FROM LOI TO CLOSING:
GETTING AN INTERNATIONAL FRANCHISE DEAL DONE

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October 15-17, 2014
Sheraton Seattle Hotel
Seattle, Washington

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I. INTRODUCTION

The franchisor has answered the question “Are you ready to expand internationally?” with a resounding “Yes, absolutely!” The authors approached this paper with the baseline assumption that some due diligence and legal analysis has been done at this point by the franchisor and its counsel in the course of readying itself to bring the brand to the international marketplace through franchising. For example, the franchisor is aware at a basic level of the need to protect its intellectual property, and has its principal trademark and domain names in the application process or better yet, fully registered. The company is prepared to dedicate the resources to open and support an international franchise business. It has identified a potential prospect with whom its salesperson has had several conversations. So now what?

Unlike the common scenario in domestic franchising, the positional power of the parties at the negotiation table for an international franchise deal may not be so one-sided, in favor of the franchisor. Quality international franchise prospects are often well-funded, experienced and sophisticated. The resources they bring to the table and the risk they are willing to undertake tends to result in them negotiating with the same fervor as if they were the brand owner. A systematic and standardized approach to documentation and negotiation, which is common with well-established franchise systems in the domestic marketplace, simply will not work in the international arena. Franchisors are well-served to have counsel involved at the initial stages of an international deal, and integrated throughout the negotiation process. For that to happen, attorneys need to possess an in depth knowledge of the business of the franchisor, an ability to balance the business goals with the legal considerations (which takes flexibility and creativity), and a willingness to work with others (including local counsel) to obtain the necessary local expertise.

Using the analogy of preparing and following a roadmap, the authors will discuss, as the title indicates, getting the deal done – specifically, what the parties should do to maneuver successfully from the letter of intent to the execution of the franchise contract. On this roadmap there are at times clear, absolute directions, but there are also potential detours, hazards and roadblocks along the way.

II. DUE DILIGENCE

Shouldn’t a franchisor’s due diligence be done far in advance of the letter of intent, which, as our paper’s title indicates, is the start of this journey? That is a fair question, and as stated in the introduction of this paper, the authors presume that by the time the parties reach the stage of entering into a letter of intent, many of the often written-about topics of due diligence regarding a franchisor’s ability to expand internationally have been covered.

The purpose of this section therefore is to focus on the more in-depth considerations that should be delved into when assessing the needs specific to a particular country and predicting the challenges that may be presented by a sophisticated party to the transaction. The use of

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1 The authors would like to thank Nixon Peabody LLP attorneys Diana Vilmenay, Pierce Han and Keri McWilliams for their assistance with this article.
local counsel, discussed in more detail in a subsequent section of the paper, is key at this stage. This due diligence may occur on parallel track with the discussion occurring internally and between the parties regarding the general approach and the specific business terms and legal provisions to include in the franchise documents. Each party in the negotiation knows the destination at the end of the roadmap, but they need to find out what the road ahead may bring during the negotiation and, importantly, to find out more about the party along for the ride.

For the franchisor, such due diligence topics include intellectual property, local laws and regulations of the applicable country (those dealing with disclosure and registration, for example), tax, supply chain, and knowledge of the franchisee. Having in-depth knowledge about how businesses operate in the country helps a franchisor to be better prepared to do business in the country with its franchisee and the consumers, to avoid surprises in the negotiation and better prepare the franchisor to argue for its positions during the drafting phase. Each of these items of due diligence can present barriers to the business from a time and expense standpoint – whether that is in the documentation phase, such as waiting periods associated with disclosure or governmental approval of registration or pose hurdles to getting the business up and running, such as getting money out of the country or product into the country. Attorneys can’t be expected to be experts in every area of the business in every country, but having an understanding of key aspects will serve counsel well by exhibiting that he or she understands and respects that other business team members should be brought into the process at an early stage. For example, the franchise attorney should be knowledgeable about the key tax issues that will arise when conducting business in a particular country, but also should involve the chief financial officer or other tax advisors for the company to take the analysis to the next level and to help the company be better prepared to actually conduct the business after the agreement is signed.

A. Intellectual Property

The intellectual property analysis, at this point, should be beyond whether to take the steps necessary to protect the principal trademarks of the franchisor. Analyzing the status of the trademark portfolio is not enough to appropriately prepare for a robust international negotiation. Sophisticated franchisees will presume that the brand’s key marks are protected in the target country and will argue that they are entering into the agreement based on assurances that the franchisor is the rightful owner of the system and the marks. On the other side, franchisors will argue that there is always an element of the unknown when entering into a new market, particularly with an agreement that spans a significant number of years. The parties’ focus during negotiation on intellectual property topics is therefore not on the issue of portfolio status, but rather on the various aspects that may impact their financial position over the course of the agreement and in the unfortunate circumstance of termination.

1. Trademark Registration

Registration of trademarks may often take many months or even years to achieve after counsel submits an application. A franchisor may find itself in a situation where some or all of the trademarks are in the registration process and therefore outright ownership is an unknown at the time the franchise agreement is being negotiated. Or, the target market may be a first to use jurisdiction rather than first to file, and a third party may present an unpredicted, yet valid claim. During the negotiation, the conversation on this topic may turn to determining who bears the risk, should a primary trademark under which the business operates need to be changed as a result of a valid third party claim. Franchise agreements commonly include language that the franchisee bears all responsibility (including related costs) for changes to the marks. But this
language is more difficult to sell to a franchisee if the marks are not yet registered and, in the case of many international deals, when significant resources are being put forth by the franchise at the onset (area fee, lease commitments, etc.). An alternative approach to consider is including a cost sharing mechanism (for example, the franchisor covering a portion or all of the franchisee’s costs to replace signage) and/or indemnification. Showing a willingness to share the risk in this area can be of significant benefit in a negotiation and in the relationship generally.

2. **Registered User or Similar Agreements**

Franchisees may be required to show proof to governmental authorities regarding their ability to use the franchisor’s trademarks in the country. The franchisor, in particular, needs to ask local counsel to confirm whether registration is necessary or just advisable and determine what type of document is best to file, if required. For example, preparing and registering a short form trademark agreement after execution of the full agreement is preferable as it keeps the other terms of the deal confidential. Further, the franchisor should analyze whether registration of the document could potentially trigger application of other laws, such as those related to agency or dealer protection (which in some countries can significantly impact the monetary considerations associated with non-renewal or termination).

3. **Injunctive Relief**

The procedure and timetable for a franchisor to get an injunction against a franchisee for trademark infringement or failure to de-identify after termination are not topics that would be discussed between the parties during the negotiation, but it is important for the franchisor to know as part of the overall risk assessment of bringing its brand to a particular country. The ability to get out of a deal is critical to determining whether to enter into it. Rarely will such an assessment stop a deal in its tracks, but it may be a tipping point should other factors not be stacking up – particularly if a franchisor is trying to establish a priority list for its international expansion opportunities.

4. **Ownership of Innovations**

It is important for the franchisor not to be caught flatfooted with an argument that public policy of the country does not allow for the franchisor to have ownership of innovations (an argument often raised by international franchisees). That may be the case, but the franchisor should be prepared in the context of the negotiation to offer an alternative. A franchisee will rarely come to the negotiation with an argument that they feel they have the right to own intellectual property associated with the brand. Instead, the argument will be based on the rationale that public policy dictates that as the only option. Franchisors and their counsel should predict the franchisees concern, so that they can offer a proposal to address their stated concern, thereby diffusing the argument. One potential solution to this issue is to craft language (with the help of local counsel, to ensure the necessary specifics are included) which contemplates an immediate transfer of all rights to innovations to the franchisor – it addresses the public policy argument, but still gives ultimate ownership to the franchisor.

B. **Local Laws and Regulations**

Franchisors, working with the expertise of local counsel, need to determine at the outset what laws may exist which may impact the sales process, the drafting of the contract, and the process for effectuating the document (including entering into any ancillary documents).
1. **Laws Regulating Franchising**

Counsel must be aware of these laws, and advise clients how they may impact the deal so as to avoid unnecessary surprises or frustration. For example, disclosure and/or registration laws can significantly impact the timing and expense related to a deal, and may restrict or dictate behavior in the sales process and negotiation phase.

2. **Laws Impacting Franchising**

Certain laws designed for application to other industries or for businesses generally may impact how a franchisor gathers information from the prospect, drafts language in the agreement and conducts business in the country. More information on certain of those laws is described in subsequent sections of this paper.

3. **Local Ownership Restrictions**

Whether local ownership restrictions exist may be quickly answered by the franchisee, particularly if it is already conducting business in the target market. Franchisors should seek independent confirmation, however, as that is not always the case. Franchisees, particularly those looking to add to their portfolio of brands or to diversify business interests, may desire entering into countries outside of their existing territory. Certainly, the franchisor should know such detail to ensure compliance, but it also can help to avoid wasting the franchisor’s valuable time. If, for example, an existing franchisee in the Middle East wants to obtain the franchise rights to the country of Kuwait, the franchisor should be knowledgeable about the ownership requirements of that country such that it can require the franchisee to find a local partner prior to going too far down the road of negotiating business terms of the deal. If the existing franchisee cannot find a suitable (to the franchisee and franchisor) partner, any time spent on negotiation may have been wasted.

C. **Tax**

Tax planning issues should be assessed by a franchisor when making the determination of how it wants to structure the franchisor entity for international business. Such advance tax planning is beyond the scope of this paper, but the section below addresses certain questions to consider when considering the tax treatment in the particular country and how they should be addressed in the relevant documents.

1. **Withholding Taxes**

A franchisor must have an understanding of the foreign withholding tax rates that may impact the fees remitted by the franchisee. An understanding is necessary to assess whether the franchisor will be able to take a tax credit, how and if a different characterization of fees may be more tax efficient, and how such fees should be addressed in the contract.

2. **Gross-Up Clauses**

A franchisor should determine at the outset whether it wants to include a gross-up clause, which would require that the franchisee pay the withholding tax payment, provide evidence to the franchisor, and still pay the full royalty amount as stated in the contract. These clauses can be extremely contentious, so a franchisor should determine at the start of a negotiation whether it is a critical element to the deal.
3. Transfer Pricing

Structuring the inter-company relationships between a franchisor and its affiliates and subsidiaries, particularly when the parties are located in different jurisdictions, should take into account the imposition of transfer pricing rules. Such rules generally require prices paid for goods and services supplied between related companies to be equivalent to that which are charged between unaffiliated parties. So, for instance, the commercial terms of any inter-company trademark licenses, services agreements and supply agreements should be assessed from this perspective.

D. Supply Chain

Counsel would or should not be expected to know all of the intricate details of a country’s import laws, but should know the pressure points such that it can tee up the issue for the appropriate business people to research – in this case, supply chain and potentially research and development (if alternative products will be considered). Certain restrictions on items such as poultry and dairy are not uncommon, so if a core menu item and key to the business model is fresh chicken wings or proprietary ice cream, it’s critical for counsel to advise clients at any early stage if limitations will cause barriers to entry. In some cases, the costs associated with tariffs and other trade impediments related to the importation of certain food ingredients can destroy the pricing model of the retail product and make the business model untenable.

E. Franchisee Information

It is commonly said that the most important element to a successful franchise relationship (domestic or abroad) is finding the right partner. Whether the research is required by law, advisable, or simply good practice, a large part of a franchisor’s due diligence is focused on the prospective franchisee. Certainly, the business team should request and review a business plan. The legal aspects of franchisee due diligence, however, are just as critical.

1. Required Due Diligence

The United States has anti-terrorism laws that prohibit a franchisor from conducting business with certain individuals or entities. At a minimum, franchisors must check the “specially designated national and blocked persons” (SDN) list maintained and monitored by the U.S. Department of Treasury’s Office of Foreign Assets Control (OFAC).

2. Advisable Due Diligence

A quick search of the SDN list may achieve compliance with legal requirements, but a franchisor should know much more about their franchisees and prior business dealings, prior to entering into a relationship. Some of this information can be obtained from third parties or other resources. For example, franchisors based in the U.S. should check to verify if the prospective franchisee is listed on any of the following lists maintained by the Bureau of Industry and Security (“BIS”) of the U.S. Department of Commerce: the Denied Persons List (those persons who have been denied export privileges), the Entity List (a listing of organizations that BIS has determined present a high level of proliferation concerns), and the Unverified Parties List (list of parties to transactions for which BIS could not perform a pre-license check or a post-license verification). Third parties are helpful with providing more in-depth background checks, which
can include items such as credit and financial history and litigation review, media hits, financial information, and the like.

Franchisors should seek additional documentation and data directly from the franchisee, to bulk up the information they gather in the due diligence phase. For example, franchisors should request certain documents (which will vary country to country) from the franchisee to reliably verify (a) who its shareholders are, (b) that it has the requisite corporate power to enter into the agreement and (c) that the person signing on behalf of the franchisee has the requisite power and authority to do so. These documents should be requested early in the process, as administrative matters can bog down the process and not get the appropriate attention once the parties move on to the business of closing the deal. The ownership information is particularly important, as U.S. franchisors will be subject to the Foreign Corrupt Practices Act (“FCPA”) and therefore should determine if the prospective franchisee or any of the key individuals of the franchisee is a foreign official, official of a foreign political party, a foreign political candidate or an officer of a public international organization. Finally, the franchisor should obtain from the franchisee other items as applicable, such as financial statements and past years’ tax returns for the company and each principal; resumes for each principal and key employees; banking and accounting information; and any personal guarantees or obligations currently imposed on the company and each principal.

III. LETTER OF INTENT

International franchise transactions are often complex, expensive, and lengthy. The timelines often referred to in connection with domestic franchising regarding “from lead to close” have no place in the context of an international deal. Negotiations can take months or even years, depending on the parties, the country, laws or regulations, etc. For those reasons, as well as many others to be discussed in this section, letters of intent and other similar so-called “preliminary agreements” are widely used precursors to more comprehensive, definitive and binding agreements. Letters of intent can be an important foundation on which to base the transaction. Using this paper’s roadmap analogy, the letter of intent is like the view taken from thousands of feet. It contains some of the key economic and business terms, but by no means does it include all of the detail contained in the definitive franchise agreement.

A. Assessing the Business Rationale

Just because letters of intent may be common in the international deal context does not mean they are necessary or appropriate for every franchisor or for every deal. In some cases, the time, effort and cost associated with the production of a letter of intent can slow the momentum of the transaction or lead to eventual deal fatigue. Franchisors should have an established rationale for using a letter of intent, and counsel and the sales team alike must be made aware of such rationale as it may dictate behavior of the negotiation team. Further, counsel may need to advise that the approach should change due to the unique circumstances of the deal or the market.

