International Franchising in an Unclear and Uncertain Legal Environment

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October 11-13, 2006
The Westin Copley Place
Boston, MA

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International franchising is increasingly important to American franchisors. Ninety exhibitors at the June 2006 International Franchise Expo in Washington, D.C., stated in program materials that they were seeking franchisees in other countries. More than one half of 104 U.S. franchisors responding to a 2006 survey conducted by The Rosenberg International Center of Franchising at the University of New Hampshire1, and commissioned by the International Franchise Association’s Education Foundation reported that they operated units outside the United States. That was a 20% increase over the previous ten years. The respondents indicated that international franchising accounted for 17.4% of their profits. Nearly 80% of the respondents indicated that they intend to open new units abroad during the next three years.

Although only about 16% of the respondents reported that they had retained international lawyers in executing their international strategies, one would naturally expect that the demand for franchise lawyers who possess the knowledge and skills necessary to guide franchisors in their international growth will increase.

As franchise lawyers, our clients will expect us to deal with a multitude of legal issues, often in U.S. jurisdictions which are far from jurisdictions where we are licensed to practice. More often than not, when franchisors consult us about a potential international franchise transaction, they often first ask, “does the country have a franchise law?” If a franchise law exists, we usually can access a translation of it in the CCH Business Franchise Guide. But after reading the laws, we often are faced with a multitude of questions about interpretation, application, risks, and remedies. However, advisors who regularly provide advice on international franchising issues know that is only the first of many questions. These consultations demand that legal counsel guide their clients to consider the transaction in the broadest possible sense and certainly outside the franchising world in order to take into account domestic and foreign laws, cultural issues and public policies that may impact the transaction.

Based upon the way we are usually able to advise franchisor clients when dealing with issues across state lines, we are often expected to be able to use uniform forms and standard procedures like the one the franchisors use themselves to grow their businesses. Unfortunately, those expectations are unrealistic, and the more we learn about cross border franchising, the more attuned we become to the ways in which different legal systems, different laws, different cultures and different business practices require a thorough analysis of numerous issues which may be germane to our clients’ franchise programs before we advise them.

In this paper we have identified recurring issues franchisors confront in granting and carrying out transnational franchising programs. Although issues raised are from the perspective of a U.S. lawyer which must advise a U.S. based franchisor, these issues must also be addressed by lawyers for foreign franchisors as well. We have not set out to identify every legal issue which may confound an international franchisor, and we certainly have not attempted to survey the laws of every country in the world. Rather, we have focused upon a blend of typical problems and key issues which have arisen in some of the markets which recently have adopted franchise regulations. We also have addressed differences in how common law jurisdictions and civil law systems may deal with the same legal issue. We note how changes from a command economy to a model economy in China have hampered predictability of legal interpretation. And, after identifying issues, we have tried to identify possible solutions for counsel to consider.

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1 Udo Schlentrich, Ph.D. & Hachemi Aliouche, Ph.D., Rosenberg Center Study Confirms Global Franchise Growth, FRANCHISING WORLD, August 2006, at 63.
An indispensable part of the solution for every issue is to rely upon the advice of competent local counsel. But, even the most experienced franchise counsel often will struggle to provide clarity when confronted with newly adopted laws or regulations. Thus, in some cases, franchisors will still face unclear and conflicting laws, and counsel may need to advise franchisor clients that it is impossible to know exactly how a law or contract provision ultimately will be interpreted, and that entering into a transaction under those circumstances requires the franchisor to assume unusual risk.

We hope that the following will illuminate the issues and provide some insights to help counsel and franchisor client make the best of the situations which they encounter.

I. Judicial Approaches in Developing and Developed Countries

The knowledge or insight of an experienced international franchise counsel into how an agreement will be read and interpreted by foreign judiciaries is critical during the course of the drafting of the agreement. One of the challenges created by a developing legal and/or judicial environment is exemplified by the situation in China. In China, the processes are confusing and legal approaches are oftentimes conflicting, thereby hindering even an experienced franchise counsel or local counsel to give any significant legal guidance.

A. Chinese Legal System – A System In Its Commercial Infancy

From a commercial standpoint, China is viewed with considerable interest. The speed of its economic development, its move away from a state controlled economy and the rise of an affluent middle class have attracted franchisors. Although what follows is specific to China, many similar issues arise in other communist countries or in previously communist controlled countries, and to a lesser extent in countries which have a strong regional or provincial governmental or court structure, as well as in countries in which the judiciary is not only appointed by the state, but also forms a separate profession, which is the case in most civil law jurisdictions.

Any discussion about the approach of the Chinese courts by necessity requires some understanding of the Chinese approach to government and to its court structure.

China’s legal system is still relatively incomplete with the country still in the process of transforming itself from a socialist law system to a civil law system. China has not yet promulgated a civil code, although it did adopt the General Principles of the Civil Law of the People’s Republic of China in 1987, which are modeled on Germany’s civil code. The lack of a full civil code means that there inevitably is a degree of uncertainty within the system.

The National People’s Congress (“NPC”) is the highest state organ, it has legislative power over the whole country, but it delegates certain legislative powers to Local People’s Congresses (“LPC”), set up at provincial levels and to local government bodies.²

Under the constitution of China, the People’s Courts are the judicial organs of the state and exercise judicial powers.³ The court system is made up of four levels. At the head of the


³ ABA Forum Paper-International Franchising 8-31-06.doc
system is the Supreme People’s Court (“SPC”), beneath it at the provincial level, lies a system of local peoples courts which are further sub-divided into basic, intermediate and high. The courts are supervised and report to the corresponding LPC.

Judges are not appointed by Central Government (other than those to the SPC) but appointed by the LPC and the equivalent Standing Committee at the same level as the court. Generally, judges serve a maximum of two, five year terms; however there is no security of tenure. Judges must answer as much to government officials than as to the law itself. Thus, they remain subject to outside political influences especially when one considers that funding is provided and personnel decisions relating to the judiciary are made by the LPC. The courts are considered to be an organ of government.

The adoption of the civil law rather than the common law model means that trials are dealt with in an inquisitorial, rather than adversarial, manner. Thus, the quality of the decisions is more directly linked to the quality of the judges than is typically found in a common law model.

The system operates a two-tier trial system whereby the second instance is the final determination of the case as prescribed by Article 12 of the Law on the Organization of People’s Courts. First instance is known as “yi shen” and second instance known as “er shen”.

The basic courts, located in rural districts, are tasked with being the courts of “yi shen” in cases that do not require trials and do not deal with cases of a serious nature which would be passed to the intermediate courts. The intermediate courts, located at city and prefecture level, are also tasked with hearing trials at “yi shen” where (i) there is a civil case involving a major foreign element, (ii) there is a case of major significance within their field, (iii) the case has been referred by the basic court, and (iv) the SPC requires it. The intermediate courts act as “er shen” where an appeal or protest is made against the ruling of a basic court. The intermediate courts also have a supervisory role in respect of basic courts and may order decisions of the basic courts to be re-examined, where errors have been found, or to re-examine the basic courts decisions itself. Higher courts, located in provincial capitals, are responsible for hearing “yi shen” in cases over which they have jurisdiction which includes cases involving complicated issues, cases referred by the SPC or by intermediate courts and deal with “er shen” in cases where an appeal or protest has been made against the ruling of an intermediate court. Again higher courts have the power to supervise and re-examine judgments of the lower courts.

The SPC tries cases at the “yi shen” level where it has jurisdiction and where it deems that the case is such that it should be tried at this level. It also hears at the “yi shen” stage if it

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3 Id.
9 Id.
has been referred by a lower court which is of the opinion that the case ought to be tried at “yi shen” in the SPC. It is the court of “er shen” in respect of appeals and protests against decisions and judgments of the higher courts. In addition, its role includes the supervision of trials conducted by the lower courts. Most importantly, the SPC issues judicial interpretations on the application of legislation in the same way that the Cour de Cassation does in France.

The judicial supervisory role exercised by the higher courts over the lower courts as described above represents a remedy to the “er shen” being the final determination of the case. A judgment may be corrected or remedied if a judgment is found to contain errors of fact or application of the law. The process can be initiated by presidents of courts, superior courts and the SPC.10

Each court contains an Adjudication Committee. The function of Adjudication Committees is to ensure that, where cases involve significant economic disputes or sensitive political matters, they are dealt with by individual judges on the advice of the particular court’s Adjudication Committee.11

China has also in recent times made amendments to its Constitution to suggest that it wishes to embrace a “Rule of Law.”12 This however needs to be seen in the context of a system whereby the NPC’s delegated some of its powers to LPC’s without the allocation of specific defined powers to these bodies; thereby allowing local levels of government considerable latitude in passing and adapting laws to suit local conditions.13 In doing so, local laws sometimes conflict with national laws. In an effort to resolve this issue, the Constitution sets out, at Article 100, that local regulations must not contravene the Constitution and the law and administrative regulations. The problem with this Article is that the enforcement mechanism associated with it is less than robust. It is suggested that local legislatures and agencies should abolish any offending rules.14 The courts do not have the power to interpret laws or administrative regulations. This power lies with the NPC and the issuing agencies, therefore, it is the judges’ role to refer conflicts in law for review by the Standing Committee of the NPC. Judges, then, are expected to follow the Standing Committee’s decision. However, this rarely occurs in practice, so courts have become accustomed to assuming this role themselves and simply leaving the conflicting law untouched. The limitation of judicial power was highlighted in a high profile case involving seed contracts, where a judge ruled that due to a conflict between the local laws and the national law, the national law should prevail and the local law was invalid. This judgment led to the relevant LPC viewing the ruling as a “serious breach of law” and a challenge to the law making authority of that National People’s Congress.15 Due to the LPC being the body responsible for the appointment of local judges, the call was for the judge to be removed. The case has become a landmark case in terms of the development of the Chinese legal system and highlighted the limits of judicial autonomy within the system. The case was subsequently reheard in the province’s high court and the verdict was the same, although the

12 Id.
13 Id.
ruling criticized the initial judge for invalidating the provincial law. In the aftermath of the Li Huijuan case, the Standing Committee announced the creation of a new review panel to mediate conflicts of law. However, the proposal has received a mixed reception because some commentators believe that the panel’s activities will be secret and the responsibility for conflicts should belong to the courts.16

Even in cases where there is no conflict of laws there is the potential for lower courts to decide similar cases inconsistently. This uncertainty exists because of the emerging nature of the Chinese system and the lack of full codification which leaves a gap which has yet to be filled. In order to counterbalance this, the SPC issues judicial interpretations on unclear statutory language and conflicting lower court decisions17 to provide some degree of certainty in the system. Although these interpretations do not have binding effect, they have become part of the Chinese system and are considered a formal source of law. There have been only 4,000 judicial interpretations issued by the SPC between 1949 and 2000.18

Adding further delays and challenges to this developing judicial system is the practice of “quingshi.” “Quingshi” is a practice Chinese judges employ which allows them to refer difficult cases to a higher court for advice on how to deal with them prior to issuing their own decision. One of the reasons behind this practice is that judges whose decisions are reversed suffer in terms of their professional reputation and career advancement. However, the practice poses problems because it leads to an increased workload for the higher courts and delays in proceedings because of the transfer of the case between the courts. It can also encroach on the appeals process because a higher court may be reluctant to reconsider issues it has already responded to as part of the quingshi process. The problems caused by the process have been recognized and in December 2003 the SPC issued a Notice to courts of remedial measures which included an instruction to phase out the use of quingshi. It is not clear how much effect this will have.19 Further, one of the busiest courts in Beijing announced in November 2005 that it would no longer punish judges if rulings were subsequently deemed to be politically or legally wrong.20 This approach, if adopted by more courts, would certainly erode one of the more significant factors encouraging “quingshi”.

