarks and other intellectual property rights;
- ◆ the franchisee in exchange undertakes to follow the method elaborated by the franchisor and to pay the compensation that is requested of it, typically an entrance fee and/or continuing fees, the latter normally being 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

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<sup>2</sup> See the description contained in the Introduction to CCH *Business Franchise Guide*, at ¶ 100. On business format franchising, see Section B, below.

- ◆ the franchisor typically undertakes to provide the franchisee with training and on-going assistance.

## ***II. ADDITIONAL UNDERTAKINGS***

In addition to the above, a variety of arrangements and undertakings by the parties may be present in the agreement or in ancillary documents.<sup>3</sup> Some of these are potentially controversial and not all are present in all agreements at the same time. Which are present will be determined by the subject-matter of the agreement. Examples of such arrangements or undertakings are:

- ◆ an undertaking by the franchisor not to grant other franchises, or not 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 recommended 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.

It should be noted that the providing of price lists, even if only indicative in nature, may at times come close to, or may be considered to be, a form of price fixing. The contract term in question should therefore be prepared having particular regard to 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;
- ◆ might be the owner or lessee of the premises the franchisee is to use and might lease or sub-lease them to

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<sup>3</sup> See Chapter 19, "Ancillary Documents".

the franchisee, thereby creating a landlord/tenant relationship;

- ◆ might provide assistance for the interior decorating of the unit so as to ensure that it conforms to that of the other units of the network;
- ◆ might assist the franchisee to find financial resources through its contacts with financial institutions; and
- ◆ might even centralise the accountancy of the whole franchise network.

Contract clauses are also to be found that:

- ◆ hold the franchisor free from liability for actions or omissions on the part of the franchisee; and
- ◆ require the franchisee to take out insurance coverage with the franchisor as beneficiary.

Often, though not always even if there are those who would consider it to be a prime element of a franchise arrangement, the franchisor will assist the franchisee in selecting the site of the unit. The franchisor will in this case provide market studies examining the community in which the proposed unit 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.

Clauses may further be found by which the franchisor reserves the right to distribute the goods that are the subject of the franchise by alternative means of distribution, i.e. the franchisor reserves the right to sell the goods it provides the franchisee with, and therefore to compete with the franchisee, in, for example, the big department store a block away, or through other shops that it does not own or franchise.

Depending on the type of franchise involved, the franchisee will undertake:

- ◆ to comply with the standards and/or procedures elaborated by the franchisor;
- ◆ not to disclose the know-how transmitted to it by the franchisor to third parties (the so-called “confidentiality clauses”); and
- ◆ not to engage in an activity competing with that of the franchise (“non-competition clauses” or “restrictive covenants”).
- ◆ Restrictive covenants will often be imposed also for a certain period of time after the termination of the franchise agreement. The franchisee will in this case be prevented from engaging in an activity competing with that of the franchise first and foremost within the geographic area it was in charge of developing, but at times also within a certain distance from other franchise units 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. Provisions on termination will typically 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 typically present independently of whether the franchise business is conducted as a direct franchise between the

franchisor and franchisee, or whether the franchisor operates through a branch or subsidiary, through a master franchise agreement or by resorting to a joint venture. It should be noted that all of these techniques are used in both domestic and international franchising.<sup>4</sup>

## **C. ADVANTAGES AND DISADVANTAGES OF FRANCHISING FOR THE OPERATORS**

Franchising is often characterised as a form of business which benefits all parties concerned. In essence this may be considered to be correct, but there is no form of business which does not have its draw-backs and franchising is no exception to this rule.

### ***I. ADVANTAGES FOR THE FRANCHISEE***

One of the main advantages for the franchisee is normally seen to be the fact that it enters into business carrying 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, it does not have to run the development risk in establishing the business as the franchisor has already run this risk. In effect, the franchisee already has a potential clientele. This is of course true if the trademark of the franchised business is well-known, but there is many a franchise business that is not well-known and for which the franchisee will need to expend time, money and efforts to make it known. This is particularly true in an international situation, as, with few exceptions, even successful franchise businesses will often not be known in other countries.

As the franchisee is normally not required to invest to make an entirely new trademark known and profitable, the investment it has to make will in most cases be of an advantageous size, as compared with the investment that would be required for an entirely new business. Statistical information on failure rates of domestic unit franchises would also indicate that the failure rate of unit franchises is substantially lower than that of traditional

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<sup>4</sup> See Chapter 1 "Fundamental Concepts and Elements".

businesses. An important factor in this connection is the maturity of the franchise system, where the maturity is the result of the experience gained by the franchisor in firstly, the testing of the system and secondly, the running of the network. If a franchise system is not mature, then the failure rate may be far superior even to that of a traditional business.

Of particular importance for franchisees who enter a business with which they are unfamiliar is the training and assistance provided by the franchisor. This training and assistance is provided first and foremost at the beginning of the relationship, so as to enable the franchisee to operate effectively. Further training is often regularly provided in the course of the agreement, so as to ensure that the franchisee is always up to date with new developments. Assistance is also provided in the course of the agreement, with a view to aiding the franchisee to solve the problems that it encounters in the running of the business. Large franchisors may even have a twenty-four hour service at the disposal of the franchisees of the network.

Co-ordinated advertising is an effective means to spread a unitary image of the network. Advertising at a national level is therefore often conducted by the franchisor on behalf of the whole franchise network, the expense being shared by all participants. Local advertising is often left to the local franchisees.

Lastly, in some businesses networks may obtain preferential rates for bulk purchases.

## ***II. DISADVANTAGES FOR THE FRANCHISEE***

To be weighed against the advantages described above is the fact that the franchisee is not truly independent and is therefore not in a position always to decide the policy of its enterprise. Any major decisions will be taken either by the franchisor or by the franchisor in concert with the whole network of franchisees. The professional capability and seriousness of the franchisor is therefore crucial for the franchisee, as in many ways it is dependent upon the franchisor.

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 agreement 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 term.

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 is under an obligation to pay the franchisor might be considerable and might therefore further reduce, at times quite dramatically, the earnings of the franchisee.

The fact that it is the franchisee that has to bear the financial risk of its business must be clearly understood: if the business fails, it is the franchisee that loses the money it has invested.

### ***III. ADVANTAGES FOR THE FRANCHISOR***

For the franchisor, the main advantage is the possibility to expand the business over a relatively short period of time, but without having to make direct investments in new places of business, as it is the franchisees that make the capital investment. In addition, the franchisor will in most cases receive fees from the franchisees.

By expanding its business with the help of franchisees, the franchisor is able to reach also smaller markets, as it will be relying on franchisees that have knowledge of the local conditions and interests and are therefore likely to be better able to exploit those markets.

The franchisor is furthermore not liable for the acts or omissions of the franchisee as the two are, and remain, independent entrepreneurs.

Other advantages include the fact that franchisees are motivated business owners with an entrepreneurial spirit and this is likely to produce increased sales. In general, franchisees will also have better relations with employees than do managers of

company-owned outlets, as well as a greater ability to motivate employees, which will result in increased productivity. An indirect benefit of franchising may furthermore be that for company employees the possibility that they might in the future become franchisees may be an incentive for them to improve their performance.

#### ***IV. DISADVANTAGES FOR THE FRANCHISOR***

If the franchise relationship does not work, the damage suffered by the franchisor, indeed by the whole network, could be quite considerable. In fact, as the owner of the trademark or trade name the franchisor is ultimately the one who will suffer most (by, for example, a reduction in sales throughout the network) if any of the units does not conform to the quality standards set.

It is very important for the franchisor to be able to exercise control over the performance of the franchisees, precisely to avoid any detrimental effect to the good name of the system. For the franchisor a disadvantage of the franchise arrangement is that the degree of control it has over the units is less than if they were company-owned. The possibility of several franchisees acting together against the franchisor might furthermore prove to be a disadvantage for the franchisor, even if their right to form associations of franchisees should be clearly recognised.

The risk of franchisees breaking away from the system and setting up competing businesses is also to be counted among the disadvantages of franchising.