1. Streamline The Process

Often, the goal is to make a complex deal more efficient and cost effective. Having a letter of intent does not serve this purpose, however, unless certain other factors fall in line. First, parties must understand at the outset that the letter of intent is not to be heavily negotiated. This likely means that the sales team must be willing to have difficult discussions at the beginning of the relationship and hold firm on the company’s position on the tough issues
included in the letter of intent. In some cases, this can cause the deal to change, or even be lost, at an early stage. If a primary reason for including a letter of intent is to make the process more efficient, counsel should be prepared to advise that a franchisor forego the letter of intent if the main reason for entering into the document simply doesn’t fit with particular legal situation in the country or the practical realities of the context.

2. Obtain a Deposit to Offset Expenses

Franchisors may look to a deposit as a way to prove the seriousness of the candidate and to gain comfort about allocating resources toward the deal. A franchisor doing appropriate research on the market may start to expend resources at the initial stages of a deal negotiation, and expenses related to travel and seeking outside advice will ramp up quickly. Before assessing a deposit, franchisors should preliminarily consider whether the deposit will be refundable and if it is in addition to or will be deducted from any other initial fees paid in connection with the deal; what, if any, are the tax implications; and what is the potential application of franchise laws (discussed in more detail below). If taking a deposit triggers application of a disclosure law and such a fee is the key rationale, the franchisor may decide to skip the letter of intent for a particular deal.

B. Application of Franchise Laws

As discussed in a previous section, certain countries have laws that require registration and/or disclosure. Compliance with such laws becomes more complicated with franchisors that enter into letters of intent, since particular elements of the letter of intent (namely, execution collecting a deposit) may result in a violation of applicable franchise laws. Unfortunately, the applicability of the franchise laws in many jurisdictions is unclear, and may be reluctant to give a firm answer on whether such laws apply to a letter of intent, given the ambiguity. A summary of various countries’ franchise disclosure and registration laws suggests no uniform treatment of preliminary agreements.² Whereas certain jurisdictions, including certain provincial statutes in Canada and Italy, with its Rule on the Regulation of Franchising, each state quite clearly the application of the law to preliminary agreements, few other jurisdictions provide such good guidance.

C. Advantages of a Letter of Intent

The advantages to a letter of intent, when drafted carefully and executed well, can be significant. Entering into a letter of intent demonstrates the seriousness of the parties – showing some type of commitment prior to expending significant time and resources negotiating the franchise agreement. From the franchisor’s standpoint, particularly if the document includes (and local law permits) a deposit, it gives comfort that the franchisee is serious about the opportunity and shows that they are willing to have some skin in the game. Form the franchisee’s perspective, especially if there is an exclusivity period, a letter of intent demonstrates that the franchisor is not working deals simultaneously and/or wooing other candidates. A well-drafted letter of intent should isolate and memorialize key deal points; therefore in the process of negotiating the letter of intent, may identify deal breakers prior to the negotiation of the full franchise agreement, thereby saving expense and time. In addition, the

² Steven Goldman, Gaylen Knack, Jorge Mondragon, and Andrew Loewinger, Using Letters of Intent, Term Sheets and Other Interim Deal Documents in International Franchising in IBA/IFA 26th Annual Joint Conference, May 18-19, 2010 at 5.
letter of intent can serve as a check and balance against the over-promising salesperson who may not be representing the deal quite correctly or completely in the sales phase. For example, it is better to find out that the franchisee has no intention of providing a personal guaranty at the initial stage of the conversation rather than further down the road. Finally, where confidentiality covenants can be used, provides comfort to the parties making disclosures to one another that the content of such disclosure will be kept confidential.

D. Disadvantages of a Letter of Intent.

Entering into a letter of intent can also carry with it some significant risks. Fortunately, many such risks can be avoided with good training of the corporate team and careful drafting by the attorney.

1. Heavy Negotiation

The negotiation of the letter of intent can easily spiral into a full scale negotiation of all terms of the franchise agreement, and the parties can end up spending the time and expense they were looking to avoid with having a preliminary agreement. Detrimental to the process and perhaps the outcome, parties can risk losing future leverage by conducting too much detailed negotiation at such an early stage. Therefore, it is best to limit the letter of intent to the key financial and business terms. In the franchise context, these are generally fairly clear-cut: area fee, territory, development schedule, royalties, store fees, marketing, and additional security (letter of credit, personal guaranty, etc.). A franchisor should consider whether it will entertain significant negotiation of the letter of intent. One could argue that if the salesperson has done a good job describing the franchise offering, there shouldn’t be much disagreement or discussion on the key terms. The challenge often is to get the business team and the prospect to understand the true purpose of the document. If the letter of intent is not binding, the parties should have the discipline to hold the line and not be tempted to open the door to all details on all issues. Without such discipline, the letter of intent can have a negative impact on the process.

2. Liability

Perhaps the biggest risk to entering into a letter of intent is the liability that a party can face if a letter of intent is not drafted carefully. Although the authors are not aware of case law in the United States evidencing this issue in a franchise context, litigation over letters of intent (in which the deal does not come to fruition) is not uncommon. No better example exists than the case of Texaco, Inc. v. Pennzoil Co., where the court found that the “memorandum of agreement” had all the essential elements of a contract, even though the parties had open terms and referenced a future definitive agreement. The court determined that the memorandum, in connection with that other action (namely, press releases issued by the parties) demonstrated an intent to be bound, resulting in an award to Pennzoil of over $10 billion. The results of this decision point to certain key drafting and behavior tips for the franchisor. If no binding intent is contemplated, it is critical to use words clearly delineating that fact, such as “would,” “possible” and “proposed.” Conversely, use binding words such as “shall” and “must” only if you mean them. Counsel should advise that the franchisor’s post-signing conduct must be consistent with the non-binding nature. It is important that the business team

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3 729 S.W.2d 768 (Tex. App 1987).
understands what verbal and non-verbal communication may be had, the risks of partial performance; the care that must be used if issuing any press release language, etc.

IV. STRUCTURING AND NEGOTIATING

There is no single structure that is ideal for every international transaction and, therefore, no single road leading to the ultimate goal. The structure chosen for a particular transaction is often a function of the business objectives and practices of the franchisor, the expectations and goals of the franchisee, as well as the market forces and business environment in the target market. These factors, and others, will dictate the road and direction to be taken.

Considering the unique advantages and disadvantages of the available structures will enable a franchisor to choose the most appropriate structure that best coincides with its goals and the realities of the circumstances in which the transaction will occur. Factors which influence these choices include the degree to which the franchisor wishes to maintain control over growth and unit franchise operations, the immediate and long term resource requirements necessary to grow the brand, the speed at which the system is desired or expected to grow in the target market, and others.

The selection of an appropriate structure is the first step. Successful implementation is a longer term and more sustained process which requires consideration and treatment of various legal and practical issues. The following identifies and discusses those issues within the context of the more commonly used expansion structures.

A. Unit Franchise

In a unit franchise model, a franchisor contracts individually and directly with single unit franchisees abroad. As such, a franchisor retains a large degree of control due to having privity of contract with each of the franchise operators. The direct relationship between franchisor and franchisee enables a franchisor to enforce contractual obligations directly against its counterparties.

This structure works best for a franchisor seeking high levels of involvement and revenue because it will control selection and oversight of franchisees and keep the entirety of the revenue generated by the system. By its nature, unit franchise development tends to result in a slower pace of franchisee recruitment, which, combined with the capital-intensive nature of the structure, tends to result in unit franchise development having a slower growth rate.

1. Corporate Planning

As with any mode of international expansion, the selection or creation of the appropriate legal entity to act as franchisor must be made. In some cases, the existing entity can be used. In other instances, it is more appropriate to use a newly formed entity, created pursuant to domestic or local law, or even a third party jurisdiction on account of particular tax treatment or corporate planning. The choice will be driven principally by tax considerations, including:

□ the realities of withholding tax compliance,

□ the need or expectation to return funds to the domestic market,
the degree to which a franchisor desires to implement corporate structuring to shield certain entities from contractual and other liabilities in home or foreign jurisdictions.

In a unit franchising model, the existence of many contracts with unit franchisees increases the number of relationships and transactions and thus gives rise to greater potential for contractual and other liability. Depending on local law, a newly formed franchisor entity abroad can be used to protect the domestic franchisor and the assets it has developed at home. Where new entities are formed, particularly where related companies exist in different jurisdictions, inter-company agreements should be used in order to satisfy transfer pricing rules and otherwise to flow funds between entities. Tax advice should be sought on all such issues.

2. Contractual Matters

Direct contractual relationships with unit franchisees results in the need to have a standard form unit franchise agreement prepared or revised for use in local markets. Local counsel should be retained to ensure that documentation is legally compliant and also conforms to local custom and practice. At the very least, provisions should be included to deal with currency, withholding tax compliance and governing law.

3. Administrative Requirements

Unit franchise development can be resource intensive and require substantial initial investment since unit franchisees tend to have less capital and less business knowledge compared to master or area franchisees. As a result, a franchisor must be prepared to compensate for lower levels of capital and business knowledge by providing more training and assistance. The existence of multiple franchisee relationships in a unit franchising model requires the commitment of management, administrative and oversight functions that are more significant than in other models, such as master franchising. Additionally, a franchisor must expend resources to resolve issues specific to the target market since assistance or expertise from local intermediaries, such as a master franchisee, is unavailable. Planning for these expenses and the investment of time should be done.

While the advantages of increased control are attractive, the slower and more capital intensive nature of unit franchise development results in it not often being considered the most commonly used structure for international expansion.

B. Area Development

Area development arrangements allow a franchisor to grant a single party, the developer, the right to build and operate a specified number of franchises within a defined geographical area and a specified time period. This method of structuring is most commonly applied when a franchisor seeks to maintain control over individual units but prefers to recruit and contract with a single party for multiple unit ownership. Although area development agreements allow a franchisor to retain contractual control, the degree of practical or management control may be lower than in unit franchising due to the increased sophistication of the area developer and the reality that the area developer may command more power as a result of controlling a large number and concentration of franchised units.

As a result of working with a small group of developers in larger markets rather than disparate groups of unit operators, there is the potential for rapid rates of growth within those
particular geographic regions. Additionally, if the area developer is a more sophisticated and better capitalized party, a franchisor may be able to invest less capital, as well as incur lower administrative, training, and monitoring costs.

1. **Corporate Planning**

Due to the fact that the franchisor will enter into multiple unit franchise agreements with the area developer, the corporate planning considerations under an area development model are substantially similar to those relevant to unit franchising.

2. **Contractual Matters**

Typically, a franchisor and area developer will enter into an area development agreement which sets out the terms and conditions of the franchise development plan, as well as individual unit agreements that govern the operation of each unit. In such cases, at least two separate forms of agreement will need to be prepared for use in local markets. A less common option is to combine these agreements so that unit agreements need not be signed each time a unit is to be developed, especially when dealing in jurisdictions with disclosure or registration requirements that require ongoing disclosure as contracts are executed. Such an approach also may save administrative hassle throughout the relationship and put franchisees at ease that the terms of the deal cannot be altered in a future form of franchise agreement.

Generally, such arrangements require the area developer to build and operate the units directly, without a right to sub-franchise. However, in some cases, for convenience of ownership, insulation from liability, or other reasons, the area developer may be permitted to conduct the unit businesses through wholly-owned subsidiaries or affiliated entities in which it has complete or majority control. In those latter cases, care should be taken to ensure that ownership of those entities is restricted to the area developer itself (without outside investment, or if permitted, under controlled circumstances) to avoid rights being granted, indirectly, to unwanted parties.

While a particular advantage of area development may be the consolidation of recruitment efforts, training and other resource deployment into a single operating party in the local market, a franchisor also assumes some substantial risk if it awards large markets to area developers who are not strong operators or who lack a willingness or ability to build the required number of units within the specified time period. As such, it is essential to include specific expansion plans, imposed through development schedules, in the area development agreement, as well as clearly defined consequences for missing targets.

3. **Administrative Requirements**

Area developers require intensive training by a franchisor in order to successfully develop and operate franchises on a larger scale. On the other hand, the area developer often has localized knowledge and expertise necessary to resolve specific problems and to provide information regarding local laws and regulations. Additionally, if the area developer is more sophisticated and better capitalized, a franchisor may be able to invest less capital, as well as incur lower administrative, training, and monitoring costs. Given these realities, the parties should identify the strengths and weaknesses of each other and specifically allocate responsibilities within their agreements for key tasks.
C. Area Representative

Under area representative arrangements, a franchisor allows a local party to market the franchises, recruit franchisees, and train and support franchisees on a franchisor’s behalf. The area representative will often pay a fee for the right to control a specific territory in this manner. The role is often analogized to that of a broker or agent since the area representative acts on behalf of the franchisor and usually reserves the right to receive a fee or portion of the sale and post sale revenue. Granting rights to multiple area representatives in multiple markets at the same time has the potential to result in the most aggressive growth rates. Area representatives also provide franchisors with insight into the target market, and can often assist with local operational issues, such as supply chain and sourcing issues.

1. Corporate Planning

Because the franchisor will ultimately contract directly with unit franchisees, this structure triggers similar structuring and tax issues as would be applicable under a direct franchising model. However, the area representative may be regarded as an agent of the franchisor and could have the effect of invoking a permanent establishment on behalf of the franchisor in the local market and thus subject it to local taxation. Care should be given to the manner in which commissions and other fees are paid to the area representative because revenue paid out of the local market to the franchisor and then commissioned paid back could result in a double taxable event.

2. Contractual Matters

Area representative agreements should include specific development expectations but should similarly ensure that the area representative makes responsible selections and has ongoing obligations with respect to the development and growth of the franchisees that it has selected. In the absence of those requirements (such as consideration being given for ongoing servicing of the unit franchisees) the area representative may be less inclined to assist in the recruitment and on-boarding of quality franchisee candidates. Back-loaded commissions or fees payable can be used to incentivize long term commitments. If the franchisor chooses to allow the area representative to deliver disclosure documents on its behalf to franchisees then the obligation to do so should be clear and should provide strong indemnities (with security or guarantees) in the case liability flows from errors made by the area representative.

