The Soul of Franchising
All Over the World: Mastering International Master Franchise Agreements

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The Facts

- Mind My Math! is a tutoring franchise system based in NJ and run by Sally Smart.
- MMM has direct unit franchises in the US & CN and an area developer in MX.
- MMM has also granted direct unit franchises in the UAE but expansion stalled, the UAE network is stagnant, and UAE franchisees are disgruntled.
Paragraph 1 - Issues

• Structure
  – Direct Franchising
  – Area Development
  – Master Franchise
  – Multi-Unit/Hybrid/Joint Venture

• Basics of Master Franchising

• Why Use a Master Franchise?
The Facts

- Dubai Trading Company is a successful master franchisee of several QSR brands in the UAE.
- Karim Mansouri is a minority owner and managing director of DTC.
- Karim approaches Sally on behalf of DTC to develop MMM in the UAE and other parts of the Middle East.
- Karim sees potential in MMM’s proprietary system of online and peer-based study groups.
Paragraph 2 - Issues

• Franchisor’s Due Diligence
  – Legal
  – Commercial
  – Master Franchisee

• Master Franchisee’s Due Diligence
  – Legal
  – Commercial
  – Franchisor
The Facts

• Karim asks Sally to grant DTC a master franchise territory covering the UAE plus most of the ME and North Africa.
• Sally wants DTC to start in the UAE and to take over support of MMM’s existing UAE franchises.
• Sally also proposes what Karim considers to be a very aggressive development schedule.
Paragraph 3 - Issues

• LOI

• Multi-Jurisdictional Considerations
  – Territory
  – Development Schedule
  – Local Law Compliance

• Existing Franchisees
The Facts

• Sally asks Karim for an unlimited personal guarantee and also asks how frequently he’ll bring prospects to NJ as part of the approval process.

• Karim tells Sally that as a minority owner in DTC, he’s not the right person to sign a guarantee.

• Karim also tells Sally that DTC expects to control all of the online presence of MMM in all the jurisdictions covered by the master franchise.
Paragraph 4 - Issues

• Guarantee
• Subfranchisee Approval
• Distribution Channels
The Facts

• Ultimately, MMM and DTC sign a MFA and relaunch the MMM brand in the UAE, but not successfully.
• Sally complains subfranchisees aren’t following the system, are using unauthorized on-line ads and teaching materials, and are charging exorbitant rates.
• Karim says deviations are to respond to local market demands.
• Sally wants Karim to issue default notices; he refuses.
Paragraph 5 - Issues

Control / Autonomy / Enforcement
The Facts

• Although Sally believes the system could still be viable in the UAE, the relationship with DTC deteriorates and Sally decides to terminate the MFA.

• Sally reviews the MFA and considers her options.
Paragraph 6 - Issues

• Drafting Issues
  – Subfranchise agreement
  – Master agreement

• Termination v. Assignment
ALL OVER THE WORLD: MASTERING INTERNATIONAL MASTER FRANCHISE AGREEMENTS

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I. OVERVIEW OF THE MASTER FRANCHISING MODEL

A. What Is A Master Franchise?

Master franchising is perhaps the most popular business model used in international franchise expansion, as it has the potential to result in rapid expansion of a brand in the target jurisdiction without the ongoing commitment of human and financial capital that would be required in other franchising models, such as direct unit franchising. In a master franchise agreement, the franchisor grants to a master franchisee the right to develop the brand within a specified territory by licensing subfranchisees the right to establish and operate subfranchised units in that territory. The master franchisee assumes the role of the franchisor in the foreign market, vis-a-vis the subfranchisees, including providing training and support, as well as day-to-day administrative duties.

The development right is usually time limited and provides for development milestones or performance standards over the course of the term, which may be measured against various yardsticks, such as gross revenue or number of outlets open and operating. Master franchisees are often required to own and operate a number of “pilot” outlets through an affiliate before they may sublicense the franchise to third parties. This is a good practice to ensure that the master franchisee understands the business and can provide practical, experienced-based advice and support to subfranchisees. Once that condition has been satisfied, master franchisees are typically able to satisfy performance standards with a mix of franchises operated by affiliates of the master franchisee and third-party subfranchisees.

Master franchise agreements are a balancing act between the franchisor’s desire for consistency and control in the franchise offering, and the master franchisee’s desire for autonomy in the target jurisdiction. A well drafted agreement will obligate the master franchisee to provide the same or similar products and services as the franchisor does in its domestic market, but will also establish processes to take advantage of the master franchisee’s knowledge and experience about local culture, customs, competition and market conditions. The degree of control will vary, but franchisors will often retain various approval or veto rights, such as with respect to the selection of subfranchisees or real estate choices, and also prescribe the standard form agreements that must be used by the master franchisee when contracting with the subfranchisees.

In exchange for effectively adopting the franchisor’s role in a foreign country, the master franchisee typically pays an initial, up-front master franchise fee, and also shares with the franchisor the fees paid to the master franchisee by the subfranchisees, including initial franchise fees and royalties. This is in consideration for the use and sublicensing of the proprietary intellectual property and operational system owned by the franchisor.
B. Overview of Advantages and Disadvantages of Master Franchising

The decision to use a master franchise business model for international expansion will depend on numerous factors, and has various advantages and drawbacks. Chief among the advantages is the opportunity to leverage the local knowledge and expertise of a master franchisee. While the franchisor has the greater knowledge about its products and services, the master franchisee may be in the better position to evaluate local market conditions, economics and other factors influencing how those products and services should be sold and any necessary adaptation of the system, and the products and services, in the territory.

A second significant advantage is that this business model minimizes the franchisor’s outlay of financial and human capital required to develop a new jurisdiction. After the franchisor’s initial effort identifying and qualifying a local master franchisee, the franchisor does not engage in day-to-day franchising issues in the jurisdiction, as the master franchisee is responsible for devoting the necessary time and resources for selling and supporting the subfranchisees. Yet the franchisor can still maintain quality control and system standards, despite typically having no privity of contract with the subfranchisees, through a well drafted master agreement with the master franchisee, including a prescribed form of subfranchise agreement and locally adapted operations manuals.

There are, however, some significant disadvantages to the master franchising process. First, once the master franchise agreement has been executed, the development of the franchise system – and the success or failure of the brand in the jurisdiction – rests largely with the master franchisee. While the franchisor may have certain controls and checkpoints in the master agreement (such as performance standards), brand depreciation, or even complete system failure, can occur quickly, and possibly before the franchisor is in a contractual position to take any action. Additionally, in some cases, having the contractual ability to terminate a master franchise agreement, for the master’s failure to meet performance standards or otherwise, does not improve the franchisor’s position as termination is often an impractical option. The franchisor may simply not have the skill, resources or legal standing to assume the role of the master franchisee in the foreign jurisdiction (which is likely why the franchisor selected the master franchise model in the first place). Identifying and appointing an alternate master franchisee to replace the current master franchisee takes time.

Another significant challenge facing a franchisor and a master franchisee is establishing an appropriate economic plan for the master franchise relationship. Franchisors want to share in the master’s receipt of various fees paid by the subfranchisees, but there must be enough economic benefit remaining for the master franchisee to make the economics work. Similarly, an overly ambitious development plan is a serious temptation for franchisors and masters alike, but unrealistic milestones can quickly lead to friction and defaults.

Furthermore, some local laws may cause problems, such as restrictions on the availability of a master franchising model, onerous disclosure requirements imposed on the franchisor in respect of the master franchise offering, and also on the master franchisee in respect of the unit franchise offering. Some jurisdiction create the possibility of vicarious liability of the franchisor for acts of the master franchisee or its subfranchisees.

