TERMINATING AN INTERNATIONAL MASTER FRANCHISEE

Stéphane Teasdale
Dentons
Montréal, Canada

and

James M. Susag
Larkin Hoffman Daly & Lindgren Ltd.
Minneapolis, Minnesota

October 16-18, 2013
Orlando, FL

©2013 American Bar Association
Table of Contents

I. INTRODUCTION .......................................................................................................................... 1

II. TYPICAL DISPUTES WHERE TERMINATION PROVISIONS OF THE MFA ARE INVOKED ................................................................. 2
   A. Non-Payment of Fees ........................................................................................................... 2
   B. Development Schedule Defaults ....................................................................................... 3
   C. Abandonment or Closure of Units..................................................................................... 3
   D. Breach of System Standards .............................................................................................. 4
   E. Breach of Confidentiality or Operation of a Competing System in Breach of Non-Competition Obligations .................................................. 4
   F. Other Defaults .................................................................................................................... 5

III. ISSUES TO CONSIDER BEFORE DELIVERING THE NOTICE OF TERMINATION..... 5
   A. A Review of the Franchisor’s Rights and Obligations Under the MFA and Applicable Law .................................................................................. 5
      1. Rights and Obligations Under the MFA ......................................................................... 5
      2. Rights and Obligations Under Applicable Law ............................................................ 6
   B. The Franchisor’s Compliance with the MFA ...................................................................... 6
   C. Termination Notice Requirements Under the MFA ......................................................... 6
   D. Identification of All Breaches of the MFA by the Master Franchisee ............................... 7
   E. A Review of Local Legal Requirements in Conjunction with Local Counsel .......... 7
      2. The Benefits of Retaining Local Counsel ...................................................................... 8
   F. An Assessment of the Market Situation (of Unit Franchisees, Suppliers, Landlords, and Other Parties) and the Impact of the Termination ................. 9
   G. An Assessment of the Survival of the System if the Master Franchisee is Taken Out of the Picture ............................................................................. 10
   H. Assessing the Elements of the Local System Controlled by the Master Franchisee that are Critical to the Ongoing Operation of the System .................. 10

IV. ISSUES TO CONSIDER BETWEEN THE DELIVERY OF THE NOTICE AND THE EFFECTIVE DATE OF TERMINATION .................................................. 11
A. Impact of Notice on the Master Franchisee and Unit Franchisees................. 11

B. Market Visits........................................................................................................ 11
   1. Meetings/Communication with the Master Franchisee …………………… 11
   2. Meetings/Communication with the Unit Franchisees …………………… 11
   3. Meetings/Communications with Landlords, Suppliers, and Other Key
      Vendors ........................................................................................................ 12

C. Assessing the Assumption and/or Assignment of the Unit Franchise
   Agreements .......................................................................................................... 12
   1. Assumption .................................................................................................... 12
   2. Transfers ....................................................................................................... 13

D. Dealing With the Dissemination of Information About the Termination........ 13

V. REGAINING CONTROL OF THE MARKET ................................................................. 13
   A. Assessing the Reason for Termination and Making Adjustments .......... 14
   B. Communication to the External Market and Unit Franchisees.......... 14
   C. Addressing Unit Franchisee Issues ................................................................. 15
      1. Payment of Royalties ............................................................................... 15
      2. Compliance with the System and Standards ......................................... 16
      3. Other Issues ............................................................................................ 16
   D. Addressing Unit-Franchisee Claims/Litigation ............................................ 16
   E. Addressing Supply Chain Issues ................................................................. 17
   F. Other Issues .................................................................................................. 17

VI. ENFORCING THE FRANCHISOR’S RIGHTS ............................................................... 18
   A. Post-Termination Obligations ................................................................. 18
      1. De-Identification ..................................................................................... 18
      2. Remittance of IT, Manuals and Other Propriety Materials ................. 19
      3. Covenants Not to Compete ..................................................................... 19
      4. Confidentiality ....................................................................................... 20
TERMINATING AN INTERNATIONAL MASTER FRANCHISE

I. INTRODUCTION

Master franchising has become one of the preferred structural models used by franchisors in the international expansion of their brands. In essence, the master franchise model delegates the sole responsibility for the development of the territory, the solicitation of unit franchisees, the training of unit franchisees, and the ongoing supervision of the unit franchises as though the master franchisee were the franchisor.

The master franchise model presents a number of advantages over other structural models such as area development, multi-unit, direct franchising or joint ventures to name a few. Master franchising also presents disadvantages over those same models. These pros and cons are not per se examined in this paper. Rather, this paper aims to address the issues and challenges that arise when the master franchise relationship fails and must be terminated. Unfortunately, such issues often arise, because the survival rate of international master franchise ventures is quite low.1 According to a 2005 study, only thirty-nine percent of international master franchise ventures survived until the end of their development period.2

Among other things, this paper examines some of the typical disputes that arise between the franchisor and the master franchisee, the issues to consider prior to delivering a notice of termination such as the franchisor’s right and obligations under the master franchise agreement (hereafter sometimes referred to as the “MFA”), the franchisor’s own compliance with the MFA, the identification of breaches and assessments of the market situation, the survival of the system post-termination, and the elements that need to be controlled for the ongoing operation of the system.

We also examine issues to consider after the notice of termination is delivered, such as the impact of the notice of termination on the master franchisee and sub-franchisees, market visits and communications with the master, the unit franchisees, suppliers and other key vendors. In addition, we address how to regain control of the market after termination, the collection of royalties, maintaining compliance with system standards, as well as supply chain issues. We also examine how to enforce the franchisor’s rights and in particular, post-termination obligations.

Finally, we address methods for dispute resolution as well as alternative methods of dispute resolution in the international context.

---

1 Arturs Kalnins, Ph.D., Biting Off More Than They Can Chew: Unfulfilled Development Commitments in International Master Franchising Ventures, 5 Cornell Hospitality Reports, no. 12, October 2005, at 1.

2 Id. at 7.
II. TYPICAL DISPUTES WHERE TERMINATION PROVISIONS OF THE MFA ARE INVOKED

Unfortunately, disputes inevitably arise in the master franchise relationship, particularly in the international arena, where differences in business practices, culture, language, operations, and misaligned or overly optimistic expectations, poor choice of master franchisees, and other issues continuously challenge franchisors. Distance, particularly where the franchisor does not have an established corporate operational base in the local market, can also have an impact on the communication between the franchisor and master franchisee to address issues as they arise.

The following issues are those most frequently encountered by franchisors in the international arena:

A. Non-Payment of Fees

One of the cornerstones of the franchise (or master franchise) relationship is the payment of fees in exchange for the use of the brand and the services provided by the franchisor. Dealing with non-payment of fees domestically is usually fairly straightforward, but can prove challenging internationally.

Typically, the master franchisee will first pay an initial fee for the rights to a country or region. The initial fee is generally paid upon execution of the master franchise agreement and before any unit franchises are actually opened in the market. The initial fee is also usually paid before training has begun and before significant know-how has been transferred to the master franchisee. Clearly, if the initial fee is not paid, the termination of the master franchise agreement will be more easily manageable, certainly from an operational point of view. A pure collection issue may remain, which will be addressed below in this paper.

Master franchisees will also generally pay royalties, which constitute the lifeblood of the master franchise relationship. Typically, in a master franchise setting, royalties will flow from the operations of the unit franchises, which will be paid to the master franchisee and then, in turn, will be shared with the franchisor. Non-payment of royalties to the franchisor may prove to be especially significant if the root cause is that the unit franchisees have stopped paying the master franchisee. In any scenario where the franchisor is no longer being paid royalties, a flag is raised and the situation should be addressed promptly rather than being left to linger. It is also, most often, a sign of other potential problems and potentially breaches, all of which should be examined swiftly.
**B. Development Schedule Defaults**

Non-compliance with the terms of a development schedule is another common dispute arising from the master franchise relationship. It has been said that “development schedules are made to be broken, or it might seem like that in the domestic and international franchise context.”

Why are development schedules often not met? One explanation may be that the parties’ appetites and expectations at the outset are mismatched with events as they transpire during the course of operation. Frequently, master franchise rights are granted for a large territory consisting of an entire country or possibly several countries (e.g. the Middle East or Eastern or Western Europe) for a sizeable initial fee. The parties then expect that a significant amount of units will be opened and operating within a relatively small amount of time, such a year or a few years. This is often the classic recipe, particularly internationally, where so many factors, including cultural, political and economic factors, need to be taken into account to determine whether anticipated plans – translated into a development schedule – are realistic expectations for contractual parties.