There has been a further development within the court system itself in order to address with the gap caused by the incomplete codification of the Chinese laws and, as is standard in civil law systems, the lack of reliance on previous case law. The Higher People’s Court of Tianjin in 2003 decided three cases to which lower courts can refer to in making judgments. This was in effect the issue of recognizing legal precedents through the form of case law and was the first time in Chinese higher courts that this had occurred. It was seen as an important step by the China Law Society in maintaining consistency between legislation and enforcement. Although precedents are not endorsed as part of the legislation in China on some occasions “typical” cases have been referred to in making judgments and the SPC releases typical cases it collects and thinks instructive on a quarterly basis. Interestingly, as discussed in section I.B

16 Id.
below, this reflects the approach of France’s Supreme Court in relation to France’s disclosure law. The Higher People’s Court of Tianjin took nine months to make the selection of the precedents. The court took the view that the use of the precedents would prevent different laws being applied to similar cases or contradictory verdicts on similar cases. The precedents are not strictly speaking legally binding on judges; however, it has been indicated that should judges choose not to follow them they would have to state their reasons and if the reasons were insufficient then the decisions given in conflict with a precedent were likely to be amended.\textsuperscript{21}

Once a ruling has been made there can be further issues concerning enforcement. Statistics suggest that as many as half of all Chinese civil judgments go unenforced.\textsuperscript{22} The problems with enforcement stem from local protectionism. The courts are dependent on the LPC to fund them and the LPC also has the power to appoint court personnel. Due to this influence, local courts can be susceptible to being used as tools to defend local government interests.\textsuperscript{23} Due to the importance placed on rank within the Chinese system, the courts are also unable to enforce judgments against defendants who are on the same administrative level as the court, such as the local government body. There is the added problem that local courts are reluctant to enforce the judgments of the courts of another area.\textsuperscript{24}

There are, clearly, crucial issues associated with the legal system in China; these issues stem predominately from the fact that the system is in its infancy. China is dealing with a developing civil jurisdiction without the benefit of full codification, which in turn leads to a degree of uncertainty within the system. This is further complicated by the state, in the form of local government, still having an enormous influence over the judicial system and not least over the judges. However, these problems are gradually being addressed through stricter qualification requirements for the judiciary, better training for judges, the recognition of the conflict between national and local laws and the issue of precedents.

The detailed analysis of issues relating to the Chinese legal system has been set out because, without a clear understanding of these issues, franchisors and their advisors cannot fully understand the risks involved in setting up a franchise network in China. Elements of the Chinese approach may be seen in other countries such as Russia, Vietnam, Cambodia and North Korea.

The task for any lawyer advising a franchisor intending to expand into China is first to advise on the uncertainties of the Chinese legal system and highlight the risks. To the extent that these risks cannot be eliminated, franchisors must consider whether it is wise to enter the Chinese market at all. For many, the attractions of the Chinese market, with its double digit growth in gross domestic product in the first two quarters of 2006, is sufficient reward to compensate for the obvious risks involved.

Because of the uncertainties concerning the treatment of franchising in China, some franchisors have chosen alternative, more cautious approaches for when entering the Chinese market. McDonald’s operates through company owned or joint venture outlets with only one franchised outlet in Tianjin. KFC has over 1,500 outlets but only seventy are franchised. Certainly an approach whereby an inbound franchisor, in a country such as China, at least initially, operates through company owned outlets has its attractions – it avoids the need to comply with unclear franchise law and enables the franchisor to obtain valuable experience without involving third parties. Clearly this may be an option which is available only to the best resourced franchisors. If direct operations are contemplated, a separate subsidiary company should be incorporated with a view to confining any issues that may arise. If franchising is the chosen route it should not be assumed that the use of choice of law/courts clauses will eliminate the difficulties highlighted in this section. Chinese Courts appear to believe that they are not prevented from hearing a case even when a foreign court has already decided the case! In a recent development the concept of “forum non conveniens” has been introduced through the second National Foreign Related Commercial and Maritime Trial Working Meeting Minutes. The Minutes envisage that a Chinese court will desist from hearing a case if to do so would be more convenient to the parties. It is, however, difficult to imagine a situation where a Chinese court would, in a dispute between a foreign franchisor and a Chinese franchisee, consider that a foreign court was more convenient. In any event, the choice of a foreign law cannot be used to avoid mandatory Chinese requirements or if the foreign law fails to comply with Chinese public policy requirements.

In summary, the steps which should be considered when entering a foreign market with an undeveloped legal system, substantial governmental control, unclear franchise legislation and a difficult language barrier, are:

1. Obtain detailed information about the current state legal position and potential developments;
2. Assess the market potential;
3. Establish whether the attractions of the market outweigh the negatives of the legal position;
4. Do not assume choice of law/courts clauses will be upheld;
5. Consider initial entry to the market by way of company owned outlets;
6. Consider employing alternative dispute resolution mechanisms.
B. Civil Law versus Common Law

It is not only in developing countries that difficulties arise in relation to differing judicial interpretations of the same legal provisions. In France, for instance, the effect of a breach of the disclosure requirements contained in the Loi Doubin25 was the subject of substantial uncertainty.

By way of background, a few general observations need to be made on the civil law system. The civil law approach is to establish general principles within codes which are then applied by judges. This needs to be contrasted with the common law approach where the common law has developed by establishing principles from specific decisions. In other words, the common law and the civil law approach are entirely different. Professor David, in his seminal work “Les grands systèmes de droit contemporains”,26 indicated that the civil law approach undoubtedly made it easier for a French practitioner to tell his client what rules of law applied to his particular situation than would be the case for a common lawyer; Professor David then goes on to recognize the supposed advantages of this are “largely illusory” because:

formulating legal rules in very general terms results in them being less precise and also results in giving judges an extremely broad power on how to apply that rule of law. Certainty is not achieved, as a result of the fact that the applicable rule or law is easier to find; rather the opposite is true.27

As a result, in civil law systems the Supreme Court has a major role to play in ensuring consistency. The difficulty is that judges in civil law systems, technically, only apply general principles to factual situations, and in this area they have complete autonomy. The French Supreme Court, the Cour de Cassation, is not supposed to influence the lower courts in relation to the application of legal principles to particular cases, but in fact, the Cour de Cassation seeks to do precisely that in certain situations. Again in the words of Professor David:

Once a factual situation appears to be sufficiently “typical” and susceptible to occur frequently, we try by one technical device or another to ensure that the situation is regulated by a rule of law, such that the interested parties know what rules will regulate them and how they have to behave. The French Cour de Cassation as a result controls, in such situations, the way in which the case judges apply the rules of law; the court will in this situation impose its “interpretation” of the rule of law, whereas in other situations which arise less frequently the Cour de Cassation refuses to exercise any control and, as a result, indicates that the case judges are uniquely capable to consider the facts giving rise to the litigation.28

This approach has had interesting consequences in relation to the application of the French disclosure law, known as the Loi Doubin. The Loi Doubin requires a franchisor to provide prospective franchisees with information and a copy of the proposed franchise agreement at least 20 days prior to the execution of the franchise agreement or the making of any payment in relation to the franchise agreement. The Loi Doubin does not specify whether

27 John Pratt’s translation, Id. at 98.
28 John Pratt’s translation, Id. at 98"
non compliance has any affect on the franchise agreement itself and, as a result, the consequences of a failure to provide the required pre-contractual information was the subject of considerable debate. The majority of lawyers considered that failure to comply would result in the automatic termination of the franchise agreement, thereby placing the parties back to the position they were before entering into the agreement. This would result in franchisees receiving back all payments that they had made under the franchise agreement. Because the invalidity of franchise agreements was not specified within the law itself, this was the position adopted by the majority of French courts, even though from a commercial perspective this caused substantial difficulty. Inevitably, unsuccessful franchisees alleged breaches of the Loi Doubin in their attempts to avoid what they then considered to be burdensome franchise agreements. Sometimes these claims were raised long after the franchise agreement was executed by the parties. The courts based their decisions on the “public policy” objective of the Loi Doubin to protect franchisees, and on the basis that the Loi Doubin, (extremely unusual in French commercial law), imposed criminal sanctions for a failure to comply.

The decisions of the various courts were difficult to reconcile. For instance, the Paris Commercial Court concluded that invalidity of the franchise agreement could not arise on the grounds that this was not specified in the law itself. Some courts followed this approach when a breach of the disclosure requirements had no real effect on a franchisee’s decision to enter into the franchise agreement, but court decisions continued to result in uncertain outcomes. In the words of one commentator:

Case law was in a state of flux in 1997 as the courts handed down contradictory decisions on sanctions for failure to disclose, on the one hand declaring automatic nullity (CA Paris 18 June 1997, CA Montpelier, 4 December 1997) and on the other requiring evidence of willful misrepresentation in order to declare a contract void (CA Versailles 6 March 1997, CA Toulouse 18 December 1997, CA Lyon 28 March 1997).

As a result on 10 February 1998 the Cour de Cassation handed down its decision in ED le Maraicher. In this case a supermarket chain had entered into a series of leases/concession agreements enabling third parties to sell fruit and vegetables within their supermarkets. Disputes had arisen, and the third parties sued the supermarket chain. The Paris Court of Appeal declared the contracts null and void because the supermarket chain had failed to provide pre-contractual information as required by Article 1 of the Loi Doubin, but the Cour de Cassation overruled the Appeal Court’s decision on the basis that the Appeal Court had failed to consider whether the lack of disclosure had prevented the lessees from entering into their agreements with full knowledge. The Cour de Cassation indicated that, if a breach of the Loi Doubin disclosure requirements occurred, courts had to consider, prior to declaring a contract void, whether the franchisee’s decision to enter into the contract had been affected.

Notwithstanding the Cour de Cassation’s clear statement, the French courts did not always follow the Cour de Cassation’s decision. The Court of Appeal of Montpellier on 12 November 1998 in the Vela v Hygiene Diffusion SA did not adopt the Cour de Cassation’s approach. The case related to an exclusive concession agreement for the distribution of health products. A dispute had arisen concerning non payment for products supplied. At first instance the franchisee was required to make payment to the franchisor. The franchisee appealed on

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29 CA Paris, April 7, 1993.
30 Remi Delforge.
the grounds that the pre-contractual information requirements of the Loi Doubin had not been satisfied. The Montpellier Court of Appeal accepted this argument without investigating the effect on the franchisee of the failure to comply, and declared the concession agreement void, even though it had been entered into several years previously. The case was then referred to the Cour de Cassation which on December 10, 1998 reversed the decision and referred the case to another appeals court for retrial. The Cour de Cassation also ensured that its decision was published in the French Supreme Court’s Special Gazette which clearly indicated that it wanted its decision to be followed by the lower courts. A subsequent decision of the Cour de Cassation on October 19, 1999 reinforced the position, and since then the lower courts have broadly followed the lead set by the Cour de Cassation.

To common law lawyers the concept of lower courts not following the decisions of the Supreme Court would be “surprising” and reinforces concerns about the reliability of court decisions; but care needs to be taken in seeking to argue the superiority of the common law approach. The position can perhaps be contrasted with what has arisen in Canada in relation to disclosure requirements.

Under existing and pending statutes in Canada (Alberta’s Franchises Act),32 Ontario’s Arthur Wishart Act 2000 (Franchise Disclosure),33 Prince Edward Island’s Franchises Act and New Brunswick’s Franchises Act, a franchisee has 60 days (from execution of the franchise agreement) to rescind a franchise agreement where the franchisor has made insufficient disclosure and two years (from execution) to rescind a franchise agreement where the franchisor has made no disclosure at all.

Notwithstanding the relatively clear wording of the statutes, Canadian court decisions do not appear clearly to distinguish between insufficient disclosure and no disclosure.34

Both Ontario Ltd v Dig This Garden Retailers Ltd35 (“Dig This Garden”) in Ontario, and Personal Service Coffee Corp v Beer36 (c.o.b Elite Coffee Newcastle) (“Beer”) dealt with rescission of a franchise agreement. In both cases some documents were provided by the franchisor to the franchisee; nevertheless, the Court held that the franchisee had two years within which to rescind the agreement. In Dig This Garden, Horkins J. held that in considering the wording of Section 5(3) of the Arthur Wishart Act, the disclosure document must be “one document” in order to fulfill its statutory obligation. In Beer, the Ontario Court of Appeal held that Beer had an absolute right of rescission because he had received an incomplete disclosure document from the franchisor at the time he entered into the franchise agreement. In effect, the Beer Court said an incomplete disclosure document amounted to no disclosure.