The franchise relationship furthermore has built into it a certain number of natural tensions. These include a resistance on the part of franchisees to modernise their premises and to acquire more modern equipment, which might not always be perceived as necessary. The possibility that unjustified requests to this effect might be made by some franchisors should not be overlooked, but franchisees should also be aware of the need for change as the market develops. The same reasoning holds true also as regards the introduction of system changes in the course of the agreement.

Lastly, the financial returns of the franchisor will be lower than would be the case with a subsidiary or a wholly-owned outlet, as it will not receive all the financial returns of the enterprise, but only a percentage thereof.

## ANNEX 2

### FRANCHISING IN THE ECONOMY

#### A. THE ECONOMIC RELEVANCE OF FRANCHISING

Statistics for franchising are often difficult to compare, as different types of businesses are included under the term "franchising" in different countries. Petrol stations are, for example, included under franchising in the United States of America whereas they are not in Europe. The criteria adopted for the surveys conducted also differ, as do the time-spans covered by the data. This notwithstanding, the simplest way to grasp the economic importance of the phenomenon is without doubt that of examining the data available. A table providing the most up to date information available for a number of countries therefore closes this Annex. The figures assembled in this table have a number of different sources. The data relating to the European countries is taken from the *European Franchise Survey*<sup>1</sup> published by the *British Franchise Association (BFA)* acting in its capacity as Secretariat to the *European Franchise Federation (EFF)*. This Survey covers twelve European countries.<sup>2</sup> With the exception of Japan and Malaysia, the data in the table referring to non-European countries is based on Table 6 of the *Industry and Trade Summary on Franchising* published by the United States International Trade Commission.<sup>3</sup> In both the European Survey and the *Industry and*

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<sup>1</sup> EFF *European Franchise Survey*, sponsored by NatWest Bank, August, 1997. The figures, in ECU in the Survey, have been converted to US dollars for comparison purposes. Unidroit wishes to thank the BFA and the EFF for permission to use the figures of the Survey.

<sup>2</sup> Austria, Belgium, Denmark, France, Germany, Hungary, Italy, the Netherlands, Portugal, Spain, Sweden and the United Kingdom

<sup>3</sup> 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

*Trade Summary* the data refers only to business format franchising. The information on Japan and Malaysia is taken from the publication *Franchising in Asia-Pacific*, an Industry Research Report produced by the Singapore Trade Development Board in collaboration with Arthur Andersen Business Consulting.<sup>4</sup>

The figures cited in the table refer mostly to business format franchising. The size of franchising activities becomes even more evident when the figures for other forms of franchising are added to those relating to business format franchising. Thus, in the United States, the total volume of sales of goods and services from franchise outlets in 1992 was estimated at US \$ 803.2 billion, as against the 249 billion dollars-worth of sales from business format franchise outlets. The remaining US \$ 554.2 billion related to product and trade name franchising.<sup>5</sup> In addition to the 429,217 business format franchise outlets, in 1992 there were 128,908 product and trade name outlets and it was estimated that sales from franchises represented some 35% of retail sales in the United States. This figure is still deemed to be valid.

According to the *Industry and Trade Summary*, the number of franchised establishments in the United States has grown significantly over the last 25 years. As of 1994 approximately one out of every 12 business establishments was a franchised business. In the period 1969 to 1992 the number of franchised establishments increased by approximately 45%, representing an annual growth rate of 1.7% (other sources indicate an annual growth rate of 10%<sup>6</sup>). 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

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Franchise Association, the Mexican Franchise Association, US&FCS Cables and USITC staff estimates.

<sup>4</sup> Singapore Trade Development Board, in collaboration with Arthur Andersen Business Consulting, *Franchising in Asia-Pacific*, Singapore, 1997.

<sup>5</sup> International Franchise Association, *Franchise Fact Sheet* (April/May 1994).

<sup>6</sup> U.S. International Trade Commission, *Industry and Trade Summary on Franchising, Op. cit.*, p. 4.

approximately US\$ 408 billion, while imports were only US\$ 5 billion. The resulting trade surplus was therefore a full US\$ 403 billion.<sup>7</sup>

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.<sup>8</sup>

In Canada, in 1984 retail sales from franchise outlets exceeded CDN \$ 48 billion or approximately 45% of total Canadian retail sales.<sup>9</sup> Of these, it was estimated in 1985 that 50% were generated from business format franchises and what at the time were considered to be other non-traditional forms of franchising.<sup>10</sup> 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.<sup>11</sup> 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

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<sup>7</sup> U.S. International Trade Commission, *Industry and Trade Summary on Franchising, Op. cit.*, p. 27.

<sup>8</sup> U.S. International Trade Commission, *Industry and Trade Summary on Franchising, Op. cit.*, p. 7.

<sup>9</sup> Canadian Franchise Association, *Franchising: The Current Situation*, Toronto, 1985, cited in A.S. Konigsberg, *International Franchising*, 2<sup>nd</sup> Edition, Juris Publishing, New York, 1996, at II.III.7.

<sup>10</sup> U.S. Department of Commerce, International Trade Administration, Office of Service Industries, *Franchising in the Canadian Economy 1976 - 1981*, Washington DC, cited in A.S. Konigsberg, *Op.Cit.*, at II.III.7.

<sup>11</sup> A. Trebilcock, *Bringing your Franchise to Canada: Regulation of Selling Practices and the Use of Disclosure Documents*, (unpublished), 1988, cited in A.S. Konigsberg, *Op.Cit.*, at II.III.7.

1986 and was projected to be 40% for the period 1988 to 1992, although as yet no confirmation of this prediction is available.<sup>12</sup>

Estimates for franchising in France indicate that prior to 1988 the annual increase in number of franchise systems was 15% and that in the same time period the average annual increase in number of units was 10%. On the other hand, since 1989 the number of systems and franchisees has hardly changed.<sup>13</sup> Sales generated by franchising in 1993 exceeded 21 billion ECU, or approximately 7.5% of all retail sales.<sup>14</sup>

The 1997 Survey on franchising in the United Kingdom, conducted by the BFA in collaboration with the National Westminster Bank plc (NatWest), indicates that the number of franchise systems was 541 (which represented an increase of 14% on the figure for the previous year), that there were 26,800 franchised units (an increase of 4.3%), that the turnover was a total of £ 6.4 billion (an increase of 8.5%) and that there were 264,100 persons employed in the industry.<sup>15</sup>

Franchising is also entering the newly opened markets of the countries of Central and Eastern Europe, in which the 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 prove a useful tool in the privatisation process. It is furthermore seen as a source of foreign investment. The only statistics available are for Hungary, in which franchising in 1994 represented 1-2% of retail trade<sup>16</sup> and in 1997 3% (the figures refer to 1996). In 1994 the revenue generated by the franchised

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<sup>12</sup> A. Trebilcock, paper presented at the Salon international de la franchise, Paris, 1989, p. 24, cited in A.S. Konigsberg, *Op.Cit.*, at II.III.7.

<sup>13</sup> EFF *European Franchise Survey*, *Op.Cit.*, p. 124.

<sup>14</sup> European Franchise Federation, *Newsletter*, Quarterly No. 1, October 1993, cited in A.S. Konigsberg, *Op.Cit.*, at II.IV.9.

<sup>15</sup> EFF *European Franchise Survey*, *Op. cit.*, p. 322. Although the Survey gives also these figures, which are the most recent for the franchising industry in the United Kingdom, for comparison purposes it uses the figures of the 1996 Survey. The table at the end of this Annex does likewise.

<sup>16</sup> Hungarian Franchise Association, *Yearbook 1993/94*, p. 38.

businesses amounted to US \$ 2.5 billion and the annual growth rate was 25%.