3. Administrative Requirements

While area representatives are involved in the selection of franchisees, a franchisor should still retain the right to issue final approval of unit franchisees. This requires a degree of oversight and involvement in the activities and recruitment process of the area representative. It also requires the franchisor to monitor, train and communicate often with the area representative to ensure that the area representative is acting on the instructions of the franchisor and that appropriate candidates are selected and brought forward. As a result of delegating some, but not all, recruitment obligations to an area representative, a franchisor should invest more focus on monitoring and enforcing its contracts with the unit franchisees.

D. Master Franchise

A central aspect of master franchise arrangements is the shift in responsibility from a franchisor to a master franchisee for developing the franchise system in the local market. This is
achieved by granting a master franchisee the right to sub-franchise, to entities that it controls or
to third parties in the local market, the right to operate individual units. This structure is most
often employed when a franchisor lacks the resources or local market knowledge to develop a
target market without the assistance of a third party, or otherwise wishes to impose the
substantial task of franchise recruitment, training, enforcement and other “franchisor-like”
responsibilities on that third party. Another benefit to this structure is that it allows a franchisor to
enter target markets without having to directly navigate many “on the ground” issues. Further,
master franchise arrangements minimize the investment required of a franchisor to achieve
accelerated system growth and brand marketing.

While the partial shift in responsibility may be considered an advantage of master
franchising, there are also corresponding drawbacks. Since master franchisees bear much
responsibility and risk, it is often the case that master franchisees demand a large percentage
of the royalty and other revenue from sub-franchisees. Additionally, a franchisor’s lack of system
control is considered a serious shortcoming. While a franchisor will still be able to exert some
control over the system, particularly through its oversight and policing function, and the
enforcement of the master franchise agreement, the degree of control will be lower than if a
franchisor had direct contractual relations with operators, such as through unit franchise
agreements.

1. Corporate Planning

In a master franchising scenario, the franchisor will contract with a single entity abroad.
Accounting and withholding tax issues are simplified in this case, given that a franchisor has a
master franchisee as a single point of contact in the local market and therefore the franchisor
has fewer transactions for which to account. In this scenario a franchisor can also reduce the
risk that it will be found to have a permanent establishment in the local market, and thus be
subject to local taxes, since the franchisor will have less involvement and business dealings “on
the ground” in the local market where the master franchisee operates. These factors should be
considered when creating a master franchise model.

In any event, the royalties and other fees flowing back to the franchisor from the master
franchisee will be subject to withholding tax, as well as many of the same factors relevant to unit
franchising. Having said that, it would be rare for a franchisor to form and license a subsidiary
entity for purposes of sublicensing to a master franchisee to then further sublicense into the
local market. In many cases, the existing franchisor is used to contract with the master
franchisee who then sublicenses into the local market.

2. Contractual Matters

The preparation of a master franchise agreement is an important and significant
undertaking since this agreement forms the only means by which the franchisor controls the use
of its brand by a multitude of foreign parties with which it has no contractual relationship.

A franchisor should consider whether the master franchise agreement will include such
requirement for a master franchisee to operate its own units in addition to sub-franchising those
rights to third parties, and if so, in what manner (i.e., operated by the master franchisee itself, or
by wholly owned subsidiaries that are licensed by the master franchisee). A franchisor will
sometimes require the local party to operate a single outlet itself at the outset to acquire the
necessary knowledge of the system. This enables the franchisor to verify that the local party can
operate the business effectively in the market. The franchisor will sometimes require that the
master franchisee continuously operate at least one unit to fully appreciate the market and what the sub-franchisees may encounter. Before imposing this obligation, a franchisor should understand that requiring a master franchisee to undertake the role of a unit franchisee may divert attention and resources away from those necessary to developing the system as the master franchisee. As stated above, requiring the master franchisee to operate units may help to ensure that the master franchisee has the “hands on” skills, experience and knowledge necessary to train and guide sub-franchisees, and can also showcase that the master franchisee has a shared commitment to the success of the business model. It is worth noting that certain jurisdictions may require the provision of a disclosure document each time a unit agreement is executed, and in such cases, provisions avoiding the requirement to execute new agreements for each unit should be considered.

The nature of a master franchisee’s right to sub-franchise additional territorial grants (for example, where a master franchisee obtains rights to a region comprised of multiple countries and then licenses sub-master franchise rights to a party in one or more of those countries) should also be properly contemplated. Allowing a master franchisee to grant sub-master franchise rights and obligations to other parties will create additional contractual layers within the franchise system and further distance the franchisor from unit operators. It also reduces the share of the revenue available for each of the parties. In any event, this is a contingency that should be addressed in the master franchise agreement.

The contractual gap caused by the lack of privity between a franchisor and the sub-franchisees presents particular challenges in cases where the master franchise agreement is terminated, expires, or there is otherwise a disruption in the relationship between the franchisor and the master franchisee. Care should be taken to contemplate such contingencies in order to provide for continuity of the business if the master franchisee has to be replaced. While master franchise agreements will often provide that the franchisor should be made a third party beneficiary of the subfranchise agreements, there are many jurisdictions that do not recognize such a concept and will therefore not permit a franchisor (who is not party to the subfranchise agreement) to enforce rights in this manner. In such cases, that reality ought to be considered, and if necessary, alternative approaches taken. Ultimately, a franchisor that permits subfranchising will typically choose to sacrifice some control to avoid certain obligations and forms of liability. Accordingly, a franchisor may seek to retain control by:

- Mandating the form of subfranchise agreement that will be used in the territory;
- Retaining the right to approve any proposed subfranchisee candidates;
- Retaining the right to approve suggested locations for the franchised business;
- Requiring that the master franchisee establish compliance and risk management processes that must be satisfied as part of the franchisee recruitment and location selection process; and
- Exercising control over the training of subfranchisees.
3. Administrative Requirements

While much of the ongoing administration of the system abroad is done by the master franchisee, the initial work of selecting the master franchisee is essential. Success is dependent on a master franchisee’s ability to replicate and sustain the franchise system in its local market. Franchisors are best to choose a party with the capital, market knowledge, and management capacity to fulfill the obligations under the master franchise agreement. It is also beneficial if the candidate has business experience, political connections, and knowledge of local laws and standards. Franchisors often restrict when subfranchisees may be appointed to ensure that the franchisee does not try to expand the system in the territory before it is appropriate to do so. The skills required to become a successful franchisor are different from the skills required to operate the businesses successfully.

E. Joint Ventures

Under a joint venture arrangement, a franchisor will typically share ownership of an operating entity with a local partner. In a traditional joint venture model, a franchisor usually contributes a license of its trademarks, know-how and ongoing operational support to the operating entity, while the local partner contributes capital, human resources, local market experience and management. However, ultimately, a joint venture arrangement is a creature of contract and will vary based on the arrangement agreed to by a franchisor and the local party. In this context a franchisor must work alongside a “partner” who has a joint interest in the franchisor’s brand and business. This requires a certain ceding of power and control and generally requires a franchisor to produce a return for the local party providing target market expertise. Further, joint ventures reduce the financial return to a franchisor given the shared nature of the agreement with the local partner. On the other hand, a joint ventures partner contributes market expertise, knowledge of local customs, valuable business information, and political contacts. These attributes can allow a franchisor to enter the target market relatively quickly.

This vehicle for international expansion is most commonly used when the franchisor believes that there is a need for local presence, has selected a key or strategic operating partner, and seeks to reduce the potential for direct financial risk. It can also be used as an alternative to “pure” franchising models in cases where the franchisor wishes to maintain a higher degree of control and/or ownership in a local market.

1. Corporate Planning

In most joint venture arrangements, a franchisor and a local partner will together own a separate operating entity in a local market that will either develop franchise units itself (in which case the joint venture entity is effective an area developer) or sublicense rights to do so to third parties (in which case the joint venture entity is effectively a master franchisee). The operating entity in these cases will, on one hand, be licensed rights by the franchisor, and on the other, receive financing and other contributions from the local partner. Properly contemplating and documenting the relationship between the franchisor, the local partner, and the joint venture entity is essential, especially given that the franchisor will act both as a licensor and an owner of the operating entity. The various relationships should be made clear, rights and obligations owing between them specified, and agreements executed to confirm the relationships. In some cases, it may be prudent for a franchisor to form a new entity to act as the shareholder or owner.
of the joint venture entity in order to remove the franchisor from the ownership scheme associated with the joint venture arrangement.

One should consider that in most cases a joint venture is typically considered a separate taxable entity locally as a result of it being party to a separate license or franchise agreement with the franchisor pursuant to which some kind of royalty is paid. On the other hand, a franchisor should be cognizant of transfer pricing rules since the joint venture does not operate at arm’s length of the franchisor.

2. Contractual Matters

The joint venture agreement should include the respective rights and duties of each party, including the activities the joint venture is authorized to undertake, the amount of capital contributions to be made by each party, the allocation of profits, losses, control and decision-making authority. At the same time, the joint venture entity will need to be licensed by the franchisor in order for it to use the intellectual property, trademarks and other benefits of the system. The franchise or license agreement may be anything from standard in form to heavily negotiated by the local partner. In any event, the joint venture agreement and the franchise or license agreement must work together to enable the franchisor the ability to exercise its respective rights in a manner that is not encumbered by the terms, conditions or restrictions in one or both agreements. In short, the contractual matrix must be considered and drafted within the overarching context of the overall relationship of the parties.

Additionally, attention should be given to termination provisions in the various agreements. A franchisor must consider possible exit strategies and situations which will enable the termination of the joint venture agreement, the franchise agreement, or both. It is wise to draft the joint venture agreement to ensure a franchisor is able to withdraw from the agreements in certain circumstances without having any encumbrances on its intellectual property, branding or know-how. In short, the franchisor should never contribute its intellectual property to the joint venture entity. In other cases, it might make sense to enable the franchisor to dispose of interests in the joint venture entity or any commonly owned unit franchises and to maintain interests only as the franchisor or licensor of the joint venture entity. Care should be taken to ensure that these terms can be enforced without interference or complication by the terms of any of the other agreements. Drafting such clear contractual terms can be tricky, especially where negotiations result in unique or complicated revisions.

3. Administrative Requirements

Joint ventures require a franchisor to analyze local operating laws as much or more than other types of structures given that a franchisor is a part owner of a business established through local laws. This is particularly so because the local partner will often have the benefit of “home court advantage” as a result of the joint venture being operated in its own jurisdiction. Careful review and oversight of rules and their interaction with the rules of the franchisor’s home jurisdiction is essential. A franchisor would be wise to obtain independent legal advice in respect of its own affairs, separate and apart from those of the joint venture entity.

F. Negotiating Strategies

International franchise agreements are almost always subject to negotiation. Parties to an international negotiation must tailor their approach to reflect the unique cultural, social, and legal norms of the target market. Whereas a hard-line approaches to negotiation may find
success domestically, these approaches are unlikely to succeed in international negotiations where, depending on the nature of the transaction, the counterparty may be more sophisticated and command more flexibility. International negotiations require a willingness to build consensus among the parties, understand the various cultural backgrounds and practices, and incorporate those practices into the negotiation strategy.

Successful negotiations involve interaction between a franchisor’s commercial and legal teams. Building relationships with the commercial team should be one of the legal counsel’s first steps in an international negotiation. The commercial and legal teams can most effectively advance the needs of a franchisor by combining their legal and commercial expertise.

Parties to an international negotiation must also engage local counsel in negotiations. Effective negotiations of a transaction require the incorporation of the practices and laws of the target market. A franchisor’s legal team will be better able to understand these unique factors by working with local counsel throughout the negotiation process.

Respecting the local market is another important element of successful international negotiations. Failure to recognize the nuances of the local market may cause counter productivity. For instance, if a franchisor’s legal counsel decides to take a firm approach on every issue, the negotiation may not progress if such a strategy violates cultural or legal norms of the target market. Negotiation practices in that local market may demand that counsel justify their positions rather than merely asserting their position. Thus, a franchisor’s counsel could develop a more effective approach by being culturally sensitive and adapting processes and approaches to the environment in which the negotiation takes place.

V. USING LOCAL COUNSEL

A. Retaining Local Counsel – Franchisor vs. Outside Counsel

Since the practice of franchise law is a specialty area that requires a mix of legal acumen and relevant experience, careful selection of local counsel is necessary in order to ensure that proper expertise and transactional experience is brought to bear on the range of issues that must be encountered when proceeding with an international franchise transaction. While there is no single method for retaining local counsel, there are two general approaches that can be used. Either a franchisor can seek out and retain local counsel to provide legal services directly to and for a franchisor, or a franchisor can arrange for its existing domestic counsel to seek out and retain local counsel to provide legal services to and for domestic counsel who will then work together with local counsel to achieve a franchisor’s goals.

There are various considerations a franchisor must take into account when deciding on the method of retaining local counsel:

1. Establishing the Attorney-Client Relationship

On the one hand, a franchisor may not wish to retain local counsel directly because of the real or perceived need to undertake the upfront work of establishing and negotiating a retainer and the administrative costs associated with such a process. On the other hand, a franchisor seeking high levels of involvement and control over the process and over local counsel may prefer to select the local advisor on its own and establish a direct retainer with local counsel.
There may be a lack of confidence or trust by a franchisor that is tasked with the job of sourcing and establishing a new relationship with unknown counsel in another jurisdiction. Franchisors of this kind may prefer to put that task in the hands of its domestic counsel and entrust its existing advisor to source and engage competent local counsel from its own network or referral sources.

Selecting and engaging local counsel directly will have the highest likelihood of success if in-house or domestic counsel is able to adequately advise and guide local counsel. Domestic counsel, who possesses the experience of working with the franchisor, should be relied upon to share information with local counsel, including any established practices, areas of comfort and sensitivity, and guidance on the general approach and perspective of the franchisor relative to certain common issues or questions.

2. Obtaining and Confirming Terms

Understanding cost and project scope are vital, and the degree to which local counsel can communicate clearly on such matters should assist in the selection process. In some cases, it will be worthwhile to obtain and compare estimates from a variety of sources. An inquiring franchisor should not hesitate to ask for a list of lawyers that will staff the file, their core capabilities and billing rates and their expected levels of involvement. In order to avoid surprises, local counsel should be asked to provide clarity on the limits of the retainer, what work, if any, is not being provided, as well as areas where there is potential for time and cost to escalate.

Confirmation should be sought in respect of the currency in which legal fees are paid, and at what times or intervals, and whether and to what extent those fees are subject to applicable foreign taxes. Most local counsel will require the payment of a monetary retainer. A franchisor should confirm the manner or form in which advice will be provided, whether it be in written or oral form. If preference is for advice to be in written form, a franchisor should be clear on the length, tone and scope of written materials provided.