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32 S.A. 1995 c F-17.1.
33 S.O. 2000, c.3.
34 Arthur Wishart Act, 2000 (Ontario): Section 6(1): A franchisee may rescind the franchise agreement, without penalty or obligation, no later than 60 days after receiving the disclosure document, if the franchisor failed to provide the disclosure document or a statement of material change within the time required by section 5 or if the contents of the disclosure document did not meet the requirements of section 5. Section 6(2): A franchisee may rescind the franchise agreement, without penalty or obligation, no later than two years after entering into the franchise agreement if the franchisor never provided the disclosure document.

Franchises Act (Alberta): Section 13: If a franchisor fails to give a prospective franchisee the disclosure document by the time referred to in section 4 (14 days prior to signing the franchise agreement), the prospective franchisee may rescind all the franchise agreements by giving a notice of cancellation to the franchisor or its associate, as the case may be, (a) no later than 60 days after receiving the disclosure document, or (b) no later than 2 years after the franchisee is granted the franchise, whichever occurs first.

Further, in *Walden v 887985 Alberta Ltd (c.o.b. Ag Connexions)*, Justice Templeton held that the disclosure document received by Mr. Walden less than 14 days prior to signing the franchise agreement was “seriously deficient” and that the franchisor had failed to prove that it had complied with the Act. The fact that Mr. Walden had rescinded the agreement following expiry of the prescribed 60 day period was not addressed by the Court.

In relation to the effects of defective disclosure, the Canadian common law system does not appear to produce a more certain result than the civil law system in France.

II. Agency Law and Good Faith Requirements

As franchisors take their franchise systems into foreign lands, they face a variety of local challenges beginning with attempts to make the agreement subject to agency law or to comply with good faith requirements.

A. Applicability Of Agency Laws Or Other Commercial Laws

Because franchising is a relatively recent commercial concept, lacking a history of regulation or judicial precedent in most countries, lawyers for franchisees have had to be creative to find remedies for their clients. They have characterized franchising in numerous ways in an attempt to fit franchise relationships into some category of regulated or recognized commercial activity under traditional legal concepts. American practitioners will recall efforts to characterize franchisors as employers, principals, securities issuers, suppliers and fiduciaries, among others, for the purpose of finding remedies for their clients. In Europe, the Middle East and Latin America, lawyers often assert that franchisees should be treated as “agents” for the purpose of evaluating their rights when a franchise agreement is terminated or is not renewed.

At least 40 countries and the European Union have some form of agency law. Each is intended to protect the rights of “agents” from unfair termination, and sometimes, from other “unfair” practices of the agent’s supplier. The applicability of agency laws to a franchise relationship depends upon the nature of the franchise program, and may vary considerably from jurisdiction to jurisdiction. These laws are noteworthy because of the generous remedies they often provide to agents, and because of the requirements they may impose on franchisors.

In Saudi Arabia and the United Arab Emirates, for example, all agreements reviewed under agency law must be translated into Arabic. Second, they contain an implied grant of exclusivity (e.g., one third of the country in Saudi Arabia, and no less than a single Emirate in

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38 Id. at ¶¶ 84 and 90.
40 E.g., Saudi Arabia Royal Decree No. 11, as amended, implementing rules in Ministerial Resolution No. 1897 of 24-5-1401AH; Principle of Islamic law, the E.U. Directive Related to Self-employed Commercial Agents (Council Directive 86/653/EEC, December 18, 1986); and the Indonesian Civil Code Article 1266 conditions termination upon obtaining a court order, unless the contract parties waive the obligation to comply with the law. However, Decree 259 requires both parties to sign and file a “Clean Break Statement” when a franchise is cancelled before expiration date. The statement is to confirm that neither party owes any for the obligations to the other. The Clean Break Statement must be filed with the Indonesian Department of Trade and Industry. Franchisors generally request a Power of Attorney when the franchise agreement is signed giving them the right to file the statements on behalf of their franchisees.
the UAE). Third, provisions selecting foreign laws may be rendered unenforceable. 41 Fourth, any termination or nonrenewal may be subject to claims for compensation unless it fits within statutory good cause definitions. 42

In some cases carefully structuring the franchise relationship to avoid one or more elements of the “agent” definition will enable a franchisor, which otherwise might be subject to the laws, to avoid or to mitigate their application. 43 Disclaimers of the existence of a commercial agency also should be considered. Often, the laws may not be avoided, or the parties will not know whether agency laws apply unless or until a court or arbitrator decides a case involving the termination of a franchise agreement.

Sometimes the use of choice of law and forum provisions designating a different country’s law and forum may avoid application of the agency laws. However, in many countries the laws may not be waived by contract.

Use of security agreements which grant the franchisor the right to foreclose on the franchisee’s interest in its franchised business in case of a financial default, including its voting rights in a franchisee entity, is another possible way of dealing with obligations under agency law. If the franchisor or its designee control the acts or decisions of the franchisee, then, in some situations, litigation may be averted.

Franchisors also may consider using purchase options held in escrow which authorizes the franchisor or its designee, in the case of default, to purchase all of the franchisee’s interest in its franchised businesses for an agreed sum, less amounts owed. The option would specify that payments to the former franchisees would be made out of proceeds from the operation or sale of the business following the exercise of the right by the franchisor or its designee.

Joint ventures which grant the franchisor, or an entity which it controls, the right to restrain certain actions by the franchisee entity also may avoid claims that the local “franchisee entity” is entitled to protections of agency laws.

B. Good Faith Requirements

1. Germany

Under German law, the parties are bound by a “relationship of obligation” imposed by law (gesetzliches Schuldverhältnis) once the formation of a contract commences. This notion of “pre-contractual” obligations facilitates the bringing of claims by the parties for, amongst other things, pure economic loss caused by conduct preceding the conclusion of the intended contract. In addition, German law imposes an obligation of good faith. The starting point in any assessment of the obligation of good faith during the term of the contract is Article 242 of the German Civil Code which reads: “The debtor is obliged to perform in such a manner as good

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41 See, e.g., UAE Article 6, Federal Law No. 18 of 1981 Governing Commercial Agencies, as amended.

42 See e.g., Mazero and Weinberg, supra, citing KG Berlin Vom 21.11.1997 Az: 5 U 5398/97 in BB (Der Betriebs-Berater) 1998, S. 607 ff, in which the right to terminate a long term franchise for nonpayment was reasonable if substantial sums remained unpaid for a long period of time.

43 These may include not drafting its franchise agreement in Arabic, and/or by refusing to file with the Ministry of Commerce and Industry. Memorandum from Haynes and Boone, LLP on Franchising in Saudi Arabia to Marshall Fisco (February 3, 2004). By refusing to notarize documents a franchisor also may not satisfy the formalities required for a filing under the agencies laws, thereby preventing a franchisee from asserting it is entitled to protection of the laws.
faith requires, regard being had to general practice.” Good faith in Germany operates so as to prevent the abusive exercise of contractual rights, implying terms into contracts and policing contractual terms.

So far as the contract formation stage and the impact of the principle of good faith on franchising, German law (which contains no specific franchise disclosure law) imposes general disclosure obligations by Articles 241(2), 280(1) and 311(2) of the German Civil Code on all those who enter into commercial contracts. A breach of the statutory obligations can occur if incorrect information is provided or if no information concerning core duties is provided.

The content and scope of the duty depend on the facts of each individual case. The experience and knowledge of the prospective franchisee, in particular, has to be taken into account. Three specific franchise cases clearly demonstrate the approach of the German Courts. The first is a decision dated 24.04.2001 (“Aufina”) of the Court of Appeal in Munich, which set out the criteria for establishing whether a pre-contractual disclosure obligation should be imposed on a franchisor and the quantum of damages a franchisee may claim if a franchisor fails to comply with its disclosure requirements.

In the Aufina case the franchise related to the promotion and support of independent property consultants. The franchisor had told a potential franchisee in course of pre-contractual negotiations that there had been only a 3% franchisee failure rate, that franchisees had generated twice or three times the turnover of other property agents and the franchisor had strong links with a bank and an insurance company which would ensure a flow of business opportunities. Relying on this information the franchisee entered into a five year agreement. Approximately one and a half years into the franchise the franchisee terminated the franchise agreement and claimed damages. The franchisee submitted to the Court 28 letters from “economically unhappy franchisees”, 23 of whom had terminated their franchises.

The Court found in favor of the franchisee on the basis of the legal principle “culpa in contrahendo” under which contractual parties are obliged to disclose matters which are likely to be of importance to the other party. The Court explained this general rule in the context of franchising as the franchisee is obliged to inform himself about the general market conditions and the impact of those conditions for the prospective franchise business, but an exception applies if there are particular circumstances of which (a) only the franchisor is aware and (b) which are clearly of importance to the franchisee’s decision as to whether to enter into the franchise agreement or not. Thus, the scope of the disclosure requirement is dependent on the franchisee’s need for information and the opportunity the franchisee has to obtain the information. As a result, a franchisor must provide information about the way the franchise system works and its prospects of success.

The Court, in calculating damages concluded that the franchisor had to put the franchisee in the position he would have been in if the franchisor had fulfilled his disclosure obligation, and there was a legal presumption that the franchisee would not have entered into the franchise agreement if correct information had been provided to him. The franchisor therefore was ordered to repay all franchise fees and to reimburse the franchisee for all expenses he had incurred in connection with the franchised business after deducting the income received by the franchisee in operating the franchise business.

Subsequently on 26 May 2004 the Regional Court (“Landgericht”) Kaiserslautern considered a case relating to a franchise for the operation of an educational establishment with private tutoring, computer courses, etc. During the course of the contractual negotiations the
franchisor provided its prospective franchisee with information about the expected profitability. The figures shown were, unbeknown to the franchisee, not based on franchisees’ performance, but on the performance of the franchisor’s own establishments which had been operating for over 10 years. The average turnover of franchisees’ businesses at the time of entering into the franchise agreement was much lower than the figures contained in the information provided by the franchisor. The franchisee terminated within a year and sought damages.

The Regional Court of Kaiserslautern awarded damages to the franchisee using similar reasoning to that in the Aufina decision. The Court held that, in particular, the franchisor should have provided information on likely profits. It was not considered sufficient for the franchisee to have had the opportunity to visit other businesses within the system in order to form his own view of likely profitability. The Court also held that there was no contributory fault on the part of the franchisee (who had not obtained information from other franchisees) because he had no reason to doubt the figures given to him by the franchisor.

The position concerning contractual disclosure was further developed in the decision of the Regional Court Essen on 9 May 2005, which held that there had been a breach of the pre-contractual duty to provide information by not providing a prospective franchisee with a detailed business site analysis setting out information about achievable turnover, fitting out costs and other relevant financial information.

In accordance with the established case law, the Regional Court held that the franchisor had to provide information on all the circumstances of which the franchisor alone was aware and which was likely to be material to a franchisee’s decision as to whether to proceed. To the surprise of many, the Court’s consideration of the circumstances included not only information on likely profits but also an analysis of the franchisee’s likely success at the proposed premises.

It is clear from these three franchise decisions that, even in the absence of specific franchise disclosure legislation, franchisors in Germany are required to disclose information to franchisees. The extent of such disclosure requirement is unclear but certainly relates to likely profitability based on the performance of existing franchisees and a specific analysis of the likely performance of the proposed franchised outlets. The consequences of failing to comply are severe – a franchisee can terminate and claim damages to put him back in the position he would have been in had he not entered into the franchise agreement.

2. Lithuania

Similar “good faith” issues to those in Germany also arise in Lithuania. However, in countries that have only recently converted to capitalism there may by a greater willingness to intervene in contractual relationships to protect the “weaker” party.