Master franchise agreements should, of course, address what would happen if the master franchisee does not satisfy the development schedule. These provisions can include the termination of the master franchise agreement, the termination of development rights, the termination of the master franchisee’s exclusive rights, or rights of first refusal, on development, or some combination of those possibilities. These provisions serve a useful purpose and should be considered if there is a breach of the development schedule. What is most important is to not allow a default to persist unaddressed for an extended period of time.

In many instances, adjustments in the development schedule are made to accommodate changes or unexpected situations in the local market. Again, however, these situations should be addressed as soon as possible. And failing an agreement between the parties, all options should be considered.

**C. Abandonment or Closure of Units**

Another relatively frequent area of dispute between the franchisor and the master franchisee is the manner in which the latter manages the system in the foreign market and in particular, what would happen if units are closed without prior consultation with the franchisor. In cases where the franchisor is faced with a “fait accompli,” little can be done other than to invoke a default under the terms of the master franchise agreement.

---

Unannounced temporary shut-downs can also occur, and may not necessarily provoke an actual default under the MFA but may be tantamount to the same. Franchisors should therefore dedicate sufficient resources to monitor unit franchise operations in foreign markets and the developments of new units in particular. Vigilance should also be insured when masters contemplate closing a significant number of units which can have a devastating effect on the goodwill of the brand.

**D. Breach of System Standards**

An uncontestable truth is that North American standards often vary widely from standards elsewhere in the world. Different tastes, culture, traditions, languages, even religion may be factors that challenge North American franchisors seeking to insure that the exact standards of their brands will be followed to the letter in foreign jurisdictions. Furthermore, in spite of the best due diligence performed on the market itself and on the master franchisee, disputes regarding compliance are hardly uncommon. This said, although it is primarily the responsibility of the master franchisee to enforce system standards in its market, the franchisor should play a supervisory role and closely monitor how closely the master franchisee may be “following” the concept. Too often, franchisors realize after the fact that master franchisees have failed to enforce standards and the brand image has already been affected or damaged. Significant initial training and follow-up training will play a large part in reducing the risk of breach of system standards. In addition, providing tools such as manuals and monitoring operations will also serve to address standards issues as they arise, i.e., when problems are small in scale, before they become too significant.

Master franchisees may breach system standards for different reasons, such as where the master franchisee makes unauthorized changes to the concept, or the master franchisee is unwilling to incur the expense of making the concept a true duplicate of the original because the master franchisee believes it can find more economical ways of arriving at the same result as the original. In the first case, provided the changes are discussed and agreed in advance and not so far removed from the original standards or concept as to alter the brand’s goodwill, these adjustments may ultimately be acceptable. In the other case, “cost-cutting” can be symptomatic of more significant issues and may be a sign of disputes to come. In either case, because the franchisor is operating in the international arena, particular attention must be given to understanding and monitoring how the brand is being implemented in practice.

**E. Breach of Confidentiality or Operation of a Competing System in Breach of Non-Competition Obligations**

Unfortunately, protecting a brand’s proprietary information abroad can prove very challenging. So many franchisors have expanded internationally and in certain markets such as China, India, Africa or in certain South American countries, have fallen victim to the theft of one of their most precious assets: their know-how. Whether a master franchisee has used the information acquired through entering into a master franchise relationship or whether unit franchisees have usurped the know-how they have acquired from the master franchisee, the result is the same, e.g., that a third party is making use of the franchise system’s proprietary information and operating a knockoff brand. In any scenario, enforcing the franchisor’s rights may prove challenging against the third party but can give rise to the termination of the master franchise agreement vis-à-vis the master franchisee.

Another classic scenario involves the master franchisee operating what is perceived by the franchisor as a competing system, in breach of the in-term non-competition obligations
contained in the master franchise agreement. First and foremost, at the time of entering the MFA, the franchisor should conduct appropriate due diligence to determine what other businesses the master franchisee may be involved in and second, determine the enforceability of the restrictive covenant in the international territory. In this regard, consultation with experienced local counsel during the drafting stage is an invaluable step. During the term of the MFA, the franchisor should determine whether the MFA has in fact been breached and if so, what remedies under the law governing the MFA are available to address the situation. The franchisor should also determine whether sufficient evidence of the breach has been gathered and whether there are options short of termination that may be practical alternatives.

F. Other Defaults

Other defaults commonly arising internationally include the unapproved transfer of the master franchise rights, unapproved or undisclosed locations, under-reporting of sales, the bankruptcy of the master franchisee, defaults under other agreements such as supply agreements, unapproved changes to the concept, unapproved unit franchisees, and unapproved changes to the unit franchise agreements or other agreements with unit franchisees.

III. ISSUES TO CONSIDER BEFORE DELIVERING THE NOTICE OF TERMINATION

The consequences related to the termination of a master franchisee in a foreign market can be significant. First and foremost, presuming the franchisor chooses to regain control of the brand and the unit franchisees (which could considered a threshold question for the franchisor to decide), how does one go about regaining such control? A number of the following issues should therefore be considered prior to proceeding with termination.

A. A Review of the Franchisor’s Rights and Obligations Under the MFA and Applicable Law

1. Rights and Obligations Under the MFA

The MFA sets out the governing and contract law between the parties and the cause for termination will generally flow from the default and terminations provisions contained in the MFA. Whether the dispute is non-payment related, or the result of a failure to comply with the development schedule or for other reasons, the franchisor should insure that its right to terminate as a result of the dispute is substantively entrenched and supported in the MFA, and does in fact give way to termination.

In addition, particularly in the case of a financial dispute but also in other instances, the franchisor should determine whether it may be possible to invoke other remedies that may have been included under terms the MFA, such as those involving rights under letters of credit or bank guaranties. Of course, such instruments should be considered when negotiating the terms of the MFA with the master franchisee. Especially in transactions with large, established corporations, these tools can provide alternatives to (or in some cases backup for) traditional personal guarantees and may provide the transaction parties with the certainty and confidence needed to consummate the transaction as well as a reliable mechanism for collection in the event of a payment default.
2. Rights and Obligations Under Applicable Law

Franchisors would also be well advised to be aware of state, territorial, and foreign laws that may apply to the MFA and the master franchise relationship, including local franchise, distribution, and commercial agency laws.

A significant number of countries around the world have franchise-specific laws, dealership, agency or similar type of legislation or regulations that govern franchise relationships. Among these are Australia, Canada (certain provinces), China, Brazil, Indonesia, Japan, Korea, Mexico, Russia, France, Belgium, Italy, Sweden, and Spain, to name a few. And although the legislation or regulations in most of those countries tend to regulate disclosure or registration requirements (or the failure to do so), some, such as Russia, address the termination of franchises.

Consultation with local counsel will therefore prove essential in considering the options available to a franchisor in the case of default and, in any case, prior to considering the delivery of the notice of termination.

B. The Franchisor's Compliance with the MFA

As much as the franchisor may have the right to terminate the MFA for cause, that step should only be taken after a careful examination of the franchisor’s own historical compliance with its obligations under the MFA. The “clean hands” theory is one that is almost universally recognized and franchisors should conduct a thorough due diligence assessment of their own performance before pulling the termination trigger. This said, where termination is necessary, franchisors should be ready to address—and defend—the list of real and perceived grievances that may be raised by the master franchisee during the termination process.

C. Termination Notice Requirements Under the MFA

In addition to the substantive rights and obligations of the franchisor to terminate the MFA, careful consideration should also be given the specific requirements for formally delivering the actual notice of termination. Once the franchisor has decided to pull the termination trigger, the notice should be delivered to the master franchisee in strict compliance with the requirements of the MFA and any laws governing the parties’ relationship with respect to format and substance, timing of the delivery, and method of delivery. Non-compliance with any of these important issues may invalidate the notice or leave it open to attack.

The default provisions of the MFA will generally stipulate the format, substance, timing, and method of delivery as well as the cure periods, which may vary depending on the type of breach. Attention should also be paid to partial cures attempted by the master franchisee, which may impede the franchisor’s ability to proceed with termination. Franchisors should also examine any applicable state, territorial, and other laws that may apply to the relationship to

---

4 These laws, including international franchise “relationship” laws and commercial agency laws, are beyond the scope of this paper. This list is by no means exhaustive and readers are invited to examine the existence and applicability of laws and regulations in specific countries.
ensure compliance with all statutory or codified notice requirements, starting with notice of
default to a separate notice of termination (if a second notice is required).

Once the cure period (if any) has expired, the franchisor is poised to deliver the notice of
termination. Franchisors should not wait long after the cure period has expired before delivering
the notice, as that may be argued to constitute a waiver of the breach, which may in turn impact
the enforceability of the initial notice of termination. Of course, in some cases, only a single
notice is required, although a second communication to confirm the expiration of a cure period
may nonetheless be advisable.

