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International Institute for the Unification of Private Law

GUIDE TO INTERNATIONAL MASTER FRANCHISE ARRANGEMENTS

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FOREWORD TO THE SECOND EDITION

Almost ten years have passed since the publication of the first edition of the UNIDROIT *Guide to International Master Franchise Arrangements*. The volume was welcomed, and over the years acquired recognition as both authoritative and a very useful guide for practitioners and others involved in franchising. Despite its age, it is still in demand, but the Institute is no longer in a position to satisfy such orders as it has sold out.

Taking the opportunity offered by the necessity to reprint the Guide, it was decided that an update should be made of those chapters that contained information on international conventions, other international instruments and national legislation. The chapters that have been updated are therefore the following:

Chapter 10 "Intellectual Property"
Chapter 11 "Know-How and Trade Secrets"
Chapter 17 "Applicable Law and Dispute Resolution"
Annex 2 "Franchising in the Economy"
Annex 3 "Legislation and Regulations Relevant to Franchising".

We are most grateful to the authors for their assistance in the updating of their chapters and to the other members of the Study Group for taking the time needed to examine the changes made. A special thank you goes to Ms Lena Peters both as author/editor and coordinator.

Herbert Kronke
Secretary-General

Berardino Libonati
President

Rome, July 2007

FOREWORD TO THE FIRST EDITION

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.

Walter Rodinò
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 widespread 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 intergovernmental 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 72nd session in June, 1993, the Governing Council of the Institute decided that the time had come for a *Study Group on Franchising* to be set up. The terms of reference of the Study Group as defined by the Governing Council were to examine different aspects of franchising, 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 74th 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

This Guide deals with one particular form of franchising, master franchising, which is that most commonly used in international franchise arrangements. The basis upon which master franchising and other forms of franchising build is, however, the simple unit franchise, in which there is a direct relationship between the franchisor and the franchisee.

A variety of different business arrangements are known as "franchising". There is no single, recognised definition that is applicable to all situations, even if a certain number of basic elements are present in all the different arrangements that may be considered to be franchising.

Franchising is often divided into industrial franchises, distribution franchises and service franchises. Other descriptions of franchising divide franchises into product distribution franchises and business format franchises.[1]

The form of franchising known as business format franchising is increasingly coming to symbolise franchising as a whole. In business format franchising a franchisor has elaborated and tested a specific business procedure (the "business format"), be it for the distribution of goods or the supplying of services, which it then proceeds to grant franchisees the right to use. A business format franchise agreement is thus concluded between two independent undertakings, whereby one, the franchisor, against compensation (normally, but not exclusively, in the form of an entry fee and/or continuing fees) grants the other, the franchisee, the right to market goods or supply services under its trademark and/or trade name following the business method or procedures which it has elaborated and tested. In order to permit the franchisee to do so, the franchisor will provide the franchisee with the know-how required and with the training needed to

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1 For a more detailed description of unit franchising, see Annex 1 "Franchising: General Notions".

use this know-how. The franchisor will also in most cases provide a detailed manual containing the necessary instructions for the running of the business. Furthermore, for the duration of the agreement the franchisor will typically provide the franchisee with any assistance it might need in the operation of the franchise.

It is therefore a package which includes (but is not necessarily limited to) intellectual property rights that are protected by statute (for example trademarks, trade names or, less frequently, patents), know-how, training and continued assistance on the part of the franchisor, franchisor control rights vis-à-vis the franchisee and obligations of the franchisee to follow the instructions of the franchisor and to comply with the financial terms of the agreement. It further permits, or may at times require, the franchise unit to be clearly identified as a member of a particular franchise network.

In the majority of cases business format franchises are those that expand abroad, often by means of master franchise arrangements.

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.

I. Master Franchise Agreements

In master franchise agreements the franchisor grants another person, the sub-franchisor,[2] 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.[3] 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

2 Often also called the "master franchisee".

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

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

In master franchise arrangements essentially two agreements are involved: an international agreement between the franchisor and the sub-franchisor (the master franchise agreement), and a 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.[5] 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.[6]

(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.

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4 See Chapter 4 “Financial Matters”.

5 See Chapter 10 “Intellectual Property”.

6 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”.