While the opportunities for quick growth are clear, the necessary corollary also is clear; a poor master franchisee can seriously harm the franchisor’s brand and reputation in the jurisdiction. It can be harder to re-launch a failed brand in the territory than it is to launch a new brand. A failed master franchise program in a jurisdiction can effectively close off a market for a significant time period.
C. **Comparison With Other Arrangements**

Master franchising is not the only vehicle for international franchise expansion. \(^1\) Other structures may be used in combination with, or in place of, a master franchising program. These arrangements are described briefly below solely for purposes of comparing them to the master franchise structure. \(^2\)

1. **Direct Unit Franchising**

Direct unit franchising refers to the direct grant of a unit franchise agreement by the franchisor to a unit franchisee, without any intermediary like the master franchisee to help in discharging the franchisor’s obligations to the unit franchisee. This type of arrangement clearly affords the franchisor much greater control over the unit franchise than it has in a master franchise arrangement. The structure also has the advantage of allowing the franchisor to retain all fees generated by the unit franchisees without the necessity of having to share a portion of the fees with an in-country master franchisee.

However, greater control and the right to retain one hundred percent of the fees paid by unit franchisees comes at a price. The franchisor bears all of the costs associated with identifying, signing and supporting the unit franchisees, as well as all enforcement costs in the event of a dispute. There are indirect costs as well, since the franchisor has no one “local expert” to advise on how best to adapt and implement the system in the local market.

As a result, one might expect to find direct unit franchising used most successfully where a franchisor already has significant multi-national operations or where the size of the franchise investment is large enough and the unit franchisee is sophisticated enough to support a different cost and support structure – for example, in the hotel industry.

2. **Area Development**

An area development arrangement adds a multi-unit component to the direct unit franchise structure described above. The franchisor and a local counterparty (the “area developer”) enter into an area development agreement which requires the area developer to establish, directly or through controlled affiliates, multiple unit franchises within the assigned geographic territory according to a time line (or development schedule) agreed to by the parties. Each unit franchise established under the area development agreement is typically evidenced by, and operated under, a separate unit franchise agreement between the area developer or its affiliate and the franchisor.

Because this arrangement is essentially a variation of the direct unit franchise structure, it offers many of the same advantages and comes with many of the same disadvantages as that

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\(^1\) A more comprehensive discussion of these arrangements may be found in Marc Mushkin, Dominic Mochrie, Robert A. Smith, *Expanding Internationally, International Franchise Association*, 48th Annual Legal Symposium, May 2015.

structure. But, franchisors benefit from not having to identify and qualify a new prospect for each franchise location. In addition, at least in theory, it allows franchisors to better control the pace of development in a particular geographic area by committing the area developer to a specific development schedule. But, as in master franchising relationships with respect to establishing an appropriate development schedule for the territory, development schedules are extended or renegotiated, more frequently than not.

Area development arrangements are often used in systems, like casual dining franchises, where the initial unit investment cost is relatively high, unit operations are relatively complex and the area developer may benefit from economies of scale.

3. **International Multi-Unit Franchise Agreements (IMUFAs)**

International multi-unit franchise agreements (an “IMUFA”) combine in a single document the development obligations and unit operating provisions that are split between an area development agreement and a unit franchise agreement in the area development structure. The IMUFA includes all provisions relating to the development, construction and operation of multiple franchise units, and the establishment of, and approval for, each unit is typically evidenced by separate location addendum to the IMUFA, rather than a separate subfranchise agreement.

The use of IMUFAs can reduce some of the administrative burdens franchisors face by eliminating the need to prepare a separate subfranchise agreement (and, if applicable, comply with related disclosure and/or registration obligations) for each new location that is developed. However, the integrated nature of the agreement can make it difficult to negotiate, document and ultimately enforce default and termination provisions that may apply to some, but less than all, of the units covered by the agreement. Attempting to use IMUFAs to cover multiple jurisdictions only adds to the complexity.

4. **Hybrid Development Agreement/Master Franchise Arrangements**

In a true master franchise arrangement, the master franchisee acts as the franchisor in the territory, soliciting subfranchisees, directly granting franchise rights to those subfranchisees, supporting the subfranchisees during the term of their subfranchise agreements and enforcing compliance with those subfranchise agreements.

In a hybrid arrangement, the master franchisee is also obligated to develop and operate a certain number of units directly, often before granting franchises to third party subfranchisees. This requirement goes beyond a requirement to maintain a training or pilot unit in the territory and frequently imposes significant development obligations directly on the master franchisee and its controlled affiliates.

By requiring the master franchisee to maintain and operate at least a minimum number of “company-owned” units in the territory, the hybrid arrangement enhances the master franchisee’s operational expertise and, at least in theory, makes it better able to provide operational support to third party subfranchisees. However, the structure requires the master franchisee not only to invest in the development, administrative and operational support structure needed to manage a network of third party subfranchisees, but also requires the master franchisee to contribute the human and capital resources needed to directly operate units. Therefore, master franchisees in a hybrid structure are often significant companies that have an established infrastructure and access to capital.
Because these arrangements include a subfranchising component, we treat them as master franchise arrangements for purposes of this paper.

5. Joint Ventures

In a joint venture arrangement, the franchisor or its affiliate invests directly in an entity (the “JV entity”) with a local partner and then enters into one of the contractual structures described above with the JV entity. While terms vary, the franchisor often holds a minority interest in the JV entity, with the local partner holding the majority interest. Nevertheless, even as a minority owner, the franchisor will have certain rights at the entity level to influence operations and it will retain its contractual controls as the franchisor under the agreements between it and the JV entity.

Joint ventures may be used in situations where the local partner wants the franchisor to demonstrate its commitment to the market by making a direct investment through the JV entity. Once the initial units have been developed and in-country support systems have been established, the franchisor may exit the JV entity by selling its interest to the local partner.

Joint ventures also may be used where the franchisor wishes to exercise more control over, or secure a direct interest in the profits generated by, in-country operations, but does not have the legal right, resources or expertise to operate the market entirely on its own. In those circumstances, the franchisor may retain its investment in the JV entity indefinitely.

D. When to Use Master Franchise Arrangements (vs Other Arrangements)

There is no set rule that determines when to use a master franchise arrangement or whether one of the other structures described above is better suited to a particular transaction, although the preceding paragraphs suggest some of the considerations that may be taken into account in making a decision.

Other considerations relate to the nature of the franchise itself. Is it a business that is relatively simple to operate with a low to moderate initial investment cost? If the franchise is easy to sell and support, a franchisor may only need to provide minimal oversight, making the opportunity particularly well-suited to a master franchise structure.

That said, in order for a franchisor to realize the full benefit of a master franchise arrangement, it must be prepared to step back once it is confident that the local master franchisee has the necessary resources and expertise to implement the system without significant direct support by the franchisor. The economics of a master franchise arrangement reward the master franchisee for taking the primary role in selling and supporting subfranchises in the market. A franchisor that insists on performing more than its secondary support role, without a commensurate share of the fees paid by the subfranchisees, will not fully benefit from a master franchise arrangement.

II. DUE DILIGENCE

International expansion using a master franchise model requires a franchisor to conduct extensive due diligence on its system, its motivation for and commitment to international expansion, the target jurisdiction, and the proposed master franchisee.
A. Franchisor's Diligence (Legal)

1. Franchise Regulation

The obvious first step for legal diligence is an examination of any franchise-specific legislation in the target market, as these laws can impose unfamiliar duties on franchisors. Some jurisdictions have legislation that mandates onerous pre-sale disclosure, requires registration (of subfranchise agreements, disclosure documents, or even technology and trademark licences), and/or can change the commercial nature of the franchising relationship. Some jurisdictions require that certain topics be included in the agreements themselves, such as minimum terms, a “cooling off” period, or specific dispute resolution provisions. Other jurisdictions adopt more self-regulatory or voluntary disclosure requirements. These laws can have a significant impact on the franchising system, relationships, and the economics between the franchisor and the master franchisee. Franchisors should pay particular attention to the legislation that is explicitly designed to address the “balance of power” concerns; remedial legislation tends to impose strict guidelines on the franchisor-franchisee relationship. A franchisor cannot assume that it is protected by the standard terms of its master franchise agreement. It must seek advice from local counsel to determine whether certain key provisions are enforceable in the target jurisdiction.