On 18 July 2000, the Lithuanian Parliament (the “Seimas”) adopted a new civil code (“Civil Code”) which included new provisions regulating contracts44. One of the main principles of Lithuanian’s Civil Code is good faith. According to Article 6.158 of the Civil Code, all parties to a contract are obliged to act with good faith and in accordance with the principle of fair

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44 Many contract law provisions of this code were based on the UNIDROIT Principles of International Commercial Contracts and the Principles of European Contract Law. For more information see V. Mikelenas, Unification and Harmonisation of Law at the Turn of the Millennium: The Lithuanian Experience – Uniform Law Review 2000/2, pp. 253-261.
dealing in their contractual relationships. The parties may not change or exclude by their agreement the duty to act in good faith or that of fair dealing.

In the words of one commentator, “This principle is not just a significant rule governing the behavior of the parties to a contact. It is also an effective tool for the courts in deciding civil cases related to disputes between parties to a contract.” Clearly it is the intention that judges will have considerable discretion to do what is “right”. This infers that franchisors, especially large and powerful franchisors and perhaps even more so if they are “foreign,” are likely to be in an “uncertain” position when having their contract interpreted by the Lithuanian courts.

The Civil Code also provides for two categories of contract: contracts entered into as the result of mutual agreement through negotiations and contracts of adhesion. A contract of adhesion is a standard non-negotiated contract. Franchise Agreements will in almost all cases be a contract of adhesion.

The Civil Code provides special rules applicable only to contracts of adhesion. These special rules regulate, inter alia, the formation of standard contracts, disclosure of standard contract terms and the use of “surprising” standard contract terms. For example, according to Part 2 of Article 6.185, standard contract terms proposed by one of the parties are binding on the other only if the latter was provided with an adequate opportunity to become acquainted with these terms.

There are currently no reported Lithuanian cases relating to franchising, but in a recent decision, the likely approach of the Lithuanian courts in relation to franchise agreements can be clearly predicted. The Court of Appeals of Lithuania has decided that a contracting party may not enforce an agreement or any provision of an agreement, if at the time of the conclusion of such agreement, the agreement or any provision “unreasonably grants a significant advantage to the other party.” In such cases account should be taken of whether one party unfairly took advantage of the situation or if the “innocent” party has economic difficulties, immediate needs, is economically weak, uninformed, inexperienced, or has no experience of conducting negotiations. Certainly franchisees could in many circumstances be expected to have at least some of these characteristics.

At the request of the “innocent” party the Court is entitled to amend the contractual provisions so that the agreement or any of its provisions meet the requirements of good faith and reasonable business practice. These provisions are likely to give franchisors very considerable concern.

In addition Part 4 of Article 6.163 provides that the parties are bound to disclose to each other the information that they have which is of essential importance to the conclusion of the contract – this broadly reflects the position in Germany.

When confronted with the substantial impediments to franchising described above, the initial reaction of American counsel may be to seek to apply the laws and to give jurisdiction to the courts of the home country of the franchisor. This would seem to reduce the initial costs, and allow standardized contracts to be used throughout the world. It also would seem to facilitate the negotiation of documentation – at least from the franchisor’s perspective. It may

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45 Professor Mikelenas of the University of Vilnius in Juridica International X/2005.
46 (Part 2, art 6.160).
not, however, always be the right approach. U.S. lawyers, in particular, may find resistance to the applicable law being that of the franchisor’s home country. For instance, a number of the UK’s largest multinational companies do not, as a matter of principle, enter into contracts which are subject to the laws of a state of the U.S., or they require such contracts to be the subject of approval by their board of directors. A number of substantial international franchisors such as Burger King, with whom contracts are entered into by Burger King Inc., a company incorporated in the U.S., apply a “neutral” country’s law. Burger King selects the laws of England and Wales. The reason for choosing a neutral country is that this is likely to be more acceptable to franchisees. The disadvantage from a franchisor’s perspective is that knowledge of the neutral country’s laws and approach is required and this requires using legal counsel in the neutral country. Most franchisors try to avoid the time and expense which this requires, despite the cost savings which might occur if a dispute later arises.

For most international franchisors the first questions to ask should not be, “can I apply my own laws (which are in any event unlikely to override mandatory provisions in a franchisee’s territory) and have disputes decided by my own courts?” Instead franchisors need to establish:

- where are the franchisee’s assets?
- is there a reciprocal enforcement of judgments convention between the franchisor’s and the franchisee’s countries?
- is the franchisor more likely to commence proceedings against the franchisee (almost always the case) or the other way round?
- if, most disputes relate to payment, as most do – can the franchisor ensure that payment is received and thereby eliminate this area of potential dispute?
- what are the applicable laws and approach in the franchisee’s territory?
- does the franchisee’s jurisdiction provide protection to intellectual property rights?
- how quickly does it take to obtain and enforce a judicial decision, and what are the costs involved?

In many cases there is no advantage to a franchisor in applying the franchisor’s home country laws and giving jurisdiction to the home country’s courts if a franchisee has no assets in the home country. Practically speaking, franchisors that want to enforce the terms of their franchise agreement, will have to do so in the franchisee’s home country. By applying their own laws, they could make this task more difficult. Further, the great majority of disputes relate to nonpayment by a franchisee. If franchisors are able to require their franchisees to purchase products or services from them, charge a mark up on the products and services, and require payment prior to delivery, many issues concerning nonpayment can be avoided or substantially reduced. Difficulties will inevitably arise when franchisors charge a continuing fee based on the franchisee’s turnover. In this situation the franchisor will not only want to receive payment, but would want to make use of any available procedures to ensure that the franchisee is making full disclosure and have access to witnesses, which is unlikely to be achievable if disputes are resolved on the franchisor’s home turf.
Franchisors should not, therefore, assume that these issues can be easily resolved by applying choice of law and venue clauses.
III. Commercial Considerations

A. Barriers to Collecting Royalties and Other Fees

Like parties to other commercial contracts, franchisors and their foreign franchisees normally negotiate contract terms expecting to pay and to receive the amounts to which they have agreed. However, several types of laws may alter that expectation, including laws that: (i) tax and require withholding of the taxes due on royalties and other fees paid to foreign franchisors; (ii) set ceilings on fees which may be paid for franchise rights; (iii) restrict payment of fees in other than the local currency; (iv) require payment only in the local currency; and (v) set exchange rate controls. In addition, franchisors need to be aware of the general effect of fluctuations in the value of foreign currencies.

In international agreements, U.S. franchisors historically have tried to avoid the risk of currency fluctuations by requiring all payments to be made in United States dollars. However, with a weak dollar and the ongoing threat of terrorism, other standards, including designating the Euro as the currency of choice, or reserving a right to designate alternate currencies for payment may be worth considering. Some countries, however, may prohibit or restrict payments made in foreign currencies.

Many foreign franchisees are evaluating whether to grant franchises in India. Based upon its population size and economic growth, its attractions are as compelling as China. Those franchisors should be aware, however, that the India Foreign Exchange Management Act provides, that except with the general or special permission of the Reserve Bank of India, no person may deal in or transfer any foreign exchange to any person who is not authorized by the Act or by the Reserve Bank acting pursuant to authority granted by the Act. Lump sum initial license fee payments of more than $2 million USD, and royalties of more than 5% of gross revenues paid on domestic sales (8% on exports) require approval of the Reserve Bank.

Restrictions on importing foreign currencies or exporting domestic currencies exist in several countries, including Spain, China and Morocco. Other countries fix exchange rates or limit currency exchange transactions to rates fixed by regulation. In Brazil, no franchise royalty fees may be remitted abroad until the franchise agreement has been approved by the Central Bank of Brazil. In Russia, before more than $5,000 USD may be remitted abroad for payment

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48 See section III.B, infra.
50 ... India has recently been declared as the second most attractive destination for retailers among 30 emerging markets.” Siejoy Das, International Franchisors-India-the Time is Right, http://www.franchise.com/en/us/template/buyer%2Cresearch center.vm/display/1252. (last visited Aug. 16 2006).
51 RESERVE BANK OF INDIA CIRCULAR NO. 76, February 2004. India also restricts payments in rupees outside the country.
53 In an Email from Luiz O. do Amaral of Dannemann, Siemsen, Local counsel, to Carl Zwisler, Haynes and Boone, LLP, of counsel, May 2006, (on file with Carl E. Zwisler), reports that the review relates only to confirmation that the franchisor has complied with Brazil’s franchise law, (Brazil Franchise Law, No. 8.955, enacted December 15, 1994, effective February 14, 1995), but that the Bank does not question the amount of payments negotiated by the parties.
of fees related to a franchise, the franchise agreement must be registered with Rospatent, and evidence of the registration must be submitted to the franchisee’s bank.\textsuperscript{54}

When structuring a transaction in any country the parties and their counsel must be aware of whether any such restrictions on payments exist and how they will affect the net returns each party will receive. Franchisors and their counsel also must be aware of potential restrictions which may emerge with either a change of government or an economic crisis, and use agreements which anticipate and address the changes. Franchisee counsel must consider the potential impact on the fees which may be incurred if the alternative payment strategies are adopted, as well as the cost of converting local currency to U.S. dollars or to other foreign currency. Franchisors should reserve in their agreements the right to designate the currency in which payments are due, and they should retain the right to terminate their agreements if laws, regulations or practices adopted after the date of the agreement materially reduce the net payments they may receive.

Agreements also should designate the party responsible for currency conversions, expenses, and establish a mechanism for determining the exchange rate which will apply to payments due.

If a law limits the amount of fees or the percentage of royalties due, the franchisor may consider whether a markup in the price of products or supplies sold to the franchisee can offset any deficit in fees collected or require the franchisee to increase its local marketing spend to offset lost revenues.

**B. Withholding Taxes**

When evaluating the collectibility of royalties and other fees, one dare not overlook taxes imposed on those payments and the existence of a duty of franchisees to withhold those taxes from payments remitted to franchisors. Generally speaking, a withholding tax is a tax imposed on certain payments made by a local tax resident payor to a non-tax resident payee. Withholding taxes are applied, generally, on certain types of payments, such as dividends, interest, royalty, service and technical fee payments. The rate of the withholding tax may vary, not only with the type of payment involved, but also depending upon the province or state of the franchisee’s country which assesses the tax. In China for example, the withholding tax on certain royalty fees have ranged from 15% to 40%.\textsuperscript{55}

Is some cases, tax treaties or the structure of the franchise program, may materially reduce tax withholding obligations. For example, the United States has taxation treaties with a number of countries which reduce, if not eliminate entirely, withholding taxes on royalties and other fees. In addition, franchisors should review the tax codes of the country in which the franchise is located to determine whether certain types of payments received preferential treatment. For example, in some countries, the technical assistance fee is taxed at a lower rate than that of a royalty fee. However, franchisors and their counsel must also be aware that some countries may combine other fees, such as service or technical assistance fees, under the “royalty fees” definition and apply a royalty fee based withholding tax, regardless of how the payments are designated by the parties.

\textsuperscript{54} Correspondence from Vladimir Biriulin, Partner, Russian Patent Attorney, Gorodissky & Partners Moscow (August 31, 2006) (on file with Carl E. Zwisler).

\textsuperscript{55} Mazero, supra 235-36, n 57.
C. Unenforceability of Agreements to Pay Interest

When conducting business internationally, the extension of credit by a franchisor adds to the complexity and risks of a transaction. Especially when initial fees for a master franchise or area development franchise are high, franchisors may be asked to allow them to be paid over time. Because starting a new franchise in a foreign country may require the importation of specialized equipment, supplies and inventory, franchisors also may be asked to finance part of the foreign franchisee’s initial investment. However, unless the franchisor understands whether or how it may collect loan payments, interest and penalties from a franchisee under the laws of the franchisee’s territory, it may find that it has little or no legal recourse.

Even franchisors, which make a decision not to become a creditor to their foreign franchisees, may become “reluctant creditors” if franchisees fail to make payments due for fees owed under franchise agreements. Thus, they must plan for the consequences.