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 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,[7] 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-

7 See Chapter 5 "The Role of the Franchisor".

franchisor they are therefore well worth investing in, even if a considerable investment in time and effort will be needed to make the system known. The technical know-how that accompanies a franchise might also be of considerable interest to a sub-franchisor. It should however be noted, that sub-franchisors are often large 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.

(1) 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.[8] 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.

8 See Chapters 2 and 10 cit.

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 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.[9]

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.

(2) 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

9 On remedies for non-performance, see Chapter 15.

dependent upon the master franchise agreement. The inability to provide for acceptable solutions to the effects of termination, especially as regards sub-franchisees, is one of the most important defects of the master franchise arrangement. The consequences need to be considered in detail at the time of the negotiations.[10]

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.[11]

(3) 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

10 See below, Section B.IV.

11 See Chapters 3 “Term of the Agreement and Conditions of Renewal” and 16 “The End of the Relationship and its Consequences”.

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 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.

Traditionally, the commercial agent was unknown to the common law which consequently did not provide for any specific regulation of this type of 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 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*.[12] 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.

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.[13]

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

12 OJ EEC L 382/17, 31.12.1986. 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.

13 Cf. Article 1(2).

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[14] or through master franchise arrangements.[15]

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

14 See below.

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

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.

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 of 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.

(α) 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.

(β) 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,[16] whereas in others it may be deemed to be implied.

16 See Annex 3 to this Guide.

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.

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.[17] 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. In a number of

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

jurisdictions there may be mandatory rules on contract forms that require that all the obligations of the parties be set out in the contract document itself and be personally signed by them. In such cases it is not possible to refer to unsigned ancillary documents. The technique adopted will to a large extent depend upon the drafting techniques traditional in the country or countries concerned.[18]

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.[19] 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.[20] 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 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

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.

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;[21]

(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;[22]

(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

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

22 See Chapter 4.

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;[23]

(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;[24]

(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;[25]

(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;[26] 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.[27]

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23 See Chapter 4.
24 See Chapter 10.
25 See Chapter 9.
26 See Annex 3.
27 See Chapter 17.

VII. SUBSEQUENT CHANGES

Franchise agreements, particularly master franchise agreements, are normally intended to last for several years. It will therefore be necessary to introduce adaptations of, and modifications to, the system in the course of the relationship as well as at the beginning, when the system is first adapted to local conditions.[28]

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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28 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.[1] 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.[2] 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
- 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.

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1 See Chapters 10 “Intellectual Property” and 11 “Know-How and Trade Secrets”.

2 See Chapter 5, Section C “Manuals”.

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.[3] 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

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.[4] In some countries it may be possible within the framework of trademark law to

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3 See Annex 1, Section B “Business Format Franchising”.

4 See, in particular, Chapter 10, Section A, Sub-Section VI “Sub-Licensing of Trademark”.

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.[5] 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 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-fran-

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5 See Chapter 10, *cit.*

chisors 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).[6] 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-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-

6 See Chapter 6, Section A "Pilot Operations".

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 that 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.[7] The master franchise agreement may, for example, require that the sub-franchisor obtain the franchisor's approval of each prospective sub-franchisee and of each transfer of the sub-franchised business to a new sub-franchisee. The master franchise agreement may further require the franchisor's approval of the terms of each sub-franchise agreement, especially if there are deviations from the standard form agreement previously approved by the franchisor. The sub-franchisee's site selection, site plans and drawings and mark usage are other areas for which the master franchise agreement may require the franchisor's approval.

It may however not be practical for the franchisor to control these aspects of a sub-franchise in another country, even if it does control such matters in 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

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7 See Chapter 5 "The Role of the Franchisor".

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.[8] 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.

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8 See Chapter 20 "Regulatory Requirements".

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.[9]

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

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9 See Chapter 14 "Vicarious Liability, Indemnification and Insurance".

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 to be assumed that margins and profitability will necessarily be the same in each and every market, particularly in view of the large number of 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 profitability after paying the continuing franchise fees to the franchisor. In many cases it is difficult to justify the payment of more than between ten and twenty per cent of the sub-franchisor's income from the continuing franchise fees it receives from its sub-franchisees. 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.[1]

(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.

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.

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1 See Chapter 9 "Supply of Equipment, Products and Services".

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.[2]

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

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2 See Chapter 8 "Advertising and the Control of Advertising".

credit risks. It is usual for a provision to be included in the contract requiring the sub-franchisor to ensure that sub-franchisees observe and perform the terms of 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.[3]

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