Franchisors granting large territories may find themselves facing multiple jurisdictions with franchise legislation within a single territory. For example, franchise legislation in Canada is regulated at the provincial level, in five of the ten provinces, so a franchisor seeking to grant a master franchise for the entire country must comply with each statute. Further, if the proposed territory includes certain regulated and unregulated jurisdictions, and the legislation in the regulated jurisdictions could impact the commercial deal, the franchisor should consider separate agreements for the regulated jurisdictions and the unregulated jurisdictions.

2. Vicarious Liability

Franchisors are accustomed to vicarious liability issues relating to the actions of their subfranchisees. The same concerns, unfortunately, can exist with respect to the actions of a master franchisee, or even its subfranchisees. An absence of contractual privity between the subfranchisees and the franchisor does not necessarily shield the franchisor from liability due to the actions of subfranchisees. Franchisors must seek advice from local counsel to discover possible avenues of exposure (both operationally and legally), and how to manage or reduce that risk. This is particularly true where the franchisor has substantial control over subfranchisees with respect to aspects of the business subject to regulatory requirements (such as consumer protection laws).

While there is no common approach to dealing with this issue, local counsel can be instrumental in demystifying judicial interpretations and regulatory requirements. Furthermore, franchisors should ensure that master franchisees are also aware of all vicarious liability risks and insist on compliance with any processes, disclaimers or other practices designed by the franchisor to reduce the risk (which can also assist the master franchisee vis-à-vis its subfranchisees).³

3. **Competition/Anti-Trust Law**

Franchisors using the master franchise model should also thoroughly review the competition or anti-trust laws in the target market. In Canada, for example, the Competition Bureau's jurisdiction includes numerous matters relevant to international businesses, such as abuse of dominance, merger reviews, price maintenance, refusal to deal or supply, tied selling, and even misleading advertising issues. The Bureau also monitors criminal offences that include bid rigging, pyramid selling, and other trade practice matters defined in the legislation. Competition law is heavily implicated in nearly all aspects of business and must be incorporated not only into initiating documents, but into the administration of the system on all levels. This applies not only to the relationship between the franchisor and the master franchisee, but also the relationship between the master franchisee and its subfranchisees.

4. **Anti-Bribery/Anti-Corruption**

Many jurisdictions, including the United States and Canada, have onerous anti-corruption / anti-bribery legislation. This is an important consideration for franchisors as they could theoretically be found liable for the acts of their master franchisees or subfranchisees, depending on the level of control over the processes in question. Under certain laws, such as the U.S. *Foreign Corrupt Practices Act*, companies can be found liable for being “deliberately ignorant” for actions infringing the legislation, so it is important to have adequate provisions in place for any required accounting and recordkeeping practices. Key employees must be educated on these requirements, as well as analogous provisions in anti-money laundering legislation.

5. **Customs & Trade (Import/Export)**

While one of the advantages of a master franchising model is the opportunity to leverage the master franchisee’s knowledge of, and experience with, local supply chains, there will almost always be import/export issues when expanding to a new jurisdiction. In the interest of control, the franchisor may be tempted to use an existing supply chain, but it may not be economically or administratively practical, given the legal hurdles, including import duties and protectionist government policies. The franchisor must carefully consider how best to deliver crucial inputs, such as inventory, promotional materials, or necessary technology. If the franchisor is unable to export its products and services, or if it would be commercially impracticable to do so, the franchisor must instead set standards and specifications to assist the master franchisee to source local alternatives.

Some non-obvious government policies may also dramatically impact the economic plan. Depending on the business and sourcing model, franchisors (and master franchisees) will have to be aware of economic sanctions or export controls on specific products or suppliers. Technical specifications, restaurant equipment, and encrypted software might all be subject to additional duties or reporting requirements. Given their potential impact, all of these potential impediments should be considered in advance, with any expected delays finding or implementing workarounds worked into the timing of the expansion.

6. **Real Property**

Many franchises still depend heavily on site locations and have some form of real estate component. While costs vary across regions and countries, real estate is typically a significant expense that may have a material impact on the economics of a unit franchise operating in the target jurisdiction. For example, does the brand need a flagship location in a high-value region?
Given the relation of location to success for many businesses, the franchisor may want to exercise control over the real estate selections by, at least, some form of approval process, but needs to recognize the importance of the master franchisee's local knowledge and experience. Similar to the real-estate considerations in a unit franchise agreement, if the master franchisee controls the property, the franchisor should ensure that enforceable assignment provisions are in place allowing the franchisor to take control if the master franchisee defaults. There is even a concern that the master franchisee, in seeking out sites for the franchisor, might accidentally be considered a real estate broker in the target market and will be required to register as such. This is another area where the insight of local counsel is invaluable.

7. Employment

Employment standards vary dramatically across the globe and franchisors will need to familiarize themselves with regulatory schemes as well as immigration requirements. In Canada, for example, employment standards are predominantly legislated at the provincial level, meaning they vary across the country. It is also important to be aware of any hurdles to sending key franchisor personnel to set up or monitor business activities in the target jurisdiction. This is especially crucial at the beginning of the expansion process as the new subfranchises begin their training and operation. Franchisors must take note of visa and permit requirements, as well as the relevant exceptions, exemptions, term limits, and impact of international agreements. This should be dealt with well before granting the master franchise. If physical travel to the target jurisdiction is not possible, the franchisor must use alternate training methods, such as internet based courses.

Another employment law consideration is the possible termination of important local employees or even the master franchisee itself. In all cases, it is essential that the master franchise agreement provide for appropriate restrictive covenants regarding competition, confidential information, trade secrets, intellectual property, and solicitation of employees. What exactly constitutes an “appropriate” restrictive covenant will vary by jurisdiction and will need to be the subject of local advice or research. For example, Canadian courts will strictly interpret non-competition clauses and will not enforce any that are “unreasonable”. Terms must be no broader than necessary to protect legitimate business interests and cannot unduly limit the former master franchisee’s ability to use his or her previously acquired skills to make a living. Ensuring adequate protection with enforceability will be a jurisdiction-specific balancing act.

8. Trademarks and Other IP

Trademarks are of critical importance to a franchise system. One of the first diligence exercises any franchisor should undertake when considering an international expansion (regardless of which business model it elects to pursue) is the availability of the system’s trademarks in the target jurisdiction. By way of example, Burger King’s master franchisee in Australia launched the system under the name Hungry Jack’s due to an existing restaurant using the Burger King trademark. Despite the Burger King trademark later becoming available, the master franchisee continued with the Hungry Jack mark. There may be different standards, or unique requirements, imposed by local law to maintain validity of a trademark, such as registered user requirements, public notices, minimum controls or inspection requirements over the subfranchisees’ activities.

Additionally, the franchisor’s domestic trademarks may not be suitable in the target jurisdiction if they are offside local laws (including language laws) or customs (they may acquire a different or inappropriate connotation in the new context). The franchisor may have to adapt its marks or create new marks. This, in turn, may prompt the master franchisee to negotiate a
reduced franchise fee, given that the modified or new marks will not have the same goodwill and brand recognition as the original marks. If this exercise isn’t completed before the master franchise is granted (although it should be), then the master franchise agreement should be clear on the franchisor’s ability to impose substitute marks, and whose responsibility it is to pay for the costs in doing so.

Every country presents distinct challenges that must be accounted for in bespoke agreements. For example, while trademarks are regulated federally in Canada that does not mean provincial rules are inconsequential—a franchisor looking to expand into Quebec will need to know if its trademarks will have to be translated or appended. Fortunately for franchisors, international treaties may be of assistance when expanding across international borders. The Madrid Protocol allows for reciprocal registration of trademarks in signatory countries, the Paris Convention prohibits national favoritism in patent or trademark administration, and the WIPO Copyright Treaty provides international protection to computer programs and databases.