The franchisor, at a minimum, should discuss with the local counsel the following items at the outset:

□ The franchisor's expectations, billing and payment procedures and terms.

□ Running a conflicts checks on the franchisor, your client.

□ Having local counsel provide a specific list of those authorized timekeepers that can work on the matter and requiring that any additional timekeepers be approved in writing by you and/or the Franchisor.

3. Formalizing the Retainer

Whatever choice is made should be formalized in an engagement letter where the relationships are made clear, conflicts of interests (if any) disclosed and addressed, and the financial terms of the engagement established. Fee quotes and timelines, if agreed upon, should be memorialized. In some instances, it might be prudent to establish a retainer with local counsel (separate from the day to day retainer) in order to capture any particular engagement terms relative to the international transaction.
In order to control costs, a franchisor may wish to be clear about the various roles of its advisors to avoid duplication and promote efficiency. A franchisor will need to determine and communicate the desired degree to which in-house and domestic counsel will maintain continual involvement in the file as the transaction progresses. This is likely a function of the confidence a franchisor has in its various advisors, the complexity and scope of the transaction, and the degree to which domestic and local legal and business issues demand attention. These issues can be set out in the engagement letters, or more informally through discussion.

B. Finding the Right Local Counsel

It has already been stated that franchise law is a specialized practice area. Providing competent representation on an international franchise transaction is even more nuanced and specialized, as it includes not only a keen knowledge of the business and legal concepts that underpin franchising, but also the interaction and relationship between a franchisor’s domestic law and the local law of the jurisdiction in which franchise rights are being granted. For those reasons, finding the right local counsel can be a difficult task.

While there is no single way to find competent local counsel, there are many reliable sources that can be consulted.

1. Domestic Counsel or Local Advisor

A referral from a franchisor’s domestic counsel, or from another trusted lawyer or advisor who has previously used counsel specialized in franchising or international business transactions in the target country, can minimize the risk of retaining inadequate local counsel. Multiple referrals can be made in order to compare various fee estimates to one another. References and peer reviews can be valuable sources of information on proposed local counsel and should be sought.

2. Industry Group Databases

To find local counsel in a particular jurisdiction, consult databases or listings lawyers published by:

- American Bar Association Forum on Franchising (consult the membership directory or post an inquiry on the organization’s listserv);
- International Bar Association;
- International Who’s Who of Franchise Lawyers; and
- Chambers Global

Local franchise associations, or other relevant trade organizations that operate in the jurisdiction in which local counsel is required can also be considered.

3. Core Competencies of Local Counsel

When choosing local counsel, one must be mindful that not all local counsel may be familiar with the intricacies of franchise law and the practice of advising clients that operate in this space. To minimize the risk of choosing local counsel who is unable to address a
franchisor's particular needs, particular consideration should be given to certain core competencies, including:

Local counsel should be familiar with the business and legal aspects of franchising, including unit franchising, area development, master franchising, joint ventures and other manners of franchising structuring and should be able to provide advice on the benefits, disadvantages, risks and opportunities associated with all such structures.

While knowledge of franchising is indispensable, successful representation on an international transaction requires skill and experience in general and international corporate and transactional matters, intellectual property, tax, licensing and distribution, and international dispute resolution. Further, local counsel should be able to communicate in the franchisor's principal language, be familiar with the franchisor's business or industry, and be knowledgeable about the local government agencies that regulate franchising.

Other advantages that local counsel might bring to the table can include having contacts with other local advisors, such as accounting and financial advisors, real estate brokers, franchise salespersons, operations managers, training staff, and so on.

Ultimately, the best local counsel is one that can provide timely, practical and excellent legal advice, but who also possesses the ability to expedite the expansion plan by unlocking key business relationships and opportunities on behalf of its client.

C. Working with Local Counsel

In order to establish a thorough and appropriate plan, and to avoid the possibility of encountering costly surprises along the way, local counsel should be involved in the process as early as possible. Whether that is to provide substantive legal advice on threshold issues or fundamental questions of structure or direction, or to provide general guidance on key steps and timelines, it is best to seek out and obtain local advice before major decisions are made or key agreements reached.

1. Division of Labor

As noted above, avoiding duplication and promoting efficiency can be accomplished where both domestic and local counsel are clear on their respective roles. The manner in which the work is divided is often dictated by the deal itself, such as the nature of the target market, the structure of the transaction, the competencies of the various lawyers, and the pressures of cost and time. The same approach may not work for the same deal done in different markets, nor different deals done in the same markets. For instance, greater involvement of local counsel might be required for a master franchise transaction (due to the added complexities of subfranchising), where local law and custom are complicated, or other reasons. For a multi-unit development deal in a “similar” market, while local counsel is required, more sustained involvement may be appropriate from domestic counsel. Most important is for expectations to be clear, responsibilities to be allocated, and action items and deliverables completed as required.

2. Initial Documentation and Steps

Local counsel should be consulted no later than when a franchisor is ready to prepare a letter of intent or any other preliminary documentation. It is imperative that local counsel be consulted at these preliminary stages since a franchisor or domestic counsel may be unaware
of local laws preventing or complicating the process of preparing and/or executing such
documents. As noted above in this article, the taking of fees, or deposits, can also be
complicated by local law and should similarly not be done until advice on such matters are
sought.

Other issues that require sufficient lead time and early stage consultation include
trademark and other intellectual property applications and registrations, franchise disclosure
preparation and registration, corporate and tax planning, and so on. These matters should be
considered early on in the process, even before substantive discussions take place on the terms
of the franchise agreements themselves.

3. Papering the Deal Documents

After completing the preliminary documentation, domestic counsel and local counsel will
often work together to prepare the remaining documents, including the franchise agreements
and disclosure documents. Deciding how to involve local counsel in document preparation will
vary based on the form and content of the documents that the franchisor has already prepared
for use in its home market or in other international transactions and the laws in effect in the
target country.

For instance, if the target market has franchise laws mandating pre-sale disclosure, then
local counsel may ask domestic counsel to provide domestic versions of franchise disclosure
materials in order to adapt existing materials to conform to the disclosure regime of the target
market. Further, franchisors will often have created template forms of agreements that
correspond to the laws and practices of their home countries. In such cases, domestic counsel
may simply rely on local counsel to review and tailor those templates to address the laws and
practices of the target market. In other cases, due to legal or business reasons, new forms of
documents can be created using precedents provided by local counsel. Where possible, forms
used in foreign markets should be consistent with those in domestic markets in order to promote
system-wide consistency.

4. Negotiation Practices

Following the preparation of documents, the parties must agree on how to negotiate the
terms of the agreements. This decision should hinge on which party can best address and
promote the franchisor’s goals. For example, if the deal involves many local market issues and
unique cultural considerations, local counsel may take charge given its familiarity with market
conditions. In contrast, domestic counsel may take the lead if the particular transaction is similar
to prior deals that they have negotiated. In either case, both parties should rely on one another
for advice, guidance and to share collective experiences and practices.

Domestic counsel and local counsel must maintain a supportive relationship throughout
the process. Both counsel share the common goal of assisting their mutual client in the most
efficient and practical manner to bring about the desired outcome. With that goal in mind, both
counsel must maintain open communication, avoid duplication and generally work in a
cooperative manner. Miscommunication and a lack of trust from either party can result in
duplicating effort, escalating costs, and the client’s goals not being achieved.
D. Consequences of Not Using Local Counsel

Using local counsel provides an important and distinct perspective to the legal and business issues that arise in international franchise transactions because local counsel should be able to provide information regarding the target market’s laws and policies that might otherwise be unknown to a franchisor and its domestic advisors. Neglecting to use local counsel, whether in whole or in a complete and responsible manner, can be costly and dangerous for a franchisor. In such cases, a franchisor is taking the risk of expending resources on documents and processes that may not be useful or applicable in the target country, or worse, result in ill-conceived materials, agreements, documents and relationships which are susceptible to legal or business risk.

Failing to employ local counsel also presents challenges for a franchisor’s domestic counsel. There is often a tendency for domestic counsel to follow clients as their franchise systems expand globally and to want to provide advisory functions along the way. This practice is often borne out of counsel’s relentless pursuit of protecting and accompanying the client in its growth plans. But lawyers must learn to recognize foreign legal issues and be careful not to counsel clients on matters on which counsel has no ability or permission to advise. Matters of competency and jurisdictional licensure are relevant in this context and can prevent domestic counsel from providing substantive legal advice applicable to a foreign market. Counsel should always be aware of the limits on its ability to provide legal advice and operate within those confines.

VI. COMMON TARGET COUNTRY LEGAL ISSUES TO BE ADDRESSED WITH LOCAL COUNSEL

A franchisor expanding internationally must review and analyze the laws and regulations of the target country that impact expansion. Often, this legislation dictates the modifications and changes to the franchise system that are necessary for its successful deployment in the target country. Below are a number of such legal considerations that should be reviewed with local counsel.

A. Government Approvals, Registrations, Ownership and Filing Requirements

1. Background

An increasing number of countries have enacted regulations specifically affecting franchising. These laws include disclosure requirements providing for the preparation and delivery of a franchise disclosure document at a certain time before the execution of a definitive franchise agreement and/or the exchange of any consideration. Other countries have enacted self-regulatory or voluntary disclosure requirements through government agencies or franchise associations. For example, in 1994, the Franchise Association of South Africa (FASA) made the use of a disclosure document by franchisors a condition of membership. Today, the FASA’s disclosure requirements are stronger than those required under franchise legislation contained in that country’s Consumer Protection Act, 2008. See id. at 330.
franchise laws requiring registrations, approvals, and/or filings with local government authorities before the offer or sale of a franchise. Other requirements could even include competition authority approvals, trademark license filings, and central bank approvals. Compliance with these laws is important to ensure the enforceability of the franchise agreement. Therefore, any franchisor counsel to any franchisor expanding internationally should discuss with local counsel (whether directly or through domestic counsel) in the target countries any significant legal issues for the franchisor before negotiations begin with the prospective franchisee.

2. **Considerations**

A few examples of these regulatory requirements are explored below:

- **Franchisor registration.** Before expanding to the target country, franchise counsel must determine whether the target country requires the franchisor to register with any governmental authorities prior to offering or selling franchises or potentially even prior to entering into a letter of intent. For example, a franchisor planning to sell franchises in Spain, Malaysia, Indonesia, or Vietnam must first complete a filing with the relevant governing authority.\(^6\) Such foreign registrations and filings may be required to be updated annually and/or when an individual franchise is sold. Non-compliance with these registration requirements may invalidate a franchise agreement or bar its enforcement.

- **Statutory requirements.** Many countries regulate the franchise relationship itself, as opposed to or in addition to regulating sales process. These countries require the franchisor to submit transactions for approval of their specific terms and conditions, including types and amounts of fees, choice of law provisions, termination rights, and non-competition provisions. Alternatively, these jurisdictions provide statutory requirements that dictate certain aspects of the franchise relationship.\(^7\)

- **Trademark license filings.** Some countries require the filing of the franchise agreement or a short form license agreement that shows that the trademarks used in the franchise system have been licensed to the local franchisee for use in the target country. Generally, the documents must be translated into the local language before their submission. Examples of countries with trademark authorities that require the filing of franchise agreements or the

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\(^7\) See John Sotos, “Recent Trends in Franchise Relationship Laws” at 7 (undated paper presented by the International Franchising Committee at the IBA Annual Conference in Dubai on Oct. 30, 2011 to Nov. 4, 2011).
short form license agreements include Brazil, Columbia, Ecuador, Guatemala, Peru, and Panama.\textsuperscript{8}

B. Pre-Sale Disclosure

1. Background

As previously referenced, a growing number of countries require disclosures of specific information to potential franchisees prior to the execution of an agreement or the payment of any monies by the franchisee.\textsuperscript{9} The scope and types of information will vary from country to country. In the case of newly enacted legislation, compliance with disclosure laws may prove difficult due to the vague or untested wording of the relevant legislation. Further, government regulators, if there are any in such jurisdictions, may not have had sufficient time to consider how the disclosure law should be interpreted or the practical implications of complying with such regulations.

2. Considerations

When a jurisdiction has a disclosure law regime, legal counsel should consider what constitutes a “franchise.” Countries’ laws vary in their definition of the term. Consideration should be given to whether a particular arrangement at issue falls within the local definition of the term. The definition of “franchise” should include a grant of rights, a plan or system related to the franchised business, and a fee or other compensation to be paid. Many business arrangements that do not appear to be “franchises” may be caught by broadly applicable definitions.

Certain versions of disclosure legislation may not provide for any applicable exemptions but counsel should confirm whether local regulatory authorities have the discretion to exempt a franchise agreement from regulatory requirements.

Once counsel has determined that the disclosure law is applicable, counsel must determine who must provide disclosure (i.e., franchisor; master franchisee; franchise consultant, agent, or broker). Different jurisdictions impose the obligation to provide a disclosure document on different parties.

Another question to explore is who must receive disclosure. Depending on the proposed transaction, counsel must determine, for example, whether a renewing or transferee franchisee or master franchisee must be “disclosed” and, if so, whether there are any exemptions for such disclosure.

\textsuperscript{8} One resource to confirm the existence of the trademark license filing requirements in other target countries is Trademarks Throughout the World (Edward Fennessy and International Contributors, Thomson Reuters 2014), \url{http://legalsolutions.thomsonreuters.com/law-products/Treatises/Trademarks- Throughout-The-World/p/100027620}.

\textsuperscript{9} These countries include Australia, Belgium, Brazil, Canada (Alberta, Manitoba, New Brunswick, Ontario, and Prince Edward Island), China, France, Germany, Indonesia, Italy, Japan, Macau, Malaysia, Mexico, Romania, South Africa, South Korea, Spain, Sweden, Taiwan, Tunisia, the United States, and Vietnam; see International Franchise Sales Laws (Andrew P. Loewinger & Michael K. Lindsey, eds., ABA, Aug. 2010).
The applicable timing for disclosure is also a critical issue. Counsel must know when disclosure must be provided (i.e., What is the timing for disclosure? Do letters of intent trigger disclosure? What are the acceptable methods of delivery of disclosure document? Are there any on-going disclosure obligations?). A disclosure law may require that a certain number of days must pass between delivery of the disclosure document to the potential franchisee and the execution of an agreement or payment of monies by the franchisee. Some countries have no specified waiting period after the disclosure document is delivered, while others have no requirement to provide pre-sale disclosure at all.