The Latin American market is developing very quickly, with Brazil, Mexico and Argentina in the forefront. Brazil has seen an explosive growth of franchising, with an annual growth rate of about 35% since the mid 1980's. In fact, in 1993 the annual revenue from franchising as a whole totalled US \$ 48.1 billion, which amounted to 10% of the GNP of the country.<sup>17</sup> In 1994 total sales of company-owned and business format franchise outlets totalled US \$ 9.87 billion, while sales of product and trademark franchises amounted to US \$ 68.389 billion. In 1994 it was estimated that there were 26,716 business format franchise outlets.<sup>18</sup>

Franchising is growing rapidly in Asia, where it is spreading in Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Thailand and even China.<sup>19</sup> The expansion of franchising in Japan has in fact been exponential. In 1970 there were 61 franchisors, in 1981 there were 381 and in 1995 there were 755. These 755 franchisors operated 158,000 establishments with sales amounting to ¥ 13.1 trillion.<sup>20</sup> Japan has the highest average number of establishments per franchisor in the world, with approximately 200 establishments per franchisor.<sup>21</sup>

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<sup>17</sup> Figures of the Brazilian Franchising Association, cited in L. H. O do Amaral, *Brazil is bound to introduce disclosure requirements*, in *Journal of Inter-national Franchising and Distribution Law*, Vol. 8, 1994, p. 102.

<sup>18</sup> Statistics of the Brazilian Franchising Association, cited in A.S. Konigsberg, *Op. Cit.*, at II.XIV.19.

<sup>19</sup> On franchising in the Asia-Pacific Region, see Singapore Trade Development Board, in collaboration with Arthur Andersen Business Consulting, *Franchising in Asia-Pacific*, *Op. cit.*

<sup>20</sup> Singapore Trade Development Board, in collaboration with Arthur Andersen Business Consulting, *Franchising in Asia-Pacific*, *Op. cit.*, p. 96.

<sup>21</sup> U.S. Department of Commerce, International Trade Administration, *Japan - Franchising Industry - ISA9009*, Market Research Reports, August 27 1994, National Trade Data Bank, IT market 111107290, in U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, *Op. cit.*, p. 26.

In New Zealand, where franchising has only recently become established, it is estimated that there are approximately 250 to 350 franchisors and that franchising accounts for between 7 and 10% of the retail sector.<sup>22</sup> In Australia, the annual growth rate of franchising for the years 1989 - 1991 reached 12.7%.<sup>23</sup>

With few exceptions, notably that of South Africa, franchising still has to develop on the African continent.

## **B. BENEFITS OF FRANCHISING TO THE NATIONAL ECONOMY**

The figures cited in Section A above are a clear indication of the importance of this business technique in economic terms. The effects of franchising are however more far-reaching, both for the national economy of the countries concerned and for the operators engaged in this form of business.<sup>24</sup>

### ***I. EMPLOYMENT OPPORTUNITIES***

The most obvious benefit of franchising to the national economy is the creation of new jobs, not only directly in the franchising industry itself, but also indirectly in the connected industries. Thus, for example, if a food franchise network is established, a demand will be created for the products and services that are used in, or in connection with, the franchise. The industries that provide these products and services will need to expand to meet the increasing demands placed upon them and will therefore hire more employees. As the franchise network spreads, the new franchisees will also be hiring employees, thereby creating yet more new jobs. With unemployment rates of 10, 12 or even 20%, the importance of a business technique which creates employment opportunities cannot be overly stressed.

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<sup>22</sup> Singapore Trade Development Board, in collaboration with Arthur Andersen Business Consulting, *Franchising in Asia-Pacific, Op. cit.*, p. 114.

<sup>23</sup> *Franchising - Australia and Abroad*, Supplement to the Franchising Task Force Final Report, March 1992, p. 12.

<sup>24</sup> See Annex 1, Section C "Advantages and Disadvantages of Franchising for the Operators".

In the United States employment in franchised establishments doubled from 3.5 million in 1975 to 7.0 million in 1988. Approximately 90% of this increase was generated by business format franchises for which the employment level grew by 162% between 1975 and 1988.<sup>25</sup> In 1992 the number of people employed in franchising amounted to eight million.

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.<sup>26</sup> This represents a substantial increase, as the Survey conducted by the Department of Industry, Technology and Commerce in 1990/91 indicated that franchised outlets employed 170,000 people.<sup>27</sup>

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 due to recessionary factors. In France, on the other hand, 10,000 new jobs were created in 1992.<sup>28</sup>

## **II. LOWER FAILURE RATES**

Another factor which is of importance, and which indeed is connected with the issue of unemployment, is the failure rate of franchised businesses. This is often substantially lower than that of more traditional businesses, although figures on how much lower vary considerably. The number of bankruptcies is also considerably lower than the average figures for non-franchised retail businesses, although here again there is disagreement as to the exact figures. According to a study commissioned by the

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<sup>25</sup> U.S. International Trade Commission, *Industry and Trade Summary on Franchising*, *Op. cit.*, p. 7.

<sup>26</sup> R. Gardini, *Review of the Franchising Code of Practice, Report to the Hon Chris Schacht, Minister for Small Business, Customs and Construction*, Australian Government Publishing Service, Canberra, 1995, p. 1.

<sup>27</sup> *Franchising - Australia and Abroad*, *Op. Cit.*, p. 3.

<sup>28</sup> European Franchise Federation, *Newsletter*, Quarterly No. 1, October 1993, cited in A.S. Konigsberg, *Op.Cit.*, at II.IV.9.

International Franchise Association,<sup>29</sup> approximately 97% of franchised establishments founded within five years of the study were still in operation, and approximately 86% were still owned by the original owners. Other estimates are more conservative, the success rate being estimated at 60%. Even if lower, this figure is still substantially higher than the overall new business success rates, which are estimated at 40% after 2 years and at 10% after 10 years.<sup>30</sup>

### **III. THE USE OF FRANCHISING FOR DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION**

A characteristic features of franchising is the provision by the franchisor of training and assistance, so as to enable franchisees, who often have no business experience whatsoever, to operate in the most effective manner possible.<sup>31</sup>

This characteristic feature of franchising has made it a form of business that is particularly attractive to countries with economies in transition, first and foremost the countries of Central and Eastern Europe, and to developing countries, many of which face problems similar to those faced by the Central and Eastern European countries, namely the transformation of a planned economy into an open market economy.

The tasks faced by the Governments of countries that have, or have had, a planned or partially planned economy 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 reduction of unemployment.

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<sup>29</sup> Arthur Andersen & Co., *Franchising in the Economy 1989 - 1992*, p. 16, cited in U.S. International Trade Commission, *Industry and Trade Summary on Franchising, Op. cit.*, p. 3. The IFA is the professional association essentially of American franchisors, even if it recently opened to membership by franchisees and has a number of foreign members.

<sup>30</sup> U.S. International Trade Commission, *Industry and Trade Summary on Franchising, Op. cit.*, p. 3.

<sup>31</sup> See Chapter 5, Sections B "Training" and D "Assistance and Other Services" and Annex 1, Section C, Sub-Section I "Advantages for the Franchisee".

It is precisely as an aid to the solution of these problems that franchising has a role to play.<sup>32</sup> As indicated above, it offers a rapid expansion of individual businesses with a greater chance of success than the average non-franchised business, it provides a system that permits the production of goods or the provision of services of consistent quality and price, it improves the production and distribution of consumer goods and it is a system that generates employment opportunities.

In the case of the countries of Central and Eastern Europe, which have actively been pursuing the transformation of their economies for a number of years, a tradition of small business enterprises had survived through the decades of socialist rule. Despite this, a class of capable entrepreneurs needed, and to a certain extent still needs, to be trained. The training and assistance in general business management, in accountancy and in the related skills that are among the fundamental characteristics of franchising are what make it an effective tool in the creation, or re-creation, of an effective class of entrepreneurs in as brief a period of time as possible. These same characteristics are also what suggest that franchising might have a role to play in the privatisation process,<sup>33</sup> although whether or not franchising in practice is effective as a tool for privatisation will to a large extent depend on the local conditions of the country concerned. Thus, even if the Governments of Poland and the Czech Republic have expressed an interest in using franchising to privatise State enterprises,<sup>34</sup> this has not been the case in Hungary.

