INTERNATIONAL MASTER FRANCHISING: THE SUBFRANCHISEES ARE DOING WHAT?!

Kevin Maher  
Baker McKenzie  
Dallas, Texas, USA

John Pratt  
Hamilton Pratt  
Warwick, UK

Tao Xu  
DLA Piper  
Reston, Virginia, USA

October 18 – 20, 2017  
Palm Desert, CA
Table of Contents

I. MASTER FRANCHISE STRUCTURE ........................................................................................................ 4
   A. Three–Tiered System ....................................................................................................................... 4
      1. Franchisor ............................................................................................................................... 5
      2. Master Franchisee ...................................................................................................................... 5
      3. Subfranchisee ............................................................................................................................. 6
   B. Reasons for Choosing a Master Franchise Structure .................................................................... 6
      1. Desired Degree of Control ......................................................................................................... 6
      2. Nature of the Business .............................................................................................................. 7
      3. Master Franchisee’s Local Experience ....................................................................................... 8
      4. Reduced Franchisor Resources ................................................................................................ 8
      5. Vastness of Territory and Speed of Expansion ........................................................................ 9
      6. Impact of Local Law ................................................................................................................ 9
   C. Typical Master Franchise Agreement Arrangements .................................................................. 10
      1. Pure Master Franchise Agreements ........................................................................................... 10
      2. Hybrid Master Franchise Agreements ....................................................................................... 10

II. CHALLENGES OF MASTER FRANCHISE STRUCTURE ..................................................................... 10
   A. Lack of Privity .................................................................................................................................. 10
   B. Attenuation of Control and Visibility ........................................................................................... 11
   C. Economic Model ........................................................................................................................... 12
   D. Profile of Typical Master Franchisees ............................................................................................ 12
   E. Striking Balance Between Control and Delegation ...................................................................... 13
   F. Termination/Unwinding the Relationship .................................................................................... 14

III. CONTRACTUAL CONTROL MECHANISMS ...................................................................................... 15
   A. Direct Contractual Controls Over Subfranchisees ....................................................................... 15
      1. Third Party Beneficiary Rights ................................................................................................. 15
      2. Direct Privity .............................................................................................................................. 16
      3. Separate Acknowledgment ....................................................................................................... 17
      4. Trademark License .................................................................................................................... 17
   B. Indirect Controls Over Subfranchisees ......................................................................................... 17
      1. Manuals/Brand Standards ......................................................................................................... 17
      2. Obligation to Enforce Subfranchise Agreement & Brand Standards ....................................... 18
      3. Intellectual Property Laws ......................................................................................................... 18
      4. Inspections ................................................................................................................................. 19
C. Communication by Master Franchisee to Franchisor ........................................19
   1. Reporting Obligations of Master Franchisee ..........................................19
   2. Determining Appropriate Reporting Requirements .................................20
D. Effect of Master Franchisee–Subfranchisee Relationship on Enforcement ......21
   1. Expense ................................................................................................21
   2. Litigation ..............................................................................................22
   3. Termination ..........................................................................................22

IV. FRANCHISOR REMEDIES ...........................................................................23
   A. Subfranchise Agreements Are Generally Controlled by Local Law ..........23
   B. Forms of Dispute Resolution ..................................................................27
   C. Does the franchisor have right to pursue injunction or equitable relief
directly? ........................................................................................................27
   D. Breach ....................................................................................................28
   E. Termination of Master Franchise .............................................................29
   F. Post Termination Relationship with Subfranchisees .................................29
   G. Remedies Other Than Termination .........................................................30

V. CONCLUSION .............................................................................................31
I. INTRODUCTION

In the history of franchising, master franchising has traditionally been one of the most commonly utilized franchise business model for international franchise arrangements,\(^1\) largely because it allows for rapid brand expansion without a substantial ongoing commitment of human and financial resources by the franchisor that would otherwise be needed in other franchising structures. Depending on the size of the territory and the exclusivity granted to the master franchisee (if any), the primary responsibility for developing the system in the particular territory may be transferred from the franchisor to the master franchisee. This means that many of the franchisor’s typical duties (e.g., establishing distribution networks and training programs, and ongoing supervision and support of the franchisees) are shifted to, and assumed by, the master franchisee. As a result, fewer resources and significantly less capital investment are required from the franchisor.\(^2\) Additionally, the local master franchisee is likely more familiar with its own market than the franchisor, which will benefit from the master franchisee’s knowledge and contacts.\(^3\)

Notwithstanding these key benefits of master franchising, the use of master franchising as a preferred method of international expansion appears to have receded in recent years. With the continued globalization of business operations, the increase in the number of global brands, greater global visibility and access with the internet, new technologies and modern travel, direct franchising has become less daunting while the downsides of master franchising have become more apparent. As the title of this paper indicates, the ability of a franchisor to control the quality and consistency of its branded products or services through a multi-tiered master franchise network is significantly weakened in a master franchise structure compared to other common structures such as direct franchising, area development and area representative arrangements.\(^4\) This paper will discuss the structural nature and limitations of a master franchise system as it relates to subfranchisees, the types of controls that franchisors may exert, both directly and indirectly, on subfranchisees, and the remedies that franchisors may pursue against subfranchisees, either directly, or indirectly through master franchisees.

\(^1\) See Chapter 1 of the Guide to International Master Franchise Arrangements, International Institute for the Unification of Private Law (UNIDROIT), 2nd Edition, 2007, providing the background of for why the UNIDROIT Study Group came to recommend, and the Governing Council of UNIDROIT to accept, that master franchise arrangements be the form of franchising primarily to be dealt with in the UNIDROIT Guide to International Master Franchise Arrangements.


\(^4\) There are other notable potential downsides of the master franchise structure. For example, the master franchise structure creates a “middle man” between the franchisor and the operating units, which may make it more difficult for a franchisor to achieve profitability, particularly in cases where the franchisor continues to provide substantial services and oversight to the master franchisee or its subfranchisees. Another criticism is that master franchisees often have no franchising experience but are then put into a role to act as the franchisor in a given territory. A further concern is that master franchisees often put rapid development (which allows for the collection of profitable initial fees and compliance with aggressive development schedules) ahead of quality development, which can be dilutive of the brand and create a high subfranchisee failure rate. See infra Sections III for a broader discussion of these challenges.
II. MASTER FRANCHISE STRUCTURE

A. Three–Tiered System

The master franchise structure is a “three–tier” structure whereby a franchisor grants to a master franchisee the right to develop the brand within a specified territory (usually, an entire country or multiple countries) by licensing subfranchisees the right to establish and operate subfranchised units in that territory. In other words, under a master franchise model, the franchisor delegates the sole responsibility for the development of the territory, the solicitation of unit subfranchisees, the training of unit subfranchisees, and the ongoing supervision of the unit subfranchisees to the master franchisee. This structure allows the master franchisee to act as the franchisor in the foreign market, vis–a–vis the subfranchisees, and provide assistance, training and support, as well as to take on day–to–day administrative duties.

In order to effectuate an international master franchise arrangement there are generally two key agreements that are involved: (1) a cross–border agreement between the franchisor and the local master franchisee (called the “master franchise agreement”); and (2) a domestic franchise agreement between the local master franchisee and each of the local sub–franchisees (called the “subfranchise agreement”). Generally, there is no direct contractual privity between the franchisor and the subfranchisees.

1. Franchisor

While the essence of master franchising is for the franchisor to shift various responsibilities to the master franchisee, the franchisor (as the brand owner) must still provide the necessary intellectual property, and continue to provide certain services to the master franchisee in a target market.

The obligations of the franchisor typically fall into two categories: (1) initial obligations (e.g., providing information to adapt to the local market, initial training, operations manual); and (2) ongoing obligations (e.g., providing information relating to system updates, modifications, ongoing training, supplying goods, promoting the franchise network, protecting the intellectual property, etc.). While the master franchisee may have more experience in operating businesses in the territory and is the main party responsible for the development of the franchise network in the territory, the franchisor is likely more experienced with the particular business of the franchise and indeed in relation to franchising generally. Often master franchisees have not previously been involved in a franchise business. Thus, for the master franchisee to be able to operate effectively, it is vital that the franchisor transmit to the master franchisee the know–how to assist it in introducing and developing the franchise system.

5 Sometimes called the “sub-franchisor.”

6 Stéphane Teasdale and James M. Susag, Terminating an International Master Franchisee, 2013 A.B.A. Annual Forum on Franchising 1.

2. Master Franchisee

Local master franchisees are a crucial part of the master franchise business in the target market. Under a master franchise structure, the master franchisee assumes the right (often, exclusive) to license the use of the brand to the subfranchisees (essentially, as the franchisor in the territory) and undertakes the duties of a franchisor to such subfranchisees. The master franchisee is responsible for the enforcement of the subfranchise agreements and for the general development and operation of the network in the country or territory it has been given the right to develop under the master franchise agreement. As such, it is the duty of the master franchisee to intervene if a subfranchisee does not fulfill its obligations under the subfranchise agreements. In some cases, the master franchisee may be required to own and operate a number of “flagship” or “pilot” units before subfranchising to third parties is permitted — this is often a good practice to encourage and confirm that the master franchisee understands the business and can provide practical, experience-based advice and support to subfranchisees.

The master franchisee should be a sophisticated business entity with extensive experience and resources to allow it to develop a new franchise system throughout a geographical region. Too often franchisors accept, with only limited investigation, prospective master franchisees who are able and willing to pay an initial fee. To be successful, a more sophisticated approach is required. Detailed due diligence should be undertaken by requiring master franchisee prospects to provide full details of their business history, their involvement in franchising, their access to funding while, at the same time, undertaking checks to ensure that the candidate has not been involved in any criminal activities, has not been involved with failed businesses and has a good credit rating. Indeed, some franchisors take the process of recruiting master franchisees even further and require candidates to spend personal time at the home of the owner, founder or chief executive of the franchisor. For the most part, the master franchisee will act as a “territory manager” as opposed to a “unit operator” (although in some cases, the master franchisee may also be a unit operator). The master franchisee must be able to identify subfranchisees, offer training and support, establish distribution networks, and prepare various promotional materials.