Finally, counsel should be aware of whether there are any continuing disclosure obligations. In cases where there is a grant of development or master franchise rights, and accordingly multiple agreements to be signed over a period of time, counsel should inquire whether a disclosure obligation is triggered in connection with the execution of each such agreement. If so, a franchisor should be prepared to make continual disclosure in the local market, or investigate options which might enable such an obligation to be avoided.

C. Relationship Laws

1. Background

Some jurisdictions have enacted relationship legislation in addition to or as an alternative to the more common disclosure and registration laws described above. While disclosure laws strive to provide protection to the franchisee prior to executing a franchise agreement, relationship laws aim to protect the on-going business arrangement of the parties after signing a franchise agreement. Typically, these laws restrict franchisors’ power over franchisees in certain areas of the franchise arrangement. This is because franchise agreements are commonly viewed as contracts of adhesion and several jurisdictions have determined that statutory intervention is necessary to mitigate the power imbalance that exists between franchisees and franchisors. Given the growing number of target countries that have enacted such laws, counsel would be well-advised to take these laws into account when drafting their franchise agreements.\(^\text{10}\)

2. Considerations

A practitioner should review whether a jurisdiction has any applicable relationship laws when considering the following issues:\(^\text{11}\)

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\(^\text{10}\) See Sotos, supra note 7.

\(^\text{11}\) With the few exceptions of “disclosure only” jurisdictions, the majority of franchise regulations around the world contain both pre-contractual disclosure and on-going relationship components; a small number of other countries have chosen to use “relationship only” regulations. Certain countries, such as Australia, Belarus, Canada, China, Lithuania, Macau, Malaysia, Romania, Russia, South Africa, South Korea, Ukraine, the United States, and Vietnam, have enacted either franchise specific or consumer protection legislation which features explicit relationship regulations. In contrast, other countries, such as Albania, Angola, Estonia, France, Georgia, Indonesia, Italy, Japan, Kyrgyzstan, Mexico, Moldova, Mongolia, the Province of Quebec in Canada, Saudi Arabia, Tunisia, and Venezuela, have more minimalist regulatory regimes with respect to franchise relationship laws that arise out of their respective Civil Codes; see id.
□ **Good faith and fair dealing between the parties.** Generally speaking, the franchisor and franchisee have an obligation to deal with each other fairly and honestly in a manner that does not destroy the right of the other to receive its bargained benefits under the agreement. When a party breaches that duty, the other party to the arrangement has a right of action for damages. This duty is reflected in various laws around the globe. In civil law jurisdictions it applies to the franchise relationship because the franchise agreement is a type of commercial contract governed by the target country’s civil code.

□ **Unjust terminations.** Some jurisdictions have enacted specific relationship laws governing the requirements for termination. These procedural requirements could include providing written notice, the reasons for termination and an opportunity to cure the default.

□ **Other restrictions.** Other areas of concern include demanding a general release or waivers of claims by the franchisee; prohibitions on interference with franchisee associations and the right to associate; discriminating between franchisees; restrictions on the franchisees’ right to assign or transfer; restrictions on the right to renew; and encroachment on franchisee territories.

D. **Tax and Corporate Structure**

1. **Background**

   The applicable taxes can vary widely by country. Typically, as noted elsewhere in this paper, withholding taxes will be charged on royalty, interest, and similar payments from a franchisee to a franchisor residing outside of the target country. The franchisee will generally be required to calculate, withhold, and remit such taxes to the target country tax authorities. The franchisee will also be required to provide the franchisor tax receipts for the payments made so that the franchisor can claim foreign tax credits in its home country based on international tax treaties that may exist between the franchisor’s home country and foreign jurisdictions. If such treaties are applicable, they should be considered to determine if tax relief of some form is available or if there are other issues that may arise.

   Some international franchisors require a gross-up of all fees including a component for any taxes withheld in the target country. The “tax gross-up” method shifts the burden of target country withholding taxes to the franchisee. The franchisee pays both the withholding tax and the royalties (or other applicable fees) at the full contract rate agreed to by the parties.

2. **Considerations**

   Here are some points to consider:

   □ **Increased Fees.** Sophisticated franchisees will often resist a gross-up requirement. A franchisor that is expecting such a response may choose to increase the fees it would have otherwise expected to receive before engaging in negotiations on the gross-up so that if the gross-up provision is lost in negotiation (such that taxes are withheld) the franchisor will be less impacted by the reduced income.
Tax Credit. In most cases, the taxes withheld by the franchisee in its home jurisdiction (on behalf of the franchisor) can be offset by the franchisor against the taxes it owes in its home jurisdiction in the form of a tax credit. In a gross-up scenario, the franchisor will obtain the immediate benefit of the grossed-up amount but also the subsequent benefit of the tax credit from the government authorities in the course of its tax filings. In those cases, out of fairness, a franchisor might elect to reimburse the franchisee for its withholding tax payments to the extent that the franchisor receives foreign tax credits for withholding taxes paid by the franchisee. If this is done, the franchisor can mitigate the negative financial impact on the franchisee. This mitigation method is complicated by the challenges of calculating allowable foreign tax credits. It may not work where the target country government objects to any provision that benefits the franchisor at the franchisee’s expense.

Unbundling. The “unbundling” method is another technique for avoiding foreign withholding tax issues. “Passive” income, such as royalties, is taxed in some target countries at higher rates than “active” income earned for the provision of services. Such services would include field supervision, training, and business counseling. The “unbundling” method separates the fees assessed for trademark and business system usage—the passive income—and the fees that compensate the franchisor for training, consultation, and other benefits or services provided by franchisor—the active income. Each set of unbundled fees are subsequently taxed at the applicable rate. This may result in tax savings for the franchisor.

E. Payment Issues – Currency Restrictions and Funds Repatriation

1. Background

Some target countries require that any commercial transactions within their borders be conducted in the domestic currency of the country. Other countries restrict the amount of domestic currency that can be converted into foreign currency, restrict the amount of foreign currency that can be withdrawn from the country, or prohibit funds to be expatriated at all.

If appropriate funds cannot be withdrawn from the target country, it may be necessary to leave all profits earned in the target country for further expansion opportunities or as an offset against expenses incurred in the country. As an alternative, the franchisor may acquire products available in the target country with domestic currency, and thereafter sell such products in the free market to obtain freely tradable currency.

The franchisor should take care to avoid any potential issues involving any applicable currency restrictions and funds repatriation, volatility in the international currency market, and uncertainty with respect to the specific payment of currency and conversion of funds. The franchisor should require payments be made in the currency of its home country and place of incorporation. The franchisor should also provide that the franchisee bear the responsibility and costs of converting local currency. This, however, is often a point of negotiation and can result in some form of shared risk.
2. **Considerations**

There are a few points to consider for U.S.-based franchisors when working with local counsel to draft these provisions, prepare for deals in particular countries and subsequently negotiate terms. As an initial inquiry, counsel should determine whether there are any specific restrictions concerning the exchange, repatriation or remittance of payments in U.S. Dollars.

In the franchise agreement, the franchisor should specify that local currency should be converted to U.S. Dollars at the electronic transfer selling rate for dollars quoted by a national U.S. bank or an internationally recognized bank that is of equivalent size and reputation. Counsel to a franchisor should provide that costs of conversion from local currency to U.S. Dollars should be borne by the franchisee. The agreement should also state that termination of the franchise agreement is appropriate if the currency control or restriction remains in effect for a specified period of time.

In jurisdictions where local law prohibits repatriation of funds to the franchisor’s home country, a franchisor should consider providing that payments be made by (i) any guarantors who have accounts outside the local country under their guarantees, while such guarantors can recover funds paid directly from the franchisee within the local country; (ii) an alternate currency such as pounds sterling instead of U.S. Dollars; or (iii) third party services or barter of assets (of the franchisee or guarantor) in the amount of fees owed.

F. **Governing Law and Venue**

1. **Background**

Each of the franchisor and the franchisee will typically want the governing law of the franchise agreement to be the law of its home country. In other cases, depending on the jurisdiction of the transaction, the relationship may be required to be governed by local law and have a venue within such jurisdictions. Contracts which provide otherwise can be made unenforceable to the extent they seek to avoid local law and venue.

2. **Considerations**

Regardless of the choice of law, often parties to the franchise agreement will seek remedies before target country courts even if only to enforce arbitral or judicial awards or decisions granted in the home country. In most countries, the courts of the host country will generally hold the parties to the laws of another jurisdiction so long as (i) the parties have agreed to it and (ii) the choice of law does not conflict with domestic public policy.

G. **Sales Agency Law**

1. **Background**

The relationship between franchisor and franchisee is not typically considered an agency relationship in most countries. However, in certain countries franchisees may be deemed agents of the franchisor and are subject to commercial agency or sales representative laws. These laws protect sales agents who market and distribute the products or services of a principal.

They often entitle the franchisee to reasonable compensation or indemnification, which is triggered upon a termination of the relationship without “good cause.” Compensation in some instances may be triggered regardless of the reason upon any termination or expiration of the franchise agreement. Other agency laws in some countries define “good cause” narrowly such that a franchisee will almost certainly be entitled to compensation upon any expiration or termination of the agreement.

The amount of compensation that may be owed to the franchisee under an agency law varies and is often left to the discretion of local courts and may include the franchisee’s actual investment and a reasonable prediction of future profits. A standard award would be the equivalent of one year’s total profits (averaged over four to five years) of the franchisee and may even include compensation for goodwill and any unused inventory.

Several jurisdictions require that a franchise agreement be registered with a government agency in the target country in order for the franchise agreement to be deemed a commercial agency agreement.

2. Considerations

In order to avoid registration, the drafter of an international franchise agreement should consider whether the franchisee itself can be at least partially owned by foreign nationals of the target country, and thus ineligible to serve as a commercial agent. Alternatively, a franchisor could also include features in the agreement that would make the overall relationship more difficult to register, or refrain from execution formalities required in the registration process. Other franchisors may be able to negotiate indemnities and seek protection against the exposure arising out of registration under the commercial agency laws.

Another option may be to require the franchisee to obtain a letter of credit or to provide a bank guaranty in an amount likely to be obtained under the applicable agency law. If that is unsuccessful, a franchisor could also seek to impose liquidated damages.

If the parties include foreign choice of law provisions, they may stand a better chance to avoid application of any agency laws altogether. Of course, a statement in the franchise agreement disclaiming the application of the agency law may also prove helpful.

H. Transfer Restrictions

1. Background

In most jurisdictions, a franchisor is able to establish procedures and conditions governing the transfer of any interests in the franchisee, the franchise agreement, or the assets of the franchised business. Alternatively, or in addition, a franchisor may wish to impose such restrictions in the charter documents and other corporate documents of the franchisee. These steps attempt to ensure that the party that the franchisor has carefully selected to act as franchisee cannot assign its position to a third party without proper consent. However, local laws affecting such transfers must be canvassed to determine whether there are limitations or other issues impacting such restrictions. Particular care should be given to ensuring that the transfer conditions are customized or otherwise adapted to local law, are reasonable where required, and that the conditions reflect the realities of the particular relationship between the parties.
2. **Considerations**

While most jurisdictions permit franchisors to impose restrictions, not all jurisdictions allow franchisors to obtain injunctive relief to prevent an improper transfer. In such cases, other measures must be considered where an unapproved transfer is advanced by a franchisee. For instance, many countries limit relief for the breach of a transfer restriction to termination of the franchise agreement or damages. Thus, franchisors must be aware that the likelihood of restrictions on transfer being upheld will depend on the jurisdiction in which the franchise operates.

It is also advisable for franchisors to carefully draft transfer provisions to reflect the intention to control the transfer and its process. A franchisor, not limited by statute to act reasonably, may seek to reserve the right to act unreasonably and arbitrarily when refusing transfer requests. In other jurisdictions the transfer may not be denied unreasonably, and in such cases, it may be advisable to have the parties acknowledge the reasonableness of the transfer restriction.

I. **Import and Customs Laws**

1. **Background**

   The ability of a franchisor to export personnel, training materials, software, equipment, suppliers, food inventories, technical equipment and other items into foreign countries is often central to the success of the franchise system. As such, a franchisor must carefully review domestic laws governing exports, duties, and customs, as well as import rules and other applicable laws in the target country. Restrictions on what can be imported or exported, qualifications regarding to whom goods and services can be delivered, and the duties and other costs to be paid on items shipped between the home and target country vary based on the jurisdictions at issue. In some cases, proprietary goods or services manufactured in a home market must be distributed to other markets for use in preparing retail products or otherwise as part of a wholesale supply chain. Where restrictions are imposed on such distribution the impact on the franchise business, in economic terms, can be substantial.

2. **Considerations**

   A franchisor should discuss with local counsel whether the target country requires government approval to import necessary products, equipment, supplies, and services for the franchise system, and specific franchise agreement language regarding who bears the costs for visas or work permits for certain specified personnel for training and/or inspection.

   Countries typically have classifications for import items that correspond with the amount of duty to be paid. Specific research into such requirements should be done at the outset and factored into the financial model of the transaction both at the outset and over time. That research should also include the costs of downstream parties in the supply chain including subfranchisees and the consuming public.

J. **Guaranties and Other Security**

1. **Background**
A guaranty or another type of security helps to reduce the inherent risk in international franchise arrangements because it provides a backup source for payment of the franchisee’s financial obligations and assurances that other obligations under the franchise agreement will be performed. A personal or corporate guaranty will provide the franchisor with additional security in the form of the personal or corporate assets of the guarantor rather than relying upon a franchisee or corporate shell entity with limited or few assets. This added protection allows the franchisor to better protect its trade secrets, enforce non-competes and recover monies owed by the franchisee.