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<sup>32</sup> For an examination of these tasks and the role of franchising in Central and Eastern Europe, see P. F. Zeidman/M. Avner/ S.P. Petri, *Franchising in the New Markets of Eastern Europe*, in BNA Eastern European Reporter, vol. 1, 1991, p. 190 ff., and P.F. Zeidman/M. Avner, *Franchising in Eastern Europe and the Soviet Union*, in DePaul Business Law Journal, vol. 3, 1991, p. 307 ff.

<sup>33</sup> See P.F. Zeidman/M. Avner, *Op. cit.*, p. 317 ff.

<sup>34</sup> In 1990 the Hungarian State Property Agency suggested that franchising might have a role to play in the privatisation of two hotel chains (the Dannubius Hotel and Spa Company, and the Pannonia Hotel and Catering Company): State and Property Agency, First Privatization Program 1990, cited in P.F.

In Hungary the officials of the State Property Agency (SPA) indicated that franchising would not be a tool used directly in privatisation, as on the one hand there was not enough capital within the country and on the other the Privatisation Act did not provide for the allocation of resources to franchise conversion, which in fact the Act did not consider at all.<sup>35</sup> The SPA however invited the Hungarian Franchise Association (HFA) to submit a study on franchising,<sup>36</sup> subsequent to which the SPA issued a booklet in its series on privatisation, dealing with how the concept of franchising can be used in the privatisation process.<sup>37</sup> In this context the role that might be played by joint ventures should not be overlooked.<sup>38</sup>

### C. 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:<sup>39</sup>

accounting/tax services (tax preparation,

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- Zeidman/M. Avner, *Op. cit.*, p. 319.
- <sup>35</sup> *A hajó elment ...* (Interview with Tóth Attila), *Figyelő*, Franchise Supplement, 7 May, 1991, p. 34.
- <sup>36</sup> Hungarian Franchise Association, *Franchising as a method of privatisation*, 1992 (a shortened version of this study is published in Hungarian and in English in PRIVINFO 1993/6.)
- <sup>37</sup> I. Kiss/J. Sajó, *Franchising and privatisation* (in Hungarian), Privatisation Series No. 21, SPA, Budapest, 1994.
- <sup>38</sup> See Chapter 1, Section A, Sub-Section III "Methods to Franchise Internationally".
- <sup>39</sup> List derived from the merging of two lists contained in M. Mendelsohn, *The Guide to Franchising*, 5<sup>th</sup> edition, Cassell, London, 1992, p. 43 ff.

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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	dispensing equipment (food and beverages)
auto	domestic services
washes/products/equipment	drain and pipe cleaning
automotive	employment and temporary help services
products/services (motor vehicle services)	entertainment
24-hour mobile	estate agency
windscreen replacement service	food operations, including:
automobile parts	barbecue
car tuning service	Cantonese
car valet services	donuts
exhaust systems	fast foods
replacement	baked potatoes
motor accessories, cycles, cycle accessories	baking and coffee
rust proofing	fish and chips
vehicle security system	fried chicken
beauty and slimming salons	hamburgers
brewers	pizza
building and construction	full menu
business aids/services	frankfurters
campgrounds	hot bread kitchens
catalogue sales	Italian
chauffeur services	Mexican
chemical maintenance products	mobile units
children's products/services	pancakes/waffles
cleaning/maintenance/sanitation services	roast beef
concrete delivery services	sandwiches
convenience stores	seafood
cosmetics	smörgåsbord
haircare and beauty products	speciality
credit/collection services	steaks
dance studios	miscellaneous food operations (e.g. bakery routes)
	fund raising
	glass tinting
	hair dressing
	health aids/services
	health clubs

hearing aids	motoring schools
home improvement	nursing homes
bathroom suite	office and industrial cleaning
renovations	office machines/systems
ceramic tiles	one-hour film developing and
bedroom furniture	printing
damp proofing	parcel delivery services
double glazing	paint/chemical coatings
hire of marquees	paint stripping
internal decoration	pest control
kitchen and bathroom	pet shops and services
furniture	physical conditioning equipment
kitchen renewal	printing/duplicating services
leading windows	publishing
roof thatching	rack merchandising
security locks	removal and storage facilities
stripping and restoration	rentals and leasing (general
of furniture	equipment)
window blinds	repairing service for brick and
woodworm/dryrot	stone buildings
eradication services	safety systems
hotels	sales training
industrial supplies/services	schools/instructions
industrial chemicals	scientific social introductions
industrial vehicle cleaning	secretarial and word processing
instant picture framing	training centres
services	sewer cleaning
insurance brokers	signs
investigation bureau	sport/recreation
landscape maintenance	stained glass
services	stores (retail)
lawn and garden care	aquatic centres
maid services	bridal salons
manufacture and sale of	coffee, tea
name badge signage etc.	coin-up laundries
marketing sales promotion	confectionary
milk and dairy produce	dry cleaners
distribution	garden buildings and sheds
motels	gift shops

health and skin care  
household furnishings  
ice-cream  
internal and external door  
furniture in brass and  
other metals  
jewellers  
ladies fashion  
neckwear and  
accessories  
non-branded foodstuffs  
pharmacies  
sewing machines  
shoe and heel bars  
soft drinks  
swimming pools  
telecopy systems  
television systems  
tool and equipment  
travel agencies  
vending operations  
vinyl/plastic repair  
water conditioning systems  
weight control  
wigs/hair pieces  
workshop consumables and  
maintenance for industrial  
users  
miscellaneous products and  
services.

Continent	Country	Year	Number of Franchisors	Number of Franchised establishments bus.form.fr.	Number of Employees bus.form.fr.	Revenues in billion dollars bus.form.fr.	Percentage of retail trade	Annual growth rate all franchising
Europe	Austria*	1997	210	3,000	40,000	1.7		
	Belgium*	1997	170	3,500	28,500	2.5		
	Denmark*	1997	98	2,000	40,000	1.0		
	France*	1997	470	25,750	355,500	9.8		
	Germany*	1997	530	22,000	230,000	15.6		
	Hungary*	1997	220	5,000	45,000	2.7	3%	
	Italy*	1997	436	21,390	49,658	12.8		
	Netherlands*	1997	345	11,910	100,000	9.8		
	Norway	1992	125	3,500		3.9		
	Portugal*	1997	220	2,000	35,000	1.0		
	Spain*	1997	288	13,161	69,000	7.2	5%**	
	Sweden*	1997	230	9,150	71,000	6.1	8%***	
	United Kingdom*	1997	474	25,700	222,700	9.5	19%****	10%

\* Figures taken from the EFF *European Franchise Survey*, August, 1997. Figures in ECU have been converted to US dollars for comparison purposes.

\*\* Figure in *Franchising International*, published by the Franchise Development Services, Summer 1997, p. 46

\*\*\* Figure provided by the Swedish Franchise Association

\*\*\*\* NatWest News Release 43/97 of 18 March 1997, *Franchising Sector continues to grow says NatWest*, p. 1.

Continent	Country	Year	Number of Franchisors	Number of Franchised establishments bus.form.fr.	Number of Employees bus.form.fr.	Revenues in billion dollars bus.form.fr.	Percentage of retail trade	Annual growth rate all franchising
North & South America	United States	1992	2,500	429,217	4,721,387	249.0	35%	10%
	Canada	1992	1,134	25,052		12.9	45% (1984)	40% (1988-1992)
	Mexico	1994		5,000	75,000	3.0		
	Brazil	1993		21,244		4.9		35%
	Chile	1994	35	200	10,000	0.1		
Asia/Pacific	Japan <sup>****</sup>	1995	755	158,000		¥ 13.1mil.		4%
	Malaysia <sup>*****</sup>	1995	125	800		609.5 mil.	2%	10%
	Australia <sup>‡</sup>	1994	555	30,500	279,000	29.0		14%
Africa	South Africa <sup>†</sup>	1992	90	2,700		1.5		

\*\*\*\* Singapore Trade Development Board in collaboration with Arthur Andersen Consulting, *Franchising in Asia-Pacific*, 1997, p. 96.