Additionally, franchisors must understand how the laws in the target jurisdiction protect non-registrable intellectual property, such as know-how, trade dress and confidential information. The foreign intellectual property regimes may not offer the same protection as the franchisor is accustomed to domestically.

9. Tax

Tax considerations will be one of the most important considerations in the franchisor’s decision-making process with respect to the target country and format of expansion. International expansions add significant complexity to the determination of the appropriate economic model, especially due to the variety of withholding taxes, sales and commodity taxes, and foreign income tax considerations. Their substantial impact on the economics of a deal mean that tax issues must be explicitly set out in the master franchise agreement and both parties should seek advice from local counsel and accountants.

Sales and commodity taxes are often imposed at various points in the manufacturing, distribution, and sales process and appropriate books and records must be kept to monitor liabilities at each step in the process. In Canada, a federal sales tax is payable on initial franchise fees, royalty fees, and advertising fund contributions. However, a foreign franchisor generally will not be required to register and collect the tax unless it is “carrying on business in Canada” and tax credits may be available. Goods imported into Canada may also be subject to federal tax under the *Excise Tax Act* and customs duties under the *Customs Act* (Canada).

Perhaps more important, Canada imposes a withholding requirement on fees, royalties, interest, and rent paid to foreign franchisors (although generally not on supplies and inventory). Canadian master franchisees are required to remit 25% to the Canada Revenue Agency and will be held personally liable if they fail to do so. Some countries, such as the United States, have tax treaties that reduce the withholding rate in Canada and tax credits may also be available in the franchisor’s home country. Regardless, treaties do not always exist and the credits may not adequately offset the amount withheld in Canada. The significant economic implications for both parties strongly suggest that tax issues, including who pays what, who remits to the appropriate authority, and who is responsible for providing the appropriate receipts, should be dealt with explicitly in the master franchise agreement and the subfranchise agreement.
10. **Inward Investment**

Another important consideration for franchisors will be any foreign investment laws that put regulatory hurdles before, or explicitly restrict, investment into a region or sector. Local ownership rules may limit a franchisor’s choices for a master franchisee to local entities or at least those with a certain percentage of local ownership. They may also cause problems with assignment provisions in the event that the master franchisee is terminated. Other foreign investment laws require government approval, fees, or registration. For example, the *Investment Canada Act* requires foreign-owned entities to notify the federal government when they establish Canadian operations or acquire Canadian businesses. Large transactions may be subject to review by the Investment Review Division and even small acquisitions may be monitored by the Cultural Investment Review Branch if they take place in a designated “cultural business” sector. As these issues can stop a transaction in its tracks, they must be thoroughly investigated beforehand.

11. **Specific Sector Laws**

Some countries have significant industry-specific regulatory requirements that may pose serious obstacles, depending on the franchisor’s business. In Canada, for example, health care, the environment, professional services, pharmacies, food and drugs, packaging and labelling, consumer protection, product warranties, travel agencies, gift cards, and even telemarketing are all subject to detailed regimes. Furthermore, privacy legislation affects nearly every aspect of Canadian business—franchisors and subfranchisees will need consent from individuals to collect, use, and disclose personal information for marketing or other purposes.

12. **Multi-Jurisdictional Issues**

The complexities inherent in master franchising arrangements are increased significantly when the master franchise agreement covers multiple jurisdictions. A master franchisee’s desire to obtain rights in multiple jurisdictions often arises when the geographic area under discussion is comprised of multiple jurisdictions that share common characteristics and are geographically proximate to one another, such as countries in the Middle East or Central or South America. But although these countries may have a number of characteristic in common, there are definite challenges to including them under the umbrella of one master franchise agreement.

Since each country has its own legal system, the franchisor must have the master franchise agreement reviewed by local counsel. While such a review in all jurisdictions before execution of the master franchise agreement is ideal, such a comprehensive review at the outset of the relationship may be cost prohibitive. The alternative is to stagger the roll-out of the master franchisee’s territory, phasing it in jurisdiction by jurisdiction as the master franchisee expands into each jurisdiction included in the territory. In that circumstance, the master franchise agreement must contemplate a phased-in review and must address which party bears the cost of the review as well as procedures for country-specific amendments in response to concerns raised by local counsel.

One concern that franchisors can anticipate is the impact of restrictions on foreign investment in certain countries included in the territory. Those restrictions may preclude the master franchisee from operating directly in one or more of the jurisdictions included in the master franchisee’s territory. In that case, the master franchise agreement must address how the master franchisee will fulfill its obligations in those jurisdictions where it cannot operate directly. For example, the agreement may allow the master franchisee to assign its rights and obligations in such jurisdictions to a local affiliate. The franchisor must take care to ensure that
the local affiliate will be bound by the master franchisee’s obligations and that the master franchisee remains responsible for the local affiliate’s performance.

Where multiple jurisdictions are involved, a franchisor also must negotiate how the master franchisee will develop those jurisdictions. Will all jurisdictions be part of the territory from the outset (either all at once or using a staggered approach as suggested above), or must the master franchisee “earn” rights in subsequent jurisdictions only by first fulfilling its development obligations in the initial jurisdiction? If all jurisdictions are part of the initial grant, will the development schedule permit the master franchisee to spread its development efforts across multiple jurisdictions simultaneously or will the development schedule phase in each jurisdiction only after certain minimum obligations in other jurisdictions have been completed? And, what type of in-market resources must the master franchisee commit to maintain in each jurisdiction?

Franchisors must also give careful thought to the default and termination provisions of a master franchise agreement involving multiple jurisdictions. Will a master franchisee’s failure to develop one jurisdiction be sufficient cause for termination of the entire master franchise agreement, or will the failure only afford the franchisor a right to sever that jurisdiction from the territory? What is the appropriate remedy if the master franchisee has fulfilled some – or even all – of its development rights in a jurisdiction but is unable to provide on-going operational support – perhaps due to forces beyond its control? If the franchisor severs the jurisdiction from the territory and finds another master franchisee to take over operations, what happens to the subfranchisees then operating in that jurisdiction?

These issues never have a one-size-fits-all solution, but must be negotiated on a case-by-case basis with the master franchisee. But, within the context of a particular multi-jurisdictional negotiation, the franchisor, master franchisee and their respective counsel will be much better served settling the business and legal issues raised as a result of the multi-jurisdictional component of the agreement at the outset of the relationship rather than on an ad-hoc basis as the issues arise during the relationship.

B. Franchisor’s Diligence (Other Considerations)

A Franchisor’s due diligence must also encompass other, non-legal complications.

1. Number of Master Franchisees

Master franchise agreements typically give a master franchisee the exclusive right to grant subfranchises within a specific timeline and territory. The geographic scope granted to a particular master franchisee is one of the most important considerations in structuring the commercial arrangement. While it is often tempting for a franchisor – having performed all the due diligence necessary to review and approve a prospective master franchisee - to provide the master franchisee with the exclusive right to develop in a large territory (e.g., an entire country), the master franchisee may simply lack the financial and human resources to effectively develop it.

Preferred alternatives to the grant of a large territory are to provide a smaller territory along with a right of first refusal or an option for further development provided that the master franchisee continues to meet development milestones. This can result in a number of master franchises within a certain country.
2. **Timeline for Expansion**

A common misstep in negotiating a master franchise agreement is an overly aggressive development schedule for a master franchisee. As with most international franchising issues, meaningful due diligence is the best way to ensure that development plans are reasonable, which includes obtaining the master franchisee’s input, examining competitors, considering the size and density of the market, and the franchisor’s experience in other jurisdictions, if any. This challenging, yet critical, element of the master franchise agreement is discussed further in Part III(C), *Development Obligations*.

A frequently overlooked aspect of the development schedule is the time it will take the master franchisee to launch the franchise system in the target jurisdiction, and there should be a reasonable period built into the development schedule in order to permit the master franchisee to do so. Depending on the division of responsibility agreed upon between the franchisor and the master franchisee, the master franchisee may have to make adaptations to the products, services and system in the target jurisdiction (with the franchisor’s approval), source suppliers, ensure that the subfranchise agreements comply with local law, adapt the manual (with the franchisor’s approval), draft a compliant disclosure document and comply with any timing requirements, and obtain any required licences, permits or authorizations.