D. Identification of All Breaches of the MFA by the Master Franchisee

Once the decision to issue a notice of termination has been made, all breaches should
be identified and most of all, documented in one or more notices of default and in the notice of
termination. This is all too important because the notice of termination will set the stage for
what lies ahead either in terms of litigation, alternate dispute resolution, or settlement
negotiations. Of course, in instances where there are major and material breaches, nothing
prevents the franchisor from identifying these and having a “savings clause” in the notice of
default noting that the list of breaches is not exhaustive. Therefore, crafting the notice of
termination in strict compliance with the terms of the MFA in substance and form can prove to
be of paramount importance.

Franchisors should also pay careful attention to their post-termination rights and
obligations once the notice of termination is delivered. Certain actions may need to be taken
immediately or very shortly after the notice is delivered and the franchisor should be prepared to
put the appropriate resources in place promptly to effect the desired outcome.

E. A Review of Local Legal Requirements in Conjunction with Local Counsel

A franchisor should not undertake any steps leading to the termination of a master
franchisee in a foreign jurisdiction without first consulting local counsel to review any
international substantive law that may apply to the franchise relationship or the MFA.


Franchisors may wish to use choice of law provisions to avoid the application of any
unfamiliar or unfavorable international law to the master franchise relationship. While
franchisors typically “prefer that the law of its own state or country control,” as other franchise
practitioners have cautioned:

If the law of the franchisor’s home state is chosen and that state
has a franchise disclosure or relationship law, or other law
unfavorable to the franchisor, the drafter should take care not to
subject an international relationship to that law if that law would
not otherwise apply to a foreign entity with foreign franchised locations.\textsuperscript{5}

For example, the applicability of the protections of the Minnesota Franchise Act, Minn. Stat. §§ 80C.01-.30 (2012), to out-of-state, and even international franchisees, transacting with a Minnesota franchisor remains unsettled at best.\textsuperscript{6} Practitioners may desire including a waiver of the potentially applicable franchise or business opportunity laws under the chosen substantive law, but should ensure that such a waiver will be valid under the laws of the target market.\textsuperscript{7}

2. \textbf{The Benefits of Retaining Local Counsel}

In addition to validating the franchisor’s analysis of its rights and obligations under the terms of the MFA, local counsel can also provide valuable insight on matters such as:

i. The weight of the evidence needed to support the termination, if challenged;

ii. The rights and remedies that the master franchisee may assert (whether in an arbitration or if an arbitral award is challenged in local courts);

iii. The most efficient and cost effective method to enforce termination;

iv. How to assist in communications and potential negotiations with the master franchisee’s counsel;

v. Providing advice relating to accessory issues such as trademarks and IP issues; and

vi. Providing advice on local legislation and rules that may apply particularly where the termination involves multi-jurisdictional rights.


\textsuperscript{6} Compare \textit{Healy v. Carlson Travel Network Assoc., Inc.}, 227 F. Supp. 2d 1080, 1088 (D. Minn. 2002) (holding the Minnesota Franchise Act does not apply to an out-of-state franchisee strictly because the franchisor is a Minnesota corporation) with \textit{Novus du Quebec, Inc. v. NOVUS Franchising, Inc.}, No. 4-95-702, Bus. Franchise Guide (CCH) ¶10,823 (D. Minn. Dec. 5, 1995) (finding that Minnesota Franchise Act applies to an international franchisee by virtue of Minnesota choice of law provision).

\textsuperscript{7} Gardner, Klarfeld & Shaw, \textit{supra} note 5, at 30.
F. **An Assessment of the Market Situation (of Unit Franchisees, Suppliers, Landlords, and Other Parties) and the Impact of the Termination**

Franchisors should possess a good understanding of the situation in the market prior to delivering the notice of termination which, as previously mentioned, will impact the sub-franchisees, and potentially other key parties.

On-site visits often represent the best manner in which to gather intelligence on the situation in the local market. Franchisor representatives should travel regularly to the local market and meet with sub-franchisees, suppliers, and other parties in order to gather information. This intelligence will prove to be extremely valuable to franchisor management to address the aftermath of the delivery of the notice of termination. Furthermore, ongoing market visits and supervision can also assist to spur higher levels of compliance with system standards and uncover hints of problems in the making.

Relevant information that should be obtained includes:

i. The status of the payment of royalties by the unit franchisees;

ii. The status of the unit franchises regarding compliance with standards;

iii. The status of payments owed suppliers by unit franchisees and the master franchisee;

iv. The situation of payments due to landlords by unit franchisees and the status of leases or sub-leases;

v. The status of the advertising fund;

vi. The amount of services (or lack thereof) provided to the unit franchisees;

vii. The general state of the brand in the local market and its position in the face of the competition;

viii. The number of store openings and closures;

ix. The state of the unit franchises;

x. The general mood of the unit franchisees;

xi. The financial situations of the unit franchisees;

xii. The status of any ongoing litigation or other disputes between the master franchisee and unit franchisees; and

xiii. A general sense of the economy and industry insofar as it impacts unit franchisees.
G. An Assessment of the Survival of the System if the Master Franchisee is Taken Out of the Picture

As previously mentioned, one of the defining characteristics of master franchising is the delegation of almost all of the franchisor’s responsibilities to the master franchisee. The master essentially becomes the franchisor in the local market and the party—really the only party—with whom the unit franchisees deal in almost all aspects of the operations of their unit franchises.

Over time, the master can become all-powerful over the unit franchisees to the virtual exclusion of the franchisor. Consequently, taking the master out of the picture can create a tremendous void and, presuming the master has built a significant system locally, presents a challenge to regaining control so as to insure the ongoing post-termination viability of the system and the brand. In short, the franchisor’s challenge will be to install new leadership in order to move forward.

The franchisor must therefore consider and weigh its options and determine the feasibility of restoring leadership and insuring viability. In this context, serious questions face the franchisor such as:

1. Will the franchisor step in directly and revert to direct franchising?
2. Can a suitable replacement master franchisee be put in place promptly?
3. Can the replacement master ensure the viability of the system?
4. Can any wrongs done by the outgoing master franchisee to the unit franchisees be corrected?

All of these questions and more need to be carefully considered prior to delivering the notice of termination.

H. Assessing the Elements of the Local System Controlled by the Master Franchisee that are Critical to the Ongoing Operation of the System

As noted above, the master franchisee generally leads the development and operation of the system in the local market and, as a result, may control certain elements such as the royalty stream, the supply chain relationships, the advertising fund, leasing arrangements (depending on the real estate model used, i.e., direct leasing by unit franchisees vs. lease-sublease arrangements through the master franchisee), bank financing arrangements with financial institutions, and commissaries owned and/or controlled by the master franchisee just to name a few. Franchisors should determine what other elements the master franchisee may control.

As highlighted above, a host of key issues need to be examined and considered prior to delivering the notice of termination. The purpose is to embark upon the termination process with the fullest possible available information in order to develop and implement the appropriate strategy to regain control of the market.

The next section examines the issues to consider after the notice of termination has been delivered.
IV. ISSUES TO CONSIDER BETWEEN THE DELIVERY OF THE NOTICE AND THE EFFECTIVE DATE OF TERMINATION

Once the notice of termination has been delivered, events are likely to unfold at a rapid pace and will inevitably involve the franchisor (and if the franchisor is not involved, are likely to unfold without influence or guidance). As noted above, the franchisor's post-termination rights may need to be enforced quickly especially if the franchisor's goal is to maintain the ongoing operation of the system and the unit franchisees' rights to operate. Communications will thus play a significant role in the management of the termination.

A. Impact of Notice on the Master Franchisee and Unit Franchisees

The termination of the master franchise relationship may come after months of attempts to right the relationship, which could involve discussions, negotiations, and disputes between the franchisor and master franchisee. In the case of termination, the franchisor will have ultimately determined that the relationship is doomed and termination must be pursued. Consequently, the notice of termination may come as no surprise to the master franchisee. Furthermore, depending on the extent of the communications with the unit franchisees prior to the delivery of the notice of termination, the unit franchisees may not be surprised either.

In any event, once the notice is delivered and assuming the master franchisee is removed, which is a major step, unit franchisees may look to the franchisor to provide services and support. The franchisor will need to have decided before the notice of termination is delivered whether it will appoint another master franchisee to assume the operations of the territory (possibly an existing unit franchisee), whether the franchisor will step in and assume the role itself, either permanently or on a temporary basis, or whether to pursue another course of action. The franchisor should tread carefully here and determine which of these options is preferable under the circumstances.