\*\*\*\*\* Singapore Trade Development Board in collaboration with Arthur Andersen Consulting, *Franchising in Asia-Pacific*, 1997, p. 107.

‡ Includes product and trade name franchising. Figures of the Australian Bureau of Statistics, Franchising Sector Survey Results - 1994, Department of Industry, Science and Technology, 1994, p. 3.

# **ANNEX 3**

## **LEGISLATION AND REGULATIONS RELEVANT TO FRANCHISING**

A healthy commercial law environment is of paramount importance for franchising. Indeed, without it franchising is not able to function. A “healthy commercial law environment” may be defined as one with general legislation on commercial contracts, with an adequate company law, where there are sufficient notions of joint ventures, where intellectual property rights are in place and enforced and where companies can rely on ownership of trademarks and know-how as well as on confidentiality agreements.

Franchise arrangements are subject to a considerable number of laws and regulations in addition to those regulating commercial contracts or intellectual property rights. Essentially, these additional laws and regulations fall into two separate categories. The first category includes laws and regulations that are applicable to contracts in general, the second those that are applicable to the specific contract concerned (franchise-specific legislation, where it exists, for example).

### **A. BRANCHES OF LAW RELEVANT TO FRANCHISING**

Franchising is a form of business that touches upon a great many different areas of law, the majority of which are regulated domestically and at times also internationally.

#### ***I. GENERAL CONTRACT LAW***

The agreement will naturally be subject to general contract law. In countries that separate the regulation of commercial contracts from that of other contracts, some aspects of the

agreement will be subject to provisions in the laws or codes that regulate commercial contracts.

## ***II. AGENCY LAW AND THE LAW REGULATING OTHER DISTRIBUTION CONTRACTS***

There may be aspects of the relationship between a franchisor and its franchisees that are covered by agency law, independently of whether the courts actually assimilate the franchise relationship concerned to one of agency,<sup>1</sup> or by the law regulating other distribution contracts.<sup>2</sup> The legislation that regulates agency relationships and distributorships should therefore be considered.

## ***III. LEASING AND SECURITY INTERESTS***

Equipment and premises might be leased and security interests might be involved. This is particularly the case where specific equipment is needed for the franchise and where the franchisor provides that equipment.<sup>3</sup>

## ***IV. FINANCIAL INVESTMENTS***

Financial investments will be covered by the legislation that specifically regulates those matters.

## ***V. INTELLECTUAL PROPERTY***

Intellectual property rights are the basis upon which the franchise relationship is built. They are therefore of fundamental importance.<sup>4</sup> In international relationships the international conventions and other regulations of international origin must be taken into account.<sup>5</sup>

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<sup>1</sup> See Chapter 1, Section A, Sub-Section II, *lit.* (a) "Commercial Agency Agreements".

<sup>2</sup> See Chapter 1, Section A, Sub-Section II, *lit.* (b) "Distribution Agreements".

<sup>3</sup> See Chapter 9, Section C "Franchisor/Sub-Franchisor Relationship".

<sup>4</sup> See in general Chapters 10 "Intellectual Property" and 11 "Know-How and Trade Secrets".

<sup>5</sup> See Chapter 10, Section A, Sub-Section VII "The International Regulation of Trademarks".

## ***VI. COMPETITION LAW***

The terms of the franchise agreement that might be covered by competition law are those that relate to the price that a franchisee should charge for the products or services it offers and those relating to the exclusive rights granted franchisees in a franchise relationship, as they might give rise to suspicions of market sharing and concerted action between the members of the network. The problem in franchising is ensuring that the franchisee is given the best possible protection to develop its territory, for example by being granted exclusive territorial rights, but without the terms of the agreement falling under the terms of the competition legislation. Care should therefore be taken in drafting the agreements.

## ***VII. FAIR TRADE PRACTICES LAW***

Fair trade practices law is of relevance in particular when post-term non-competition clauses are considered and in relation to the right that franchisors may reserve to themselves to distribute their products through alternate channels of distribution. It is also relevant in relation to tie-in arrangements.<sup>6</sup> Legislation dealing with particular trading schemes, such as the 1996 Trading Schemes Act adopted in the United Kingdom which covers pyramid selling, should also be considered. Although not directly applicable to franchising, this latter legislation has a direct effect also on certain types of franchising. An issue to be determined with reference to pyramid selling is whether the statutes cover also the internal relationship between the parties to the franchise agreement and not only that between the sub-franchise or franchisee and the consumer.

## ***VIII. CORPORATE LAW***

The corporate form the franchisor and the franchisees adopt is also relevant, in particular for questions of liability and taxation.<sup>7</sup>

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<sup>6</sup> See Chapter 9, Section D "Regulation of Supply Relationship".

<sup>7</sup> See, in general, Chapter 2 "Nature and Extent of Rights Granted and Relationship of the Parties" for an examination of the relationship of the parties and Chapter 14, Section A "Vicarious Liability" for questions of liability.

## ***IX. TAXATION***

Taxation regulation is of considerable importance, not the least because taxation issues often decide the corporate form the parties will adopt, the franchisor for its presence in the host country and the franchisee for its unit. Issues such as who has to pay withholding taxes need to be regulated in the franchise agreement.<sup>8</sup>

## ***X. PROPERTY LAW***

Property law will also need to be considered in relation to the assets of the franchise. It is particularly relevant in case of termination of the agreement.

## ***XI. LEGISLATION ON CONSUMER PROTECTION AND PRODUCT LIABILITY***

Legislation on consumer protection and product liability is of relevance particularly where the possible liability of the franchisor for products or services sold by the sub-franchisee or franchisee is concerned.<sup>9</sup> Consumer protection must be considered at two levels: firstly, at the level of liability towards the consumer in the ordinary sense, secondly at the level of liability towards the sub-franchisor or sub-franchisee. At the latter level what should be considered is whether the sub-franchisor or sub-franchisee can itself be regarded as a consumer and therefore be covered by the consumer protection statutes. The question is whether the reach of those statutes can be viewed as broad enough to protect sub-franchisors or sub-franchisees that are not purchasing items for consumption, but are making an investment and are therefore traditionally not thought of as consumers, even if they might be treated as consumers for the purpose of the statutes.

## ***XII. INSURANCE LAW***

Insurance law is relevant as master franchise agreements will often require sub-franchisors to take out insurance with the

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<sup>8</sup> See Chapter 4, Section E "Fiscal Considerations".

<sup>9</sup> See Chapter 14, Section A, *cit.*

franchisor as beneficiary.<sup>10</sup>

### ***XIII. LABOUR LAW***

The issue of the applicability of labour legislation to the franchise relationship has been studied in particular in countries in which the regulation of labour relations is highly developed, such as Germany and Sweden. The different issues involved include:

- ◆ the relationship between the franchisor and the franchisee;
- ◆ the relationship (if any) between the franchisor and the employees of the franchisee, for example where the franchisor retains the right to approve the employees of the franchisee; and
- ◆ the position of the employees of the franchisee in the franchise system, which includes questions such as the right of the employees to be consulted on important business decisions. In this connection the possible application of the European *Council Directive 94/95 on the establishment of a European Works Council or a procedure in Community-scale groups of undertakings for the purpose of informing and consulting employees*<sup>11</sup> should be taken into account, although its application to franchising is controversial.

### ***XIV. THE LAW REGULATING THE TRANSFER OF TECHNOLOGY***

Franchising may be covered by the broad definition of technology transfer contained in some domestic legislations. If the technology transfer legislation is found to apply to the franchise agreement concerned, the latter may have to be approved by the local authorities responsible for contracts for the transfer of technology and registered in the appropriate register. In this context the recent European Regulation on technology transfer agreements should be noted.<sup>12</sup> Adopted on 31 January 1996, it

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<sup>10</sup> See Chapter 14, Section C "Insurance".

<sup>11</sup> OJ EEC L 254/64 of 24 October 1995.