3. Subfranchisee

Much like the considerations that a franchisor may make in selecting its direct–unit franchisee (e.g., experience, business acumen, financial soundness, familiarity with the industry, etc.), the master franchisee should select subfranchisees in a master franchise arrangement based on similar considerations. In some cases, the franchisor may reserve the right to approve subfranchisees or instead may set forth certain criteria (i.e., similar to the criteria used for selecting a direct–unit franchisee) that must be satisfied in the master franchisee’s selection of the subfranchisees. Whether a franchisor wishes to be involved in the recruitment process or simply set out guidelines which a master franchisee must follow in recruiting subfranchisees will depend on a number of factors. First, the extent to which a franchisor has the resources and desire to be actively involved in this process and, secondly, whether, the type of franchise business requires particular characteristics from a subfranchisee which the franchisor believes are essential for the success of the business. Another factor is the extent to which the master franchisee, who may have committed to a development schedule is prepared to accept that the franchisor could reject candidates and, thereby, limit the speed of expanding of the network and the master franchisee’s ability to meet its development schedule commitments. Also, to the extent that the master franchisee or its affiliate own and operate units (which is often required by franchisors), they could be deemed as the subfranchisees for those units.
B. Reasons for Choosing a Master Franchise Structure

The decision to utilize a master franchise structure for international expansion will depend on a variety of factors, and with various advantages and drawbacks.

1. Desired Degree of Control

In the master franchise relationship, the franchisor typically forgoes total control. While the franchisor may still exert control over its system (through various approval rights and the ability to update the system) – in order for the franchisor to benefit from master franchising to the fullest extent possible, the oversight function will need to be less than if the franchisor had entered into the unit franchise agreements directly. For example, the master franchisee will likely select and train subfranchisees, find locations, install equipment and décor, provide operational support, establish distribution networks, propose local updates, and often be responsible for advertising and promotional initiatives.\(^8\) Further, the geographic distance between the home country of the franchisor and the country in which it seeks to expand the franchised network may be vast, such that the franchisor would be unable to effectively control the performance of unit operators. There may also be economic and logistical burdens making it difficult for the franchisor to enforce the terms of the unit agreements. Adding a local master franchisee to assume the franchisor’s role in a given country is therefore advantageous to the franchisor if the franchisor is willing to delegate a level of control and oversight to the master franchisee.

Despite the distance, the franchisor can still maintain quality control and system standards, without any privity of contract with the subfranchisees, through a well drafted master franchise agreement with the master franchisee, including a prescribed form of subfranchise agreement and locally adapted operations manuals.

Given the lack of privity of contract in the master arrangement between the franchisor and the subfranchisee, it is very difficult for the franchisor to enforce unit subfranchise agreements directly. To address this issue, master franchise agreements usually provide some remedies for the franchisor, including, for example, designating the franchisor as a third party beneficiary under the subfranchise agreements. In practice, however, such remedies may be of limited effectiveness. In some jurisdictions, the approach may not be legally enforceable. In others, franchisors may wish to avoid the possibility of litigation in a foreign country from subfranchisees who they have not selected. Indeed, many master franchisees believe it is important that foreign franchisors are kept at arms–length from their subfranchisees because allowing franchisors to take direct action against subfranchisees without involving the master franchisee would undermine the master franchisee’s role.

2. Nature of the Business

The nature of the business is fundamentally important in selecting the most appropriate franchise structure. For example, if the franchise is relatively easy to sell and support, a franchisor may only need to provide minimal oversight, making the opportunity particularly well-suited to a master franchise structure. Examples of these types of franchises include fitness, cleaning and frozen yogurt or ice cream franchises. On the other hand, if the franchise concept

---

has rigid quality standards, specific execution techniques and limited capacity or desire for local adaptation, the franchisor’s direct involvement will need to be high, making such systems not well-suited for a master franchise structure.

The greater the operational complexity (and need for franchisor support services and oversight), the less likely a master franchise structure is appropriate. For example, if the franchise concept is highly technical, then an expansion method that affords the franchisor more control (that is, direct unit franchising or area development) may be more appropriate, rather than an expansion method with less control like master franchising. Examples where master franchising may not be appropriate include hotel businesses, elder care, IP-intensive entertainment concepts or complex food businesses. Also, the greater the per-unit cost for establishment, the less ideal for a master franchise because attracting a large number of smaller investors for the subfranchised units is a key to its effectiveness in promoting quick expansion.

Another consideration under the master franchise model is whether the potential revenue streams and profits are acceptable. That is, in most cases under a master franchise model, the franchise fees and royalties that would have belonged entirely to the franchisor must be shared with the master franchisee, meaning lower returns ultimately for the franchisor. On the other hand, because the master franchisee takes an increased role in the master franchise context, the master franchisee must also be compensated such that the master franchise arrangement is a worthwhile proposition and so that the business can be viable.9

3. Master Franchisee’s Local Experience

As noted above, the role of the master franchisee’s market knowledge cannot be understated in the master franchise context. As the home country of the franchisor and that of the master franchisee often differ in a number of ways (including, culture, customs, traditions, laws, language, religion, social norms, role of government agencies, and employment practices), one of the most notable reasons for choosing master franchising as a contractual structure is to obtain the benefits of the market knowledge, experience and contacts that a local master franchisee can bring to bear for the brand.

As such, a properly structured master franchise arrangement can deliver considerable advantage to the franchisor. It allows the franchisor to rely on a local party who is intimately familiar with the country(ies) concerned and who can advise the franchisor on the modifications that are necessary to adapt the system, the products and services and execution to the local market.

4. Reduced Franchisor Resources

For the franchisor, an advantage to the master franchise structure includes the possibility of expanding the brand network without the franchisor having to invest as much capital (both in staffing and financial terms) as would be necessary if the franchisor were to set up foreign operations directly. Further, the grant of a master franchise enables a franchisor to expand without substantially increasing the size of its management team.

---

On the other hand, the master franchise structure may also decrease a franchisor's potential revenue stream as the master franchisee will receive only a portion of the royalty payments made by subfranchisees. Further, there may still be significant expenses associated with the master franchise arrangement, since the franchisor must still research and plan the international expansion, find an appropriate master franchisee, and provide at least some amount of training and support.

5. Vastness of Territory and Speed of Expansion

When executed properly (and timed correctly to account for market conditions), master franchising is one of the most effective means of rapidly expanding the franchise network. This is because the master franchisee has the primary responsibility for finding and soliciting (or serving through its affiliates) unit operators in the territory.

Most master franchising arrangements provide that the rights are granted, often on an exclusive basis, for a specific territory. While it may be tempting to choose a single master franchisee for an entire country or region, franchisors may also consider dividing the territory into smaller areas and have several master franchisees. Also, given that growth is essential to success, it is especially important in the master franchise arrangement to set forth clear growth objective targets (i.e., development schedule) for the master franchisee. Often, a franchisor may also consider incentivizing growth and continued development by offering multi-tiered growth incentives, giving rewards for good performance, or suspending certain rights (e.g. exclusivity) for failing to meet goals. As a best practice, the franchisor might develop targets by testing the market through an initial direct franchise arrangement with the master franchisee.

6. Impact of Local Law

In some instances, local laws will have an impact on a franchisor’s choice of expansion method. For example, in Malaysia, Vietnam and China, there is some form of experience

---


11 See Ned Levitt, Kendal H. Tyre, and Penny Ward, The Impossible Dream: Controlling Your International Franchise System, 2010 A.B.A. Annual Forum on Franchising 8 (discussing how Canada functions commercially more like four countries rather than one and as such, few master franchisees have done a superior job of fully developing a franchise system throughout Canada. Also, the whole of the European Union or the Middle East as the territory for one master franchisee may result in strong development in only parts of those territories, leaving other valuable opportunities unrealized.


13 In Malaysia, franchisors and local master franchisees must operate their own outlets profitably for at least three years before they are permitted to appoint subfranchisees.

14 In Vietnam, the master franchisee cannot subfranchise unless it has already run the franchised business for at least one year and has obtained written consent from the franchisor to offer subfranchises. This theory is based on the fact that the master franchisee should itself have experience with the franchised brand prior to subfranchising.

15 In China, before offering franchises, the franchisor must have owned and operated two units under the brand to be licensed for at least one year somewhere in the world (the so-called “2+1” requirement).
requirement imposed on all franchisors. In such jurisdictions, a master franchisee will not be in a position to subfranchise immediately after the signing of the master franchise agreement. If the franchisor thinks immediate subfranchising is a priority, then it may consider using an area representative method, at least initially, before the master franchisee itself is qualified to subfranchise under the local laws.\textsuperscript{16}

C. **Typical Master Franchise Agreement Arrangements**

1. **Pure Master Franchise Agreements**

   In a “pure” master franchise arrangement, there is a master franchise agreement which highlights the master franchisee’s role as the franchisor for subfranchised units (without any provisions addressing unit operations), and also subfranchise agreements that the master franchisee enters into with each subfranchisee. The subfranchise agreement provides the unit operational details and the subfranchisees’ obligations thereunder. Whether a subfranchised unit is operated by the master franchisee through an affiliate (i.e., “company-owned”) or operated a third–party subfranchisee does not make a difference – the unit will be operated pursuant to the subfranchise agreement entered into with the master franchisee. There is no privity of contract between the franchisor and the master franchisee or the subfranchisee for the subfranchised units in the “pure” master franchise arrangement.

2. **Hybrid Master Franchise Agreements**

   In a “hybrid” master franchise arrangement, the common practice is to have a single agreement cover both the master franchisee’s role as the franchisor for subfranchised units and the operation by the master franchisee of the master franchisee units. As such, master franchisee units are not operated pursuant to subfranchise agreements, but rather through joinders (or other addenda) to the main master franchise agreement, which results in privity of contract between the franchisor and the master franchisee for the master franchise units. Third–party subfranchised units are still operated under separate subfranchise agreements (entered into between the master franchisee an each subfranchisee), for which there is no privity of contract between the franchisor and third–party subfranchisees. Because the “hybrid” arrangement contemplates the master franchisee developing master franchisee units, master franchisees in this structure are often larger companies which have an established infrastructure and access to capital, given the requirement to maintain and operate at least a minimum number of master franchisee units in the territory.