B. Market Visits

Market visits are highly recommended. As previously mentioned, they generally serve to provide valuable intelligence and facilitate communications and foster a better understanding of the market situation.

1. Meetings/Communication with the Master Franchisee

Unless the master franchise relationship has been dissolved amicably and with all issues resolved (which is seldom the case), further discussions between the parties (franchisor, master franchisee, and possibly unit franchisees) may likely be necessary either to achieve a complete settlement or to facilitate alternative dispute resolution methods. All of these events will generally require representatives of the franchisor to be present in the market. In any event, the presence of the franchisor representatives in the market will also likely be required to address issues of elements of control by the master franchisee such as those noted in Section III H.

2. Meetings/Communication with the Unit Franchisees

Assuming the franchisor has decided to continue the operation of the market managing the relationship post-delivery of the notice of termination should be foremost on the franchisor’s to-do list. In this regard, an on-the-ground physical presence by the franchisor’s representatives may serve to alleviate the unit franchisees’ tension and concerns. Meetings with unit franchisee
leadership should also serve as opportunities for the latter to air their grievances and for the franchisor to communicate its plans to address ongoing operations of the market after the departure of the master franchisee.

Franchisors should seize these opportunities to show the unit owners that it is committed to the market and to them. Furthermore, having plans already devised to address certain unit franchisee grievances should also contribute to the franchisor’s effort to regain control of the market and make way for a more favorable future for the system.

In addition, the mere regular presence of franchisor representatives, particularly in an international market, will serve to underscore the franchisor’s commitment. Where needed, the use of the local language (even if through interpreters) in communications with unit franchisees will also serve to demonstrate the franchisor’s commitment to communicate with unit-level operators and their staff to learn more about on-the-ground operations.

3. Meetings/Communications with Landlords, Suppliers, and Other Key Vendors

News of the delivery of the notice of termination will likely have spread like wildfire within the system and will have also made its way to the ears of suppliers, landlords and other key parties, such as financial institutions and other vendors. These valuable business partners will also need to be reassured that the system in that country (and perhaps elsewhere as well) is not ready to close merely because of the termination of the master franchisee.

Consequently, direct communications and ideally, face-to-face meetings with all or some of these parties will go a long way to lay the foundation for a new beginning and instill the idea that new leadership has arisen. Furthermore, addressing issues such as payment of unpaid sums by either the master franchisees or unit franchisees will also serve to reassure these parties that the franchisor is conscious of and committed to resolving those issues.

C. Assessing the Assumption and/or Assignment of the Unit Franchise Agreements

“Termination of an international franchise is without doubt one of the most difficult issues for a franchisor to face.”

There is no easy answer in deciding whether to assume or assign the unit franchise agreements.

1. Assumption

Assuming direct-control of the unit franchise agreements may present the most significant challenge for a franchisor. Assumption signifies that the franchisor will step into the shoes of the defunct master franchisee and engage in direct franchising going forward. This decision may rest largely on company culture, proximity to home market, language, the

---

8 Mark Abell, The International Franchise Option (Waterlow 1990).
franchisor’s business model, and past experiences. Some franchise systems may elect not to engage in direct franchising internationally, for several reasons:

a. It requires considerable financial and human resources dedicated to provide services and support;

b. It requires that unit franchisees be recruited individually;

c. It requires knowledge about the country, its culture, its business practices, customs, and laws; and

d. It requires resources needed to comply with local legal requirements.

In addition, franchisors should determine whether the existing unit franchisees operate viable units and if there is a business case to keep them. Franchisors may therefore opt for this scenario only if there is no other viable candidate to step in and if the franchisor is committed to saving the market.

2. Transfers

Transferring the rights to the unit franchise agreements to a third party appears, at the outset, the most viable option and likely with the least cost and inconvenience to the franchisor. However, there are still several issues to consider.

First and foremost, a new suitable (in all respects) master franchisee has to be available; barring that, of course, a transfer may not be an option. Another option to consider is whether an existing unit franchisee can step up and fill the role of master franchisee. The advantages of this option, provided the unit franchisee has the financial capacity, resources and business savvy to assume the responsibility of master, are that the unit franchisee knows the market, knows the existing unit franchisees, and possesses a good operational understanding of the business.

D. Dealing With the Dissemination of Information About the Termination

In the absence of imminent threats such as a disaster or real potential danger to the brand image, franchisors are often reluctant to comment publicly on issues related to the termination of a master franchisee. Termination is a private matter and not one generally in the interest of the public at large; moreover, public comments may be fodder for a claim to be asserted by the former master and its management team. Therefore, in addition to keeping the lines of communication open with the master franchisee, the unit franchisees and other key parties as noted in previous sections, the franchisor should likely refrain from commenting on the termination unless the information circulated by other parties, in the media or otherwise, is clearly false, misleading, or slanderous. In any case, it would be advisable to channel information through one single spokesperson so that the franchisor can express a consistent message.

V. REGAINING CONTROL OF THE MARKET

Once notice of termination is delivered and the franchisor has committed to continuing operations within the territory, the franchisor must commit to regaining control of the market. As stated above, the franchisor must first determine whether to step in directly and maintain corporate operations, revert to direct franchising, or to bring in a suitable replacement master
franchisee—whether or not the replacement is an existing unit franchisee. Regardless of the direction, the key elements in regaining control are: assessing the circumstances that led to and caused the termination, communicating with the market and the unit franchisees, assessing the unit franchisee issues including royalties, compliance, claims and litigation, addressing supply chain issues, and other matters that pose a risk to the stability and growth of the franchise business.

A. **Assessing the Reason for Termination and Making Adjustments**

In order to successfully maintain or regain control of the brand in the international territory, the franchisor must evaluate the circumstances that led to and caused the termination in order to avoid the same outcome in the future. These circumstances include but are not limited to: unrealistic development goals and expectations among the parties; choosing the wrong master franchisee; inadequate research and understanding of the foreign market; a lack of franchisor support including a lack of advertising; as well as unsustainable fees.\(^9\)

Once a candid evaluation is conducted, the franchisor may consider re-evaluating and adjusting its strategy for brand development in the market to lessen the probability that development in the international territory will face the same challenges the next time around. In the case of a failed master franchise relationship not caused solely by, for example, a malfeasant master franchisee, quite often a revised growth strategy will be necessary as well as greater commitment of resources including training, marketing and advertising, and financial contributions. If the franchisor decides to work with another master franchisee, the franchisor will need to obtain a dependable background check about the master franchisee’s business reputation, available capital and credit history, and management capacity to achieve the objectives under the current or adjusted MFA.\(^10\) Franchisors should carefully examine whether the replacement master franchisee is sufficiently capitalized to re-launch the brand in the market and whether it has sufficient liquid assets and borrowing capabilities.\(^11\)

B. **Communication to the External Market and Unit Franchisees**

After assessing the reason(s) for the termination and reevaluating the overall market strategy and MFA, the franchisor should prepare to make the necessary adjustments and proactively communicate the upcoming changes to the external market and the unit franchisees. The franchisor may need to communicate with unit franchisees to alleviate their fears and concerns about the termination of the master franchisee. The franchisor may choose to make clear that it will support the unit franchisee during the transition period and provide long-term stability. The message to unit franchisees must be consistent and should communicate the continuity of the business at a high level of customer service.


\(^10\) *Id.* at 3-6.

The termination and the events leading to the termination may have also affected customers, potentially impacting brand loyalty, landlords, vendors, and other third parties. To regain control, the franchisor likely has to start to communicate with the external market. The franchisor should communicate its message through a broad range public relations and advertising campaign using available media and business development organizations as well as coordinating face-to-face meetings with unit franchisees in either regional sections of the territory or a centralized national meeting. The message should be clear that issues relating to legitimate customer and unit franchisee grievances will be addressed, and that the brand will receive the necessary support to achieve high quality customer satisfaction and long term business growth and profitability.

Additionally, the franchisor may also need to communicate with vendors, to secure the supply chain, and landlords, to continue any ongoing real estate discussions between the former master franchisee and/or any unit franchisees.

C. Addressing Unit Franchisee Issues

The primary method to regaining control of the market after terminating a master franchisee is to assert the necessary confidence into the market place by pro-actively communicating and addressing the unit franchisees’ issues. The franchisor should evaluate the legal and financial relationships between the unit franchisees and the former master franchisee and address necessary issues promptly, either directly or with the newly-identified master franchisee.