<sup>12</sup> Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85(3) of the Treaty to certain categories of

replaced the existing regulations on patent and know-how licensing agreements.<sup>13</sup>

***XV. LEGISLATION REGULATING FOREIGN INVESTMENTS  
CURRENCY CONTROL REGULATIONS AND IMPORT  
RESTRICTIONS AND/OR QUOTAS***

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

***XVI. LEGISLATION REGULATING JOINT VENTURES***

Joint ventures are frequently used for the international expansion of franchise systems, particularly in situations where the local partners suffer from a lack of financial means. In such cases the legislation on joint ventures will also need to be considered.

***XVII. INDUSTRY SPECIFIC LAWS OR REGULATIONS***

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

**B. SPECIFIC LEGISLATION**

Although an increasing number of States are considering the introduction of franchise-specific legislation, still only very few regulate franchising. Furthermore, where it exists the legislation adopted refers to simple domestic franchising and not to international franchising. Its applicability to international franchise transactions, to master franchise agreements and other arrangements, therefore needs to be assessed. In part, this lack of

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technology transfer agreements (Text with EEA relevance), in OJ EEC L 31/2 of 9 February 1996.

<sup>13</sup> Regulation (EEC) No 2349/84 of 23 July 1984 on the application of Article 85(3) of the Treaty to certain categories of patent licensing agreements (OJ EEC L 219/15 of 16 August 1984), as last amended by Regulation (EC) No 2131/95 (OJ EEC L 214/6 of 8 September 1995); and Regulation (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 (OJ EEC L 61/1 of 4 March 1989).

franchise-specific legislation is due to the complexity of the relationship and to the great number of areas of law involved in a franchise relationship. With few exceptions the legislation adopted is disclosure legislation and not legislation regulating the relationship between the parties. The European Union regulation of franchising falls into a separate category, in that it deals only with competition law issues.

With a varying degree of detail disclosure laws will require the franchisor to provide the prospective franchisee with information on a number of points that will enable the franchisee to make an informed decision on whether or not to enter into the agreement. The points on which information should be offered, or documents provided, include:

- ◆ the franchisor and the directors of the enterprise;
- ◆ the history of the enterprise;
- ◆ the legal constitution of the enterprise;
- ◆ the intellectual property concerned;
- ◆ the financial situation, with audited financial statements for the two or three preceding years;
- ◆ the other franchisees in the network;
- ◆ information on the franchise agreement, such as the duration of the agreement, conditions of renewal, termination and assignment of the agreement; as well as
- ◆ information on any exclusivities.

It should be noted that although it is not sanctioned by law, there is also an extensive duty on the part of the prospective sub-franchisor or franchisee to disclose all relevant information to the franchisor, so that the franchisor can evaluate whether or not the prospective sub-franchisor or franchisee fulfils the 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.

## ***I. THE UNITED STATES OF AMERICA***

- ◆ Franchise specific legislation exists at two levels in the United States. At federal level the 1979 Federal Trade Commission (FTC) Rule on Disclosure Requirements and Prohibitions Concerning Franchising and Business

Opportunity Ventures<sup>14</sup> regulates the information a franchisor is required to supply the prospective franchisee with in order to provide it with all the elements necessary to evaluate the franchise it is proposing to acquire. It applies to franchises as well as to a number of business opportunities. The FTC Rule applies in all fifty states and is intended to provide a minimum protection. It therefore applies wherever states have not adopted more stringent requirements.

At state level the majority of states have no legislation regulating franchising. Seventeen states have however adopted legislation requiring disclosure. A number of these also require the registration of the disclosure document. Other states have adopted legislation regulating aspects of the franchise relationship, including termination. Twenty-two states have adopted legislation regulating the offer and sale of a business opportunity and this legislation might be applicable also to franchise agreements. It should be noted that in addition to the above legislation there is legislation that is industry specific, such as that applicable to gasoline retail and distribution franchises.

Under the legislation that regulates the franchise relationship the franchisor is subject to a process of registration and examination by state administrators. This is the case also under the disclosure legislation when the obligation is imposed at state level, but not if it is imposed at federal level as there is no federal Government agency with which to file the disclosure document.

The FTC Rule, which, as indicated above, is a disclosure law, requires franchisors to provide prospective franchisees with a document with detailed information regarding:

- ◆ the franchisor;
- ◆ the directors and executive officers of the franchisor;
- ◆ litigation and bankruptcy histories;
- ◆ the franchise to be purchased;
- ◆ initial and recurring payments;
- ◆ obligations to purchase;
- ◆ financing;
- ◆ required personal participation;

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<sup>14</sup> 16 C.F.R. § 436.

- ◆ termination, cancellation and renewal provisions;
- ◆ statistics on the number of franchisees;
- ◆ training;
- ◆ site selection; and
- ◆ financial reporting, including audited financial statements.<sup>15</sup>

The North American Securities Administrators Association (NASAA)<sup>16</sup> has adopted a Uniform Franchise Offering Circular (UFOC) that indicates what information should be furnished to prospective franchisees. The format prescribed varies from that in the FTC Rule, but the substance is essentially the same. The FTC permits the use of the UFOC as an alternative to the basic document it has prescribed in its Rule. The UFOC has been accepted for use, with minor modifications, in all states that regulate the offer and sale of franchises by registration and/or disclosure.<sup>17</sup> 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 the detailed information indicated above. In addition it requires state administrative agencies to review and approve the disclosed information and other information prior to all franchise offerings.<sup>18</sup>

## **II. CANADA**

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<sup>15</sup> See P. Zeidman, *United States*, p. 2, in *Survey of Foreign Laws and Regulations Affecting International Franchising*, 2<sup>nd</sup> edition, American Bar Association, Chicago, 1990. For the text of the FTC Rule and interpretative guides thereto, see CCH, *Business Franchise Guide*, at ¶ 6080 ff.

<sup>16</sup> 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.

<sup>17</sup> Reproduced in CCH, *Business Franchise Guide*, at ¶ 3700.

<sup>18</sup> P. Zeidman/A. Loewinger/J. Gilbert, *Report from America*, in *Journal of International Franchising and Distribution Law*, 1991, p. 147 f.

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.<sup>19</sup> The new Franchises Act abolishes the registration requirement contained in the previous version of the Act, but still requires pre-sale disclosure. It also provides civil remedies and promotes self-government by the franchising community. The recent adoption of the New Civil Code in the province of Quebec, which contains a broad definition of contracts of adhesion in its Article 1379, has raised the question of the applicability of the provisions relating to adhesion contracts to franchise agreements.<sup>20</sup> The possibility of introducing legislation in the province of Ontario has also recently be aired, but as yet nothing more specific has been developed.

### **III. FRANCE**

In Europe, the first country to adopt legislation relating to franchising was France: on 31 December 1989 Law No. 89-1008, concerning the development of commercial and artisanal enterprises and the improvement of their economic, legal and social environment<sup>21</sup> 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

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<sup>19</sup> Franchises Act, (Chapter F-17.1), assented to May 17, 1995, effective November 1, 1995. The text of the Alberta Franchises Act and implementing regulations is reproduced in CCH, *Business Franchise Guide*, at ¶ 7010 ff.

<sup>20</sup> The New Civil Code of Quebec entered into force on 1 January 1994. For a consideration of the applicability of the Civil Code to franchise agreements, see B. Floriani, *The impact of the Civil Code of Quebec on franchising*, *Journal of International Franchising and Distribution Law*, 1995, p. 124 ff.

<sup>21</sup> *Loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social*, in *Journal Officiel*, 2 January 1990. This law is more commonly known as the *Loi Doubin* after the minister who introduced it.

of 4 April 1991.<sup>22</sup> It should be noted that this law is not franchise-specific, but nevertheless covers franchising.

#### **IV. SPAIN**

In Spain, provisions relating to franchising were introduced as Article 62 of Law No. 7/1996 relating to the retail trade.<sup>23</sup> Also this provision relates mainly to disclosure, although it does contain a registration requirement. At the time of writing, the implementing regulations had not yet been adopted, although proposals were under discussion.