Personal guaranties are more common since many franchisees are owned and operated by individuals. Further, the individual owners may determine that the potential risk associated with a personal guaranty is preferable to upfront costs that come with letters of credit or bank guaranties. While less common, a corporate guaranty may be provided where the franchisee is owned by another entity and that entity has adequate capital to support the guaranty. Other forms of security may include letters of credit and bank guaranties which are useful in that funds may be drawn from them without having to enforce the terms of the franchise agreement before a tribunal in the franchisee’s country.13

While guaranties in franchise agreements are permitted in most jurisdictions, several require certain execution formalities or format requirements for guaranties.14 Consequently, a franchisor’s form guaranty may not suffice for a particular country. Local counsel may help navigate through particular jurisdictional requirements. For example, in the Cayman Islands, consideration is required for all agreements except for agreements made by deed. One common issue with guaranties involves whether consideration has been paid for the guaranty itself. For this reason, local practice suggests that guaranties should be signed as a deed. As another example, a best practice in the Middle East and North Africa is to have guaranties translated and have signatures notarized and authenticated.15

2. Considerations

The franchisor should request the following, if applicable: (i) a guaranty from the individual owners or corporate parents of the corporate franchisee; (ii) an indemnity from the guarantors in favor of the franchisor; (iii) bank guaranties; (iv) letters of credit; and/or (v) a security interest granted by the franchisee in its assets or the assets of a related party. The franchisor should also work with counsel to confirm that the guaranty will likely be enforced in the target jurisdiction and to determine any particular form or execution formalities.

K. Anti-terrorism

1. Background

U.S. and other foreign laws regarding anti-terrorism and anti-corruption may impact the sale or operation of an international franchise. A violation of such laws does not have to be


14 Id.

15 Id.
purposeful or knowing to result in legal problems for a franchisor. Officers and directors of a franchisor in prohibited transactions may become personally liable regardless of the specific terms in the agreement. Thus, it is recommended that franchisors perform a comprehensive background check of any potential franchisees before executing the definitive franchise documents, conduct comprehensive training internally, include specific language in the contract (including requirements for the franchisee to submit ongoing certifications or other assurances).

For example, the Foreign Corrupt Practices Act (“FCPA”), a U.S. federal law that applies broadly to practically every individual or company with nexus to the United States, prohibits bribery of public officials and political candidates to obtain an improper advantage in doing business. The penalties for violation of the FCPA are onerous and can result in criminal and civil fines and imprisonment.\textsuperscript{16} The Office of Foreign Assets Control (OFAC), U.S. Department of Treasury overseas and enforces economic sanctions against terrorists, criminals, countries and governments.\textsuperscript{17} These laws apply to U.S. entities and may also apply to their affiliates, employees, foreign subsidiaries and related persons.\textsuperscript{18}

\section*{2. Considerations}

In light of the foregoing, the agreement should contain provisions requiring compliance with anti-terrorism law such as Executive Order 13224 issued by the President of the United States, the Terrorism Sanctions Regulations (Title 31, Part 595 of the U.S. Code of Federal Regulations), the Foreign Terrorist Organizations Sanctions Regulations (Title 31, Part 597 of the U.S. Code of Federal Regulations), and the USA PATRIOT Act among others. It should also require the franchisee to acknowledge that neither it nor any of its owners or affiliates appears on the list of Specially Designated Nationals and Blocked Persons published by OFAC and available at: http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx or that it or any of its owners or affiliates is controlled by, acts for on or on behalf of the government of any country that is the target of economic sanctions administered by OFAC. As a best practice, the agreement should also contain provisions requiring compliance with anti-corruption laws such as the FCPA and the U.K. Bribery Act of April 2010. Another important consideration is to require franchisees to certify compliance with business codes of ethical code and/or internal compliance programs that explain the franchisor’s policies and procedures regarding foreign trade, export controls, bribery, economic sanctions, etc.

\section*{L. Termination and Renewal Issues.}

\subsection*{1. Background}

The term of an international franchise agreement is typically expressed for a certain number of years and extension or renewal rights are usually included. Conditions of renewal will be similar to those provided for in the franchisor’s home country unit franchise agreement.


\textsuperscript{17} \textit{Id.}

\textsuperscript{18} \textit{Id.}
Post-term rights and obligations of the parties must be provided for in the agreement, if the document expires or terminates. By way of example, the franchisee may be allowed to continue as a subfranchisor on a non-exclusive basis and to operate its existing owned or operated outlets. However, further development rights for additional units will normally terminate. Alternatively, if the franchisee is precluded from continued operation of the franchise system, de-identification obligations of the franchisee and its subfranchisees must be stipulated. In some instances, the franchisor may include a right to purchase or otherwise take assignment of the franchisee’s and the subfranchisees’ outlets on expiration.

2. Considerations

A few examples of points to consider when working with local counsel to draft provisions related to renewal, expiration and termination:

- **Renewals.** Typically, the number and length of renewal terms will be included in any provision related to renewals. The conditions for renewals may include execution of the then-current form of international unit franchise agreement conformed for use in accordance with the local territory; execution of a release; satisfactory operation of the franchised business; no defaults by the franchisee; satisfaction of all monetary obligations; compliance of store or unit with then-current requirements for the franchised business; renovation including all repairs, replacements or acquisitions of updated furniture, fixtures, equipment and computer hardware and software; and training.

- **Expiration.** The franchisee or the franchisor typically provides notice of its election not to renew within a certain time frame prior to the end of the then-current term. If the franchisor elects not to renew and the lease underlying the franchise agreement has not expired, the international franchise agreement provides that the franchisor has an option to operate the franchised business until the lease expires or to buy back the franchised business at an established value. Conditions on expiration include return of the franchisor’s proprietary materials and payment of all fees due. See also Section 7 (Term and Post-Term Rights and Obligations).

- **Termination.** Upon expiration or termination of the international franchise agreement, an agreement will typically include post-term covenants such as the return of the franchisor’s proprietary materials, including operations manuals, agreements, advertising and promotional materials, products and supplies, and trademarked products on a pre-determined formula or third-party determination basis.

The post-term non-compete covenant of the franchisee requires an understanding and application of applicable laws in the target country, as well as the definition of prohibited activities, the geographical scope of application, and the time period for the covenant. A drafter will also need to determine the persons to whom the covenant applies, such as the franchisee, principals of the franchisee, family members, and designated shareholders.
M. Privacy/IT

1. Background

Franchise systems typically collect, store, and use personal information gathered from sales information, website, emails, and through Internet transactions with customers. Personal data of the franchisee may also be collected from application forms, interview notes, performance reviews and field assessments. Certain jurisdictions have enacted specific privacy and data protection laws that control the manner in which information is obtained, stored and used, particularly in cases when such information is moved across national borders. These practices should be modified to account for local laws.

2. Considerations

It is recommended to require the franchisee to adopt adequate security safeguards for its computer systems and to abide by the franchisor’s privacy policies regarding the collection, protection and destruction of customer information that complies with the then-current privacy and data protection laws of the host and home country. Additionally, the franchisee should covenant that the protection of privacy and customer information is a continuing obligation, which survives the termination or expiration of any franchise agreement. The franchisee should also covenant to promptly notify the franchisor of any material security breaches of customer information, confidential information or trademark infringement.

VII. COMMON LEGAL AND BUSINESS ISSUES TO BE NEGOTIATED IN THE FRANCHISE AGREEMENT

There is no such document as a “standard” franchise agreement in the international context, as agreements of this type commonly need revisions based on local law, and are nearly always negotiated to some extent, often heavily. A checklist of “standard” issues is helpful to refer to when negotiating any international franchise deal.

Preparing a “standard” form of international franchise agreement complicates the issue further. The typical drafting issues must be considered in addition to legal, socio-economic, cultural, linguistic, and commercial factors of two or more countries. A number of these issues are explained below:

A. General Considerations

As an initial step in drafting an international franchise agreement, many lawyers who represent franchisors with a domestic franchise system start the drafting process by “internationalizing” their client’s domestic form franchise agreement. Starting with the domestic form may prove to be an efficient means to create an international agreement since many of the

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core provisions and concepts will already be present. This can ensure consistency between the forms to the extent possible. Annual updates or modifications to domestic and/or international forms in the future, for example, should be easier to reflect across forms that share a common basis and structure.

To create an international form franchise agreement, counsel to a U.S.-based franchisor should take the domestic form franchise agreement and consider, at the very least, the following suggestions:

- If applicable, change currency references to specifically reference U.S. Dollars and specify the currency in which payment must be made;
- Change mile references to kilometers;
- Add a trademark addendum listing the specific trademarks of the franchise system that are being licensed, registered or pending in the jurisdiction;
- Add a paragraph dealing with withholding taxes by the foreign franchisee;
- Verify that gross-up provisions, if any, are enforceable in the jurisdiction;
- Add an English language requirement for notices and correspondence under the franchise agreement; specify that if the agreement is translated, the English language version of the agreement will govern;
- Remove references to the Franchise Disclosure Document or FDD where appropriate;
- Remove references to in applicable U.S. laws (e.g. ADA, U.S. Bankruptcy Code);
- Remove references to “state” and “federal” – change to national and local;
- Remove references to attorneys and attorney's fees. Change to legal fees;
- Revise dispute resolution paragraphs to refer to international rules and procedures where appropriate;
- Conduct a search throughout the document for use of the abbreviation and term - U.S., United States, and make sure all references have been updated as necessary;
- Add “Country” or “Territory” as a defined term;
- Specify that the system and business model were developed in the U.S.;
- Consider changing governing law of the agreement to accord with applicable local law;
- Change references to financials and audits to be in accordance with generally accepted accounting standards in the target jurisdiction; and
Add provisions regarding applicable foreign privacy laws where appropriate.

B. Territorial Rights and Limitations

To the extent granted, the franchisor must define the scope of the franchise system for which exclusivity is being granted. Territorial rights and limitations are particularly sensitive for international franchisees, who often feel strongly about obtaining exclusive rights to the brand and its products in the target country. Most franchisees will seek a franchise agreement that provides them the exclusive geographical right, license, and privilege to use the franchise system in a local segment of the market or the entire jurisdiction. Exclusivity in terms of the territorial restrictions applicable to the franchisee should be clearly defined. A map or description of the boundaries as they exist at the time of executing the franchise agreement could be included in the agreement. Exclusivity issues are not, however, limited to geographical considerations. Rather, defining the nature of exclusive rights is equally important as the territory in which the rights are to be exercised.

It is not uncommon for a franchisor to grant third parties, other than the franchisee, exclusive or reserved rights to sell the franchisor’s products or services within the territory granted to a franchisee. If this is the case, these rights must be specifically carved out in any documents being drafted or under consideration.

Notwithstanding the exclusive rights granted to a franchisee, most international franchisors reserve to themselves certain rights, such as the right to acquire a competitor or be acquired by a competitor, to sell the same or similar products or services associated with the franchise system or the right to sell such products or services through other channels of trade, including the Internet, or to specific customers, and national or international accounts. These reserved rights often place the franchisor in competition with the franchisee or its subfranchisees, so the franchisor may be required to disclose those reservations depending on the laws of the relevant jurisdictions. In any event, clauses dealing with such reserved rights should be clear, unambiguous and fulsome.

Because an international franchisor imparts know-how, trade secrets, and confidential information relating to the operation of the franchised business, the franchisee should covenant to deal exclusively with the franchisor and the franchise system, and not to compete (at least during the term of the franchise agreement). Any such covenants require a number of drafting considerations, including the geographical scope of the restriction, to whom the covenant will apply, and exceptions for potential existing businesses of the franchisee. In the international context it is common for franchisees to have the development and/or operation rights to more than one brand. The franchisee’s business portfolio at the time of entering into the contract, as well as its future plans, should be discussed during the negotiation and drafted for accordingly.

Finally, if international franchisees wish to expand the franchise system beyond the boundaries of the target country to adjoining countries or markets, rights of first refusal or options to develop additional countries may be provided for in an international franchise agreement. These rights are often granted when the adjoining countries have similar cultural, language, and/or commercial characteristics and may also require that certain quotas or target sales figures be reached before the rights may be exercised. They may have time restrictions on the exercise of the options following which the options will be forfeited.
C. Fees

The initial fee for international franchise rights is typically calculated in one of two ways. It is either a fixed fee or a fee based on quota or performance. Franchisors may frequently underestimate the costs involved in expanding their franchise systems internationally, particularly in less developed or emerging target countries. Accordingly some franchisors recoup their costs by requiring the reimbursement of their expenses in developing products and services for the franchise system for target markets. Examples of reimbursed costs may include:

- expenses incurred in connection with governmental reviews, registrations, and approvals; and
- expenses incurred by the franchisor for training the franchisee and its staff, communications expenses, translation and other development costs for the operations manual and other materials, and legal and other professional costs incurred related to the development of the franchise system documents.

As for fees for the opening of individual franchisee locations, the agreement may provide for payment to the franchisor of fees for a specific number of initial or additional outlets. Fees may be incurred on a fixed-amount basis, a per unit basis, or in accordance with some formula basis. Agreements typically express continuing fees as a royalty percentage of gross sales or revenues of the franchisee. Continuing fees may also be expressed on a fixed-fee basis for each unit developed. Fees may be expressed on a constant or variable percentage. Alternatively, the agreement may provide for minimum periodic fees, usually on a quarterly or annual basis.

Definitions of gross or net sales typically provide for certain exclusions, including refunds, discounts, taxes, and other similar non-profit items to the franchisee. In some instances, the fees will be subject to an inflation factor or adjustment based on a cost of living or other index. This type of adjustment is especially important in jurisdictions with historically high inflation records.

The agreement must describe the mechanics for payment, including the frequency of payment, any interest on late payments, and the methods of payment. For example, the agreement could provide for payment to a designated bank account of a franchisor. If withholding taxes are exigible on fees paid to the international franchisor from the target country, the agreement may be written to break up specific components of the fees into certain services that may not be subject to withholding tax. These components may include technical assistance services, training, rights to know-how, trademark license fees, site selection, inspection, and consultation fees.

D. Development of Territory

International franchise agreements often specify development rights and obligations of the franchisee defined in terms of a specific number of outlets that are required to be owned and operated by the franchisee or by sub-franchisees within a specified period. These rights will often be defined in a development schedule. The schedule will set forth the aggregate number of outlets that must be opened and in operation at the end of each development period. The relevant provision must also cover replacement obligations in the case of any closed or terminated outlets and the ability of the franchisee to carry forward outlets developed beyond the schedule requirements.
In most agreements, the franchisee is required to own and operate at least one and perhaps more franchise outlets. The agreement may provide that the franchisee must open and operate a certain number of outlets itself or own and operate outlets for a certain period before being allowed to subfranchise (which is a consideration in itself). The franchisee may also be required to own and operate a specified number of outlets during the term of the agreement to be allowed to continue subfranchising.

For outlets to be developed by subfranchisees, the franchisor may require that certain information be provided to it before approving such outlets or subfranchisees. The franchisor may stipulate site selection criteria and franchisee selection criteria rather than approving each outlet and subfranchisee individually. As an alternative, the franchisor may require the right to approve each site either during an initial period or during the entire term of the franchise agreement.