Reluctant creditors usually draw some solace from the language in their franchise agreements entitling them to collect interest and penalties if payments are untimely. However, U.S. franchisors may be caught off guard when they encounter Sharia, the Islamic law based on the Koran which is controlling law or highly influential in many Muslim countries. Bahrain, Indonesia, Iran, Iraq, Kuwait, Pakistan, Saudi Arabia, United Arab Emirates, Yemen, are among the countries where Sharia may determine not only whether traditional western methods of financing franchise fees, equipment purchases or payments for other services may be used, but also whether interest typically charged on late payments may be collected. According to Sharia, any money paid for the use of money, “interest,” is “usury,” and is forbidden.56 Although lenders are permitted to participate in the profits of a borrower,57 traditional methods of debt financing requiring interest to be paid regardless of whether the debtor’s investment is profitable, are not enforceable under Sharia.58 Moreover, penalties for late payments also are unenforceable.59 And, although guarantees are not prohibited, Sharia, does prohibit guarantors from charging fees for their services.

Several strategies may be helpful, depending on the country and the transaction. Of course, the simplest is for a franchisor not to extend credit to a franchisee. However, that still does not address how the franchisor is protected if it becomes an inadvertent creditor. Rather than to sell products on credit, a company may lease products or equipment. Leases are acceptable under Sharia, so long as they are properly structured.60 Although a creditor may not collect a penalty, creditors sometimes use provisions through which the debtor “voluntarily agrees” that if a payment is late, that it will pay a fixed amount to a bona fide charity. This

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59 Usmani, supra.
serves as a disincentive to withhold payments, but does not provide any compensation to the creditor.

Discounts are sometimes used to motivate purchasers or debtors to make early payments. Under Sharia a contract requiring the payment of a discount for early payment is prohibited. However, voluntary payments of such discounts are permitted.

Because these issues are complex, advice of counsel should be sought before any financing obligation is incurred. Franchisors also should consider the use of enforceable security agreements to protect against losses if payments are not received on time. Franchisors need to determine before execution of agreements which remedies, if any are available. Most franchisors find that using an irrevocable letter of credit issued by a financial institution in a creditor-friendly jurisdiction mitigates much of the risk of dealing with financial defaults and the potential for loss of the use of money between the date of default and collection following the enforcement of a judgment. The use of guarantees by individuals or institutions in creditor-friendly jurisdictions is another approach worth considering.

D. Ability to Enforce Security Agreements (e.g., bank letters of credit/guarantees)

Whether extending credit to franchisees for initial fees, equipment purchases, computer systems or system upgrades, or protecting themselves against the possibility of nonpayment of fees owed, franchise lawyers routinely counsel franchisors to obtain security (collateral or personal guarantees) to provide some protection in case of default. As is the case with other issues discussed, it is incumbent upon the parties to understand before the agreement is executed whether traditional forms of security agreements or any form of security will be enforceable. When franchisees are operating in countries where enforcement of contractual rights may either be uncertain or slow, having enforceable security agreements become even more important.

In countries with inefficient or notoriously corrupt legal systems, franchisors desire access to enforceable security arrangements which permit extrajudicial foreclosures and avoid the need for litigation. They may also demand that security be posted in more creditor-friendly jurisdictions, where the security can be more readily foreclosed upon.

A traditional protection sought by franchisors is to obtain guarantees of the obligations of franchisees. They may be personal guarantees of owners or of third parties, of sureties or of commercial banks. For large investments in potentially unstable countries, political risk insurance may be sought to protect against expropriation and other political risks. Insurers included the Overseas Private Investment Corporation (OPIC), a quasi-governmental organization established by the U.S. Congress to promote U.S. exports, the World Bank, Multilateral Investment Guaranty Agency (MIGA) and several private insurance companies, including AON, Marsh, Lloyds of London, American International Group, and Chubb & Sons. Coverage may cover currency inconvertibility and transfer restrictions, political violence, “financed asset nonrepossession,” and breach of contract. In the case of large investments, the foreign franchisor may try to take advantage of rights under bilateral investment treaties or

\[61\] For a discussion of issues related to guarantees, see Mazero, supra, at 269.

free trade agreements. Sometimes this can be accomplished by forming the franchisor entity in a country which is a signatory to such a treaty or agreement so as to take advantage of its protections when granting a franchise in a country with emerging political uncertainty.

Other forms of security that are often used include irrevocable letters of credit, bank guarantees, security deposits from franchisees, and personal or bank guarantees from persons located in jurisdictions which will enforce guarantees. Some of these techniques are used often in import/export transactions, but may be perceived as cumbersome or costly when goods or equipment are not sold by franchisors to their foreign franchisees.

Like creditors everywhere, franchisors can often improve the incentive for full and timely payments if their franchise agreements require the franchisor or entities which they control, to supply products or services which are essential to the successful operation of their franchisee’s businesses. Then, if a franchisee fails to pay, supplies may be cut off until the payment issue is resolved.

Franchisors also might consider (i) structuring regular payments to be subject to a discount if they are timely received, or (ii) requiring that all sub-franchisee payments to master franchisees be paid to a bank account from which the franchisor is authorized to make withdrawals. What a franchisor can do to protect itself against nonpayment risks will be a function of local laws, availability of cost-effective security arrangements, and, ultimately what the franchisor and franchisee can agree upon.

Finally, franchisors should recognize what investors and lenders have done for years, that the price charged for a loan is dependent, in part, upon the risk of default. The higher the risk, the higher the interest rate or the cost of the product sold. Franchisors dealing in high risk countries should consider charging fees that reflect a risk premium, whether that is in initial fees, or other initial and ongoing charges associated with the franchise they are granting (keeping in mind, however, some local restrictions on foreign exchange).64

E. Trademark Protection Issues

The most important component of a franchise system is the franchisor’s trademark and service marks. When franchising internationally, it is critical that a franchisor ensures that its trademarks can be registered and are properly registered in each country in which it desires to franchise. In conducting the trademark registration process, franchisors need to ensure the word or design used in their home country is appropriate for use in other countries as it pertains to cultural, linguistic and other challenges. Obviously, trademark registration analysis should not be so narrowly tailored to limit one’s international registration strategy to one country and thereby registering trademarks one country at a time. Rather, franchisors should plan and develop a global franchising strategy and from that strategy register trademarks in countries that a franchisor desires to do business in and those with substantial commercial importance. To assist and consolidate the trademark registration process, a number of treaties, such as the Paris Convention, Madrid Agreement, Madrid Protocol and the European Community Trademarks, have been developed to help coordinate the trademark registration process among nations.

63 Id.
64 See section III.A.
Beyond the filing of trademark registrations, franchisors still must be cognizant of local license requirements such as registered user or license recorder obligations. Several countries, including Mexico, Brazil, Columbia, Lithuania and Peru require all trademark licensing agreements to be registered and approved by their respective national trademark offices. While some of these countries require no substantive review, such as Mexico, or minimum review such as Lithuania and Peru, failure to register can have such serious ramifications as:

- the license may be found to be void and not enforceable against the licensee or third parties;
- the licensor may be unable to collect royalties and fees and/or to remit them out of the local country; and
- the use by the licensee will not inure to the benefit of the licensor, meaning that trademark rights will be considered lost or abandoned because the licensor may be unable to prove use to maintain its registration, defend against a nonuse cancellation action, or enforce its trademark rights against third-party infringers or applicants.67

It is imperative that franchisors engage knowledgeable trademark counsel and local counsel to ensure that their trademarks are properly registered and the license is properly recorded, if needed, so that the franchisor has the ability to successfully prosecute any trademark infringement.

F. Arbitration

Despite weeks or months of discussions and, in some cases, mediation, the parties may need to seek a formal and final resolution to a dispute affecting a part or the whole of an agreement. The use of arbitration, rather than litigation, as an international dispute resolution device is quite common. Although the cost effectiveness of arbitration over litigation is worthy of much debate, what cannot be debated is the fact that the arbitration hearing itself does provide each party with a greater likelihood to have an equal opportunity to argue their claims and defend their positions. Unlike litigating in a local court where an influential party could heavily influence or prolong a case, or where the lack of familiarity of a local courts rules and procedures gives the local party an advantage, an arbitration, especially one conducted with one of the major international arbitration associations (London Court of International Arbitration, Stockholm Chamber of Commerce, International Chamber of Commerce, World Intellectual Property Organization or Singapore Arbitration Center) gives a party more certainty both in its neutrality and procedures. In addition, arbitration agreements and awards are viewed to be more easily and reliably enforced in other countries (particularly those countries that are signatories to an international arbitration treaty).

To encourage the use of arbitration, the United Nations and other international bodies have promoted arbitration. The most recognized international arbitration treaty is the Recognition and Enforcement of Foreign Arbitral Awards, also known as the “New York Convention.”68 The New York Convention, established by a United Nations conference in 1958, provides that the court of each signatory will abide by, recognize and enforce foreign arbitral

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66 Id. at 87.
67 Id. at 92.
awards unless certain grounds are proved by the party challenging the award. These grounds include:

1. The arbitration agreement is invalid due to the incapacity of a party or because the agreement is not valid under applicable law.

2. A party lacked notice or opportunity to present its case.

3. The award concerns a matter beyond the submission of the arbitral claim.

4. The composition of the tribunal or its procedure fails to follow the arbitral agreement or the law of the place of arbitration.

5. The award is not yet binding or has been set aside or suspended in the country where it was made.

6. The subject of the dispute is not capable of settlement by arbitration in the enforcement jurisdiction.

7. The award is against public policy of the country in which the awards is being sought to be enforced.

However, the New York Convention is not enforceable on a signatory without implementing legislation. It is the implementing legislation and local courts’ judicial interpretation of the implementing legislation that is critical to understand for a party employing arbitration. For example, local law will impact the proceedings, in terms of (1) what can be arbitrated, (2) who can represent a party and, (3) and where the proceedings conflict with public policy. In other countries, courts have refused to recognize arbitral awards on grounds not delineated in the New York Convention.

The laws of the country where the arbitration is being held can have a significant procedural impact on the manner in which the arbitration proceedings will be conducted. Parties need to be concerned with the degree to which local courts may interfere in the arbitration process. For example, the allocation of authority between the arbitrators and national courts over the interpretation and enforceability of the arbitration agreement is an ongoing issue. Many international arbitral bodies provide for arbitrators to determine their own jurisdiction. However, enacting legislation may impede an arbitrator’s ability to exercise the authority provided to him in a certain jurisdiction. While many developed countries have enacted legislation providing for effective support of the arbitration process, other countries, particularly in Latin America, remain suspicious of international commercial arbitration. Such
interference can include mandatory requirements for interlocutory judicial resolution of issues of laws, or interference with procedural issues.

G. Disclosure Laws

First concern among U.S. based franchisors is whether the Federal Trade Commission Rule on Franchising (the “Franchise Rule”) applies extra-territorially. The application of the Franchise Rule on foreign franchise agreements remains vague despite the decision in Nieman v. DryClean U.S.A. Fran. Co. (holding that the FTC rule did not apply to an agreement between a franchisor based in Florida and a master franchisee based in Argentina for a franchise to be operated outside the United States) and the FTC’s Advanced Notice of Proposed Rulemaking (clarifying what many already believe, that the Franchise Rule does not apply extra-territorially). Beyond the question of the applicability of the Franchise Rule on international franchising is the applicability of state franchise laws on international franchising. In the Eleventh U.S. Circuit Court of Appeals opinion in Nieman, the court noted that the FTC could not regulate international commerce because it could only do so under the U.S. Constitution if the Congress expressly authorized it to do so. Using the same constitutional arguments, it is difficult to imagine how a state could constitutionally regulate international commerce when that right is retained exclusively by the Congress.

Beyond the U.S. borders, even more disclosure confusion and challenges await. With the rampant growth of international franchising comes an increase in the level of study and development of franchise regulation by various countries, particularly in the area of pre-sale disclosure. In the last twenty four months, several countries such as Belarus, Belgium, China, Italy, Mexico, Spain and Vietnam, and the Canadian Province of Prince Edward Island have initiated new regulations or amendments to regulations requiring pre-sale disclosure; joining approximately 15 other countries in mandating some form of pre-sale disclosure. The differing levels of disclosure and the opaqueness of the pre-sale disclosure regimes make complying with the disclosure requirements, much less preparing one all encompassing disclosure document, difficult.