#### **V. BRAZIL**

In Brazil, a law relating to franchising contracts and other measures was adopted on 15 December 1994.<sup>24</sup> This law deals mainly with disclosure but contains provisions also on other aspects of franchise agreements, such as franchise fees and other continuing fees.

#### **VI. MEXICO**

A country that has included provisions regulating franchising in its law on industrial property is Mexico.<sup>25</sup> Pre-sale disclosure of information to prospective franchisees is required, as is the filing of information about the franchisor and registration of the

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<sup>22</sup> *Décret n° 91-337 du 4 avril 1991 portant application de l'article 1er de la loi n° 89-1008 du 31 décembre 1989 relative au développement des entreprises commerciales et artisanales et à l'amélioration de leur environnement économique, juridique et social*, in *Journal Officiel*, 6 April 1991 (a correction to the Decree was published in the *Journal Officiel* of 4 May 1991).

<sup>23</sup> *Ley 7/1996, de 15 de enero, de Ordenación del Comercio Minorista*, *Boletín Oficial del Estado*, number 15 of 17 January 1996.

<sup>24</sup> *Lei n. 8.955 de 15 de dezembro de 1994 - Dispõe sobre o contrato de franquia empresarial ("franchising"), e dá outras providências*. It entered into force sixty days after its official publication.

<sup>25</sup> *Ley de la Propiedad Industrial*, in *Diario Oficial*, 27 June 1991, effective as of 28 June 1991. The relevant sections of this law are reproduced in the CCH, *Business Franchise Guide*, at ¶ 7210, in an English translation by CCH staff and the Monterey Office of the law firm of Brownstein Zeidman and Schomer, Washington, D.C.

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.<sup>26</sup>

### **VII. INDONESIA**

On 18 June, 1997, the Indonesian Government issued Government Regulation No. 16/1997, which relates specifically to franchising. This Regulation requires disclosure and the registration of both the franchise agreement and the disclosed information with the Ministry of Industry and Trade. Implementing regulations are expected, but have as yet not been issued.

### **VIII. JAPAN**

A general duty of disclosure is provided for in the 1973 Medium-Small Retail Business Promotion Act.<sup>27</sup> The act was implemented by the Medium-Small Retail Business Promotion Act Enforcement Regulation<sup>28</sup> and is administered by the Ministry of International Trade and Industry (MITI). The Act is not franchise specific, indeed, only Articles 11 and 12 are of relevance to franchising, the remainder of the Act regulating the way Government subsidies are allocated to small and medium-size retailers. It should also be noted that, as is evident from its title, the Act is of relevance only to retail franchising. Other types of franchising are consequently excluded from its sphere of application.

### **IX. THE REPUBLIC OF KOREA**

On 7 April, 1997, the Fair Trade Commission of Korea adopted Notice No. 1997-4 containing criteria for what constitutes unfair trade acts in the franchise business. This Notice provides for a

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<sup>26</sup> *Reglamento de la Ley de la Propiedad Industrial*, in *Diario Oficial*, 23 November 1994. These Regulations came into effect on 8 December 1994. For an English translation, see CCH, *Business Franchise Guide*, at ¶ 7215.

<sup>27</sup> Law No. 101 of 1973.

<sup>28</sup> MITI Ordinance No. 100 of 1973.

general duty of disclosure, but also deals with the business relationship itself.

#### **X. THE RUSSIAN FEDERATION**

The legislation adopted in Russia does not regulate disclosure, but proposes instead to regulate certain aspects of the relationship between the parties. The provisions are contained in Chapter 54 of the new Russian Civil Code (Part 2, Articles 1027 - 1040) which entered into force on 1 March 1996. Chapter 54 does not actually refer to franchising in the text, but only to "Commercial Concessions". The descriptions of aspects of the relationship that the provisions are aiming to regulate are however clearly referred to franchising and indeed the commentaries published refer explicitly to franchising. The provisions *inter alia* deal with the form and registration of the contract, sub-concessions, the obligations of the parties and the consequences of the termination of the exclusive rights granted in the agreement.

#### **XI. AUSTRALIA**

In Australia, in 1986 an attempt to legislate met with opposition from all sectors involved. In December, 1990 the Minister for Small Business and Customs appointed a Franchising Task Force to examine and propose mechanisms for the reduction of barriers and impediments to the efficiency and growth of the franchising sector. The terms of reference of the Task Force were to examine and report on the potential of self-regulatory codes for countering marketing failure in franchising, focusing on business format franchising, and to recommend the measures by which industry and Government could enhance the efficiency and growth of the franchising sector.

The outcome of the work of the Task Force was the development of a voluntary and self-regulatory Franchising Code of Practice<sup>29</sup> applicable to franchisors (including sub-franchisors), franchisees, service providers (including banking and financial

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<sup>29</sup> See *Report by the Franchising Task Force To the Minister for Small Business and Customs The Hon. David Beddall M.P.*, December, 1991, Recommendation 6.

institutions that provide franchise-related financial support to franchisors and franchisees and publishers or advertising media providers who accept work and publish advertising for the purpose of selling or promoting franchise systems), advisers (persons, firms or associations such as lawyers, accountants, marketing or management consultants and business brokers who provide advise to franchisors and franchisees) and State Small Business Corporations. The Code provides for and regulates:

- ◆ prior disclosure;
- ◆ the certification by franchisees of receipt of the disclosure document, of a *Guide for Franchisees* and of a copy of the Code of Practice;
- ◆ cooling off periods for franchisees within which they may terminate the franchise agreement;
- ◆ unconscionable conduct;
- ◆ alternate dispute resolution; and
- ◆ contains the requirement that the franchisee be identified as being a franchisee.

To be noted is that the Code does not apply to master franchise arrangements between a foreign franchisor and a domestic franchisee.

The Minister for Customs and Small Business reviewed the functioning of the Code in 1994. The report was completed in October 1994 and released some time thereafter.<sup>30</sup> The publication 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

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<sup>30</sup> R. Gardini, *Review of the Franchising Code of Practice, Report to Senator the Hon. Chris Schacht, Minister for Small Business, Customs and Construction*, Australian Government Publishing Service, Canberra, October, 1994.

Code. A number of recommendations were proposed by the Reviewer and extensively debated.

To administer the Code a Franchising Code Council had been set up in early 1993 with initial funding from the Department of Industry, Science and Technology. The Council comprised five franchisor representatives, five franchisee representatives, two members representing service providers and advisers and one lawyer representative. Following a decision on the part of the Department of Industry, Science and Technology to discontinue the funding as from 1997/1998, the Council ceased to operate on 31 December, 1996.

The situation of franchising was reviewed by the House of Representatives Standing Committee on Industry, Science and Technology in its examination of business conduct. In its report the Committee arrived at the conclusion that self-regulation had not worked and that it was necessary to underpin codes of conduct with legislation.<sup>31</sup> This enquiry prompted the Australian Government to adopt a mandatory Franchising Code of Conduct<sup>32</sup> and to underpin it by modifications to the Trade Practices Act 1974 (Cth). The provisions of the Code, the most significant of which are those that relate to disclosure, are based on the voluntary Code of Practice.<sup>33</sup> Compliance with the Franchising Code of Conduct became mandatory on 1 July, 1998.

### **C. THE EUROPEAN UNION AND FRANCHISING<sup>34</sup>**

The European Union has to date limited its activities in relation to franchising to the field of competition law. The examination of

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<sup>31</sup> *Finding a balance - Towards fair trading in Australia*, Report by the House of Representatives Standing Committee on Industry, Science and Technology, Australian Government Publishing Service, Canberra, May, 1997, p. 114 and Recommendation on p. 120.

<sup>32</sup> See *Franchising Code of Conduct*, Commonwealth of Australia, 1998.

<sup>33</sup> See J. Darbyshire, *Reform in the Australian Franchising Sector*, in *Journal of International Franchising and Distribution Law*, 1997, p. 96 f.

<sup>34</sup> 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.