1. Payment of Royalties

As previously mentioned, royalties constitute the lifeblood of the master franchise relationship. Because the royalties flow from the unit franchisee, it is crucial to reinforce the absolute requirement that unit franchisees make consistent royalty payments. Some local unit franchisees may erroneously believe they are no longer obligated to pay royalties because their contract may only be with the terminated master franchisee and not the franchisor. To minimize any disruption in the payment of royalties, franchisors may want to include language in the MFA assigning to the franchisor the master franchisee’s right to collect royalties from the unit franchisees upon termination of the master franchise agreement.12

Additionally, there may be a perception among some unit franchisees that if the master franchisee is no longer providing support and service, then the unit franchisees are not obligated to pay royalties. Irrespective of the unit franchisees’ position, the franchisor's message to the unit franchisees should be consistent, outlining the services and support they will continue to receive from the franchisor in return for their required payment of royalty fees. The franchisor should also ensure the unit franchisees are aware of how to pay royalties either directly to the franchisor or to the new master franchisee after termination of the original master franchisee.

2. **Compliance with the System and Standards**

The unit franchisees’ compliance with the franchisor’s system and standards is paramount to managing the fundamental structure of a franchise business. Regardless of the events leading up to the termination of the master franchisee, the franchisor has to insist on absolute compliance with the franchise system in order to protect the brand after termination of the MFA. There may have been some reliance on local standards, but these business practices need to adhere to the standards of the franchise system, as adapted for the local market place.

The franchisor has to primarily focus on enforcing compliance with the standard of customer service and quality control. This goal is, rightfully, the focus of ongoing attention by the franchisor, its master franchisee, and unit franchises at every stage in the life of the business—certainly including a time after terminating the master franchisee, when customers may question the system’s reliability and stability. This goal is increasingly difficult to accomplish in an international setting, where the reality is that the franchisor is unlikely to have employees on the ground to easily visit unit franchisees. To remedy this problem, a franchisor may wish to retain a local or regional consultant to perform unannounced inspections or mystery shopping.\(^\text{13}\)

3. **Other Issues**

There are a myriad of other issues that may arise with unit franchisees after the termination of the MFA. The franchisor should make itself available to the unit franchisees either directly or in conjunction with a new master franchisee in order to identify, assess, and resolve these issues. One unit franchisee’s issues may be unique to that particular unit franchisee, or these issues may permeate throughout all the franchise locations. The issues may be simple and evident ranging from inadequate training and inconsistent management structure; or the issues may be complex and convoluted ranging from improper site selection to unauthorized financial arrangements. Regardless of the size and scope of the unit franchisees’ issues, a commitment should be made to resolve any outstanding issues in order to reestablish confidence among the unit franchisees and regain control of the market.

Additionally, the franchisor should assess the development and changes to the territorial laws and their affect on the current and future business climate. Changes in the territories’ laws may affect not only the franchisors operations but may affect the franchisees’ ability to successfully operate their units and follow the terms of the subfranchise agreements.

D. **Addressing Unit-Franchisee Claims/Litigation**

It is possible that the events leading up to and the reason for the termination of the master franchisee involved disputed claims, lawsuits, or arbitration between the unit franchisees and the former master franchisee. It is also possible that a franchisor was unaware of any such disputes, only to learn about them post-termination. In addition to claims or litigation between the unit franchisees and the terminated master franchisee, claims may also exist between the master franchisee and/or unit franchisees and vendors, issues that will likely need to be

acknowledged and addressed by the franchisor. Much like during the term of the MFA, a franchisor should exercise caution and closely monitor any disputes that may negatively impact the brand. Franchisors should also take care to not unwillingly involve themselves in disputes among vendors and the unit franchisees, or unit franchisees and the terminated master franchisee. In such circumstances in a foreign jurisdiction, franchisors may be unwillingly subjected to foreign laws and procedures, not to mention foreign judgments that may be enforceable against the franchisor in its home territory.

E. Addressing Supply Chain Issues

Effectively managing the supply chain is challenging and is essential to the success of any franchise business. This challenge is amplified when a franchisor expands into an international territory. The relative difficulty in managing the supply chain is also based on the type of business. While almost all franchise businesses have to deal with supply chain issues, operating a fast food or restaurant franchise presents a unique and challenging set of issues that a chain of health and fitness clubs may not face.

The complexity of dealing with the supply chain in an international territory is one of the reasons that a franchisor may opt not to directly enter the international market, choosing instead to work with a master franchisee. If the supply chain was improperly established and poorly managed by the former master franchisee, the franchisor may have to expand resources either directly or in conjunction with a new master franchisee to secure for the unit franchisees an efficient and cost effective supply chain to maintain quality control and brand loyalty.

F. Other Issues

Regaining control of the market after terminating a master franchisee may involve re-assessing the overall market strategy, particularly the development commitment reflected in the MFA. Large development commitments put a strain on a master franchisee and may "generate unrealistic expectations and a misallocation of resources that decrease the likelihood of a venture's survival."14

According to the study conducted by Professor Arturs Kalnins and referenced in the introduction of this paper, the survival rate of international master franchise ventures is quite low.15 The study suggests that where the first master franchisee could not meet its development schedule, the franchisor may want to consider reevaluating and creating a more manageable development commitment schedule (and possibly limiting the size of the franchise region to certain cities or sections of the territory) for the successor master franchisee. “If the [master] franchisee succeeds in fulfilling the initial commitment, the parties can then negotiate a larger development commitment in exchange for exclusivity in the entire nation.”16

14 Kalnins, supra note 1, at 14.
15 Id. at 7.
16 Id. at 14.
VI. ENFORCING THE FRANCHISOR’S RIGHTS

After terminating the master franchisee, the franchisor may have to enforce the terms of the MFA, particularly the master franchisee’s post-termination obligations. Enforcing these rights may entail direct discussions with the former master franchisee with an understanding and agreement on complying with the post-termination obligations. However, if the termination was less than amicable, it is likely that the franchisor will have to take legal steps to enforce the relevant terms of the MFA, steps that are prone to a myriad of challenges in the international arena. Prior to taking legal action in whatever the form, any benefits to a successful legal action should be weighed against the possibility of the master franchisee raising and successfully prosecuting counterclaims against the franchisor, including claims resulting from the franchisor’s failure to comply with the MFA’s termination requirements, failure to comply with the termination requirements under the applicable law, breach of contract, fraudulent misrepresentation, or breach of the covenant of good faith and fair dealing.17

Should the franchisor decide not to maintain its presence in the particular international market, then the enforcement of the post-termination obligations of unit franchisees, in addition to the master franchisee, becomes important upon the termination of the MFA. Most likely, the franchisor will not be a party to the unit franchise agreements between the master franchisee and the unit franchisees, and will arguably not be in privity of contract with the unit franchisees to enforce their post-termination obligations, which were put in place to protect the franchisor’s brand. Franchisors are therefore advised to include language in the MFA, and require language in unit franchise agreements, assigning all the rights of the master franchisee to the franchisor upon the termination of the MFA (where possible) in order to enforce the terms of the unit franchise agreements and protect their trademarks.18

A. Post-Termination Obligations

Most MFAs detail the post-termination rights and obligations for both the franchisor and the master franchisee. The master franchisee’s obligations will most often include, similar to the termination of a domestic franchisee, de-identification, remittance of proprietary materials, complying with noncompete obligations, obligations to maintain confidentiality, and financial claims. Similar to the termination of a domestic franchisee, the franchisor will need to assess its ability to ensure compliance with these post-termination obligations, an exercise that may be increasingly difficult in an international environment.

1. De-Identification

A terminated master franchisee will be required to immediately stop using the franchisor’s trademarks and other intellectual property licensed to the master franchisee, including the name, logos, and any derivative of the trademark that may be used in a Web


18 Kirk W. Reilly, Franchisors as Third-Party Beneficiaries of Master Franchise Agreements – A Matter of Intent, 26 FRANCHISE L.J. 199, 199 (Spring 2007).
address.\(^{19}\) Should the franchisor desire to discontinue franchising in the international territory, the unit franchisees will also be required to de-identify from the brand. The cessation of the use of intellectual property by the master and unit franchisees may be dictated by the MFA, by the unit franchise agreements, and by the applicable law.\(^{20}\) Ceasing the use of all of the franchisor’s trademarks and other intellectual property will require the master franchisee and unit franchisees to refrain from identifying any office or business as a current or former affiliate of the franchisor, or as being in anyway associated with the franchisor.

Monitoring de-identification in an international territory will require similar if not greater effort to investigate whether the former master franchisee and any terminated unit franchisees are continuing to use the franchisor’s trademarks, representing themselves as current franchisees, or otherwise implying to the market that they remain affiliated with the franchisor after termination.\(^{21}\) Because the franchisor is unlikely to have any employees on the ground to monitor de-identification, franchisors should retain local counsel, or a local consultant, to monitor the de-identification process.