On February 1, 2005, China implemented a set of franchise rules entitled, “Measures for the Administration of Commercial Franchising Business” (“China Regulations”). The China Regulations, require pre-sale disclosure “in a timely manner, disclose relevant information before signing the franchise agreement and during the operation of the franchise business.” Upon careful review of the items to be disclosed, there are several points within the disclosure requirements requiring further refinement. First, the requirement to disclose legal proceedings related to the franchisor for the past five years does not define what is meant by a “legal proceeding.” Does it include litigation associated with personal injury claims arising out of a franchisee’s operation of the franchised business in which the franchisor is also named? Does it include collection suits brought by the franchisor against current and former franchisees?

76 U.S. Const. art. 1, § 8.
77 See generally Bus Franchise Guide (CCH) ¶¶ 7000-7275.
79 Australia, Belgium, Brazil, Canadian provinces of Alberta and Ontario, France, Indonesia, Italy, Japan, Malaysia, Mexico, Romania, South Korea, Spain, Taiwan and the United States.
80 Bus. Franchise Guide (CCH) ¶ 7065.
81 Bus. Franchise Guide (CCH) ¶ 7065.
Does it only apply to legal proceedings in China? Second, the China Regulations require franchisors to provide other information that the “franchisee should know.” This requirement is so open ended as to be unreasonable. Finally, the China Regulations state that the franchisor has an open ended obligation to continue to provide disclosure after the franchise agreement is executed.

On February 1, 2006, Belgium’s franchise law became effective.\textsuperscript{82} The new law, which is heavily influenced by the French disclosure law, avoids the problems posed in attempting to define franchising and instead refers to “commercial partnerships”. These are defined as “agreements made between two persons, each of whom is acting in his/her own name on his/her own behalf, by which one person grants to the other, in return for a consideration of any nature whatsoever, whether directly or indirectly, the use of one or more commercial formulae for the sale of goods or the provision of services in one or more of the following forms: a common sign; a common trade name; the transfer of know-how; commercial or technical assistance.”\textsuperscript{83} The commercial formula definition means that the law will have much wider application than ordinary franchises; although according to parliamentary debate a “certain intensity in the relationship between the parties” is required.

The law requires that the franchisor provides potential franchisees with a disclosure document at least one month before closing and stipulates that “No undertaking may be given, and no consideration, sum of money or deposit may be paid or required prior to the expiry of a period of one month following the issue of the [disclosure] document”.\textsuperscript{84} It is possible that French and Italian case law on this might be taken into consideration by the Belgian Courts if the matter comes before them.\textsuperscript{85}

The law provides that the disclosure document consists of two separate sections and must be in either the French or Flemish language. The first part of the document summarizes the main terms of the franchise agreement\textsuperscript{86} and the second part details “information relating to the correct evaluation of the commercial partnership agreement.”\textsuperscript{87} Summarising the terms of the franchise agreement can be difficult. The general good faith and loyalty obligations under Belgian law will mean that the summary must be exactly that and not be a wholesale copying of the terms of the agreement.\textsuperscript{88} If there is any inaccuracy the franchisor will be held liable.

The second part, which includes providing typical franchisor information, demands details of the current state of the market forecasts and network market shares both locally and generally. The original draft required information about the Belgian market to be given, but during the parliamentary debate it was suggested that this be expanded to include the

\textsuperscript{82} Law Relative to Pre-Contractual Information in the Framework of Agreements of Commercial Partnership. Doc. 51 1687/007. Chamber of Representatives of Belgium, 19\textsuperscript{th} December 2005 (Modified 27\textsuperscript{th} December 2005).
\textsuperscript{83} Law Relative to Pre-Contractual Information in the Framework of Agreements of Commercial Partnership. Article 2, Doc. 51 1687/007. Chamber of Representatives of Belgium, 19\textsuperscript{th} December 2005 (Modified 27\textsuperscript{th} December 2005).
\textsuperscript{84} Law Relative to Pre-Contractual Information in the Framework of Agreements of Commercial Partnership. Article 3, Doc. 51 1687/007. Chamber of Representatives of Belgium, 19\textsuperscript{th} December 2005 (Modified 27\textsuperscript{th} December 2005).
\textsuperscript{85} Michael Vanden Abbeele, Verhaegen, Walravens, EFN Annual Conference, London, 24 March 2006
\textsuperscript{86} Law Relative to Pre-Contractual Information in the Framework of Agreements of Commercial Partnership. Article 4, Doc. 51 1687/007. Chamber of Representatives of Belgium, 19\textsuperscript{th} December 2005 (Modified 27\textsuperscript{th} December 2005).
\textsuperscript{87} Law Relative to Pre-Contractual Information in the Framework of Agreements of Commercial Partnership. Article 4, Doc. 51 1687/007. Chamber of Representatives of Belgium, 19\textsuperscript{th} December 2005 (Modified 27\textsuperscript{th} December 2005).
\textsuperscript{88} Michael Vanden Abbeele, Verhaegen, Walravens, EFN Annual Conference, London, 24 March 2006
international market.\textsuperscript{89} This is an extremely heavy burden for franchisors, especially those not located in Belgium.

Clearly, these national regulations vary dramatically from country to country. At times, franchisors in an attempt to close a deal quickly and inexpensively neglect to step back and examine the local legal regulations which can undermine and interfere with franchisee/franchisor contractual relationships. The penalties associated with failing to comply with these regulations vary from voiding a contract or certain provisions of a contract, to losing one’s license to engage in business in a particular country. It is crucial, therefore, that franchisors take the time and examine the local regulations and engage competent local counsel to provide the necessary legal and cultural due diligence to avoid running afoul of the law.

IV. Compliance with Franchisor’s Own Country Laws – “When in Rome ...”

In their efforts to learn about the foreign laws and customs which will govern relationships with new franchisees in different countries, franchisors dare not overlook laws of their own jurisdictions which regulate their conduct, even in foreign countries. Three principal U.S. laws regulate the conduct of most U.S. franchisors, and they sometimes prohibit the franchisors from “doing as the Romans do.” Moreover, the same laws may regulate conduct of their franchisees as they transact business in their own countries.

Areas of particular concern involve (i) requests to pay government or party officials or their families to get things done – bribes – demands that as a condition of doing business that a company refrain from trading in the goods or services of a particular country (e.g., Israel); (ii) requests to purchase restricted products without obtaining approval of the United States Government; and (iii) entering into contracts with people who may be terrorists or organizations that support terrorists organizations as designated by the United States Government.

U.S. companies also must be concerned about agreements which would grant franchisees rights to do business in countries which are on the list of countries in which United States citizens and companies are forbidden from transacting business.

Restrictions on these forms of conduct also may be barred by law of the target country, and by international treaties, as well as U.S. law. However, when local agents or franchisee candidates explain that the local laws are not customarily followed, or that violating them is the best way to become or remain competitive, a U.S. franchisor must understand the real world risks of following the “everybody does it” approach. Regardless of customs and practices in the part of the world where business is being done, the United States government, among others, may take action against franchisors for conduct in which they or their agents and sometimes their franchisees engage in foreign countries.\textsuperscript{90}

A. Anti-bribery Provisions of the FCPA

The Foreign Corrupt Practices Act, 15 USC Sections 78 m(b), (d)(1) (g)-(h) 78dd-2, 78ff (1994) as amended by the International Anti Bribery and Fair Competition Act of 1998, 15 USC Sections 78dd-1 to 78dd-3, 78ff is the first of these laws.

\textsuperscript{89} Id.
\textsuperscript{90} Section IV. is adapted from Bradley J. Richards, Doing Business Internationally: Foreign Corrupt Practices and Antiboycott Laws, White Collar Crime for the Civil Practitioner, State Bar of Texas (November 14-15, 2002).
The Foreign Corrupt Practices Act (the “FCPA”) criminalizes the bribery of a foreign public official, and requires publicly traded companies to have stringent bookkeeping requirements to make it more difficult for them to hide bribery transactions. Earlier U.S. laws had prohibited the tax deductibility of bribes. Congress subsequently amended the FCPA to create the so-called “grease payment” exception and the “reasonable and bona fide expenditure” affirmative defense, and to permit individuals in companies (including officers, directors, employees and agents) to be prosecuted regardless of whether the company has been convicted or prosecuted. Since 1997 the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions by the OECD (the “OECD Convention”) has been in effect. The United States and 35 other countries have adopted the OECD Convention and have enacted national anti-bribery laws to carry out its objectives.

An “issuer,” “domestic concern,” or any other person (while in the territory of the United States), or any of its officers, directors, employees, stockholders or agents will violate the FCPA if the person or entity:

(1) uses the mails or any means or instrumentality of interstate commerce
(2) corruptly, in furtherance of
(3) an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to
(4) any “foreign official,” foreign political party or party official, any candidate for foreign political office, or any other person (such as an intermediary),
(5) “knowing” that the payment or promise will be offered, given or promised, directly or indirectly to a foreign official, foreign political party or candidate, to
(6) influence an official act, induce that person to act or fail to act in violation of that person’s official duties, or secure an improper advantage, or
(7) obtain, retain or direct business to any person.

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92 I.R.C. § 162(c).
93 As of July 1, 2006 the following countries were signatories: Argentina, Australia, Austria, Belgium, Brazil, Bulgaria, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States of America.
95 A domestic concern means - (A) any individual who is a citizen, national, or resident of the United States; and (B) any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of a State of the United States or a territory, possession, or commonwealth of the United States. See 15 U.S.C. §78dd-2(h)(1) (Supp. 2002).
96 The term foreign official means any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization. See 15 U.S.C. § 78dd-1(f)(1)(A)(Supp. 2002).
For all issuers of securities (including foreign persons with registered securities in the United States), and other U.S. persons (including U.S. companies owned by foreign persons), the FCPA also eliminated the requirement that the mails or instrumentalities of interstate commerce be used. Thus, issuers and U.S. persons acting outside the United States are covered. Any conduct by such persons in furtherance of illegal payments is actionable. The legislative intent is that domestic companies are to be vicariously liable for the actions of their officers, directors, employees and agents.

1. Fines and Penalties under the Anti-bribery Provisions of the FCPA

Fines and penalties under the FCPA are subject to the Federal Sentencing Guidelines, which mandate sentences for certain violations of law, and apply a point system for mitigating factors that may reduce sentences. Issuers, domestic concerns and other persons subject to U.S. jurisdiction which are not natural persons and which violate the FCPA are subject to criminal fines of up to $2,000,000, and civil penalties of up to $10,000. Any natural person who willfully violates the FCPA is subject to criminal fines of $100,000 and up to five years imprisonment, as well as civil penalties of up to $10,000. No fines payable by a natural person may be paid, directly or indirectly, by the issuer, domestic concern or other person for whom such natural person is employed or has acted. Thus, no individual person can be indemnified effectively against FCPA liability.

2. The Safe Harbors

a. Facilitating (“Grease”) Payments

Facilitating payments to foreign officials to induce them to perform the type of routine tasks they should perform anyway are not proscribed by the FCPA. Thus, payments to a foreign official, political party or party official to expedite or facilitate the performance of “routine government actions” do not violate the FCPA. “Routine government actions” are actions routinely or commonly performed by an official to (i) obtain permits, licenses or other documents required to do business, (ii) process government papers (such as visas and work orders), (iii) provide police protection, mail pickup and inspections, (iv) provide phone service, power and water supply and cargo loading, and (v) take actions of a similar nature. A distinguishing characteristic of “routine government actions” is that they generally are not activities over which the official exercises legitimate discretion, and they generally involve payment of fairly nominal sums.

b. Lawful Payments

Payments which are expressly permitted under local law do not violate the FCPA.