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 Schillgalis (Hamburg).<sup>35</sup> The case was referred to the Court of Justice under Article 177 of the EEC Treaty by the German Federal Court of Justice for a preliminary ruling on the interpretation of Article 85 of the EEC Treaty and Commission Regulation No 67/67/EEC of 22 March, 1967, on the application of Article 85(3) of the Treaty to certain categories of exclusive dealing agreements. It concerned the franchisee's obligation to pay the franchisor arrears of fees. The Court came to a series of conclusions of general applicability in its discussion of the Pronuptia case. Inter alia, the Court admitted that the franchisor must be in a position to protect certain interests vital to the business and to the identity of the network (for example the know-how), although the provisions must be essential for this purpose. However, certain categories of clauses that limit the franchisee's activities (for example price determination clauses) were not considered acceptable by the Court.

Following the landmark Pronuptia decision, the Commission of the European Communities has rendered five Decisions on franchising cases<sup>36</sup> and has adopted a Block Exemption Regulation on franchise agreements.<sup>37</sup>

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

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<sup>35</sup> Case 161/84 of 28 January 1986.

<sup>36</sup> Decision 87/14/EEC, Yves Rocher, of 17 December 1986 (OJ EEC L 8/49 of 10 January 1987); Decision 87/17/EEC, Pronuptia, of 17 December 1986 (OJ EEC L 13/39 of 15 January 1987); Decision 87/407, Computerland, of 13 July 1987 (OJ EEC L 222/12 of 10 August 1987); Decision 88/604, ServiceMaster, of 20 August 1988 (OJ EEC L 332/38 of 3 December 1988) and Decision 89/94/EEC, Charles Jourdan, of 2 December 1988 (OJ EEC L 35/31 of 7 January 1989).

<sup>37</sup> Commission Regulation (EEC) No 4087/88 of 30 November 1988 on the application of Article 85(3) of the Treaty to categories of franchise agreements, in OJ EEC L 359/46 of 28 December 1988.

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".<sup>38</sup>

The text of the Regulation further gives what within the Communities has come to be regarded as a more or less standard definition of franchising, when it states that for 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 types of 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".<sup>39</sup>

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<sup>38</sup> Recital (5).

<sup>39</sup> Article 1(3)(a) and (b). The European Franchise Federation (EFF) has adopted a definition of franchising in its Code of Ethics which is in substantial agreement with the definition in the Regulation - it was in fact prepared in consultation with the Commission. This definition indicates that: "[f]ranchising 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

The Regulation indicates to which restrictions of competition the exemption shall apply,<sup>40</sup> to which it shall apply notwithstanding the presence of certain obligations,<sup>41</sup> to which it shall apply on certain conditions<sup>42</sup> and to which it shall not apply.<sup>43</sup> 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

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technical methods, procedural system, and other industrial and/or intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between the parties for this purpose". A footnote specifies that "know-how" means a body 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.

40 Article 2.

41 Article 3.

42 Article 4.

43 Article 5.

oppose such exemption within six months.<sup>44</sup>

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.

The Commission is also in the process of reviewing its competition policy. In January, 1997, it published a Green Paper on Vertical Restraints in EC Competition Policy<sup>45</sup> in which it examines the structure of distribution in the Community, makes an economic analysis of vertical restraints and the single market, examines current Community procedures and their institutional framework, the current rules for vertical restraints and the advantages of the current system, compares Community law with member State and third country law and policy applicable to vertical restraints, gives a review of the results of the fact finding and offers options for the competition policy of the future. Franchise agreements and the Block Exemption Regulation and its operation are also examined in this Green Paper.

#### **D. VOLUNTARY REGULATION OF FRANCHISING**

A number of franchise associations, both national and international, have adopted Codes of Ethics that are to regulate the conduct of their members. These Codes of Ethics often also deal with disclosure, albeit in a more summary manner: in general they provide that prospective franchisees have to be provided with accurate and full disclosure, but do not contain detailed provisions as to what is to be understood thereby.

##### ***I. THE CODE OF ETHICS OF THE EUROPEAN FRANCHISE FEDERATION***

The European Code of Ethics for Franchising adopted by the European Franchise Federation (EFF), a federation of the national franchise associations of Austria, Belgium, Denmark, France, Germany, Hungary, Italy, the Netherlands, Portugal and the United Kingdom, provides that "[i]n order to allow prospective

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<sup>44</sup> Article 6.

<sup>45</sup> COM(96) 721.

Individual Franchisees to enter into any binding document with full knowledge, they shall be given a copy of the present Code of Ethics as well as full and accurate written disclosure of all information material to the franchise relationship, within a reasonable time prior to the execution of these binding documents".<sup>46</sup> 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",<sup>47</sup> 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".<sup>48</sup> The European Code is applicable to the members of the national associations that are members of the EFF.

## ***II. CODES OF ETHICS OF NATIONAL FRANCHISE ASSOCIATIONS***

In addition to the European Code that it has adopted as a member of the EFF, the *British Franchise Association (BFA)* has adopted an Extension and Interpretation of the Code that contains further indications on its application and on how some of its terms should be understood. As regards disclosure, this Extension and Interpretation states that "[t]he objectivity of recruitment literature (Clause 3.2) refers specifically to publicly available material. It is recognised that in discussing individual business projections with Franchisees, Franchisors are invariably involved in making assumptions which can only be tested by the passage of time".<sup>49</sup>

In October, 1994, the *Italian Franchise Association (Assofranchising)* adopted internal Regulations integrating the European Code. These Regulations entered into force on 1 January, 1995.

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<sup>46</sup> Clause 3.3.

<sup>47</sup> Clause 3.1.

<sup>48</sup> Clause 3.2.

<sup>49</sup> Clause 2.

The *Code of Principles and Standards of Conduct* of the *American International Franchise Association (IFA)* provides that “[f]ranchise relationships should be established by the delivery of clear and complete disclosure documents, as required by law, and by clear and unambiguous franchise agreements.”<sup>50</sup> 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”<sup>51</sup> 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”.<sup>52</sup> In this case it is therefore to the franchise legislation that one must turn to have a clearer idea of what is required as to disclosure. It should however be noted that this Code of Principles is applicable only to the domestic activities of the members of the IFA.

The *Franchise Association of Southern Africa (FASA)* has adopted a *Code of Ethics and Business Practices* which in Appendix 1 gives details on the disclosure document required. It should be noted that the information that should be disclosed in accordance with this Code is considerably more detailed than that required by the European Code. The Code also calls for fairness in the dealings between franchisors and their franchisees<sup>53</sup> and for every effort to be made on the part of the franchisor to resolve complaints, grievances and disputes with its franchisees with good faith and good will through fair and reasonable direct communication and negotiation, failing which consideration should be given to mediation or arbitration.<sup>54</sup>

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<sup>50</sup> Section III, Clause 1 para. 2.

<sup>51</sup> Section V, Clause 1, para. 1, first sub-paragraph.

<sup>52</sup> Section V, Clause 1, para. 2, second sub-paragraph.

<sup>53</sup> Clause 15.

<sup>54</sup> Clause 17.

Of the other Codes of Ethics or Practice that have been adopted mention may be made of that adopted by the *Canadian Franchise Association, (CFA)* the *Franchise Association of New Zealand (FANZ)*, the *Philippine Franchise Association (PFA)*, the *Singapore International Franchise Association (SIFA)* and the *Hong Kong Franchise Association (HKFA)*. Of these the *Code of Ethics* of the Hong Kong Franchise Association is of particular interest, as it does not only contain provisions of general applicability, it also contains provisions that relate specifically to the franchisor, others that relate to the franchisee and others yet again that relate to franchise consultants. A point of interest is the fact that the franchisee is required to "provide full and frank disclosure of all information considered material to facilitate Franchisor's selection of an appropriate franchisee for the franchise business".<sup>55</sup>

Readers are invited to consult the Unidroit web site at <http://www.unidroit.org> for an up-dated version of this Annex.

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<sup>55</sup> Clause 19.

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