III. **CHALLENGES OF MASTER FRANCHISE STRUCTURE**

A. **Lack of Privity**

   As we discussed in Section I.C above, there are different ways to structure a master franchise program. Broadly speaking, a franchisor can either have the master franchisee enter into a subfranchise agreement for each unit, regardless of whether such unit is technically a master franchisee unit or franchised unit; or it can use a hybrid master franchise agreement that

is both a multi-unit franchise agreement for the operation of the company-owned units and addresses the subfranchising of the third-party subfranchisee units, which will enter into separate subfranchise agreements.

For the master franchisee’s company-owned units, the second “hybrid” structure gives the franchisor a direct contractual link to those units, as they will be operated under the master franchise agreements. In the first structure (which can be viewed as a “pure” master franchise agreement structure) where even the company-owned units are required to sign subfranchise agreements with the master franchisee, there is not a direct contractual relationship between the franchisor and the unit. For third-party subfranchisees, these two structures do not differ – there is not a direct contractual relationship between the franchisor and the subfranchisees, and both require the units to have a subfranchise agreement with the master franchisee.17

Therefore, with regard to third-party subfranchisees, franchisors typically do not have a direct contractual relationship with them, which presents an obstacle if the franchisor wishes to enforce either the terms of the subfranchise agreement, or certain aspects of the system standards, directly against a subfranchisee.

**B. Attenuation of Control and Visibility**

Although there are a number of contractual and non-contractual techniques that can be utilized to mitigate the challenges caused by franchisor’s lack of privity, some of which we will discuss in the sections below in this paper, ultimately, the lessened control is inherent in a master franchise structure. In fact, compared to other franchise structures, such as multi-unit development, direct franchising, area representative, and joint venture, master franchising typically affords franchisor the least degree of control over the activities occurring at the unit level.

Such lessened control is symptomatic of the structure itself: The master franchisee, not the franchisor, recruits the subfranchisees; the subfranchisees deal with the master franchisee on a daily basis, not the franchisor; the system standards of quality and service, more often than not, are communicated by the master franchisee, not necessarily the franchisor, to the subfranchisees; and, perhaps most importantly, the subfranchisees understand that typically it is the master franchisee, not the franchisor, who has the legal ability to terminate their subfranchise agreements if they do not adhere to the terms and conditions of such agreements. These and other factors inevitably dilute the franchisor’s control of the activities at the unit level.

Along with a lessened degree of control, the franchisor will also have less visibility into the unit operations under a master franchise structure, stemming from the franchisor’s lack of privity with the units, especially third-party subfranchisees. Again, there are ways to mitigate this risk, but it is inherent in a master franchise structure. To put it in another way, if the subfranchisees were to report directly to the franchisor, and the franchisor were to monitor the subfranchisees’ performance directly as if they were the franchisor’s direct franchisees, then a

---

17 See Chapter 7 of the Guide to International Master Franchise Arrangements, International Institute for the Unification of Private Law (UNIDROIT), 2nd Edition, 2007, for an extensive discussion on the preparation of subfranchise agreements, laying out two alternatives: (a) the franchisor prescribes a standard form of subfranchise agreement for the master franchisee to adapt for the local country, with modest changes to reflect local law, customs and business practices; or (b) the franchisor prescribes a list of mandatory provisions, but otherwise leave the actual drafting of the subfranchise agreement to the master franchisee.
key rationale for using the master franchise structure would be lost, and the franchisor might as well enter the market via direct franchising. Franchisors use master franchising because they want the master franchisees to take on most of the responsibilities of running a franchise system in the host country. Consequently, the franchisor typically will not have the same degree of visibility into the unit operations locally. That is the trade-off that franchisors cannot avoid, and if a franchisor is unwilling to make this trade-off, or if the nature of the business is such that such a trade-off would be unwise, then master franchising is simply not the best choice for the brand.18

C. Economic Model

As noted above, franchise systems that require smaller investments by unit operators often gravitate towards master franchising, for good reasons – the units in general are less complex to operate, and the system expansion can be accelerated exponentially by leveraging investment (both financial and labor) from a large number of relatively small investors. Conversely, because of the increased layer of the master franchisee, which needs to be compensated for the services, support and supervision it carries out, there is an increased level of financial stress on the master franchise structure.

—In this model there is a significant danger that both the franchisor and master franchisee view the operation to be a “numbers game” with the emphasis being on recruiting franchisees in order to achieve rapid network expansion. As a result both master franchisee and the franchisor may accept that a significant number of outlets will fail. This approach has its own dangers. In many jurisdictions significant failure rates – those exceeding 10% – are considered unacceptably high. More fundamentally, it creates difficult issues for a franchisor in terms of maintaining system standards. A master franchisee may simply not have the management team in place to ensure that standards are maintained. Very often in this model, the master franchisees management team is principally devoted to recruitment and unit openings and not to operational audits or inspections, which creates system standard challenges.

There are a number of ways in which franchisors can seek to address this by, for instance, requiring the master franchisees to recruit and maintain a certain level of appropriately qualified staff whose sole role is to ensure that brand standards are maintained. Alternatively, or in addition, franchisors could require a certain number of field visits to be undertaken with reports from those field visits made available to the franchisor. A slightly different approach is to limit the extent to which the initial fee contains a profit element for the master franchisee. Many franchisors believe that the smaller the profit element of the initial fee, the less likely it is that over ambitious recruitment of subfranchisees will take place by master franchisees.

Further, as is often the case with this type of model, area development agreements or multi unit franchise agreements are entered into, franchisors should consider a much more active role in vetting and recruitment area developers than would be the case in relation to single outlet subfranchisees.

18 UNIDROIT Franchising Guide admits that “[a]lthough 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.” Supra note 7 at p. 6.
D. Profile of Typical Master Franchisees

To a large extent, the challenges to a successful master franchise program stem from the difficulty in finding the ideal master franchisees.

Compared to large area developers that will develop multiple units on their own, it is not necessary for a master franchisee to have this level of capital resources. In fact, many potential investors gravitate towards systems offering master franchising opportunities rather than area development opportunities precisely because they either lack the funding, or are not willing to make the investment, to develop their own units. As a result, master franchisees are often less capitalized than area developers who must fund the cost of developing of individual units rather than just providing support and supervision to the brand.

Perhaps more importantly, the skill sets required of a successful area developer and a successful master franchisee are very different. To be successful, a master franchisee not only needs to be an excellent operator of the franchised business, but also needs to be good at being a franchise broker, a trainer of the subfranchisees’ employees, and a supervisor of the subfranchisees’ operations. The pool of candidates with this kind of combination of different skills is rather small, and most of them are located in jurisdictions where franchising is a relatively mature way of doing business – e.g., Korea, China, Brazil and France. In markets where franchising is less developed, it is exceedingly difficult to find these ideal master franchisees, but it is those markets where franchisors tend to most want to explore master franchising, rather than area development.

The requirement of this different skillset means that franchisors must be equipped to judge these skills. Franchisors are very well equipped to select franchisees who will operate the franchised businesses, and have a lot of experience in making this selection on a large scale in the domestic market. However, they do not have nearly as much experience in screening and selecting master franchisees that require rather different skillsets. To be successful, franchisors must change their franchising criteria and place a premium on skills that are important to the success of a master franchising business, which are quite different from the operational skills required for the success of a unit business. The skills that franchisors should be looking for are a knowledge of franchising, the relevant industry which is being franchised and the market in the territory. Ideally, a master franchisee will have an existing track record in franchising either as a successful multi-unit franchisee or in a senior role with a franchisor. If the master franchisee is mainly an investor then it will be essential for the franchisor to be in a position to ensure that appropriately qualified senior executives are recruited. A challenge for many investor–type master franchisees is that their primary focus will be on franchise recruitment and achieving the development schedule without regard to the quality of execution. Very often prospective master franchisees are too influenced by the speed of growth in the franchisor’s own territory, particularly if that territory is large and has an entrepreneurial culture. Further, franchisors should take great care that they are not seduced by prospective master franchisees who have ambitious plans concerning outlet openings. While at first blush they are attractive candidates and a focus on development is desirable for franchisors, franchisors must ask themselves whether an ambitious commitment to openings is a sign of lack knowledge of the relevant market, ignorance of the challenges in recruiting prospective franchisees in that market or a willingness to recruit subfranchisees without the skills required to be quality operators.
E. Striking Balance Between Control and Delegation

Most of the challenges associated with master franchising, including those identified above, have to do with the reduced degree of control in a master franchising structure. Naturally, some franchisors have made a lot of efforts, both in the agreements (master franchise agreements and subfranchise agreements) and in the actual interactions among the franchisor, the master franchisee and the subfranchisees, to increase their control to try to mitigate these issues. They typically do so through two avenues: (1) in the master franchise agreement, requiring the master franchisee to obtain the franchisor’s prior written consent regarding a host of matters relating to the master franchisee’s dealings with subfranchisees, including the recruiting of subfranchisees, the terms of the subfranchise agreements, and the modification, transfer, and termination of the subfranchise agreements; and (2) either through a direct contract between the franchisor and the subfranchisee, or relying on the theory of third-party beneficiary, to have certain rights to enforce directly against subfranchisees if they fail to comply with certain obligations.19

Neither approach, however, proves to be a satisfactory solution to the control risk, for two reasons. First, controlling every aspect of the master franchisee’s dealings with its subfranchisees runs the risk of making the master franchisee the franchisor’s “agent” in this arrangement, which presents many unintended consequences that are associated with a principal–agent relationship.20 Second, making all the relevant decisions for the master franchisee, and having the ability to directly enforce against the subfranchisees runs counter to the premise of a master franchising arrangement. If this is the direction a franchisor wants to take with its master franchising program, then it might be better off with a model that gives it more control—i.e., area development or area representative.