3. **Finding Master Franchisee Candidates**

While it is not unusual to receive unsolicited offers from potential master franchisees, franchisors must conduct substantial research to ensure the candidate and market are appropriate for expansion. The significant responsibility and risk placed on a master franchisee suggests that this is possibly the most important decision to make in the expansion process. Resources should be allocated accordingly.

A franchisor’s international recruiting team must be staffed with individuals willing to travel extensively for personal interaction with candidates and market inspections. The franchisor’s, and thus the recruiting team’s, interests should be focussed on long-term growth and success, meaning sufficient resources must be dedicated early so that they can pay off in the future.

Clarity and consistency are also crucial. Thus, the protocols for candidate approval must be clear and universally known—there should be no confusion on the model by which formal approval is granted by the franchisor’s company. It also helps to use consistent forms for applications, letters of intent, terms sheets, confidentiality agreements, ethics statements, and any forms or statements specific to the industry in question. These should be modified for the target jurisdiction, including a review by local counsel. The franchisor should establish criteria for evaluating candidates, such as developing questionnaires to gauge business skills, operational experience, and net worth, in addition to personal interviews and extensive background checks to provide a complete picture of the potential master franchisee. Candidates’ histories, businesses, creditworthiness, reputations, and even families must be examined. Principals and guarantors should be subject to criminal, credit, and terrorist background checks, as well as any checks specific to certain regions. Especially where the franchisor is new to a market, the master franchisee will be as much a business partner as a franchisee—while mistakes happen, all efforts should be put towards making sure this decision is the right one.

The qualities sought in a master franchisee depend on the business, but are generally analogous in broad strokes. Master franchisee candidates must have the ability and resources
to establish, maintain, and expand any infrastructure needed to develop the franchisor’s brand. They will also need experience and skill in the market at issue as well as significant familiarity with local rules and customs. Depending on the industry, industry connections (e.g., with landlords) may be a necessity as well. Potential master franchisees should be informed of the business plan and development goals, in order to examine how well his or her skills can fit into the overall scheme.

4. Adapting the System

Franchisors cannot expect that their domestic franchise offering will apply internationally without modification, any more than they can expect that their products are equally suited to all markets. Up front, franchisors should give honest consideration to which aspects of their system are crucial as opposed to which aspects can be modified or discarded if necessary. The franchisor may elect to undertake this exercise in advance of finding a master franchisee, or with the input of a master franchisee. This process will also impact the cost and timing of the franchisor’s international expansion.

5. Attitude to Franchising

International franchising is a substantial commitment and while the potential for profit is obvious, it is important that the franchisor appreciate the magnitude of the process. The motivation and strategy for expansion must be clear and franchisors must be sure that they can commit the necessary resources. The investment required is typically front-end loaded, with the franchisor conducting all necessary diligence described above, adapting the system for the target jurisdiction (including translation, if required), securing intellectual property rights, identifying and qualifying prospective master franchisees, developing disclosure documents (if required by law), all before the master franchise agreement is signed. However, the commitment continues during the term of the agreement, with ongoing support, site visits, training and advice for the master franchisee (and maybe subfranchisees). Frequent visits to the new market can be expected. Ultimately, senior management must fully buy into the process to avoid the inevitable failure of the brand that will result from a lack of resources or support for the target jurisdiction.

6. Sourcing Supplies and Suppliers

Master franchise agreements should clearly articulate the franchisor’s right to insist that the master franchisee use only designated supplies and products, but the desired product supply chain may not be legally or practically feasible. Indeed, a significant advantage of using a master franchising model over, for example, direct unit franchising is the opportunity to avoid such hurdles by relying on the master franchisee’s local knowledge and experience. While the franchisor should always retain the right to reject suggestions, the master franchisee is often in a better practical position to seek out and establish relationships with local vendors that meet the franchisor’s standards if the franchisor’s existing supply chain is impractical or unavailable for any reason. Thus, the master franchise agreement should detail the procedure for the master franchisee to make proposals for alternate suppliers or products; of course, the franchisor’s criteria and approval process should also be clearly outlined.

If the franchisor wants the subfranchisees to purchase supplies, products, or inventory from the franchisor on an ongoing basis, this needs to be clearly addressed in the agreement, as well as any issues regarding customs and import duties that will perforce arise. However, using a local supplier can help address any import restrictions as well as anti-trust laws or even transport delays. Furthermore, it might be necessary to repackage products for the target
market anyway if, for example, there are language requirements similar to those in Quebec. Whether it makes sense for the franchisor to use its own network or the master franchisee’s network will be determined on a case-by-case basis.

7. Ensuring Payment

Perhaps not an obvious consideration, but a franchisor must ensure that it can get paid its royalty fees and other fees from the master franchisee. To do so, the franchisor must investigate the local economy and the ability of the prospective master franchisee to move money out of the territory. Similarly, if the currency in the target jurisdiction has unpredictable fluctuations, who bears the risk of an unexpected change in the exchange rate? In some cases, currency fluctuations can suddenly result in the entire business model becoming economically unviable. In such cases, simply defaulting and terminating the master franchisee will not solve the underlying issue, nor will it compensate the franchisor if the brand ultimately fails in the jurisdiction.

8. Quality Control

Quality control begins at the selection of the appropriate master franchisee, but various practices can help the franchisor ensure a consistent franchise offering by subfranchisees in the target jurisdiction. These include utilizing standard-form agreements for subfranchisees as well as standards for supplies or products. As discussed above, franchisors need to consider the degree to which a product must be localized in order for the brand to be successful in a different market and culture. As implementation and operations are firmly in the hands of the master franchisee, the franchisor needs the appropriate contractual remedies to ensure that the master franchisee implement sufficient practices and procedures to result in a consistent offering by the subfranchisees.

9. Cultural Differences

Beyond specific rules regarding “cultural” market sectors, franchisors need to be aware of cultural differences between the home and target markets. This should be as much a part of due diligence as the more concrete legal explorations. Franchisors may find that religious or cultural restrictions on certain products or services will slow or prevent market penetration. A franchisor cannot assume that a product will perform as well in a foreign market that resembles the domestic one, and should perform sufficient market research to evaluate the reception of the product in the target jurisdiction.

C. Master Franchisee’s Diligence

Much has been written about the importance of adequate due diligence on the part of a franchisor entering into master franchising. The type and level of due diligence that the franchisor conducts can contribute directly to the ultimate success – or failure – of the master franchise relationship. Less has been written about the need for the master franchisee to conduct its own due diligence, but that effort too can contribute to the success, or failure, of the master franchise arrangement. Franchisors should be wary of a master franchisee who is ready to buy, “sight unseen,” and without conducting its own due diligence review.

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1. **System Adaptability**

Before entering a new market, a franchisor will often conduct studies designed to determine whether its system can be adapted to the local market. But in a master franchise, the primary responsibility for “localizing” the franchise system lies with the master franchisee, subject to the franchisor’s right to approve system changes. Therefore, it is important for a prospective master franchisee to make its own determination as to whether the system can be effectively implemented in a market that will likely have laws, customs, culture and tastes that are different from those in the franchisor’s home market.

Because the master franchisee will be acting as the franchisor in the local market, it must consider whether it can, among other things: import essential products or find acceptable substitutes; create a reliable and cost effective supply chain; secure appropriate locations; implement key elements associated with the brand under the local laws and customs; and replicate any necessary technology and service standards.

The prospective master franchisee also needs to assess the franchisor’s flexibility and willingness to consider modifications to the system in order to adapt it to the local market. While both parties may acknowledge that some level of adaptation is necessary, there can be differences of opinion as to how many and what changes are needed. Starting the conversation early in the process can help both sides determine whether their visions for transitioning the system to the new market are aligned.