2. **Remittance of IT, Manuals and Other Proprietary Materials**

Franchisors use technology, training and operating manuals, and other proprietary materials as a mechanism to operate their system and develop their brand in an international market. The franchisor’s proprietary information, such as manuals and market research, financial, legal, and operational documents, and information technology, represents years of work and capital investment to develop a franchising system. Such proprietary information must be protected to make sure the former master franchisee does not use this system to start a competing business. While it may be difficult to prevent a former master franchisee from copying all or some of the system, the franchisor must demand a remittance of all proprietary materials.

3. **Covenants Not to Compete**

Franchisors have several interests in having and enforcing covenants to not compete. Included in these interests are the development and protection of their goodwill, confidential business information, trade secrets, specialized operating methods and training, and ensuring franchisee loyalty.\(^{22}\) Covenants not to compete may be used to protect the franchisor’s

---


\(^{21}\) Appleby & Duffin, *supra* note 19.

legitimate business interests at home and abroad, although the prudent practitioner should either confirm its covenants will be enforceable under the applicable law, or understand the risk in developing an international territory where a covenant not to compete may not be enforceable.

Franchisees’ primary interests in avoiding the enforcement of covenants not to compete is the ability to continue working in the trade or profession around which they have built their careers. Franchisees most often will argue that a covenant not to compete is unenforceable or unreasonable in temporal and/or geographic scope, making it impossible or impractical for the franchisee to continue to work in his or her field of expertise, and these arguments are likely to be the same in the international context.

The enforceability of covenants not to compete within the United States varies from state to state. Similarly, practitioners should be aware of the laws of international jurisdictions and the impact those laws may have on the enforceability of the covenant not to compete in the master franchise agreement. Franchisors will also want to have a clear understanding of whether an order, judgment, or arbitral award enforcing a covenant not to compete will be recognized and readily enforced in the international territory. A practitioner advising a client considering entering a master franchise transaction should consult with counsel in the target country to learn about: any laws applicable to the interpretation and enforcement of the covenant not to compete, including any international franchise or business opportunity laws; any laws that may limit the franchisor’s ability to obtain timely injunctive relief; and the enforceability of a domestic injunctive or restraining order or arbitral award in an international jurisdiction. To the extent a franchisor seeks to include a choice of law provision in the master franchise agreement, franchisors should also ensure there are no foreign laws that may invalidate the choice of law provision, or any other provisions of the MFA.

4. Confidentiality

Some of the more common provisions in an MFA are post-termination restrictions on a franchisee’s use of a franchisor’s confidential information and trade secrets, such as sales and

---

23 Greene and Lokker, supra note 22 at 1.
24 Greene and Lokker, supra note 22 at 1.
25 Greene and Lokker, supra note 22 at 1.
26 Greene and Lokker, supra note 22 at 1.
27 See also supra Section III(E)(1).
marketing strategies, recipes, customer data, promotional campaigns, and computer software.  

These provisions may be increasingly important in an international context where the foreign territory may lack common law, codified, or statutory protections, such as the Uniform Trade Secrets Act, adopted in most United States jurisdictions. Again, practitioners are advised to determine the enforceability of their contractual provisions in an international jurisdiction, and to assess whether any foreign law may protect their interests, and, quite possibly, assess the risks of transacting in a jurisdiction that may not afford protections to the franchisor.

Notwithstanding a franchisor's ability to protect its confidential and proprietary information through legal action, franchisors are well advised to make reasonable efforts to always preserve the confidentiality of their information throughout the franchise system. First, a court or arbitral panel may look to see if the franchisor has taken steps to preserve the confidentiality of its proprietary information in making a determination with respect to the application of a confidentiality provision in the MFA or under applicable law. Second, if access to confidential information is consistently restricted on a "need to know" basis throughout the system, if the information is later misused or misappropriated, the damage may be minimized, irrespective of whether a confidentiality agreement can be enforced.

5. Financial Claims

One possible reason why a franchisor terminates a master franchisee may be a dispute regarding payments of initial franchise fees, royalty fees, or other financial claims that are not sufficiently resolved and deteriorate the relationship. When the franchisor ultimately terminates the master franchisee, there may still be outstanding financial obligations the franchisor will want to enforce. Franchisors are advised to deliver notice to the master franchisee throughout the term of the MFA and in accordance with its notice provisions, as well as after termination of the MFA, of any amounts due and owing to the franchisor. Collecting amounts due and owing under an MFA is increasingly difficult in an international setting. Franchisors should consider the best methods of obtaining, and enforcing, a monetary judgment or award in a foreign jurisdiction before entering the franchise relationship, and should further consider the difficulty in locating and attaching foreign assets to satisfy an award or judgment, should those assets not have been disclosed or have changed subsequent to the parties' entry into the relationship.

B. Methods of Dispute Resolution

There are a variety of methods to resolve disputes if direct negotiations have failed or are not able to take place. Perhaps even more so in an international context, contractual dispute resolution provisions are increasingly necessary to ensure franchisors can maintain a level of control over the dispute resolution process, particularly where a franchisor may be

---


29 Id. at 1.

30 For a more detailed discussion of trade secret laws and the steps franchisors must take to preserve the confidentiality of their proprietary data within the United States, see Lockerby & Mittenthal, supra note 28.
unfamiliar with the international territorial laws that may govern all or part of the franchise relationship. Mediation and/or arbitration provisions may be negotiated as a part of the MFA to dictate dispute resolution procedures when the international master franchise relationship disintegrates, provisions that may be critical to protecting the viability of the franchisor’s brand in the target market. Alternative methods of dispute resolution may also be considered, perhaps at a lower cost than that afforded by the legal process, such as master franchisee work-outs, remedial plans, or the purchase of the master franchise by the franchisor.

1. Mediation

The parties to an international MFA may have negotiated the terms of a pre-arbitration or pre-litigation mediation provision, requiring the parties to submit their dispute to mediation before commencing a legal action. Absent such a provision, however, there is certainly no bar to a franchisor and master franchisee agreeing to submit a dispute to mediation. Mediation is often a desirable option to both franchisors and master franchisees, often employed to avoid lengthy, unpredictable, and expensive legal proceedings. Mediation may also serve as a confidential mechanism to resolve a dispute out of the public eye, thereby preserving the stability of the brand, particularly in a new foreign market, and may also resolve dispute without fracturing the relationship. Much desirable to franchisors contracting with a master franchisee in an international jurisdiction, mediation will likely also serve to facilitate dispute resolution without the application of the unfamiliar foreign laws of the target jurisdiction, and allow the parties to decide, pre-dispute, where any follow-on arbitration will be conducted.

In addition to an agreement to mediate as a condition precedent to arbitration or litigation, the MFA may contain other provisions dictating mediation procedures, whether mediation is required pre-litigation or pre-arbitration, or when mediation is required during the course of an arbitration or lawsuit. The parties may agree in the MFA to use certain dispute resolution associations, such as the United States’ National Franchise Mediation Program, designed specifically for the franchise industry, to resolve the dispute.\(^{31}\) The parties may seek to dictate the manner of selecting the mediator, the minimum qualifications of the mediator, and the location of the mediation. The parties may also agree that the parties must mediate for a certain number of hours prior to seeking alternative methods of dispute resolution.\(^{32}\) Another useful clause in a mediation provision in the MFA is a penalty to the party failing to mediate prior to commencing litigation or arbitration, such as the requirement that the party failing to mediate compensate the other party for all attorneys’ fees and costs associated with the failure to first mediate the dispute.\(^{33}\) Given the likelihood of increased attorneys’ fees and costs in an international forum, such a penalty may be a useful tool for franchisors.

Prior to entering the master franchise relationship, practitioners should consult with local counsel to learn if mediation is compulsory in the target country, and gain an understanding of


\(^{32}\) See *Brosnan v. Dry Cleaning Station, Inc.*, No. C-08-0202 EDL, 2008 WL 2388392, at *2 (N.D. Cal. 2008).

\(^{33}\) See, e.g., *Delamater v. Anytime Fitness, Inc.*, 722 F. Supp. 2d 1168, 1180-81 (E.D. Cal. 2010) (dismissing complaint for failure to mediate and awarding the franchisor its attorneys’ fees resulting from a violation of the mediation provision in the franchise agreement).
any mediation procedures required by the applicable laws.\textsuperscript{34} The enforceability of a mediation provision in a foreign jurisdiction should also be considered when drafting the MFA and again when seeking to enforce the clause.