In practical terms, it is not at all clear that most franchisors have the necessary resources (or a willingness to invest resources), information and expertise to make these decisions for the master franchisees. In addition, by reducing the master franchisee’s authority, it inevitably reduces the master franchisee’s motivation to take initiatives on its own, and may very well negatively affect the master franchisee’s credibility and status in front of its subfranchisees. Finally, although it is not a key consideration in most cases, one benefit associated with master franchising is the insulation of the franchisor from the subfranchisee’s claims, for the exact same reason that the franchisor doesn’t have control – lack of privity. By controlling almost all aspects of the master franchisee’s dealings with its subfranchisees, and by establishing a direct contractual relationship with the subfranchisees, franchisors undoubtedly are increasing the risk of claims by the subfranchisees against the franchisor. Therefore, in

19 UNIDROIT Franchising Guide identified two approaches to establish a direct contractual relationship between franchisors and subfranchisees: (1) a tripartite agreement between the franchisor, the master franchisee and the subfranchisee for each subfranchise granted – this is relatively rare; and (2) a direct license agreement between the franchisor and the subfranchisee for the intellectual property licensed. Supra Note 7 at p. 45-46. In authors’ experience, both approaches are rarely used in international transactions. A third approach, which is perhaps most commonly used, is for the franchisor to sign onto the subfranchise agreement between the master franchisee and the subfranchisee, either under a specific provision in the subfranchise agreement or through a joinder, which gives the franchisor certain contractual rights that it can directly enforce against the subfranchisee.

20 UNIDROIT Franchising Guide also points this out. “There may furthermore be liability implications, as the nature of the relationship between the franchisor and the sub-franchisor may be considered to have changed if the franchisor retains such extensive rights of control. The two might in other words no longer be considered to be two independent entrepreneurs, but two branches of the same entity.” Supra Note 7 at p. 42-43.
mitigating the risk of reduced control, franchisors could potentially swing the pendulum too far in the other direction, defeating the purpose of using a master franchising structure in the first place.

F. Termination/Unwinding the Relationship

Compared to other models, with the possible exception of a joint venture structure, master franchising is immensely more complicated to unwind. Upon the termination or expiration of the master franchise agreement, the subfranchise agreements then in existence will also come to an end, whether by the express terms of the subfranchise agreements, or by law (for the reason that the “grant” under the subfranchise agreements by definition cannot exceed what the franchisor grants to the master franchisee under the master franchise agreement).

However, this seemingly simple arrangement raises many challenges. First, given this reality, more and more subfranchisees are demanding as part of the subfranchise agreement negotiation process that there is a commitment in place (whether directly from the franchisor or as part of the subfranchise agreement) whereby a subfranchised in good standing at the time of the master franchise agreement’s termination will be able to preserve its subfranchise—similar to a non-disturbance agreement (SNDA) between a tenant and a landlord’s lender addressing the rights of the parties upon foreclosure. Indeed, more and more master franchisees are demanding this commitment from the franchisor as well, because this will make their task of selling subfranchises much easier. From a franchisor’s perspective, however, this commitment, while a seemingly reasonable ask, carries much risk – after all, the reason that the franchisor chose master franchising in the first place is to avoid having a direct franchising program in that market and the related costs and exposure that that structure entails. It is difficult for a franchisor to accept that if it ever wants to terminate the master franchise agreement, it will be saddled with the cost and expense of running the system directly in a foreign market. The ideal solution would be to find a replacement master franchisee who is ready to take over the network of subfranchisees before the franchisor effects a termination. However, circumstances rarely afford franchisors the luxury to go through this time-consuming process prior to exercising their right of termination.

IV. CONTRACTUAL CONTROL MECHANISMS

A. Direct Contractual Controls Over Subfranchisees

As detailed above, inherent in a master franchise structure there is a certain level of diminution of the franchisor’s ability to control the operations of unit subfranchisees and to enforce brand standards and legal remedies. Franchisors have employed various contractual mechanisms aimed at lessening this limitation of the master franchise structure. Some of these mechanism are more effective than others; all have legal or practical challenges that limit their effectiveness.

1. Third Party Beneficiary Rights

Many subfranchise agreements are drafted to provide that the franchisor is a named third party beneficiary of the master franchisee’s rights under the subfranchise agreement. Such third party beneficiary clauses often provide that a franchisor has the right to enforce the terms of the subfranchise agreement as if franchisor were a direct party to the subfranchise
agreement in the same capacity as the master franchisee. Such clauses have varying degrees of effectiveness depending on the jurisdiction in which enforcement is sought. For example, certain countries recognize third party beneficiary rights under common law\(^{21}\) and other countries have statutory recognition of third party beneficiary rights.\(^{22}\) On the other hand, many civil law and religious law countries do not recognize or enforce third party beneficiary rights even where such rights are expressly set forth in a contract.

Accordingly, it is imperative that franchisors do not rely on the enforceability of third party beneficiary clauses without seeking specific advice from local counsel in the subfranchisee’s home jurisdiction. Practically speaking, even in jurisdictions where third party rights are recognized, such clauses should only be an emergency backstop for situations where the master franchisee has failed or refuses to enforce the terms of the subfranchise agreement against the subfranchisee.

2. Direct Privity

In some cases, franchisors will require a tri–partite subfranchise agreement with the franchisor, master franchisee and subfranchisee all being direct parties to the subfranchise agreement. This approach puts the franchisor in direct privity of contract with the subfranchisee. Structuring the subfranchise agreements in this manner may allow the franchisor to overcome some of the enforceability issues related to third party beneficiary clauses, particularly in civil law and religious law jurisdictions where third party rights are often not recognized.

Having direct privity of contract with the subfranchisee means that the franchisor will typically have the direct right to enforce the contract against the subfranchisee. Often, the rights of the enforcement of the franchisor in this context are limited to situations where the master franchisee has failed or refuses to enforce obligations. In other cases, such direct rights are required by the franchisor to allow the franchisor to enforce audit and inspection rights to confirm compliance with standards—with or without the knowledge or consent of the master franchisee.

Creating direct privity between the subfranchisee and the franchisor can be an effective means of overcoming some of the key limitations to the master franchise structure. However, having the franchisor be a party to the subfranchise agreements also diminishes certain of the key benefits of using a master franchise structure. In particular, if the franchisor is in direct privity, the likelihood of direct liability to the subfranchisee is greatly increased. In addition, in the context of negotiations, it is much more likely that the subfranchisee will request that the subfranchise agreement must remain in effect in the event of a termination of the master franchise.

\(^{21}\) In most common law countries, the general rule (known as privity of contract) is that only a signatory to a contract may sue upon it. In Canada, for instance, in the leading cases of *London Drugs Ltd v Kuehne & Nagel International Ltd* [1992] 3 S.C.R. 299 and *Fraser River Pile & Dredge Ltd. v Can-Drive Services Ltd.* [1999] 3 S.C.R. 108, the Supreme Court of Canada created certain exceptions to when a third party may obtain the benefit of protections extended under a contract (effectively, using the contract as a “shield”), but was reluctant to overthrow the rule entirely or give third parties the right to enforce a contract to claim a benefit, thereby using the contract as a “sword”. Nevertheless, the Province of New Brunswick has enacted legislation that abolishes the third-party-beneficiary rule unless the contract provides otherwise.

\(^{22}\) Such as the United Kingdom by virtue of the *Contracts (Rights of Third Parties) Act 1999* [1999] c.31. Similar statutes exist in many of the Commonwealth countries.
franchise agreement, greatly limiting the flexibility of the franchisor to deal with subfranchisees in the context of a termination of the master franchise agreement.

3. Separate Acknowledgment

Another approach used by franchisors in master franchise structures is a requirement that a subfranchisee sign a separate written acknowledgment addressed to, but not executed by, the franchisor acknowledging the franchisor's rights under the subfranchise agreement or master franchise agreement (e.g., the right to perform quality inspections) and acknowledging that the subfranchise agreement will terminate upon a termination of the master franchise agreement.

This approach may be more effective than merely relying on third party beneficiary rights, but it is likely to be less effective than having the franchisor sign the subfranchise agreement directly.

4. Trademark License

Finally, in some structures, the franchisor will have the subfranchisee sign a trademark license agreement with the franchisor. Such a trademark license agreement is often structured as a short form agreement that would not, by itself, constitute a franchise agreement in most jurisdictions. The trademark license agreement may or may not require the payment of royalties, depending on how the royalties are structured in the master franchise agreement.

The benefit of this approach would be to give the franchisor direct rights to enforce its intellectual property rights and enforce standards without having the franchisor be a direct party to the actual subfranchise agreement. The trademark license agreement may contain provisions specifically dealing with what happens upon termination of the master franchise agreement, giving the franchisor enhanced rights both under intellectual property laws and contract law in the context of a termination of the master franchise agreement. As already discussed, some master franchisees may be reluctant to allow franchisors to have any direct contractual relationship with subfranchisees which would enable a franchisor to take direct action and thereby bypass the master franchisee. Further, from the franchisor's perspective, there may be a fear that entering into a direct contractual relationship with subfranchisees in a foreign country increases the likelihood of the franchisor incurring liability for the acts of the master franchisee.

B. Indirect Controls Over Subfranchisees

Absent one of the direct methods of controlling the activities of subfranchisees described above, the franchisor will still have certain indirect controls over the subfranchisee either under the terms of the master franchise agreement or under applicable intellectual property laws. These means will vary in effectiveness and, in some cases, will depend on the cooperation of the master franchisee.

1. Manuals/Brand Standards

While a master franchise agreement often contemplates that the master franchisor may “localize” the franchisor’s operations manuals, any local adaptations of the manuals generally must be approved by the franchisor and such adapted manuals represent the standards applicable to the franchise system in the subfranchisee’s market. In the subfranchise
agreement, the subfranchisee typically agrees to observe the standards, processes and other requirements set forth in the operations manuals. In this way, a franchisor can directly affect how a subfranchisee operates its business by amending its manual. The challenge in a master franchise relationship is that generally master franchisees have to provide subfranchisees with the proposed manual changes. As a result some master franchise agreements provide that the franchisor can provide those changes directly to the subfranchisees thereby eliminating the risk that the master franchisee fails to do so. If this approach is adopted the franchisor may have to incur the cost of translation, which generally franchisors would want the master franchisee to bear. Further, granting a franchisor the direct right to amend the manual does not overcome what, in practice, is likely to be the issue of a master franchisee failing to ensure compliance with the manual.