As for development obligations, the franchisor must establish clear growth targets with the franchisee. Often, development targets in international franchise agreements are not met.\(^{21}\) To counter this, international franchisors should consider growth incentives and providing rewards for good performance. For example, if a franchisee opens more than “x” complying units in a particular city or region within “y” period, it may be granted the right of first refusal over additional territory.

If the franchisee fails to comply with its development obligations, a number of alternatives may be triggered. The most severe would be the termination of the franchise agreement. Alternatively, the franchisee’s development rights may be terminated. Under this scenario, the franchisee would continue to service existing subfranchisees. The franchisee may also trigger the right to continue limited development on a right of first refusal basis, or its exclusivity may be terminated. This would allow the franchisee to continue developing but in competition with the franchisor or some other newly appointed franchisee.

Surrendering of a portion of the territory for which exclusive rights were granted could be another consequence of failing to comply with the development schedule. This would permit the franchisor to further develop the territory or to enter into a franchise or other agreement with a new franchisee or developer.

Yet another alternative when drafting development obligations is to require the parties to renegotiate a reduced development schedule. This may be a viable option particularly when the franchisee may be able to demonstrate that the original development schedule was unrealistic because of economic or market changes.

\(^{21}\) See, e.g., Arturs Kalnins, *Biting Off More Than They Can Chew: Unfulfilled Development Commitments in International Master Franchising Ventures*, 5.12 CHR REPORTS 1, 8 (2005). Specifically, research revealed that in a sample of 142 ventures of 53 U.S.-based franchisors in 37 countries: (1) only 55 (39 percent) of the ventures survived to the end of the development term which was typically five years; (2) the median number of units that were intended to be open was 34; (3) of the 55 ventures that survived to the end of the development term, the median number of units opened was 3; and (4) only six (11 percent) of the ventures satisfied their development obligations.
E. **Term and Post-Term Rights and Obligations**

The term of an international franchise agreement is typically expressed for a certain number of years and extension or renewal rights are usually included. Conditions of renewal will be similar to those provided for in the franchisor’s home country unit franchise agreement.

Post-term rights and obligations of the parties must be provided for in the agreement, if the document expires or terminates. The franchisee may be allowed to continue as a subfranchisor on a non-exclusive basis and to operate its existing owned or operated outlets. However, further development rights for additional units will normally terminate. Alternatively, if the franchisee is precluded from continued operation of the franchise system, de-identification obligations of the franchisee and its subfranchisees must be stipulated. In some instances, the franchisor may include a right to purchase the franchisee’s and the subfranchisees’ outlets on expiration.

Upon expiration or termination of the international franchise agreement, typical post-term covenants include return of the franchisor’s proprietary materials including operations manuals, agreements, advertising and promotional materials, products and supplies, and trademarked products on a pre-determined formula or third-party determination basis.

As indicated above, the post-term non-compete covenant of the franchisee requires an understanding and application of applicable laws in the target country, as well as the definition of prohibited activities, the geographical scope of application, and the time period for the covenant. A drafter will also need to determine the persons to whom the covenant applies, such as the franchisee, principals of the franchisee, family members, and designated shareholders.

F. **System Adaptation and Modification**

Often franchisors must modify their franchise systems so that they will be accepted in the target country. The franchisor’s trademarks are one of the essential elements of the franchise system that may be subject to modification. The franchisor must determine whether its trademarks can be used in the target country or whether they must be modified. The franchisor must also ensure that it complies with all appropriate legal requirements to maintain continuing ownership of its principal trademarks and any modified or translated versions.\(^\text{22}\)

Other typical franchise system modifications in the target country include site selection procedures, specifications for system facility, equipment, fixtures, furnishings, decor, signage, and location standards. In addition, approved products and services are often modified to local customs, tastes, laws and regulations, and cultural and religious standards. Training procedures and facilities, as well as advertising and marketing programs, may also be impacted.

Some international franchisors maintain approval rights over each and every such change and modification, but this approach is often impractical. The franchisor approves certain critical matters relating to the franchise system and retains a right to approve, at its option, less critical changes in the system. The franchisee will typically be required to modify or change the operations manual to comply with local standards, but in any event the franchise agreement

\(^{22}\) See also Kenneth S. Kaplan, Andrew P. Loewinger, & Penelope J. Ward, “System Standards in International Franchising,” ABA Forum on Franchising (2005).
should specifically state that all modified versions of the operations manual will be owned by the franchisor including specifically all copyrights in and to the modified and translated versions.

The form of subfranchise agreement used by the franchisee for subfranchisees is often attached as an exhibit to the international franchise agreement and requires approval by the franchisor. An international franchisor will often require approval of any modifications, or may allow for some non-material changes to comply with local requirements. If the franchisee develops the form of subfranchise agreement, the franchisor should prescribe for certain mandatory provisions and for an absolute right to approve the form of subfranchise agreement. Finally, there should be a separate form of subfranchise agreement for each such unit owned and operated by the franchisee or its affiliate.

**G. Proprietary Marks**

Franchisors should familiarize themselves with the trademark registration process of a country in advance of any agreement. Franchisors should ensure that its franchise agreement stipulates the following: compliance with any registered user or licensing registrations in the target country; marking and public notification of ownership; and translation of the franchisor’s trademarks. If necessary, the franchisor should also provide for appropriate legal proceedings to protect the trademarks against infringing uses. This may include provisions relating to who initiates those procedures, the selection of counsel, the payment of expenses and the control of proceedings.

An international agreement should also provide that translated versions of its trademarks, and new trademarks in the future, regardless of who introduces them, will be owned by the franchisor. The degree to which a franchisor will indemnify a franchisee for trademark infringement or other claims related to the trademarks is often a point of concern dictated by the perceived risk that such claims may actually surface and the degree to which a franchisor has taken proactive measures to protect and register its marks in the relevant markets.

**H. Franchisor’s Obligations**

The franchisor will often provide certain services to fulfill certain obligations to international franchisees on a periodic and continuing basis. For example, a franchisor will typically conduct an initial training session for the franchisee. Topics typically covered during such training include site selection, operating systems, systems standards, and marketing. If the international franchise agreement provides for subfranchising, training may also include the recruitment and training of subfranchisees, the servicing of subfranchisees, and the sourcing of equipment and products for subfranchisees.

Following the initial training, the franchisor may mandate periodic additional training related to the introduction of new products and services, the modifications to existing facilities and/or system standards. Subsequent training sessions may take the form of conferences, seminars, or workshops. Attendees may include representatives of the franchisor and/or the relevant suppliers.

The international franchise agreement must specify where the training session will be conducted, who will cover the costs related to such training and what, if any, support franchises may provide with respect to obtaining any travel visa to attend such training sessions.

If the training will be conducted in a particular language, such as English, the franchisor should specify this in the franchise agreement and, if appropriate, stipulate that training program attendees must be fluent in the designated language and/or provide that the franchisee will be responsible for the expense of any interpreter required for the program attendees.

The franchise agreement should mandate that the franchisee and its designated personnel satisfactorily complete all initial training programs. If the franchisee and its personnel fail to satisfactorily complete the initial training, the consequences should be set forth in the agreement. For example, the franchisee could be required to attend additional training at the franchisee’s expense or replace any personnel that did not successfully complete training or, at the discretion of the franchisor, terminate the agreement.

The franchise agreement may also specify certain ongoing assistance to be provided by the franchisor, such as:

- periodic inspections of outlets to ensure they comply with the system standards;
- support consultations with the franchisee with respect to operating problems and changes in system standards; and
- additional services and assistance requested by the franchisee that may incur a charge at designated per diem or other rates.

I. Franchisee’s Reporting and Payment Obligations

An international franchisor will typically require certain reports submitted to it relating to the performance of the franchised units in the target country. The reports will cover the franchise operations of the franchisee and, if applicable, any subfranchisee. The franchise agreement must therefore prescribe the type and frequency of reports required, including operational reports outlining the number of outlets opened or under development, the identification of subfranchisees, the locations of all outlets, the revenues from each outlet and other operating statistics submitted to the franchisor.

Financial statements will generally also be submitted to the franchisor. The financial reporting requirement in some target countries may differ from generally accepted accounting principles in the franchisor’s home country. Consequently, conversion of financial statements and reports may be required.

The agreement may specify that reporting obligations may be satisfied by electronic means, including e-mail, and this may require special computer hardware and/or software as required by the franchisor.

Special payment terms may be required in certain target countries, especially where there are temporary or permanent restrictions on payment. For example, a franchisor may require payments to a designated bank or other financial institution or intermediary located in
the target country. The franchisor could also require payment in the form of tangible property or drawdown payments against deposits lodged in the franchisor’s home country.

Finally, a franchisor will typically require the right to: (i) inspect rights of the franchisee’s and subfranchisees’ outlets, (ii) audit statements submitted by the franchisee, and (iii) review the books and records of the franchisee and outlets operated by the franchisee and subfranchisees.

The franchisee may also be required to furnish to the franchisor copies of inspection reports performed by the franchisee and related to outlets operated by the franchisee and subfranchisees. The parties will typically negotiate whether the inspection and audit rights of the franchisor must be subject to prior notice and/or what the notice procedure should entail.

As part of any audit, the franchisor should review each of the periodic reports for typical errors that may result in royalty and fee underpayments, including inadvertent miscalculations; inconsistent frequency of payments to the franchisor; inaccurate sales for different items with different royalty rates; unreported sales of products or services that are not reflected in revenue numbers reported; and/or an unclear definition of “gross revenues” (or similar term) that leaves the calculation of royalty payments up to interpretation.

J. Training

The franchisor should require the franchisee and its key personnel and managers to be competent in English and be trained as required and in accordance with the franchisor’s policies and procedures.

When working with local counsel to draft provisions related to training, counsel should specify the franchisee’s personnel that are required to complete training as well as the parameters of any initial training program and ongoing training. It is important to keep in mind the personnel that will be required to attend and any logistical issues including language barriers and costs, including wages, fees, travel expenses, visas and related costs. The franchise agreement should specify whether franchisee or franchisor will bear the costs for initial training and/or ongoing training; and the types of ongoing assistance the franchisor will provide and in what format (i.e., webinars, in-person, videos, manuals, etc.).

K. Supply and Suppliers

A franchisor’s system standards and specifications will likely prescribe certain materials to be used by the franchisee in its business operations. Before entering an international agreement, franchisors should investigate the likely supply chain and any challenges presented. For example, KFC and other fast food brands require adequate supplies of chicken that meet their standards. This may be difficult in certain African countries where the supply of chickens from local chicken farmers fail to meet the franchisor’s criteria for not only food safety and security but also quality and quantity. At this point, South African KFCs sell almost 10% of South Africa’s commercially grown chickens. In these instances, local franchisees are required to purchase their supply from outside the country from franchisor-approved suppliers.24 In any

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event, the agreements should be clear on which party has the right to source and deal with suppliers. Further, the agreement must provide which party will obtain the benefits of the supply chain, including rebates and mark ups. They should also make themselves aware of anti-trust, competition and other related laws as it relates to the use of suppliers.

L. Advertising and Marketing Fund

Franchisors may administer a national advertising fund in their home countries as part of their franchise system. Franchisees in these domestic systems often contribute a percentage of gross sales to the fund. Similarly, an international franchise agreement typically establishes and administers an advertising and marketing fund for the target country to which franchisees must contribute. In forming an advertising and marketing fund in the target country, the franchisor must consider what the franchisee will contribute and the benefits to be obtained. The franchisee should have access to any advertising promotions and marketing materials, and to use such materials in the target country, subject to any necessary translations and modifications based on the customs, culture, and local laws of the target country. The franchisee’s contribution to the fund may be a percentage of aggregate revenues from the franchise system in the target country, or an individual percentage of royalties or fixed fees paid by the franchise units of a franchisee or subfranchisee.

The right of the franchisor to approve marketing programs in the target country must also be addressed in the franchise agreement. The agreement should provide the criteria for granting approval, the time limits for granting such approval, and the method by which approval must be obtained by the franchisee. Alternatively, the franchisor could require the franchisee to consult with the franchisor before initiating a marketing program of a material nature, if the franchisor does not retain rights to approve such programs.

M. Transfer and Assignment

Franchise agreements typically restrict a franchisee’s ability to transfer an agreement or the assets of a controlled entity (which in turn owns the franchise). Franchisors should evaluate this possibility and strongly consider provisions limiting transfers in the franchise agreement. Some franchisors may wish to require that franchisees include provisions in their governing documents that make it difficult to transfer control or assets of an entity that is part of a franchise. The law of assignment in the applicable jurisdiction should be considered when drafting an appropriate transfer provision, whether it is to restrict such actions by a franchisee or permit such actions by a franchisor. For instance, a contract which does not specify whether the right to assign exists in a jurisdiction may mean that the parties may in fact assign their rights whereas the same provision may result in a bar against assignment in another jurisdiction.

Some typical transfer and assignment provisions provide that the franchisee must be in full compliance with its obligations under the franchise agreement and all other agreements between the parties; pay a transfer fee; and execute a release of the franchisor from any claims. Typically, the proposed transferee candidate must satisfy the franchisor’s standards for franchisees; execute the franchisor’s current form of franchise agreement and other agreements; renovate or upgrade the franchised business to meet then-current standards; have its principals execute a guaranty; and complete the franchisor’s training program.
N. Default and Termination

An international franchise agreement stipulates a variety of events constituting default of the agreement. Cure periods may be negotiated for certain events, but others will provide for the right of the franchisor to terminate the franchise agreement.

Standard defaults include a breach of representations or warranties by the franchisee. Other defaults may include franchisee’s failure to comply with the development schedule; failure to meet target quotas or development obligations; and breach of any bankruptcy or insolvency provisions of the agreement.

In addition, there may be certain events, which if not met, result in termination. These events include failure to obtain any required government approvals, failure to register trademarks, and failure to comply with exchange controls that prevent payment of fees to the franchisor for some period of time.

Depending on the negotiation of the parties, cure periods will provide the franchisee a reasonable period of time to cure those defaults that can be cured.

As noted earlier, many target countries have general agency laws requiring that the franchisor have “good cause” to terminate or fail to renew a franchise agreement, provide the franchisee prior notice of a termination or non-renewal, and give the franchisee an opportunity to cure a breach. In most target countries “good cause” for termination includes franchisee’s failure to comply with material provisions of the agreement, including a failure to make payments under the agreement, and a felony, abandonment, fraud, bankruptcy, or insolvency of the franchisee.