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97 Note that issuers may face additional penalties for violating the accounting and record keeping provisions of the FCPA, which are not discussed in detail in this paper.
98 Alternative fines against individuals also may be imposed under federal law and are not preempted by the FCPA, including fines of up to $250,000 or twice the amount of the illicit gain. See FOREIGN CORRUPT PRACTICES ACT ANTI-BRIBERY PROVISIONS (Justice Department Brochure 1992), reprinted in FOREIGN CORRUPT PRACTICES ACT, 140.001, 140.004 (Business Laws Inc. 1997).
100 Id. at §§78dd-1(c)(1), -2(c)(1).
c. Reasonable and Bona Fide Expenditures

“Reasonable or bona fide expenditures” made to foreign officials directly related to promotion, demonstration or explanation of products or services, or for the execution or performance of a contract with a foreign government also are permitted.\textsuperscript{101} For example, U.S. companies frequently pay the cost of foreign government officials’ airline tickets and accommodations in the United States so that they can demonstrate their products or negotiate transactions with them.

3. Recordkeeping Violations

All “issuers” must make and keep books, records and accounts detailing compliance with the law. Enforcement of the recordkeeping provisions of the FCPA is the responsibility of the SEC.

The first step is for the franchisor to develop and implement an FCPA compliance policy and training program so that all employees who may be involved in international franchising transactions are aware of their duties and of the risks of noncompliance. Employee manuals, as well as manuals provided to international franchisees should communicate the policy and designate a contact within the franchisor company who is charged with providing advice.

All new employees involved in international franchising should receive training in the company’s policy. Periodic retraining is advisable. Franchisors also should consult with counsel to determine the extent to which foreign master franchisees should receive the same type of training.

Franchisors should adopt procedures for determining whether violations have occurred, and should act swiftly to avoid recurrences if any violations should occur.

In international franchise agreements franchisors should expressly prohibit violations of duties arising under the FCPA and similar laws by their franchisees, and make violations an offence which subjects the agreements to immediate termination. Franchisors may wish to request annual certifications by franchisees and master franchisees they are in compliance with their obligations under the law, and require notification whenever a violation of the FCPA duties occurs.

B. Patriot Act Implications

The USA Patriot Act\textsuperscript{102}, which was enacted to deter and punish terrorist acts, deals extensively with bribery, money laundering and related activities supporting the financing of terrorism. Under the Patriot Act, persons bribing foreign government officials may be convicted of a money laundering crime, as well as a violation the FCPA. Section 1956©(7) of title 18 of the United States Code, makes “bribery of a public official, or the misappropriation, theft, or embezzlement of public funds by or for the benefit of a public official” a money laundering crime.\textsuperscript{103}

\textsuperscript{101} Id. at §§78dd-1(c)(2), -2(c)(2).
\textsuperscript{103} Id. at § 315.
Passed in the days immediately following the attacks of September 11, 2001, the USA PATRIOT ACT, and Executive Order 13224 prohibit persons from directly or indirectly dealing with or having an ownership interest in any entity which is on the list of “Specially Designated Nationals and Blocked Persons” (SDNs) maintained by the Office of Financial Asset Control of the United States Treasury Department. The laws further prohibit persons from engaging in money laundering or aiding or supporting persons who may conspire to commit acts of terror against any person or government.

The laws impose a duty on franchisors to know the identity of their franchisees, including all investors and to ascertain whether they are on the Specially Designated Nationals and Blocked Persons list.

To ensure compliance with these laws the franchisor should adopt a compliance policy which should be written and communicated to all international franchising sales staff. It should be memorialized in staff manuals, as well is in manuals provided to franchisees (both domestic and foreign based.) Franchise agreements should describe the franchisee’s duty to comply with the laws, and may contain links to U.S. government websites which fully describe the laws and which provide up to date lists of SDNs.

Franchise owners should annually certify that they are in compliance with their obligations.

Franchisors should consider using software programs available from several vendors which will scan the most recent OFAC lists and compare names of prospective franchisees, employees, and if applicable, customers, to determine whether a risk of violation exists.

C. Illegal Boycotts

1. Conduct Prohibited under Tax Laws

Under Section 999 of the Internal Revenue Code, a U.S. person may lose tax benefits by participating in or cooperating with an international boycott. A person participates in or cooperates with a boycott if the person agrees:

(a) as a condition of doing business directly or indirectly within a country or with the government or a national of the country, to refrain from (i) doing business with or in a country which is the object of the boycott or with the government, companies or nationals of that country, (ii) doing business with any U.S. person engaged in trade with a country which is the object of the boycott or with the government, companies or nationals of that country, (iii) doing business with any company whose ownership or management is made up, all or in part, of individuals of a particular nationality, race or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality, race or religion; or (iv) employing individuals of a particular nationality, race or religion; or

(b) as a condition of the sale of a product to the government, a company, or national of a country, to refrain from shipping or insuring that product on a carrier owned, leased or operated by a person who does not participate in or cooperate with the international boycott.
(c) with foreign countries or subsidiaries to evade U.S. antiboycott laws.\textsuperscript{104}

2. Exceptions to Export Law Prohibitions

The regulations establish certain exceptions to the prohibitions on furnishing information and taking discriminatory action.\textsuperscript{105} Specifically, when supplying goods or services to a boycotting country, a U.S. person may:

(a) comply or agree to comply with the requirements of the boycotting country prohibiting the importation of goods from the boycotted country or by a business organized under or nationals of the boycotted country;

(b) comply or agree to comply with the requirements of a boycotting country prohibiting shipment on a carrier of a boycotted country or requiring shipment by a specific route;

(c) comply or agree to comply with the shipping document requirements of a boycotting country, regarding (1) country of origin of goods, (2) name and nationality of carrier, (3) route of shipment, (4) name, residence and address of supplier and (5) name, residence and address of a provider of other services, provided that such information is stated in positive, nonblacklisting, nonexclusionary terms;

(d) comply in the normal course of business with the unilateral and specific selection by a boycotting country of carriers, insurers and suppliers to be performed within the boycotting country (although, if a request is received from another U.S. person and the recipient knows or has reason to know that a selection is made for boycott reasons, the recipient has a duty to inquire about who made the request to ensure that it came from a boycotting country);

(e) comply with the export requirements of a boycotting country, regarding (1) shipments to a boycotted country, (2) any business concern of a boycotted country, (3) any national or resident of a boycotted country;

(f) comply or agree to comply with information required on immigration, passport, visa or employment documents required by a boycotting country (if the information is supplied only about oneself or a member of ones own family);

(g) comply or agree to comply with the local laws of boycotting country for activities by a U.S. person resident within that country (including entering contracts, employing residents, buying or selling goods or services within the country and furnishing information); or

(h) comply or agree to comply with the import laws of a boycotting country for goods for personal use when a U.S. person is resident in the boycotting country.

3. Recordkeeping Violations

Section 999 of the Internal Revenue Code requires a company and all of its foreign and domestic subsidiaries and affiliates to report on all operations in any listed country on its yearly tax return, whether or not the company participates in or cooperates with a boycott.

\textsuperscript{104} Id. at § 760.4. The evasion provisions are set out in a separate regulation designed to avoid persons from “finding a way” to get around the regulations.  
\textsuperscript{105} Id. at § 760.3.
U.S. Commerce Department regulations require that a U.S. person who receives a boycott-related request to file a report of each request, regardless of whether the U.S. person intends to comply. Even requests to take boycott related actions which are permissible must be reported, unless the regulations set forth a reporting requirement exception. Reports must be postmarked by the end of the month following the calendar quarter in which the person receives the request if the person is located in the United States (two months following the calendar quarter if the person is located outside the United States). All reports are available for public inspection, although at the time of filing a report a person may have information regarding quantity, description and price redacted if the person certifies (and such certification is accepted by the Commerce Department) that it would be put at a competitive disadvantage if the information became public.

D. The Arab Boycott

The Arab boycott of Israel is the principal current target of the anti-boycott laws. It is coordinated through the Arab League’s Central Boycott Office. Individual countries decide, however, whether to apply the boycott rules to a particular transaction. The League’s members approach to interpretation of the boycott rules varies considerably. Typically, someone expecting to sell products or services to a country that participates in the boycott, will be asked to complete a “boycott questionnaire” as a condition of entering into a contract. If a U.S. person completes the questionnaire, he or she will violate U.S. anti-boycott prohibitions. Another typical situation is a request for a “certification” that goods are not of Israeli origin or were not manufactured by a company that has been blacklisted by the Arab League.

Because the Arab boycott of Israel is of particular concern, correspondence and documents relating to the following countries should be given special scrutiny to ensure compliance with U.S. antiboycott laws (although many of these countries have not actively supported the boycott for some time): Syria, Lebanon, Bahrain, Oman, UAE, Dubai, Kuwait, Saudi Arabia, Qatar, Yemen, and Libya. The following Islamic countries also have a boycott law on their books and at any time might apply a secondary or tertiary boycott to U.S. persons: Bangladesh, Indonesia, Iran, Malaysia and Pakistan.

As part of a comprehensive international compliance program, franchisors must train their international sales (including franchise sales) staff to understand the laws. Because each request to comply with an illegal boycott must be reported to the U.S. Department of Commerce, each company must designate a compliance officer to advise company personnel well of their duties, and to consult with outside counsel as issues arise.

Franchisors should document their compliance policies, retrain personnel annually, and annually assess the efficiency of their compliance procedures.

V. Data Protection and Privacy

All countries within the European Community (“EU”) are required by EU Directive (95/46/EC) (“the Directive”), which was intended to harmonize data protection throughout Europe, to have implemented broadly similar data protection legislation. In the UK it is the Data Protection Act 1998 (“DPA”). The provisions of the DPA are largely replicated throughout

106 Id. at § 760.5.
107 See id. at § 760.5(a)(5).
the EU. The DPA applies where personal data is processed by a “data controller” and largely requires that such processing is in accordance with the eight Data Protection Principles as set out in the DPA and the Directive which specifies that processing has to be fair and lawful as well as for a specified and lawful purpose. In most cases processing will not be considered fair and lawful unless specific information is provided to the individual to whom the personal data belongs (referred to as data subject) as to how the data will be processed. A “data controller” under the DPA is defined as the person who determines the purposes for which and the manner in which any personal data is or is to be processed\textsuperscript{109} - this is usually both the franchisor and the franchisee. Personal data is data which relates to a living individual who can subsequently be identified from that data.\textsuperscript{110}

Processing personal data for the purposes of the DPA includes obtaining, recording or holding the information or data or carrying out any operation or set of operations on the information or data. It also includes the disclosure of the information or data by transmission, dissemination or otherwise making available. Clearly in a franchising context franchisees will be likely to collect information about their customers and possibly suppliers. Many franchisors require their franchisees to provide customer information perhaps to enable the franchisor to market to customers, to undertake quality control procedures or to enable the Franchisor to verify the information provided by the franchisee. The collection of the information by the franchisee, the provision of the information to the franchisor and the use of the information by the franchisor will all be regulated by the DPA.

In international franchising there is usually an additional step where the master franchisee, subsidiary or developer (all of whom will be “data controllers”) provides information to a foreign franchisor. If the transfer involves a transfer outside of the EEA\textsuperscript{111} then this creates further issues. Such transfers are subject to a general prohibition both under the DPA\textsuperscript{112} and the Directive. The prohibition applies unless the country or territory where the data is to be transferred ensures an adequate level of protection for personal data. The prohibition contains certain exemptions, including where the data subject has provided consent to the transfer (however, this consent must be freely given, specific and informed) or in certain circumstances where the transfer is required in order to give effect to a contract, where the contract is between the “data controller” and the data subject and the transfer is necessary for the performance of the contract (in practice this is unlikely to arise in an international franchising context) or the transfer is a necessary part of pre-contractual steps taken by the data controller at the request of the data subject (this certainly could arise in the context of a prospective sub-franchisee requiring the consent of the foreign franchisor to the grant of a franchise). Transfers in connection with contracts are also permitted where a contract is in place between the data controller and an entity other than the data subject where the contract is entered into at the data subject’s request or in his/her interests and the transfer is necessary for the performance or conclusion of the contract (again this is unlikely to arise in a franchising context) or where the transfer is necessary for the purpose of or in connection with legal proceedings or obtaining legal advice. However, there is no exemption for where a data controller is required by the law of a country outside of the EEA to transfer the personal data.\textsuperscript{113} Other exemptions exist with


\textsuperscript{110} Id.