2. **Obligation to Enforce Subfranchise Agreement & Brand Standards**

Nearly every master franchise agreement places an express obligation on the master franchisee to enforce the terms and conditions of each subfranchise agreement upon its subfranchisees. This provides the franchisor with the right to declare a default of the master franchise agreement if the franchisor discovers that the subfranchisees are not complying with the terms of their agreements or brand standards and the master franchisee is failing to police and enforce the agreement terms and brand standards on the subfranchisees. This is the most traditional means for a franchisor to enforce its rights against subfranchisees and gives the franchisor significant leverage over master franchisees to ensure that standards are observed by the subfranchisees at the risk of losing their master franchise rights and potentially any units directly operated by the master franchisee if the master franchise agreement grants direct operating rights or if the franchise agreements for any master franchisee operated units contains a typical cross–default provision. The issue here, as with so much in master franchising, is the extent to which a franchisor will be aware of a master franchisee’s failure to enforce the subfranchise agreement and brand standards. If a franchisor is willing to take an active role in an overseas territory, then reserving to itself the ability to undertake inspections —, discussed in Section IV. B.4 below, would certainly enable a franchisor to obtain first–hand knowledge of what is going on in that market and thereby eliminate the danger of that information being “filtered” by a master franchisee.

3. **Intellectual Property Laws**

Franchisors also have the right to enforce their trademark and other intellectual property rights by means of intellectual property laws in the jurisdiction where the subfranchisees are operating. Typically, the franchisor, as registered owner of the trademark rights, will have the right to directly sue a subfranchisee if they are infringing the franchisor’s rights to the trademark. This is true even though the subfranchisee has the right to use the trademark because the subfranchisee’s use of the trademarks in violation of the subfranchise agreement may be deemed to be an infringement under the terms of applicable intellectual property laws. The specific process for pursuing claims directly against the subfranchisee and the degree of the master franchisee’s involvement (if any) will vary depending on the jurisdiction involved and the terms of the master franchise agreement. In particular, the master franchise agreement should reserve the right of the franchisor to pursue claims for infringement under local laws without the involvement or consent of the master franchisee.
4. Inspections

Another means for franchisors to enforce brand standards is through inspections performed by the franchisor. Depending on the franchise concept in question, it is often quite easy for the franchisor’s personnel or a third party contractor to be a mystery shopper at a subfranchised unit and to report back any “front of house” quality issues presented upon inspection. It is likely more difficult to conduct a “back of house” quality inspection without the consent of the subfranchisee (which is often addressed in the terms of the subfranchise agreement itself). Nevertheless, these surprise visits by franchisors may have the effect of both keeping subfranchisees in line and causing master franchisees to more routinely and rigorously inspect the subfranchised units to ensure that franchisor not put the master franchisee in default for failing to police the subfranchisees’ compliance with standards. The downside is that regular inspections by the Franchisor is time-consuming and costly and can dilute the profitability of a master franchise arrangement if conducted routinely.

C. Communication by Master Franchisee to Franchisor

1. Reporting Obligations of Master Franchisee

Master franchise agreements often contain covenants by the master franchisee to provide periodic reports to the franchisor or otherwise notify the franchisor that certain events have occurred.\(^{23}\) There is a delicate balance to be struck when drafting reporting and notification obligations. The franchisor likely does not want or need to know about every interaction between the master franchisee and its subfranchisees as this could create an undue burden on the master franchisee and give the franchisor more information than it really needs or wants. However, franchisors should consider requiring reports from master franchisees on a periodic and event-specific basis such as a specific number of complaints, issues concerning health and safety, legal proceedings and the serving of a breach notice on a subfranchisee to ensure that the franchisor is kept abreast of the master franchisee’s performance in policing the subfranchisees and the actual performance of the subfranchisees.

The difficulty with relying too heavily on master franchisee reporting requirements is that detecting noncompliance is not always possible. Therefore, it is important that franchisor’s separately police and verify master franchisees’ reports.

a. Complaints

Depending on the franchised concept, a franchisor may have a strong interest in being kept informed about customer complaints. However, a restaurant franchisor, for example, likely does not need to be made aware of every complaint lodged by a customer if the complaint is being addressed appropriately by the subfranchisee or master franchisee. On the other hand, a significant volume of less serious customer complaints may signal a larger problem. Therefore, it may be advisable for a master franchise agreement to require immediate reporting of certain types of serious complaints (e.g., over a certain dollar amount, involving criminal activities, health and safety issues) and periodic (quarterly or monthly) reporting of less serious complaints.

\(^{23}\) Note that reports in this context would relate to events like defaults and customer complaints as opposed to financial reports, like gross sales reports or financial statements.
complaints. This allows the franchisor to track and address serious issues right away and identify trends (both positive and negative) based on periodic reporting of complaints.

b. Breaches

Master franchise agreements ought to require the master franchisee to report breaches of subfranchise agreements to the franchisor. A reasonable question may be raised as to whether all subfranchisee breaches should be immediately reported to the franchisor or whether minor breaches may be reported only periodically or not at all. For example, if a subfranchisee is one day late in paying royalties, should that be reported if the default is cured? Many times, it is difficult to distinguish between material defaults requiring immediate reporting and minor defaults. It is also difficult to leave this determination up to the master franchisee. Thus, a best practice may be to require a master franchisee to immediately notify the franchisor of any defaults that remain uncured after any applicable cure period and of any defaults for which no cure period is allowed. This allows the franchisor to monitor the compliance of subfranchisees while allowing the master franchisee sufficient time to deal with more minor defaults directly without franchisor intervention.

c. Terminations

Immediate notice of the termination of any subfranchise agreement, or an event giving rise to a termination right, should be required in all master franchise agreements. The franchisor has a significant interest in maintaining a list of all active subfranchisees for regulatory and practical purposes. For example, many franchise disclosure laws require disclosure of all franchisees and subfranchisees and any terminations of franchisees or subfranchisees. The franchisor should be tracking this information to allow it to comply with its franchise disclosure obligations as well as other more practical reasons. For example, if the franchisor controls a global website, the franchisor may need to remove the location from its website. The franchisor should also ensure that the master franchisee has enforced the master franchisee’s compliance with its post-termination obligations, including removing signage and other proprietary items from the former subfranchised location, returning confidential materials such as operating manuals and observing post-termination non-competition obligations.

2. Determining Appropriate Reporting Requirements

As discussed above, imposing appropriate and effective reporting requirements on master franchisees is a balancing act. In a healthy master franchise structure, the main relationship with the subfranchisee lies with the master franchisee rather than the franchisor for various reasons: geographic proximity, common language, common culture and more frequent contact. Requiring overly burdensome reporting requirements can divert the resources of the master franchisee and interfere with the important relationship between the master franchisee and franchisor. Therefore, crafting a balanced reporting structure in a master franchise agreement is crucial to both the franchisor–master franchisee relationship and the master franchisee–subfranchisee relationship.

a. Mandatory Periodic Inspections/Reports

Depending on the particular needs of the franchise system, periodic reporting from the master franchisee on the activities of its subfranchisees on a quarterly basis seems appropriate and reasonable. Such a reporting covenant may also mandate that the master franchisee
conduct an inspection of all or a portion of its subfranchisees during this period in order to accurately report the required information.

b. **Contents of Periodic Reports**

Effective periodic reports from a master franchisee should cover various operational and contractual compliance matters. On the operational side, the report should confirm that the master franchisee has inspected the subfranchisees’ operations, detail whether the inspections were satisfactory or not and, if unsatisfactory, detail any remedial actions taken and whether the situation has been resolved. For unsatisfactory results, a plan of action for further monitoring of the problem subfranchisee should also be outlined.

On the contractual side, the report should confirm that each franchisee has timely reported gross sales, timely paid royalties, whether any defaults have occurred and detail the facts of such default.

D. **Effect of Master Franchisee–Subfranchisee Relationship on Enforcement**

As discussed above, the primary relationship with a subfranchisee appropriately rests with the master franchisee rather than with the franchisor. As a result, master franchisees are often reluctant to bring enforcement actions against subfranchisees, not only because of this relationship but also due to the expense and distraction of pursuing these remedies. In addition, a master franchisee may fear that subfranchisees’ failure reflects poorly on them in the eyes of the franchisor and also puts them at risk of being in default of the master franchise agreement.

Accordingly, it is crucial that the franchisor–master franchisee relationship is as strong or stronger than the relationships between the master franchisee and its subfranchisees. As always in franchising, this does require good communication from the franchisor. A common complaint of master franchisees is that all that the franchisor is concerned about is receiving fees. To remedy this, franchisors should consider visiting the master franchisee’s territory periodically, taking an active interest in store openings, and providing brand developments and additional training to the master franchisee. The master franchisee must be comfortable that complete and timely compliance with its reporting and enforcement obligations will not be used by the franchisor as the basis for placing the master franchisee in default of its master franchise agreement or otherwise reflecting negatively on the master franchisee (absent other issues, of course).

Similarly, the franchisor must appreciate that enforcement actions can be prolonged and expensive affairs, particularly in certain foreign jurisdiction. In addition, the same legal remedies (e.g., injunctive relief, specific performance) may simply not be available in the master franchisee’s home jurisdiction, making enforcement by the master franchisee different or more challenging than what the franchisor may be used to in its home country.

1. **Expense**

Pursuing remedies against a subfranchisee entails administrative costs, diversion of internal resources from routine operations, legal fees and, particularly in larger territories, travel time and expenses. All of these factors have the potential to make enforcement a costly matter for master franchisees. As a result, franchisors should not expect master franchisees to pursue every minor default with their full time and attention—much like a franchisor may not formally
pursue every small noncompliance against its direct franchisees. While brand standards are critically important, master franchisees, like franchisors themselves, must make certain cost–benefit decisions based on their limited resources to pursue the issues that most require the time, attention and resources of franchisor to protect the integrity and reputation of the brand.