2. **Brand Performance Analysis**

A prospective master franchisee must not only assess whether the brand can be adapted so that it appeals to customers in the new market, it also must determine whether the brand can be adapted to operate profitably in that market. Adjustments may need to be made for differences in pricing and costs between the new market and the franchisor’s home market.

In order to make the necessary analysis, the prospective master franchisee must fully understand the unit economics of the brand in the franchisor’s home market, how those unit economics translate to the new market, and what, if any, adjustments must be made in order to reproduce a profitable operating model. For example, if real estate costs are higher in the target market than in the franchisor’s home market, can the footprint of the unit be reduced without sacrificing revenue, or will lower costs in other areas compensate for higher real estate costs?

3. **Strength of Franchisor**

Franchisors are rightly cautioned to conduct diligence on the financial resources and operational experience of prospective master franchisees. Master franchisee candidates also should consider the financial health and experience of the franchisor.

A franchisor that is thinly capitalized is, at best, unlikely to be able to provide meaningful support to the master franchisee in the critical early stages of development - at least, not without shifting the cost of that support to the master franchisee. At worst, a franchisor that lacks adequate financial resources may be a bankruptcy risk.

Prospective master franchisees should review the franchisor’s audited financial statements available in each U.S. franchisor’s franchise disclosure document and should obtain any other publicly available information or reports, like SEC filings or Dun and Bradstreet reports, in order to better understand the financial position of the franchisor.
Master franchisees should also investigate the franchisor’s management team, not only to form an opinion on the capabilities of the current team but to determine as well if there has been excessive turnover in senior management positions which could be indicative of other underlying problems.

4. Franchisor’s Commitment to the Market

Even if a prospective master franchisee determines that the franchisor has the financial ability and managerial capability to support development in the target market, it should also consider whether the franchisor has demonstrated a commitment to international franchising generally and to the target market specifically.

Has the franchisor dedicated financial and human resources to its international development program, or is international expansion approached opportunistically (e.g. in response to a one-off solicitation from a master franchisee) and as an afterthought? Is the franchisor willing to assign a single point of contact within its organization to work with the master franchisee to open the market and establish systems to streamline development? What specific levels and types of in-country and remote support is the franchisor prepared to provide?

Another way to judge a franchisor’s commitment to the target market is to investigate whether it has secured protection for its trademarks and other key intellectual property rights. The master franchisee should determine whether the franchisor’s marks are registered locally. Even if registered, there may be legitimate concerns about the strength of the marks in the local market and whether the marks are subject to attack. If these concerns exist, the best time to address them is before the master franchisee makes its own investment in the market.

5. Alignment of Objectives

A financially strong, capable master franchisee and a financially strong, capable franchisor with a firm commitment to the local market may still not be a good match due to differences in management styles or business objectives.

A franchisor that insists on personally approving every candidate and every site rather than relying on the master franchisee’s ability to make those judgments based on established criteria may frustrate an experienced master franchisee.

A master franchisee that wants to leverage its infrastructure to manage multiple non-competing brands in the market may resist demands by a franchisor to dedicate specific resources to that franchisor’s brand.

A franchisor that wants to control the distribution of its products in channels outside the franchised units may not be a good fit for a master franchisee that believes it should have the right to capitalize on all distribution channels in the market.

While it may not always be possible to identify every point of difference at the outset, the implementation of a thorough diligence process by both parties can help minimize the risks to each.
III. DRAFTING AND NEGOTIATING THE MASTER FRANCHISE AGREEMENT – CHALLENGING PROVISIONS

A. Introduction

Negotiating master franchise agreements is often a lengthy and complex process. Whilst franchisors will undoubtedly submit their standard form documentation to the master franchisee, that documentation, unlike the “take-it-or-leave-it” approach that prevails in domestic franchising, will likely be extensively reviewed and amended by the master franchisee. Franchisors need to prepare for this. Many franchisors, in order to reduce the risk of substantial disagreement on important terms, prepare a letter of intent (“LOI”) or memorandum of understanding setting out those important terms. This document cannot be left solely in the hands of the international development team, as they may only address the business terms of the transaction (e.g., term, fees, territory, etc.), and omit from the LOI critical legal issues such as personal guarantees. If those issues are not contained in the LOI, it will make it more challenging for a franchisor subsequently to introduce them into the transaction. At the same time, franchisors need to guard against producing overly complex LOI’s which are themselves substantially negotiated, thus delaying the transaction.

Franchisors should also form a reasonable commercial view as to the strength of their bargaining position. Any number of factors will have an impact on this, but may include:

- Does the franchisor have a track record of successful international franchising?
- What is the potential for the products/services in the target country?
- Is the franchisor’s brand recognized as a global brand, or is there limited or no goodwill or brand recognition in the target jurisdiction?
- Does prospective master franchisee have an established track record of successful business activities and, ideally, a track record of introducing international brands to the target country?

B. Establishing the Master Franchisee

1. Creating a New Master Franchisee Entity

It is usually desirable, from a franchisor’s perspective, for a newly created legal entity to carry out the proposed franchising activities because an existing legal entity will have undertaken other trading activities and thereby incurred liabilities from such activities which could impact on the master franchisee’s financial position. From a master franchisee’s perspective, a franchisor’s desire to dictate the master franchisee’s use of a specific legal entity and the corporate structure which it is to use may appear to be an unwarranted inference into what the master franchisee would consider to be matters which are for the master franchisee to decide. Further, of course, master franchisees argue that it really does not impact on the financial performance and ability to progress development of franchise units whether or not the master franchisee is a new legal entity or not because that entity, if it forms part of a group, will be affected by the financial performance of the group as a whole.

Another reason why the creation of a special purpose entity may be the sensible practical alternative is that many master franchise agreements provide that on a sale of the master franchisee’s business the franchisor has the option to match any offer received by the master franchisee. In such circumstances, a franchisor would not want the option to extend to the master franchisee’s non-franchised business activities because, in such circumstances, the option in favor of the franchisor would contractually relate solely to the franchised business but
the offer received from the third party may not. Alternatively, but this is more complex, if a special purpose entity is not used, to require, before any transfer of the master franchise business, that it be transferred at that time to a separate entity in respect of which the franchisor would be able to exercise its purchase option.

2. **Inter-company Management Agreement**

Franchisors generally want the management of the master franchisee to be devoted exclusively to the activities of the franchised business. However, the size and managerial sophistication of the master franchisee will dictate the extent to which separate management, focused solely on the franchised business is, in fact, possible. Often the master franchise agreement itself will specify the senior executives and their roles in the master franchisee’s business and will oblige the master franchisee to ensure that such roles are filled, often, with personnel that have to be pre-approved by the franchisor. Master franchisees will argue that at least in the early part of the development phase of the master franchise, it simply makes no sense for management to be diverted from its other activities and that the sharing of management expertise and costs relating to such expertise is in the interests of the franchise project. If, however, group management resources are to be used, the franchisor will want to know that there is a formal arrangement in place to specify precisely what services will be provided, the extent of the time commitment and to regulate issues relating to confidentiality.

The protection of confidential information is likely to be a major concern for franchisors, if the master franchisee is part of a group, because franchisors will not want confidential trading and financial information obtained in relation to the master franchise business to be passed on to other group companies, especially if such entities carry on similar or competing businesses. Master franchisees argue that the creation of a new entity or special purpose entity is entirely neutral as to whether or not confidential information is made available more widely within the group and that the way to regulate this issue is with a suitable management or confidentiality agreement.

If the master franchisee group does undertake similar or competing business activities, the franchisor should consider inserting provisions which go beyond protecting know how and confidential information and require certain structures to be put in place such as the use of independent or separate accounting staff, using separate office space and ensuring that data is ring-fenced. In practice, these provisions are extremely difficult to monitor.