2. \textbf{Arbitration}

Arbitration is a desirable dispute resolution mechanism in the international arena because of the broad enforceability of arbitral awards in foreign jurisdictions.\textsuperscript{35} Over 150 countries are signatories to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (more commonly known as the 1958 “New York Convention”), providing that “the court of each signatory will abide by, recognize and enforce foreign arbitral awards.”\textsuperscript{36}

The perceived advantages of arbitration as compared to litigation, discussed below, in addition to the relative ease of enforcement of an arbitral award compared to the enforcement of a foreign judgment or order, are reduced costs, faster decisions, the finality of decisions, the ability to select an arbitrator or panel with substantive knowledge, limitations on discovery, and confidentiality.\textsuperscript{37} Arbitration may also be used as a mechanism to limit class actions or the right to a jury trial in certain jurisdictions.\textsuperscript{38} To ensure arbitration remains more cost effective than


\textsuperscript{37} \textit{AT&T Mobility LLC v. Concepcion}, 131 S. Ct. 1740, 1749 (2011) (Scalia, A.), stating arbitration allows for: “streamlined procedures, tailored to the type of dispute. It can be specified . . . that the decisionmaker be a specialist in the relevant field, or that proceedings be kept confidential to protect trade secrets. And the informality of arbitral proceedings is itself desirable, reducing the cost and increasing the speed of dispute resolution.” See also Rost, Schachter, Dodd & Grajeda, supra note 35, at 125; Gardner, Klarfeld & Shaw, supra note 5, at 4, 8-9.

\textsuperscript{38} See, e.g., \textit{AT&T Mobility}, 131 S. Ct. at 1753 (holding that the Federal Arbitration Act, 9 U.S.C. § 1 et seq. (“FAA”) preempts a California Supreme Court decision making most class action waivers in consumer arbitration agreements unconscionable). In that 5-4 decision, Justice Scalia stated that “[t]he ‘principal purpose’ of the FAA is to ‘ensur[e] that private arbitration agreements are enforced according to their terms.” 131 S. Ct. at 1748 (citations omitted).
litigation, the parties should ensure arbitration provisions in the MFA are carefully drafted to streamline the arbitration process and place limits on procedures that may increase the cost of arbitration, such as discovery and motion practice.

Prior to entering into the international MFA, the franchisor should consider whether the target market is a signatory to the New York Convention, or any other international treaties or agreements that may limit enforcement of a foreign arbitral award. Practitioners will also want to be advised on whether a court in a foreign jurisdiction will stay or dismiss litigation commenced by an international master franchisee or unit franchisee in violation of a contractual arbitration provision, and whether a local court will review any part of an arbitral award de novo to determine whether national interests are implicated. Practitioners may also want to consider drafting agreements to arbitrate consistent with the regional requirements of the target territory, such as arbitration agreements in line with the Gulf Cooperation Council when franchising in a member Arab nation, or in line with UNCITRAL Model Law. The key point is, agreements to arbitrate should be individually tailored to fit the particular target market.

Prudent franchisors seeking to employ arbitration will have drafted their MFAs to include contractual provisions to enhance the value of international arbitration. These provisions may include:

1. integrated arbitration provisions that clearly identify the scope of the arbitrator’s authority;

---

39 For example, the United States and most South American countries are signatories to the Inter-American Convention on International Commercial Arbitration, or the “Panama Convention,” providing for the general enforcement of arbitration agreements and arbitral awards. See Panama Convention, Department of International Law, Organization of American States, Washington, D.C., www.oas.org/juridico/english/treaties/b-35.html (last visited Aug. 14, 2013). Members of the Panama Convention are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, United States, Uruguay, and Venezuela. Id.

40 See Rost, Schachter, Dodd & Grajeda, supra note 35, at 125 (in Mexico, Canada, the United States, and England, courts will generally stay court proceedings in favor of arbitration); see also Ust-Kamenogorsk Hydropower Plant JSC v. AES Ust-Kamenogorsk Hydropower Plant LLP, [2013] UKSC 35 (a decision of the U.K. Supreme Court, holding a party to an arbitration agreement is entitled to an injunction restraining the other party from commencing court proceedings in a jurisdiction outside of the European Brussels/Lugano Convention countries).

(2) criteria for arbitrator selection, including the qualifications and experience required for each arbitrator (whether a singular arbitrator or a panel). In this provision, the MFA could dictate that the arbitrator have franchise, or international franchise, experience, a qualification a judge or magistrate may not have;

(3) cost allocation;

(4) an outline of the procedures and rules to guide the arbitration, such as an agreement to follow the Federal Rules of Civil Procedure, the American Arbitration Association, the International Centre for Dispute Resolution;\(^\text{42}\)

(5) the choice of law that will govern the validity and interpretation of the franchise agreement and agreement to arbitrate;

(6) the location of the arbitration and the language(s) in which the proceeding will be conducted;\(^\text{43}\) and

(7) language indicating that the award is enforceable in any court of competent jurisdiction.

3. **Litigation**

   It is not surprising that many franchisors desire to steer clear from subjecting themselves to the unfamiliar laws of foreign courts. Similarly, even if a franchisor includes an enforceable choice of venue provision selecting the franchisor’s home state or territory, the difficulty of enforcing a judgment in a foreign jurisdiction presents a litany of challenges, if not a complete bar in practical terms, in contrast to the comparative ease of enforcing an arbitral award in an international jurisdiction who is a party to the New York Convention. Add to all this the possibility of a terminated master franchisee enforcing a judgment on its counterclaims against the franchisor obtained either in the franchisor’s home country or abroad, while the franchisor can do nothing to enforce its judgment against the master franchisee in the master franchisee’s home jurisdiction. While individual circumstances and certain relationships may benefit from the use of litigation as a dispute resolution mechanism, in the authors’ opinion, in most circumstances litigation is the least desirable option in the international arena.\(^\text{44}\)


\(^{44}\) The authors’ opinions are consistent with a survey conducted of international corporations, finding 73% preferred international arbitration over other dispute resolution mechanisms and that 95% of corporations expect to continue to use international arbitration. *Id.* (citing *International Arbitration Franchise Agreements (Webinar)*, DLA Piper 3 (2012); http://www.dlapiper.com/files/Uploads/Documents/PRESENTATION-DECK-Franchise Arbitration-1.pdf.)
Other deterrents to international litigation include cost, the length of the process, and the lack of confidentiality.\textsuperscript{45} Also, unlike in an arbitration, where the parties select a qualified arbitrator or the arbitral panel, the litigants are not able to select a presiding judge, which may be a great disadvantage in a complex dispute.\textsuperscript{46} Parties seeking to engage in litigation, either due to a lack of a contractual agreement to arbitrate or submit to another form of dispute resolution, or because the particular master franchising relationship is best suited for this form of dispute resolution, perhaps because the target market is not a party to the New York Convention, are advised to be aware of all court procedures, codes, and laws that may impact the litigation, and seek the advice of local counsel before and of course throughout the course of the proceedings.

C. Alternative Resolution Methods

There are numerous opportunities for conflict between a franchisor and a master franchisee, especially in an international territory.\textsuperscript{47} While neither party enters into a franchise agreement with failure as a goal, unfortunately termination of a master franchise agreement does occur. Terminating a master franchise relationship is likely to be costly for both parties. Negotiations break down, a termination notification is issued, and the parties turn to one of the above methods of dispute resolution. However, before or during the commencement of formal dispute resolution, be it mediation, arbitration, or litigation, the parties may determine that a remedial plan and work-out of the conflict may offer an opportunity to restore the relationship or, at a minimum, minimize the harm suffered by the parties.

1. Remedial Plan and Work-Out

If the cause of the master franchisee’s non-compliance with the MFA and subsequent termination was strictly a monetary reason, such as unpaid royalties and advertising contributions, and the master franchisee maintains a willingness to continue operations, then the work-out may be a good alternative to arbitration or litigation. A remedial plan could be structured to give the master franchisee some monetary relief that may include a reduction or deferment of fees owed under the terms of master franchise agreement, likely memorialized by the terms of a promissory note. While this cost is primarily borne by the franchisor, it may nonetheless represent an attractive alternative to termination.

On the other hand, if the franchisee’s non-compliance with the MFA is more severe, such as a breach of an in-term covenant not to compete, inferior operating standards, use of non-approved products, etc., than a remedial plan and work-out would require greater effort and more commitment and contribution by the master franchisee. Both parties would have to work together to create the remedial plan and actively participate in the work-out, followed by significant monitoring by the franchisor. To facilitate success, the parties may desire to create a committee and include representatives from the franchisor and master franchisee, as well as

\textsuperscript{45} Schmidt & Mazero, supra note 42.