2. **Litigation**

As noted above, subfranchise agreements are typically domestic contracts covered by the laws of the country where the master franchisee and subfranchisee reside.\(^{24}\) Therefore, depending on the jurisdiction involved, subfranchise agreements will often resort to dispute resolution in the courts of the home jurisdiction of the master franchisee and subfranchisee. This can often result in protracted lawsuits with little guaranty of long term success—particularly in jurisdictions where the legal system is underdeveloped or overburdened.\(^{25}\) Also, not all legal systems have the same types of remedies available that franchisors are used to in the United States or their home jurisdiction. This often makes pursuing litigation or other dispute resolution procedures against a subfranchisee a poor business decision. It is difficult to ask a master franchisee to pursue protracted, expensive and uncertain legal claims. However, franchisors are often forced to pursue such claims as a matter of principle to protect the reputation and image of the brand. If the master franchisee is truly a steward of the brand in its territory, then the master franchisee will understand the value of pursuing such cases beyond the direct costs and resources that must be devoted to them. If the master franchisee views itself as merely filling a role and not as the steward of the brand, asking a master franchisee to take a principled stand in litigation for the best interest (rather than its own bottom line) is often a request that will fall on deaf ears unless the relationship between the franchisor and the master franchisee is strong, which can be achieved if the guidelines set out above are followed.

3. **Termination**

The remedy of termination is usually a last resort for franchisors. This may be more true for master franchisees than sub–franchisees for several reasons. Much like termination in the direct franchise context, termination of a subfranchise agreement by a master franchisee means that the master franchisee will lose a source of revenue and put itself at risk of litigation from the subfranchisees. More specifically, however, a master franchisee may also have a conflict of interest in deciding whether to pursue a termination. After all, most master franchise agreements contain a rigid and aggressive development schedule under which the master franchise is required to open and continuously operate a certain number of subfranchised units in the reserved territory. If a subfranchisee is terminated, this potentially puts the master franchisee at risk of default under its own master franchise agreement.

Moreover, the suggestion of termination may put the master franchisee in a defensive position vis–à–vis the franchisor. For many master franchisees, pursuing termination is the same as admitting failure. It means the master franchisee failed by recruiting a subfranchisee who could not live up to its obligations, failed by not being able to rehabilitate the subfranchisee

---

\(^{24}\) See *Infra* Section V.A.

through training, support and other remedial measures, failed by allowing the brand to suffer under a poor operator, or all of the above.

These reasons make the decision to terminate a subfranchisee a difficult decision for a master franchisee. This often means that the franchisor may have to intervene to ensure that the master franchisee enforces the agreement against failing subfranchisees using all remedies available to it, including remedies that may run counter to their direct financial or contractual interests.

V. FRANCHISOR REMEDIES

A. Subfranchise Agreements Are Generally Controlled by Local Law

When expanding overseas, franchisors will generally have a form of franchise agreement used in their home jurisdiction with their direct franchises. This agreement is typically developed by the franchisor at considerable expense over a long period of time, involving much trial and error. The franchisor often will have formed a relationship with experienced franchise counsel who has also devoted a great deal of time developing the franchise agreement. Thus, the franchisor and its counsel become very familiar and comfortable with the provisions of their franchise agreement. As a result, it is perfectly understandable why the franchisor would strongly prefer not to change their form of agreement when expanding overseas. Indeed, with large franchisors who may also have an in–house legal team, it may be the case that for the simplification of the legal and administrative function, considerable importance is placed upon maintaining the same or very similar franchise agreements in all territories. These are powerful arguments, but they may not necessarily lead to the right approach in the context of master franchising.

When developing an international master franchise program, a franchisor will generally convert its preferred form of franchise agreement into a subfranchise agreement. Some franchisors may already have a master franchise agreement that they are comfortable with and that works with their franchise agreements.

Before signing up a master franchisee, a franchisor will typically submit its form of master franchise agreement and subfranchise agreement for review by local counsel in the jurisdiction or jurisdictions to be covered by the master franchise agreement. This review is generally limited to ensure that the master franchise and subfranchise agreements comply with mandatory legal requirements in the master franchisee’s territory. Sometimes, very sensibly, a review is broader and requires advice to be given to ensure that the agreements also comply with local custom and practice. Often more sophisticated franchisors or franchise attorneys request specific advice on various key contractual provisions and legal concepts, such as:

- the enforceability of third party beneficiary provisions in favor of the franchisor;
- what are the advantages/disadvantages of a franchisor being a party to the subfranchise agreement between the master franchisee and the subfranchisee?
- can the franchisor require additional fees to be paid if the master franchisee fails to take action against subfranchisees?
• can franchisors specify the due diligence that must be undertaken in respect of a prospective subfranchisee and be involved in the process of selecting a subfranchisee?

• should a separate trade mark license between the franchisor and the subfranchisee be required?

• can the franchisor require personal guarantees to be given subject to the laws/courts of the guarantors, even if the master franchise agreement is subject to the laws of the franchisor?

• can a franchisor (to the exclusion of the master franchisee) be given an option to enforce the terms of the subfranchise agreements through local laws and courts?

• can a subfranchise agreement specify that requirements to comply with brand standards be set by both the master franchisee, who is a party to the subfranchise agreement, and the franchisor who is not?

• can a provision be inserted in favor of a franchisor who is not party to the subfranchise agreement that gives the franchisor power of attorney to take certain actions in the name of the subfranchisee as may be required to remedy a breach?

• can a provision be inserted in a master franchise agreement which requires a master franchisee to transfer a claim against a subfranchisee to the franchisor if so required by the franchisor?

• should there be a separate contract governed by local law directly between a franchisor and a subfranchisee dealing with specific issues such as non-compete and confidentiality covenants?

All of the above questions (and more) are relevant for the purposes of investigating the ways to strengthen a franchisor's ability to ensure compliance with the franchisor's system requirements and the terms of the master franchise agreement.

When a franchisor based in a common law jurisdiction expands to another common law jurisdiction, it is relatively straightforward to ensure that the franchisor's form of subfranchise agreement is used as a basis for the subfranchise agreement in the master franchisee territory, especially since the language of common law contracts is typically English. The task is significantly more challenging in civil law countries or countries which enforce religious laws.

26 Anguilla Antigua and Barbuda, Australia, Bahamas, Barbados, Belize, Bermuda, Canada, United Kingdom, Cook Islands, Dominica, Hong Kong, Fiji, Gibraltar, Grenada, Guam, Jamaica, Kiribati, Falkland Islands (Isla Malvinas), New Zealand, Palau, Pitcairn Islands, Saint Helena, Saint Kitts and Nevis, Saint Vincent and the Grenadines, American Samoa, South Georgia and the Islands Tokelau, Tonga, Trinidad and Tobago, Turks and Caicos Islands, Tuvalu, United States, Virgin Islands, British Virgin Islands, Bhutan, Ghana, Guyana, India, Kenya, Lesotho, Liberia, Malawi, Burma, Nepal, Nigeria, Papua New Guinea, Saint Lucia, Samoa, Singapore, Solomon Islands, Tanzania, Uganda, Zambia.

27 Albania, Andorra, Angola, Argentina, Armenia, Aruba, Austria, Azerbaijan, Azores, Belarus, Belgium, Benin, Bolivia, Bosnia and Herzegovina, Botswana, Brazil, Bulgaria, Burkina, Faso, Burundi, Cambodia, Cameroon, Cook Islands, Cape Verde, Central African Republic, Chad, Chile, China, Colombia, Congo, Costa Rica, Côte d'Ivoire, Croatia, Cuba, Cyprus, Czech Republic, Denmark, Djibouti, Dominican Republic, East Timor, Ecuador, El Salvador, Equatorial Guinea, Eritrea, Estonia, Ethiopia, Faroe Islands, Finland, France, French Guiana, French Polynesia, French Southern and Antarctic Lands, Gabon, Georgia, Germany, Greece, Greenland, Guadeloupe, Guatemala,
The approach in both civil law and religious law countries is to prepare much shorter and less detailed agreements, although there is evidence to suggest that the influence of detailed U.S.-style franchise agreements is increasing the complexity and length of subfranchise agreements, even outside common law countries.

At the risk of oversimplifying the distinction between common law and civil law jurisdictions, in civil law jurisdictions numerous provisions are implied by the applicable civil code and are, therefore, not generally inserted into commercial contracts, such as subfranchise agreements. These jurisdictions will require much more substantial amendment to a common law drafted subfranchise agreement and, indeed, almost certainly an entirely new civil law or religious law subfranchise agreement would have to be prepared which would have a very different look and feel to the franchisor’s preferred common law subfranchise agreement. Simply amending a common law agreement is unlikely to result in an agreement which is in a form which complies with custom and practice in those jurisdictions.

Another issue is the language of the agreement. It may not be helpful for an English language agreement to be prepared in jurisdictions where English is not the language of that country. Even if the subfranchisees and/or master franchisee are sophisticated business persons who speak excellent English, if the relevant agreement is subject to the laws and courts of the target country there may still be difficulties with enforcement due to the language and cultural differences on top of the difference in legal systems. Indeed, in some countries, it is a legal requirement that franchise agreements are in the language of that country. In others it is a requirement of national franchise associations that the agreement be in the local language. In all countries, a failure to provide a subfranchise agreement in the local language will make the recruitment of subfranchisees much more challenging. If a foreign language agreement is provided, the franchisor must ensure that the agreement—which is often prepared by the master franchisee’s lawyers at the master franchisee’s expense—contains all of the elements required by the franchisor to the extent enforceable (and sometimes even when of dubious enforceability).

---

Guernsey Guinea, Guinea-Bissau, Haiti, Honduras, Hungary, Iceland, Indonesia, Italy, Japan, Jersey, Kazakhstan, Korea, South Kyrgyzstan, Laos, Latvia, Liechtenstein, Lithuania, Luxembourg, Macau, Macedonia, Madeira, Malta, Martinique, Mayotte, Mexico, Moldova, Monaco, Mongolia, Montenegro, Mozambique, Netherlands, New Caledonia, Nicaragua, Niger, Norway, Panama, Paraguay, Peru, Philippines, Poland, Puerto Rico, Portugal, Reunion, Romania, Russia, Rwanda, Saint Barthelemy, Saint Martin, Saint Pierre and Miquelon, San Marino, Sao Tome and Principe, Scotland, Senegal, Serbia, Slovakia, Slovenia, Spain, Suriname, Swaziland, Sweden, Switzerland, Tajikistan, Thailand, Togo, Turkey, Turkmenistan, Ukraine, Uruguay, Uzbekistan, Vanuatu, Holy See, Venezuela, Vietnam, Wallis and Futuna, Zimbabwe Guinea, Guinea-Bissau.