\textsuperscript{111} Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Irish Republic, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden and United Kingdom.


respect to substantial public interest transfers that are necessary for crime prevention or
detection, national security and tax collection. This exemption is applicable if there would be
likely to be a substantial prejudice to the public interest if the transfer did not occur. Transfers
will also be allowed in a number of other limited exceptions which will not arise in franchising.114

The Information Commissioner in the UK has issued guidelines about transfers of
personal data outside of the EEA. Similar considerations will apply in other European Union
countries. These guidelines set out questions that data controllers need to address when
considering whether a transfer will comply with the eighth Principle of Data Protection as set out
by Article 25 (1) of the Directive. These questions are:

- Is there a transfer of personal data?
- Is the destination country outside of the EEA?
- Has the country been designated as “adequate”?
- Does one or more of the exceptions apply?
- Is there an alternative basis for the transfer?

Transfer does not include mere “transit”, where data only passes through a country on
its way to its eventual destination. It will only be deemed as having been transferred to a
country where some substantive processing has taken place en route, i.e. if the data has been
accessed or altered in some way. It will include the transfer of personal data which will be held
as personal data after a transfer takes place, for example, where details are phoned through
with the intention that they will subsequently be stored on a computer.115 In respect of
adequacy, alongside the specific designations of a country as adequate by the European
Commission (currently Argentina, Canada (Private Sector only), Guernsey, Isle of Man,
Switzerland, the US Department of Commerce’s Safe Harbor Privacy Principles and the transfer
of Air Passenger Name Records to the United States’ Bureau of Customs and Border
Protection) there is guidance which allows “data controllers” to make their own assessment of
whether a country provides adequate protection. Such an assessment must be based on a
consideration of whether the level of protection afforded in all the circumstances of the case is
commensurate with the risks, to the rights and freedoms of data subjects, in relation to the
processing of their personal data.116 The “data controller” must also consider whether there are
effective mechanisms in place for data subjects to enforce their rights or obtain redress if things
go wrong.117 In some situations a “data controller” will be allowed a strong presumption of
adequacy; this presumption will depend on the circumstances in which the transfer is taking
place. For example, transfers of personal data to a third party overseas processor is likely to be
presumed adequate because the exporting controller remains the “data controller” subject to
there being a written contract in place between the “data controller” and the data processor.
Other types of transfer have been considered as having a presumption of adequacy such as
transfers within an international company or group of companies, where an internal code of data
protection is in place, transfers between consortiums of independent organizations such as in
the banking sector and transfers between providers of professional services whose client’s
affairs are international in scope. These latter two types qualify because of the added protection

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(last visited May 18, 2006).
(last visited May 18, 2006).
116 ICO Guidance Note, The Eighth Data Protection Principle and Transborder Dataflows,
(last visited May 18, 2006).
given by professional codes of conduct. In practice, master franchisees in the UK who are subject to master franchise agreements with franchisors in the United States may well, by incorporating appropriate provisions in the master franchise agreement, and requiring U.S. franchisors to comply with a code of conduct, be able to pass personal data to the franchisor.

If adequate protection does not exist, transfers can still be made if one of the relevant exemptions, discussed above, applies and in many cases a “data controller” will choose to rely directly on an applicable exemption as opposed to making a call on adequacy themselves. There is also scope for “data controllers” to rely on an alternative method of transfer such as the use of standard contracts. Standard contracts can either be EC standard contracts or UK standard contracts which have been approved by the European Commission or the UK Data Protection Commissioner, respectively. The International Chamber of Commerce and the Confederation of British Industry have both submitted model contracts to the European Commission. Once standard terms are approved by either the European Commission or the UK Data Protection Commissioner then “data controllers” in the UK or EU who have a contract based on these terms or which incorporate those terms, with a recipient of personal data in a country outside of the EEA, will be able to transfer personal data without making an assessment of adequacy, provided any conditions attached to the standard terms are complied with. The relevant standard terms are available from the European Commission website and there have been three sets since the Directive entered into force in 1998, the latest set having been agreed in early 2005. The implementation of the new set of clauses is due to be assessed in 2008.

Under the DPA, sanctions can be imposed whereby an individual who has suffered damage or distress as a result of a breach of the DPA can seek compensation from the “data controller”. The “data controller” may claim that it has taken reasonable care to comply with the relevant DPA provision as a defense in circumstances where compensation is sought.

A. Issues between EU and U.S.

One of the consequences of the lack of a unified national standard within the U.S. has been that the EU does not deem the U.S. to have an “adequate level of protection for personal data” as required by the Eighth Data Protection Principle. The effect has caused difficulty between the EU and the U.S and in a bid to find a solution that would allow the free flow of personal data between the two jurisdictions the Safe Harbor bilateral agreement was negotiated. The Member States of the EU approved the agreement on May 31, 2000 and it was finally agreed in July 2000 despite the opposition of the European Parliament. Under the Safe Harbor agreement U.S companies have been able voluntarily to adhere to a set of seven principles that meet the requirements of the EU and therefore allow personal data to be transferred from the EU to the U.S. However, under the terms of the agreement the EU

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Commission is able to review the implementation of the agreement periodically. The latest review, conducted in 2004, produced a working document and a study on its findings which found numerous deficiencies in the implementation of the Safe Harbor arrangements. The report targeted three main areas: (i) the compliance of registered US organizations, (ii) whether the bodies and organizations that support the implementation are working effectively, and (iii) whether the agreement was being implemented in a discretionary manner. The report’s findings suggested that the adoption by companies to the scheme was slow; only just over 400 companies had registered by the end of 2003. Although this figure has now risen to 943, the list contains very few franchisors. There was also concern that a minority of members were falling short of the requirements of the Safe Harbor because, although they signed up to the Safe Harbor agreement, they failed to make clear within their privacy policies that they adhered to the data protection principles, required by the Safe Harbor framework. The report also highlighted other problems with registered companies and their actual implementation of the Principles. One of the suggested solutions was to suspend the transfer of data under the agreement where there is evidence of non-compliance by a registered organization. The Federal Trade Commission ("FTC") was asked to be more proactive in ensuring compliance. Currently the Safe Harbor agreement remains in place. However, there have been calls by the European Court of Justice’s ("ECJ") Advocate General for the European Council and Commission’s decisions relating to the transfer of airline passenger data to the US Bureau of Customs and Border Protection ("CBP"), which had previously found that the CBP provided a sufficient level of protection for personal data transferring between the EU and the US, should be annulled by the ECJ. The opinion of the Advocate General is not binding on the ECJ, but serves as an independent proposal; however, in 80% of cases these opinions are followed by the full court. The case was due to be heard by a full court in early 2006.

B. Global Trends

The 7th Annual Privacy and Human Rights survey 2004 which reviews the state of privacy in sixty countries identified that in the wake of September 11, 2001 and subsequent terrorist attacks what it considered to be invasions of privacy had increased in the preceding 12 months. This was due to countries around the world pursuing legislation and schemes that aim to increase state power whilst at the same time weakening data protection schemes. It also highlighted various trends one of which was the mismanagement of personal data and major data leaks which highlighted bad online data processing and security practices or the use and

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dissemination of individuals’ personal data outside any legal data protection framework which clearly showed the damaging effects for data subjects’ privacy. It cited some examples including the publication on the internet of a Communist era former secret service agency’s old police files on 1.5 million individuals (Slovenia), the leak of personal data from government agencies and private companies to crime syndicates (Taiwan) and the regular disclosure of personal information from government computers because of a poor culture of security (U.K.).

Alongside those findings the survey also confirmed that since the previous year’s survey all EU countries, including the 10 newest Member States had transposed the Directive into national law. It highlighted that Costa Rica, Malaysia, Mexico, Thailand and Turkey were all in the process of drafting comprehensive data protection laws, which were, with the exception of Malaysia, following the model of the Directive. It was also noted that Ukraine had created its first Data Protection Authority.  

Some commentators have considered the possibility of some form of data protection regulation on a global scale monitored by the World Trade Organization, whilst noting the extremely unlikely possibility of this occurring given the historical, cultural and social considerations which impinge on this area.

In many jurisdictions compliance with data protection legislation will create the same issues as compliance with any other mandatory provisions in a franchisee’s home country. Problems arise when data is required to be sent outside a country’s jurisdiction and that country either prohibits this or imposes requirements/safeguards which are not met. The steps that a franchisor should take in relation to data protection legislation are:

- establish with local counsel what information can and cannot be provided without restriction;
- determine whether the information required by the franchisor may be provided in a form so as to fall outside any prohibitions by, for instance, not providing any names and addresses but providing the information in a generic format?
- if the information cannot be reconfigured so as to avoid prohibition and restrictions, can compliance be achieved? This may not be possible if personal data has to be “exported” to a “black listed” country. In such circumstances franchisors should consider requiring their foreign master franchisees to retain such information in their home country for review by the franchisor’s representative or nominee.

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VI. Conclusion

International franchising offers franchisors a tremendous opportunity for growth, particularly in emerging markets such as China, India and Latin America. However, international franchising requires much more flexibility, creativity and risk assessment than what most U.S. based franchisors are accustomed to when franchising domestically. As shown here, the laws, cultures and policies require franchisors to be keenly aware of the jurisdictions that they are entering into. In order for franchise counsel to be aware of some of the myriad of issues facing them in the international arena, this paper sets out many examples such as (i) developing judicial systems, (ii) religious laws that unsuspecting franchisors may not even consider in their day-to-day business, (iii) simple administrative necessities to protect a franchisors' most prized possession - its trademark, and (iv) U.S. laws directly impacting international business. The solutions offered are not meant to be conclusive but are intended to give an alternative or direction to finding the proper solution for the franchisor. At the end of the day, many of the solutions are derived from a franchisor analyzing, with the help of its counsel, the business risks and creating a solution that is right for it at that time. Hopefully, this paper provides some initial insights in understanding some of those risks and traps so that as franchise counsel we can give the clients some comfort, assistance and direction in making the proper business decision.
John Pratt

John Pratt is the founding partner of Hamilton Pratt. He had previously been managing partner and head of franchising at Pinsent Masons, President of the Birmingham Chamber of Commerce and Honorary French Consul in Birmingham. Hamilton Pratt is the largest specialist franchise law firm in Europe and acts for more than 25% of the full members of the British Franchise Association (BFA).

John became involved in franchising over twenty five years ago when he acted for the first chairman of the BFA and since then has specialised in franchising. John lectures on franchise issues all over the world.

In June 2005 John was appointed Legal Advisor to the BFA. He has written the UK text book on the legal aspects of franchising – “Franchising: Law & Practice” and contributed to a very broad range of franchise publications including PLC’s Commercial Contacts and International Sales and Marketing Manuals and the UK chapter of “International Franchising Law” as well as the franchising chapter in “Practical Commercial Precedents”. He is current Chair of the International Bar Association’s “International Franchising Committee” and was a past President of the U.I.A’s Franchise Committee.

John obtained his law degree from Oxford University and subsequently successfully completed a doctorate course in comparative law at the University of Aix-Marseille.
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Since 1992, he has conducted a 3-day symposium on international master franchising at IFA’s annual International Franchise Expos. He is the author of the book, “*Master Franchising: Selecting, Negotiating and Operating a Master Franchise*” (Commerce Clearing House, 1999).

A former IFA General Counsel, Carl shaped U.S. franchise laws, testifying before Congress, the Federal Trade Commission, and state legislatures in 21 states. He served on the advisory committee which developed the original Uniform Franchise Offering Circular Guidelines.

He created the IFA’s interactive Internet course, “*Franchising Basics: The Official IFA Course,*” and he was a member of the Board of Editors of *International Franchising* magazine. He is listed in the *International Who’s Who of Franchise Lawyers*.

A former chairman of the Advisory Board of IFA’s Supplier Forum, he has served on the IFA Board of Directors and currently serves on IFA’s Legal/ Legislative and Franchise Relations Committees. In September, 2005, he became the first lawyer to receive the IFA’s Distinguished Service Award.

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