C. **Grant and Territory**

1. **Scope of the Grant**

Generally, franchisors want to retain flexibility and therefore seek to grant rights only in respect of the particular method of distribution to be undertaken by the master franchisee. This is unattractive to master franchisees who argue that they are incurring substantial costs in developing a new market and building up the brand awareness in that market and so it would be unfair for the franchisor to obtain the benefit of such investment. Further, master franchisees argue that it is confusing in the market place to have different entities undertaking different activities in relation to the same products or services, and if that were to happen, one party could find itself adversely affected by the activities of another party over which it simply had no control.

Nevertheless, often franchisors seek to retain distribution channels which may best be served by the franchisor itself. This may arise if the franchisor has a strong relationship with a
third party or where, in practice, third parties are only prepared to deal with the “head office”. As a result, it is not uncommon for franchisors to retain the ability to distribute products or services from airports, military bases, academic institutions or stations. Undoubtedly from a master franchisee’s perspective, the master franchisee would have to have clear evidence that it really was necessary for the franchisor to enter into these arrangements and/or that any such existing relationship was such that the franchisor had to be actively and exclusively involved.

Often franchisors also seek to exclude internet sales from the grant to a master franchisee. In some jurisdictions this may not be allowed. For instance, within the European Union, it is a breach of European Union competition laws to prevent a subfranchisee from selling products or services (but usually products) on the internet. The European Union considers that to be a form of passive selling which cannot be restricted. Further, in those jurisdictions where no such limitation is imposed on a franchisor’s ability to exclude internet sales from the grant of rights, the reality is that such an exclusion would, in an increasingly digital age be, in practice, difficult to defend commercially.

Even if a master franchisee is prepared to accept that the franchisor is in a better position to develop other distribution channels, the master franchisee may seek some financial benefit from such activities arguing that it is the master franchisee that has created the brand awareness in the territory which the franchisor is seeking to exploit. Master franchisees could, in such circumstances, seek payment in respect of sales made by the franchisor through such other distribution channels especially if the master franchisee is required to participate in the fulfilment of any orders either by providing supply chain management or sourcing supplies.

2. Scope of Exclusivity

Franchisors seek to ensure that any exclusivity relates to the brand being licensed to the master franchisee and does not extend to other brands which the franchisor may wish to introduce into the master franchisee’s territory. The challenge for master franchisees is that the franchisor’s other brands could have a direct impact on the brand being licensed. By virtue of the terms of the master franchise agreement, the franchisor will have detailed market information that the franchisor may use to decide if and when to introduce such new brands within the territory. The introduction of such brands could, in the eyes of the master franchisee, impact the master franchisee’s ability to achieve its development schedules. Further, if exclusivity relates simply to a specified brand, franchisors can simply create new brands with which to compete. Whilst few franchisors would adopt a strategy whereby, using the artificial creation of new brands, they competed with their master franchisees, the relative ease with which Burger King created a new brand in the Australian market – Hungry Jacks – in order to overcome the difficulty created by a third party that had obtained rights to Burger King in that country - would no doubt be worrying for master franchisees who were simply offered exclusivity in relation to a particular brand and not a broader exclusivity relating to the type of goods or services being franchised.

Further, franchisors may only be prepared to grant territory-wide exclusivity during the active development phase. Once development ceases and/or the development schedule has been met, franchisors may seek to remove the territory wide exclusivity and replace it by smaller areas of protection around the existing opened outlets. From a master franchisee’s perspective, this would cause challenges because unconnected third parties would be operating in the territory and could operate their businesses in such a way as to have a detrimental effect on the master franchisee’s business. Further, master franchisees are likely to feel that they have created, by their efforts, the market in the territory and it would be unfair for the franchisor or a third party to benefit from those efforts by subsequently opening outlets. A compromise is that
the master franchisee is given the option to retain exclusivity by committing to opening a specified number of further outlets.

3. Establishing the Territory

Inevitably, master franchisees want as large a territory as possible, arguing that they should benefit from taking the initial commercial risk of launching a brand in their country and it would be unfair for a third party to benefit from such activities by being granted rights to other areas within their country. From a franchisor’s perspective a particular master franchisee may have strong connections in part of the territory only and, indeed, may have the financial wherewithal only to develop in part, but not all, of the target country.

The franchisor’s position is, usually, that the master franchisee needs first to prove itself with a successful development in a limited area. If that is done then, at that stage, further territories can be granted. The franchisor would want to grant, therefore, a small exclusive territory with an option, in favor of the master franchisee, over other territories provided that the development schedule is met in that initial, small exclusive territory.

A further challenge for franchisors, especially those that come from large countries such as the United States or Australia where regional master franchising is common, is that in many smaller countries such an approach, because of the relatively small size of the target country, is both unusual and make no commercial sense.

4. Right of First Refusal

Although a franchisor wants its master franchisee to ensure the success of the brand being licensed and not to be distracted by building up other brands, a franchisor may, as is the case in terms of territory options, be prepared to grant a master franchisee that is successful with its first brand the option to take on additional brands. The same considerations apply in respect of this option as apply to extending territories. There must be a proven track record of success by the master franchisee in relation to the brand being licensed and usually success would be measured in terms of achieving the development schedule but, in addition, a franchisor will need to ensure that the master franchisee is able to take on, both financially and from a management perspective, additional brand responsibilities.

D. Development Obligations

1. Development Schedule

Very few, if any, master franchise agreements are granted without exclusivity of some sort being offered to master franchisees, but no franchisor should be prepared to grant such exclusivity without ensuring that the master franchisee adequately exploits the territory. In the great majority of master franchise agreements such general obligation to promote and extend the business in the master franchisee’s territory is reinforced by a development schedule requiring a minimum number of outlets to be opened and operated, or minimum system-wide aggregate gross sales, calculated, usually, at each anniversary of the subfranchise agreement during the development period.

Whilst master franchisees accept the need for development schedules, inevitably the level at which such development schedules are set will have a direct impact on their acceptability. Unfortunately, during the process leading up to the franchisor expressing a willingness to contract with the master franchisee, master franchisees inevitably “big up” not
only the opportunity for the brand in their country, but also their ability to develop the brand in their country. This does encourage over optimistic forecasting of outlet openings. The reality is that at least in the food and hospitality sectors (and almost certainly in all other sectors as well) only a small percentage of development schedules are met.\(^5\) As a result master franchisees should, in assessing development schedules, consider:

- the extent to which other master franchisees of that brand had been successful in achieving their development schedules;
- potential problem areas such as the limited availability of real estate and zoning issues; and
- the consequences of failing to achieve the development schedule.

Nevertheless, it will always be difficult to know in advance how reasonable a development schedule is in a new jurisdiction until the master franchisee launches its business. Despite best efforts and reasonable diligence, the parties may ultimately find that the original schedule was too ambitious. In that case, they should take stock of the situation and determine what factors, or number of factors, resulted in the master franchisee’s failure to meet the targets. Was it a one-time issue that has now been resolved (such as an unexpectedly long time to find local suppliers), or is it ongoing (such as an inability to find quality real estate)? Can the master franchisee identify with precision the reasons for the delayed performance standards, or is it a combination of varying factors or theories? Does the master franchisee have a concrete plan going forward?

2. Remedies for Non-Compliance with Development Schedule

While the franchisor may have the right to terminate the master franchisee if the development schedule is not met, this result is likely to be disadvantageous for both parties because the franchisor may not have the knowledge or resources to take over the role of the master franchisee in the territory. A well-drafted master franchise agreement should afford the franchisor options other than termination, such as a reduction in territory, removal of exclusivity, or payment in lieu of performance. If the delay is the result of a one-time issue that is resolved, a temporary postponement of subsequent milestones may be appropriate, whereas if the delay is caused by a systemic issue, it may be more appropriate to consider a permanent reduction in territory with a commensurate reduction in the performance standards. Ultimately, the overall goal for both parties should be steady, reasonable growth.