28 Afghanistan, Algeria, Maldives, Saudi Arabia Bahrain, Bangladesh, Iran, Iraq, Israel, Brunei, Comoros, Egypt, Gambia, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malaysia, Mauritania, Morocco, Oman, Pakistan, Palestine, Qatar, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, Yemen.

29 For instance, Article 5.3 of the recently revised European Code of Ethics provides:

“Franchisors shall offer to franchisees all agreements and all contractual arrangements in connection with the franchise relationship, in writing, in the official language of the country the individual franchisee is established in or in a language in which the franchisee formally declares itself competent. Signed agreements shall be given immediately to the individual franchisee.”

EFF countries – Belgium, Croatia, Czech Republic, Denmark, Finland, France, Greece, Hungary, Italy, Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey and the United Kingdom.
The master franchise agreement will typically provide that a translation of the subfranchise agreement, if necessary or desirable, be prepared at the cost and expense of the master franchisee. Nevertheless, it is ill-advised for franchisors to rely on the translation provided by their master franchisee without having the translated version verified by its own lawyers or translators for quality, completeness and accuracy.

It may be possible (although the choice of law rules in some jurisdictions may not permit it) for a subfranchise agreement to be governed by foreign law and be in foreign language. However, there are substantial disadvantages to this approach. From a practical standpoint, it will be harder to find local subfranchisees willing to enter into subfranchise agreements with a local master franchisee that are governed by the laws of another country and are in a foreign language. One of the key benefits of using a master franchise structure is to allow the local master franchisee to recruit individuals and smaller businesses (particularly in remote areas) to become subfranchisees. Using a foreign law or foreign language agreement (or both) will put a significant chilling effect on this benefit and thereby inhibit the effectiveness of the master franchisee’s recruitment abilities.

Furthermore, mandatory local laws will continue to apply regardless of the foreign choice of law. In addition, as noted above, certain jurisdictions may require agreements between local parties to be governed by local law or be in the local language. Moreover, even in cases where local laws allow for contracts to be governed by foreign law or a foreign language, local courts will typically require guidance on the foreign law to be applied, which usually means that two sets of lawyers will need to be involved in the case (both the local lawyer and a foreign legal expert), which adds substantially to the cost and complexity of enforcement, but also increases the likelihood of an unpredictable decision from the court or tribunal.

Of course, countervailing considerations apply in jurisdictions where the law of the master franchisee’s jurisdiction are undeveloped or uncertain or where the courts may not be impartial. In these situations the disadvantages of using a franchisor’s home laws/courts highlighted above may be outweighed by the need to achieve certainty and a fair result. However, the capacity to remove the enforcement of the agreement from local courts will depend upon other factors, such as whether arbitration is favored and reliable as an alternative in the jurisdiction in question and whether the courts will enforce a foreign dispute resolution mechanism in a contract between two domestic parties.

While some master franchise agreements are subject to the laws and courts of a neutral jurisdiction – often as a negotiated concession because of the master franchisee’s fear of litigation in the United States or the franchisor’s home country – it is rare, but not unheard of, for a subfranchise agreement to apply the law of a jurisdiction other than the local law of the subfranchisee and master franchisee. If the courts or laws of an neutral jurisdiction apply, it

---

30 Indonesia and Philippines.
31 See supra Section IV.D. for discussion on challenges for master franchisees in pursuing local law litigation. Having a foreign law or foreign language agreement will only compound these challenges and increase the related expenses.
32 One example where foreign law is often used in subfranchise agreement is where a master franchisee is a regional master franchisee with rights over multiple jurisdictions. In such cases, it is common to see the subfranchise agreements governed by the laws of the master franchisee’s home jurisdiction where the subfranchisee may be located in another jurisdiction within the master franchisee’s territory.
likely means that the parties have no connection to that jurisdiction. As a result, the use of a neutral governing law tends to increase the cost of dispute resolution and increase the likelihood that the subfranchisee will not participate in, or comply with, any resulting proceeding, judgment or award.

**B. Forms of Dispute Resolution**

Franchisors are not usually a party to subfranchise agreements between a master franchisee and a subfranchisee. Thus, subfranchise agreement disputes are often dealt with by mediation, arbitration, litigation or some combination of those three mechanisms with the local law of the master franchisee and subfranchisee governing the agreement and the dispute. Even in subfranchise agreements where a franchisor has been granted the right to bring a claim against a subfranchisee directly, it would be unusual for the location, dispute resolution procedure or governing law to be changed as a result of the franchisor’s participation.

**C. Does the franchisor have right to pursue injunction or equitable relief directly?**

If the master franchise agreement contains a provision requiring the master franchisee to enforce the provisions of the subfranchise agreement, or to take other steps against subfranchisees, then a failure by the master franchisee to do so would amount to a breach of contract, which would entitle the franchisor to damages. The challenge for the franchisor is that the subfranchisees may have already caused substantial damage to the brand’s reputation by the time the franchisor learns of the subfranchisee’s breach and then demands the master franchisee to take action. Accordingly, franchisors often seek to require master franchisees to take action by threatening the master franchisee with an injunction or similar emergency relief that may be available.

Master franchise agreements will typically deal with the availability of injunctive relief or emergency remedies in favor of franchisors. Indeed, master franchise agreements often provide that a franchisor may bring such proceedings in the master franchisee’s home jurisdiction. If that were not the case, franchisors, in a situation where they would want to enforce contractual provisions by way of injunctive proceedings, would have to commence those proceedings in their home jurisdiction first and then seek to enforce the judgment or award in local courts—making it a two-step process. This creates, at least two problems for a franchisor. The first is that courts are often unwilling to grant injunctions in respect of jurisdictions outside their borders where they would not be able to ensure compliance with their order. Second, the master franchisee would be unlikely to participate in the foreign proceedings which, when it came to enforcement in the master franchisee’s jurisdiction, may make enforcement of the foreign court or tribunal’s order difficult as local courts may refuse to enforce the order on due process grounds, may revisit the case on its merits or may not enforce the award because no similar remedy exist under the laws of the master franchisee’s home jurisdiction. Accordingly, except in rare circumstances, pursuing injunctive remedies outside of the master franchisee’s home jurisdiction, is ineffective.

While obtaining effective injunctive relief in favor of a franchisor against a foreign master franchisee may be challenging, seeking injunctive relief in favor of a franchisor against a

---

33 See supra Section IV.B.2 for a discussion of a master franchisee’s obligation to enforce the terms of subfranchise agreements.
subfranchisee with whom the franchisor has no direct contractual relationship is doubly so. With a lack of contractual privity, the franchisor must rely on the terms of the master franchise agreement (to which the subfranchisee is not party) or local laws and statutes to avail itself of direct injunctive remedies against a subfranchisee.

A master franchise agreement may expressly provide that the master franchisee transfers its rights to enforce the provisions of the subfranchise agreements to the franchisor if so required or requested by the franchisor. In addition (or in the alternative), a master franchise agreement may name the franchisor as an express third party beneficiary. In either case, however, the effectiveness of such contractual mechanisms will require specific input and advice from local counsel. In some cases, such mechanisms may not be recognized or enforceable in the subfranchisee’s home jurisdiction. Further, at a practical level, the franchisor often relies on the master franchisee to make it aware that a subfranchisee is in breach of its obligations. As discussed above, master franchisees often do not inform franchisors of such breaches or do not do so quickly as doing so may be against their interests. In many jurisdictions, a failure to commence injunction proceedings with due speed can result in a refusal to grant an injunction. As a result, a master franchisees’ failure to inform franchisors in a timely fashion may deny the franchisor the opportunity to seek an injunction against a subfranchisee, even if a contractual mechanism has been granted giving a franchisor the right to do so directly.

D. Breach

Every master franchise agreement should contain provisions requiring the master franchisee to take certain actions or communicate certain information to the franchisor relating to its subfranchisees. For example, the master franchise agreement should require that (i) copies of the executed subfranchise agreements be forwarded to the franchisor in a timely fashion, (ii) complaint letters/threats of legal action against a subfranchisee be forwarded to the franchisor in a timely fashion; (iii) statements showing overdue payments are forwarded to the franchisor in a timely fashion; (iv) insurance policy premiums (possibly with other provisions such as requiring a franchisor to be a named party to subfranchisees’ insurance policies) are forwarded to the franchisor in a timely fashion; and (v) an obligation on the master franchisee to enforce the provisions of the subfranchise agreement against the subfranchisees.

Even with the contractual provisions set out above, franchisors are faced with the challenge of enforcing these contractual rights. Enforcing these rights involve significant monitoring and oversight by the franchisor. In many instances, however, a master franchise agreement will contain very detailed obligations on the master franchisee that the franchisor does not monitor or enforce due to the administrative burden of doing so.

On the other hand, even if a franchisor is aware of a breach by the master franchisee of its obligations, franchisors are often reluctant to remedy the breach by serving a formal default notice on the master franchisee. The reasons for this reluctance are varied but may include (i) a desire to maintain the relationship with the master franchisee by handling issues on an informal

34 See supra Sections IV.C and D. discussing reporting master franchisee reporting requirements and the intricacies of the master franchisee-subfranchisee relationship.

36 See supra Section IV.C. for a discussion of master franchisee reporting obligations and striking the balance between adequate and intrusive reporting requirements.
basis, (ii) the administrative burden and legal cost of bringing a proceeding against a master franchisee and the damage it may inflict on the relationship with both the master franchisee and the subfranchisees, and (iii) direct money damages arising from a breach of these types of provisions may be difficult to prove.

E. Termination of Master Franchise

Practically speaking, it may be quite difficult for a franchisor to effectively terminate an entire master franchise relationship solely on the basis that the master franchisee has failed to enforce the terms of its subfranchise agreements, unless the failure was material, endemic and demonstrable. If a widespread failure to enforce the subfranchise agreements arises and the franchisor is made aware of the situation, urgent action to remedy the situation will be required. Accordingly, in practice, commercial solutions must be fully investigated prior to adopting the “nuclear” option of terminating the master franchise agreement. Franchisors may, for instance, consider offering financial assistance to the master franchisee in relation to proceedings against subfranchisees, making the management team available to assist in ensuring compliance with the system on a going forward basis, offering additional training for subfranchisees or any combination of the above. For such commercial solutions to succeed, they must be offered at an early stage and must be monitored by the franchisor to ensure ongoing and continuous compliance.