\textsuperscript{46} Id.

\textsuperscript{47} See Section II, supra.
other franchisees within the brand system, and, possibly, other experts in franchise business turnaround.

The remedial plan would have to be agreed to by both parties and followed with strict compliance. Both parties would also have to commit to open and consistent communications between each other and with any advisory committee created to implement that plan and workout.

2. **Franchisor Buys Out the Master Franchisee**

The franchisor may determine that the best option, or only option, to protect the brand is to purchase the franchise from the terminated master franchisee. The franchisor may do this as a permanent business strategy or as a temporary step to support the brand until a suitable replacement master franchisee is found. Added to the benefits of avoiding the costs and uncertainty of arbitration or litigation, the franchisor will likely be able to purchase the assets of the master franchisee at a discounted rate. While the franchisor will have to allocate valuable human and financial capital to the unexpected endeavor, a buy-out of the master franchisee may nonetheless be a viable alternative to legal action. Similarly, while the master franchisee may well be displeased with the final sale price, the master franchisee may have sold the business to the only available and willing buyer—the franchisor—avoiding the myriad of problems associated with a struggling business venture unable to be sold, such as financial defaults, possible legal actions by vendors and unit franchisees, among others, and bankruptcy.

3. **Assigning the Master Franchisee’s Obligations and Interests**

Another possibly viable alternative to legal proceedings, or available to the parties during the course of those proceedings, is the assignment of the MFA, and the assignment of the terminated master franchisee’s rights and obligations under any unit franchise agreements, to a new master franchisee. In order to prevent the assignment of the MFA to an unqualified third party, franchisors will most often include a provision in the MFA requiring their review of and consent to a proposed transfer. When considering an assignment of the MFA to a third-party, the parties may desire to consider current unit franchisees, a master franchisee in a neighboring country—if cultural barriers are not prohibitive—or another operator that has the financial and business capacity to purchase and grow the brand. Regardless of the choice, in order to succeed with a new master franchisee the franchisor must assess the reasons for the initial termination and make any necessary adjustment to avoid the same challenges arising with the new party.

VII. **CLOSING THE MARKET**

A franchisor should never exclude the possibility of exiting from the international territory after the termination of an international master franchisee. While the franchisor likely conducted detailed market research on the viability of its brand in the international territory and on the business acumen and financial strength of the master franchisee, the relationship still resulted in termination. All the circumstances surrounding the termination would have to be considered in order to make a cost-effective financial and market decision whether to close the market. Economic necessity will likely dictate whether the franchisor withdraws from the international market.

Franchisors seeking to withdraw from the market entirely should be wary of claims of abandonment by unit franchisees. Cautiously drafted unit franchise agreements may include
provisions indicating that, upon termination of the MFA for cause, unit franchise agreements are either automatically terminated, or subject to termination by the franchisor who has assumed all rights under the unit franchise agreements. Such provisions may work to limit claims of abandonment by unit franchisees faced with a complete market withdrawal. Franchisors should also be aware of potential claims from vendors resulting from the terminated unit franchisees’ cessation of operations, in all likelihood leading to breaches of vendor contracts.

Finally, the franchisor should consider the balance between the effect on the brand of closing the market versus staying in the market and facing challenges with a new master franchisee. While there is little upside from closing the market, the franchisor has the potential of limiting the downside on the brand, financial exposure, and diversion of management attention and resources.

VIII. CONCLUSION

Terminating an MFA and international master franchise relationship has become a necessary evil as franchisors continue to employ the master franchising model for expansion into international territories. Cultural differences, language barriers, differences in business practices, distance, and other factors will continue to challenge franchisors and master franchisees as they conduct business together, however these challenges may be minimized by both parties’ acknowledgment of such challenges early in the master franchise relationship and managing those challenges by drafting an MFA that anticipates and addresses those challenges, including the challenges faced at the end of the relationship.

When an international master franchise relationship breaks down, for whatever the reason, franchisors must ensure they are taking the proper steps to terminate the MFA under both the terms of the MFA and the applicable law. A well-drafted MFA may serve to eliminate or lessen many of the challenges faced by franchisors, including carefully drafted choice of law provisions, mediation and arbitration provisions, and notice requirements for termination. Whatever the termination process brings, in the authors’ opinions the preservation of the quality of the brand is the primary goal and the franchisor should take whatever steps necessary, and consider all dispute resolution options, whether in the form of legal proceedings or a negotiated resolution, to maintain the image of quality and strength of the brand.

48 Should a unit franchisee pursue claims for abandonment resulting from the market withdrawal, United States case law shows that the defense of economic necessity, in most jurisdictions, will protect a franchisor’s decision to withdraw from a market, particularly given any evidence of anti-competitive activity. See Brian B. Schnell and Andrew P. Zappia, The Pros and Cons of Defranchising, Workshop 15, 2006 A.B.A. Forum on Franchising 33 (citations omitted).
Stéphane Teasdale

Stéphane Teasdale is a partner in the Montreal office of Dentons Canada LLP (“Dentons”), co-chair of its Commercial Group and chair of Dentons’ International Franchise Law Group. He is a leading practitioner in the area of commercial law and is internationally renowned for his unique expertise in the area of franchising.

For 25 years, Stéphane has provided legal and strategic counsel in transactional and litigation matters dealing with commercial, competition, real estate, intellectual property and other areas of law. He advises prominent Canadian, American and foreign franchise systems wishing to establish themselves or expand in Canada, particularly in Quebec, and to Canadian franchise systems expanding internationally to destinations such as the United States, Europe, Australia and Africa.

Actively involved in Canadian, American and international franchise associations, he is currently the vice president and an executive committee member of the Quebec Franchise Council. A frequent lecturer on franchise matters at both domestic and international forums, and author of numerous published articles, Stéphane is recognized in Canada, the United States and abroad as one of the few experts in franchising law in Quebec and Canada, an honor that has been repeatedly acknowledged by The Canadian Legal Lexpert Directory, Who's Who Legal, Franchise Times magazine and, more recently, The Best Lawyers in Canada 2013. A graduate of the University of Ottawa Faculty of Law, the Université du Québec School of Business and the Queen's School of Business, Stéphane was called to the Quebec Bar in 1988 and is a member of the Canadian, American and International Bar Associations.
James M. Susag

James M. Susag is a shareholder and trial lawyer with Larkin Hoffman. His trial practice focuses on franchise, dealer and contract disputes. Mr. Susag has extensive first-chair trial experience, representing clients in numerous jury and court trials, arbitrations, administrative proceedings and appeals. Some of his recent successes include enforcement of franchise and dealer agreements in Federal District Courts in California, Wisconsin, and Minnesota, and in arbitration.

Mr. Susag joined Larkin Hoffman in 1997 after two years with a Minneapolis-based litigation boutique. Between 2005 and 2007, he was Chief Litigation Counsel for U.S. Bancorp. There, Mr. Susag was responsible for complex litigation on a nationwide basis, and learned about litigation from the client’s perspective. He resumed his trial practice with Larkin Hoffman in 2007.

A member of the state bars in Minnesota and Wisconsin, Mr. Susag is admitted to practice in state and federal courts in both states as well as the United States Court of Appeals for the Seventh and Eighth Circuits, and the United States District Court for the Northern District of New York. He is a member of the American Bar Association Forum on Franchising and the International Franchise Association. Mr. Susag is also certified as an arbitrator and mediator by the Minnesota Alternative Resolution Review Board.

Mr. Susag is a frequent writer, public speaker and panelist. He recently presented on the topic “Advanced FPRs: Writing, Using, Attacking and Defending Financial Performance Representations” at the 46th Annual International Franchise Association Legal Symposium (held on May 5-7, 2013 in Washington, D.C.). Mr. Susag also published the articles “Non-Compete Cases: Does Anyone Really Win?” for the *LJN Franchising Business & Law Alert* (co-authored with Charles Modell) and “Are Franchisors More Vulnerable after Toledo Mack Sales & Serv., Inc. v. Mack Trucks, Inc.?“ for the *ABA Franchise Lawyer*. He is a regular contributor to Larkin Hoffman’s *E-News: Franchise and Distribution Law Update*.

Mr. Susag is a *summa cum laude* graduate of William Mitchell College of Law and a *summa cum laude* graduate of the University of St. Thomas, both located in St. Paul, Minnesota. He serves as a volunteer arbitrator for the Hennepin County Bar Association Legal Fee Arbitration Program, a volunteer mentor to high school, college and law school students and as career day speaker to both junior high and high school students.