O. Consequences of Termination

Unwinding a franchise agreement after termination can be complicated. The franchisor should consider matters such as lease terminations and transfers as well as how it will implement any necessary transition period between franchisees.

Moreover, the franchisor should consider the following issues that may arise upon termination: (i) how to adequately protect the intellectual property of the franchised business; and (ii) how to enforce any applicable post-term restrictions and/or obligations and protection for the franchisor and the franchise business.

Finally, if the franchise agreement allows for a right of first refusal or any option to repurchase assets, the franchisor should have a clear determination of whether the purchase price of the assets is the fair market value or depreciated value of such assets.

P. Liquidated Damages

Most target countries enforce liquidated damage provisions. As a result, franchisors often include them in international franchise agreements, because damages may be difficult to prove in foreign courts and other proceedings. They also deter the franchisee from engaging in activities that could cause irreparable harm to the franchisor, such as violations of transfer restrictions, non-competition, confidentiality, and trademark or other intellectual property protections. Foreign courts review liquidated damage amounts to ensure that the amount of damages stipulated is commensurate with the damages of the franchisor. As a result, the
franchise agreement should only provide for that amount of liquidated damages based on a reasonable expectation of the damages that may occur. Foreign courts view excessive liquidated damage amounts as a penalty and reduce such amounts to an amount that approximates the actual damages resulting from the breach. Moreover, in certain target countries, the inclusion of liquidated damage amounts in an international franchise agreement may not be beneficial to the franchisor. A court may use the amounts specified as liquidated damages as a cap on damages, even if actual damages exceed such amount.  

Liquidated damages in the franchise context are generally triggered by a breach of the franchisee’s competition restrictions, confidentiality requirements, transfer restrictions, intellectual property protections, or expiration obligations, and in such cases, entitle the franchisor to a predetermined monetary payment by the franchisee. Having said so, if a liquidated damages provision serves as a threat to induce performance, or if the purpose of the clause appears to only secure performance, the clause will likely not be enforceable.

A franchisor should, however, be aware that the enforceability of a liquidated damages clause will depend on the jurisdiction in which the franchise agreement was entered. Care should be taken to understanding the benefits and drawbacks, if any, that are created by the inclusion of such provisions. For instance, in some jurisdictions the existence of a liquidated damages provision can interfere with the availability of injunctive relief where one of the considerations in the granting of such relief is the inability of monetary damages to compensate the harm done by the activity sought to be restrained.

Even if a jurisdiction recognizes and accepts the liquidated damages clause, the determination of whether the damages are reasonable, and how to deal with damages that are deemed unreasonable, will vary based on jurisdiction.

Q. Indemnification

Indemnification provisions allocate losses and expenses between the parties. In drafting these provisions, the parties should address: (i) who is indemnified; (ii) who initiates, controls, and pays for an indemnitee’s legal counsel; (iii) who has authority to settle disputes; (iv) whether the parties must mitigate damages; and (v) whether the indemnification provision survives termination of the agreement.

In international franchise agreements, the franchisees are usually required to indemnify franchisors for any losses or expenses involving: (i) any lawsuit, dispute resolution proceeding, settlement, or investigation; (ii) a breach of the agreement; and (iii) any acts and omissions in the construction or operation of the franchisee’s unit(s). Moreover, in some instances, franchisors indemnify franchisees for third-party actions related to the franchisee’s authorized use of the franchisor’s trademarks.

Most target countries will enforce indemnification provisions provided that parties are not indemnified for their own gross negligence or intentional acts. Some countries, however, will generally require mitigation of damages. Moreover, in other jurisdictions, drafters should be aware that overly broad indemnification provisions are vulnerable to challenge. In these target countries, indemnification is often restricted to what was reasonably foreseeable at the time of execution of the franchise agreement.

While indemnification provisions are generally upheld in foreign jurisdictions and by international courts when deemed reasonable, there are many considerations that franchisees entering into international agreements must recognize:

- Whether the target countries limit indemnification for negligence or strict liability claims;
- Whether the target countries apply principles of reasonableness, good faith and fair dealing when interpreting indemnification provisions;
- Whether the target countries have specific contract laws that impact the enforceability of indemnification provisions. In some cases judicial intervention may be imposed to limit the enforceability of an otherwise overbroad or unreasonable indemnity provision.
- Whether the target country imposes limitations regarding the types of damages that may be addressed in an indemnification provision. The most common damages not covered are a franchisor's gross negligence, wilful misconduct, or punitive damages.
- A franchisor should work with local counsel to ensure that the target country does not impose a specific format, signing formality, or require notarization in order to enforce the indemnity provision.

R. Dispute Resolution

Because parties to the franchise agreement typically want to avoid judicial proceedings, it is common for alternative dispute resolution methods and requirements to be specified in the agreement.

The first step in attempting to resolve any dispute in many international franchise agreements is the requirement that the senior executives of the parties meet in an attempt to resolve any disputed issues prior to the commencement of any further dispute resolution proceedings. The agreement should require the parties to meet in good faith to resolve the dispute. It should also specify who are the required participants, the location of any meeting, the minimum period of time for the meeting, and who incurs the costs of such meeting.

If the senior executive officers of the parties are unable to resolve the dispute, non-binding third-party mediation is typically the next step. The agreement should provide for who the mediator will be or how the mediator will be selected, the place of mediation, the procedures for mediation, and who incurs the costs of the mediation.

If mediation cannot resolve a dispute, the agreement may provide for formal arbitration. However, certain dispute items may fall out the purview of arbitration so that the parties may seek immediate relief. These items include equitable remedies, remedies with respect to use or misuse of the franchisor’s trademarks, and remedies with respect to non-payment.

All details concerning the arbitration should be provided in the international franchise agreements, including whether the arbitration will be held in the home country, the target country, or in a neutral location. Arbitration rules should also be specified. Typical rules include the rules of the American Arbitration Association (*Commercial Arbitration or International*
Arbitration Rules, the International Chamber of Commerce, the United Nations Conference on International Trade Law (UNCITRL), and the London Court of International Arbitration.²⁶

The agreement should specify the number of arbitrators, how they will be selected, the language of the arbitral records, the jurisdiction for enforcement of the arbitral award, the governing law, and who has responsibility for expenses and fees of the arbitration as well as responsibility for payment of each party’s own fees and expenses.

If any disputes are to be resolved by judicial determination, provisions must be included in the franchise agreement specifying a number of items. Each of the franchisor and the franchisee will typically want the governing law of the franchise agreement to be the law of its home country. Regardless of the choice of law, in many cases, parties to the franchise agreement will seek remedies before target country courts even if only to enforce arbitral or judicial awards or decisions granted in the home country.

The laws of the target country will also control intellectual property issues (e.g., trademark infringement claims), currency restrictions imposed by the target country, withholding taxes, disclosure requirements, and competition restrictions.

In providing for choice of forum, the franchisor may want to designate the forum for dispute resolution within the home country, while the franchisee may want to designate the forum within the target country. To resolve the issue, the agreement could provide that the courts of the domicile of the party that does not commence legal proceedings will serve as the choice of forum. Another alternative is to confer concurrent jurisdiction on the courts of the domicile of each party.

Because the judicial systems in some target countries do not recognize equitable remedies, the parties may need to specifically provide for preliminary relief in the form of interlocutory injunctions, temporary restraining orders, orders of specific performance, and other similar types of relief in the agreement.

It will also be necessary to specify who is responsible for fees and costs, although in some judicial systems it is within the discretion of the court to order costs. Nevertheless often the losing party pays all fees, expenses, and costs of the other party.

Other dispute-related issues to cover in an international franchise agreement include a period of time for asserting claims, severability of agreement provisions, waiver of jury trial, and waiver of exemplary or punitive damages.

Set out below are some of the typical considerations when using international arbitration as the means to resolve disputes:

- **Choosing the applicable law.** Counsel will have to decide whether a separate law governing the arbitration agreement needs to be specified and, if so, which one.

Choosing the place of arbitration. In choosing the place (seat) of the arbitration, a drafter should determine whether the country in question is a signatory to the New York Convention, whether it has adopted the UNCITRAL Model Law and if it has, whether there are any significant qualifications to its adoption. Finally, to complete the analysis, if the country has not adopted the UNCITRAL Model Law, counsel must determine whether the procedural laws of the country are up to date and arbitration-friendly.

Choosing the language of the arbitration. The parties will need to specify the language of the arbitration proceedings in the agreement. When choosing a language, the parties should consider the governing law of the contract; the place (seat) of arbitration; the language of the contract document(s); the language of other documents likely to be relevant in any dispute; the language of party representatives and likely witnesses; and the ability of arbitrators/counsel to work in the designated language.

Choosing the rules. The parties will need to consider whether an ad hoc procedure or institutional rules are to be adopted. If considering ad hoc rules, they should consider selecting an institution to provide administrative support for the process. If the parties elect to use institutional rules, it is important not to modify or adapt the rules without seeking the advice of an expert.

Choosing the arbitrators. In choosing arbitrators, drafters have two essential options. They can identify the number of arbitrators (i.e., one or three) or they can leave the choice open. Typical, sole arbitrators are selected for simple, low-value agreements, while three arbitrators are often selected for complex, high-value agreements. If three arbitrators are selected, the agreement must state how they are to be appointed and what is the deadline for the process. It is also useful to identify criteria which the arbitrators are to satisfy. Regardless of the criteria, however, counsel must determine if the proposed country has a sufficient pool of resident, experienced and qualified arbitrators that satisfy the criteria selected.

Determining any exclusions. Finally, the parties should check whether there are any nationality requirements and/or exclusions under institutional rules for sole or presiding arbitrators. Moreover, the parties should confirm whether these rules are in compliance with applicable law.

VIII. CLOSING AND EXECUTION FORMALITIES

Each country has its own execution formalities. Franchise agreements may also need to be authenticated before they are deemed enforceable by the courts of a particular jurisdiction. In some countries, the execution procedures differ depending on the location of the party when it executes the agreement. Others require that any documents required for government approval

27 Over 145 countries have adopted the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”). Under the New York Convention, arbitration awards are recognized and enforced with relatively little interference from foreign courts in the signatory countries in most instances.
must be translated into the local language and that the translated form of the agreement must be signed.

If possible, franchisors should specify in their franchise agreements that regardless of whether the agreement is translated into another language, the English language version of the document must be executed by the parties and will govern any dispute between the parties. Franchisor should address, in the franchise agreement or otherwise, who will be responsible and pay for translations of applicable documents. Counsel should also determine whether the local formalities mandate witness requirements; spousal acknowledgements; notarization requirements; legalization requirements; or payment of stamp duties.

IX. CONCLUSION

In advising clients entering into an international franchise arrangement, franchise counsel should have an appreciation for issues related to the due diligence review, the selection and use of local counsel, the various franchise structures, the laws of target countries in which the franchise will operate and the options in drafting key contractual provision. The checklists and topics covered in this paper should provide some guidance in successfully closing a typical international franchise transaction.
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Frank is an associate in the Business Law and Franchise Law Groups at the offices of Cassels Brock and Blackwell LLP, in Toronto, Ontario. He practices business law, with a focus on franchising, licensing, distribution and intellectual property. Frank also provides counsel on mergers and acquisitions, and general corporate, commercial and contractual matters.

Frank advises Canadian and international companies on all matters relating to franchising, licensing and distribution including structuring and expansion strategies, legal and regulatory issues, contract drafting and negotiation, intellectual property, and in particular, compliance with Canadian franchise disclosure legislation. Frank has worked with a broad range of product and service distribution and franchise companies, from local start-ups to international and global corporations, and in industries as diverse as retail, financial services, apparel, automotive, food services, software, commercial and residential services, hospitality, personal services, construction, health care, and others.

Frank is a member of the Canadian Bar Association, the Ontario Bar Association, including the Franchise Law Section, and the American Bar Association, as an attendee and participant in the Forum on Franchising. He is a member and participant in various franchise industry groups, including the Canadian Franchise Association and International Franchise Association.

KENDAL TYRE

Kendal Tyre is a partner in the Washington, D.C. office of Nixon Peabody LLP. He counsels franchisors, licensors and distributors as well as others on international business transactions. He represents clients in mergers and acquisitions, private equity and venture capital transactions, joint ventures and strategic alliances, licensing and franchise matters as well as corporate law matters.

In his franchise practice, Kendal counsels franchisor clients regarding foreign and U.S. state and federal franchise laws, drafts franchise disclosure documents, and prepares and files franchise registration and exemption applications. He has experience drafting and negotiating a variety of commercial franchise agreements, license agreements, and purchase and sale agreements.

Kendal has spoken at numerous seminars on franchising and distribution matters conducted by various organizations, including the American Bar Association, the International Franchise Association and the National Bar Association. Kendal is the national co-chair of the firm’s Diversity Action Committee and leads the firm’s efforts in Africa. He is the executive editor Franchising in Africa 2014: Legal and Business Considerations, a publication of LexNoir Foundation.
KERRY OLSON

Kerry Olson is Vice President and Assistant General Counsel for International Dairy Queen, Inc., based in Minneapolis, Minnesota. As part of her responsibilities at DQ, Kerry provides franchise and legal support to the international division. Before joining Dairy Queen, Kerry was Associate General Counsel at Buffalo Wild Wings, Inc., for two years and in private practice, where she specialized in franchise corporate counseling and worked with franchisors in the retail, restaurant, hospitality and service-based industries. Kerry is a frequent speaker locally and nationally on topics related to franchising and is an active participant in the franchise community and industry, holding several leadership roles. Currently, she is a member of the American Bar Association's (“ABA”) Forum on Franchising and serves as Chair of the Steering Committee of the International Franchise and Distribution Division. She also is an active member of the International Franchise Association, with leadership roles as the Chair of the Women’s Franchise Committee from 2009 to 2011 and prior to that, as Chair of the Legal Legislative Committee from 2007 to 2009.

In 2011, Kerry was honored as part of the “40 under Forty” list published by the Minneapolis St. Paul Business Journal. She was named a “Rising Star” of Minnesota lawyers for 2006, 2007, 2008 and 2009 by Minnesota Law and Politics magazine and listed as a “Legal Eagle” by Franchise Times in 2006, 2007 and 2008. Franchise Times named Kerry as one of “20 to Watch” in 2010. Kerry graduated summa cum laude, Phi Beta Kappa, from St. Olaf College in 1997. She earned her law degree, magna cum laude, from the University of Minnesota Law School in 2000, where she was awarded membership in Order of the Coif.