It is likely that the termination of a master franchise agreement will lead to the termination of the subfranchise agreements or the transfer of the subfranchise agreements to the franchisor. In the case of a large and established subfranchise network, the franchisor may simply not have the inclination or indeed the capacity to undertake management of such a network in a foreign country. If, on the other hand, the network in the master franchisee’s country is at an early stage of development, the master franchisor may be reluctant to incur the cost of establishing and growing a network in a foreign country. Franchisors are often reluctant to terminate a master franchise agreement because the management and logistical issues resulting from a termination are messy and complex, making commercial resolutions or negotiated exits much more palatable, less expensive and less damaging to the brand.

F. Post Termination Relationship with Subfranchisees

What happens to subfranchise agreements upon termination of a master franchise agreement will be regulated by the terms of the master franchise agreement and the subfranchise agreements. Typical master franchise agreements contain a right in favor of the franchisor to take an assignment of the subfranchise agreements upon termination of the master franchise agreement. Often, the terms of the master franchise agreement give the franchisor an opportunity to select or “cherry pick” desirable subfranchise agreements (i.e., high revenue, good locations, etc.) while allowing the remaining subfranchise agreements to terminate. While such provisions are helpful for franchisors, master franchisees generally do not want to be left with the undesirable subfranchise agreements—usually those with challenging or underperforming subfranchisees. While it is common for a subfranchise agreement to provide that the subfranchise agreement will terminate upon termination of the master franchise agreement if the franchisor does not exercise the option to transfer the subfranchise agreement, such a provision highlights to subfranchisees that through no fault of their own, their rights to operate their subfranchise business could be terminated. Without such a provision, termination
The master franchisee would immediately put the master franchisee in breach of the subfranchise agreement.36

A further challenge for the franchisor who terminates a master franchise agreement and takes over the subfranchise agreements (or certain of them) due to the master franchisee’s failure to adequately enforce the subfranchise agreements is that the franchisor is now faced with enforcing contractual provisions that the master franchisee had historically failed to enforce. Depending on the facts, this changing of the guard may not be well–received by the subfranchisees. Further, there is a potential for legal challenges. For instance, the subfranchisee may challenge the transfer or assumption of the agreement by the franchisor under local contract law. Alternatively, as the master franchisee has not enforced the terms of subfranchise agreements for a considerable period of time, there may be issues of waiver or estoppel raised by the subfranchisees to resist enforcement by the franchisor.

Also, what happens if the subfranchisees do not want to stay in the system and have their agreements assigned to the franchisor or a replacement master franchisee? Well prepared subfranchise agreements often try to mitigate this concern by making sure that the agreements will be assigned to the franchisor or its designee without any consent or further action on the part of the subfranchisees. But how easily this provision will be enforced through local courts, and how well it can work in practice, is far from certain. If the host country has a franchise disclosure or registration law that requires the franchisor or the replacement master franchisee to undertake certain actions (e.g., obtaining regulatory approvals) before they are allowed to assume the subfranchise agreements, that will further complicate the process.

Finally, one should not assume that the outgoing master franchisee will be willing or available to assist with the transition. In fact, if the master franchise agreement has been terminated involuntarily, one should assume that the terminated master franchisee will take steps to impede the transition, particularly if the master franchisee believes the termination was not justified. Regardless of the reason for termination, the master franchisee may try to make a case that it should be compensated for the subfranchise agreements that are assigned to the franchisor or the replacement master franchisee – after all, the subfranchise agreements are revenue–producing assets of the outgoing master franchisee. Even if the franchisor ensures contractually that no compensation will be payable under such circumstances, the master franchisee may be able to resort to local law to petition for compensation. Accordingly, a legitimate question could be raised as to whether a franchisor would be better off agreeing to some contractual compensation in the master franchise agreement (and apply a “default” discount), instead of leaving this issue unaddressed. All of these concerns should be carefully considered by the franchisor before entering into a master franchise agreement, and whatever contractual mechanism it arrives at to resolve or at least mitigate these risks, it should engage competent local counsel to ensure that it is enforceable under local law, or at least will not negatively affect its other rights under the agreement or at law.

36 See supra Section III.F discussing a trend of more sophisticated subfranchisees or experienced counsel requesting protection from franchisors in the event of a termination of a master franchise agreement.
G. Remedies Other Than Termination

Since termination of a master franchise agreement may be unattractive to a franchisor for a number of reasons, franchisors should think carefully about the commercial leverage points that may provide them with a more attractive or effective means of ensuring compliance.

A common provision in subfranchise agreements is a remedy that allows a franchisor to suspend the supply of goods or services to the subfranchisees if the subfranchisee is not in compliance with its subfranchise agreement. This enables franchisors to put commercial pressure on subfranchisees to comply if those services are essential or necessary for a subfranchisee’s business. Master franchise agreements should also make the supply of goods or services by the franchisor to subfranchisee contingent upon the master franchisee’s compliance with its contractual obligations, putting the master franchisee at risk of default vis-à-vis its subfranchisees if they fail to adequately police brand standards to the satisfaction of the franchisor.

The impact that the withdrawal of services or products may have on a master franchisee or subfranchisee depends very much on the nature of the sector in which the agreement operates. Obviously, in the hotel or car rental sector, the withdrawal by a franchisor of the benefit of its reservations system has immediate and significant effect on the master franchisee and the subfranchisee. Indeed, because of the potentially catastrophic effect that such withdrawal may have, franchisors would need to adopt a cautious approach to invoking such a right, which may be viewed as a de facto termination of the agreement. Indeed, its use for anything other than a highly material breach by the master franchisee may be subject to attack for lack of due process, unconscionability/proportionality grounds or as a breach of implied good faith principles.

Other commercial remedies are available. For instance, franchisors may require CRM data to be stored on the franchisor’s hardware or in the cloud. As a result, a franchisor may restrict a subfranchisee’s access to its own data. If the data contains billing information then a lack of access would have an immediate effect on subfranchisees’ businesses but would not give rise to an immediate termination. Subject to compliance with data protection laws, a franchisor could require such a provision to be inserted into the approved form of subfranchise agreement.

Similarly, if products are required to be purchased from the franchisor, or its nominated suppliers, a franchisor may be in a position to withhold supplies of products to those subfranchisees who are not complying with their subfranchise agreements if the subfranchise agreement expressly allows the franchisor to do so. Again, great care needs to be taken in withholding supplies because it gives subfranchisees little alternative but to obtain those supplies from third party sources and once that opportunity is created for subfranchisees, it may be difficult to reverse course.

VI. CONCLUSION

Master franchising remains a popular option for international franchise expansion. It is attractive because it is viewed as a low cost, or indeed a cost positive, way of expanding overseas which relies on local input and expertise and does not divert a franchisor’s management and financial resources away from the home market. These are indeed significant advantages but there are significant disadvantages which need to be considered as well. Those
relate principally to loss of control over subfranchisees where, generally, franchisors either have no contractual relationship or a limited contractual relationship, and in either situation very little day-to-day interaction with the subfranchisees on the ground. This means that franchisors have to rely on their master franchisees taking action to maintain standards and prevent contractual breaches. But master franchisees may not have the financial resources to take action and may be reluctant to do so for commercial reasons, such as the need to maintain a certain number of subfranchisees either to maintain the income stream from subfranchise royalties or to comply with the requirements of the development schedule.

This paper examines ways in which issues around lack of control may be addressed. However, any attempt to limit the negative impact of a franchisor’s lack of control come at a price – primarily resulting in greater involvement in the master franchise business which may defeat the object of master franchising in the first place. Franchisors share fees with master franchisees and almost always the majority of those fees are retained by the master franchisee. The more actively a franchisor participates in the master franchise business, or in controlling subfranchisees, the less attractive the financial arrangements inherent in master franchising become. To be successful in master franchising, franchisors will have to strike the right balance between control and financial return.
Kevin Maher has a broad-based business-transactional practice focusing on complex cross-border corporate and commercial contract matters, with a strong emphasis on global brand expansion and international business growth. His experience extends to cross-border joint venture transactions, international franchising, licensing and distribution transactions, international mergers and acquisitions, international regulatory compliance, multi-jurisdictional corporate reorganizations, international corporate formation and maintenance and international real estate and finance. He graduated cum laude from University of Dallas and summa cum laude from the Texas Tech University.

Mr. Maher routinely advises and counsels clients in various industries with respect to the myriad challenges and opportunities presented by expanding, acquiring, selling, financing, franchising and licensing brands and businesses on an international level.
John H Pratt  
Partner  
Hamilton Pratt  
Warwick, UK

John obtained his law degree from Oxford University and afterwards successfully completed a doctorate course in comparative law at the Universite d'Aix- Marseille. He is the senior partner of Hamilton Pratt, Europe’s largest specialist franchise law firm. He is the immediate past Legal Advisor to the British Franchise Association and a past Chair of the International Bar Association’s International Franchise Committee and Director of the American Bar Association’s International Franchising Division. He is currently Chair of Euro Franchise Lawyers. He has written “Franchising: Law & Practice”, “The Franchisor’s Handbook” and contributed chapters to a number of franchise publications. He is the joint editor of an upcoming ABA publication on franchising in Europe.
Tao Xu
Partner
DLA Piper LLP (US)
Reston, Virginia

Tao Xu devotes his practice to franchising and distribution matters, especially international franchising, licensing and distribution transactions. Tao counsels a broad range of clients in their international expansions, including master franchising, multi-unit licensing, area development, single-unit licensing and direct investment (both joint venture and wholly owned).

Tao is particularly active in food and beverage, hospitality and leisure, and retail industries, having acted for a number of high profile US brands in their international expansion efforts.

Tao is deeply involved in franchising activities in China, having both acted for a number of clients in entering the Chinese market and lobbied on behalf of the International Franchise Association in connection with the Chinese government's franchise regulations and their implementation rules.