Remedies for a failure to comply with the development schedule should be proportionate. In many cases termination of the master franchise agreement and also the payment of damages to the franchisor calculated on the loss of earnings to the franchisor in respect of those outlets by which the master franchisee falls short of the development schedule, will not be seen by the master franchisee as proportionate. More acceptable to master franchisees is that a failure gives rise to an opportunity to cure over a period of time and/or a payment to the franchisor in respect of such failure. A middle ground could be the loss of exclusivity or the exclusivity being reduced to a more limited territory but no claim to damages or any other payment in favor of the franchisor. In either case, if the agreement allows a franchisor to remove exclusivity, franchisors do need to consider whether, as a practical matter, it makes commercial sense to have more than one master franchisee operating within a country.

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E. The Subfranchise Agreement

1. Form of the Subfranchise Agreement

Franchisors have developed their own subfranchise agreement with which they are familiar and which works in their jurisdiction, but great care needs to be taken in requiring that form of agreement to be used by a master franchisee. A common-law subfranchise agreement simply does not work in civil-law jurisdictions. It is essential that subfranchise agreements used by a master franchisee are, not only legally compliant with provisions applicable in that country, but also are in the form and use the type of language that prospective subfranchisees and their legal advisors would expect to see. In many jurisdictions the major challenge facing franchisors is the small number of suitably qualified and financially stable subfranchisees. It simply makes no sense for those candidate subfranchisees to be discouraged from progressing because of unusual terms in the proposed subfranchise agreement.

In view of the above, whilst franchisors should present to master franchisees the form of their standard subfranchise agreement, master franchisees must be allowed to produce their own subfranchise agreement in the language of the country in which they operate, which addresses issues that are specific to that jurisdiction, which complies with local laws and which reflects the approach to drafting subfranchise agreements in that country. In such situations the franchisor must, of course, approve the terms of the master franchisee’s subfranchise agreement. The franchisor has a choice as to how to ensure that the subfranchise agreement complies with its requirements. It can instruct local franchise counsel to prepare the agreement, require an independent franchise attorney in the master franchisee’s territory to review the agreement prepared by the master franchisee and confirm that it contains the elements in the franchisor’s home agreement or it can require a translation to be prepared to enable its own franchise attorney to review – in the latter case, no doubt, with assistance from local counsel.

2. Enforcing the Subfranchise Agreement

In a master franchise arrangement, the imposition of the master franchisee between the franchisor and unit franchisees can present numerous control issues for the franchisor. As noted in the introductory section of this paper, master franchise arrangements require the franchisor to balance its desire for consistency and control over the brand and the operations of the subfranchisees, with the master franchisee’s desire for autonomy in its home jurisdiction.

As discussed further below, franchisors often want to retain some form of approval rights for the master franchisee signing up subfranchisees. Similarly, a master franchise agreement will typically include provisions relating to the enforcement and termination of the subfranchise agreements, including limitations on the master franchisee’s ability to terminate a subfranchise agreement (e.g., either requiring prior notice to the franchisor, or prior notice to, and consent from, the franchisor).

As a practical matter, the economic benefits in a master franchise relationship are premised on the master franchisee assuming most of the obligations and bearing most of the costs that would normally be borne by a franchisor establishing the brand and operating the system in the market, which includes not only providing ongoing support of the subfranchise businesses, but enforcing the subfranchise agreements. If a franchisor negotiates a smaller share of the fee revenue from the market based on the premise that the master franchisee will undertake most of the direct obligations to identify and support subfranchisees, thereby bearing most of the costs, but the franchisor then injects itself too much into local market operations
thereby increasing its own costs, it will not fully realize the economic benefits of the master franchise arrangement.

Further, as a legal matter, the franchisor simply may lack the privity of contract required to directly enforce the terms of the subfranchise agreement against the subfranchisee. Consequently, many U.S. franchisors will include in the master franchise agreement the ability to direct the master franchisee to take enforcement action against a particular subfranchisees. Master franchisees, on the other hand, in their desire for autonomy in their home jurisdiction, will try to negotiate to limit these enforcement actions to core concepts of the franchise system (e.g., misuse of the trademarks or confidential information, violation of noncompetition provisions, etc.).

Alternately (or in addition to these enforcement provisions), some U.S. franchisors require that all subfranchise agreements identify the franchisor as a third party beneficiary of the agreement, with the independent right to enforce the agreement if the master franchisee fails to do so. Such provisions can be particularly helpful in the event that the relationship with the master franchisee has soured, or the master franchisee is no longer in the picture, or the master franchisee is otherwise unwilling or unable to enforce the terms of the subfranchise agreement. A number of jurisdictions do not recognize third party beneficiary rights. If such a jurisdiction is a part of the territory granted to the master franchisee, the franchisor must consider an alternative. One possibility is to include a tri-party addendum to the form of subfranchise agreement, in which the subfranchisee agrees to attorn to the franchisor in the event the master franchisee fails to enforce the agreement or is terminated.

F. Term and Renewal

1. Term of Development Rights v Term of Master Franchise Agreement

Master franchise agreements are long term agreements because master franchisees, who are likely to incur very substantial initial costs in launching the brand in their country, need to know that their investment can be amortised over a substantial period of time. Further, of course, master franchisees need to know that they have sufficient time in which to grant subfranchise agreements which will also contain renewal rights in favor of the subfranchisees. The term of the master franchise agreement will depend, therefore, not only on the master franchisee’s initial investment costs, but also on the subfranchisee’s initial investment and therefore duration of the subfranchise agreements.

Whilst master franchise terms are lengthy, the development term – the period in which the master franchisee is required actively to open outlets (either corporate or franchised) – can be shorter. It is by no means easy to forecast a sensible development schedule over a period that exceeds five years but a period that exceeds ten years is, in practice, unlikely to be based on commercially defensible data.

2. Conditions for Renewal

As with national franchising, master franchisees require the ability to renew the agreement on expiry of the initial term and indeed franchisors who are faced with very substantial commercial challenges in replacing a master franchisee with a substantial number of corporate and/or subfranchised outlets in their territory would want the relationship to continue if it has worked well.
As with subfranchising, conditions are attached to renewal which are similar to those that apply to the renewal of subfranchises so that notification of a desire to renew has to be given (although the period of notification is usually much longer in master franchise agreements because of the challenges that the franchisor would face in replacing an incumbent master franchisee). Of course, the master franchisee would only be able to renew if it has performed satisfactorily and, in most cases, this means having achieved the development schedule or any modified development schedule that is subsequently agreed.

Two challenges usually arise in terms of the renewal terms. The first is whether a renewal fee is payable and, here, there are conflicting interests. The franchisor can argue that it would obtain substantial fees for the grant of a new master franchise agreement to a third party and, therefore, it would not be fair to be deprived of those fees, if the franchisor were to retain the incumbent master franchisee. Master franchisees argue that, if they are required to continue development in their country, the master franchisee’s financial resources are better used for such development activities rather than paying the franchisor a fee. The second challenge is that if the master franchisee is likely to be required to agree a new development schedule and if that development schedule is to be set by the franchisor without any contractual limitations, then the renewal right is of limited value because, in effect, the franchisor is in a position to specify development obligations which may be so unattractive to the master franchisee that the master franchisee would not want to renew. It is not easy to solve this issue because franchisors, very properly argue, that it is simply not possible to predict what may or may not happen in ten to twenty five years in terms of the market for the franchisor’s products/services and, as a result, they need to retain a broad discretion in setting the development obligations. In some agreements, a formula is specified based on the performance of the master franchisee over the previous five to ten years, with the result that the new development schedule does not reflect a material increase in development obligations over what has in fact been achieved. The argument here is that if the franchisor is sufficiently satisfied with the master franchisee’s development performance so as to allow the master franchisee to renew, then the development schedule should be based on that performance.

G. Subfranchisees

1. Process for Approving New Subfranchisees

Franchisors have an interest in ensuring that the master franchisee selects only suitable subfranchisees, but must adopt what, in practical terms, the franchisor is willing or able to do in terms of vetting prospective subfranchisees. There is little point in the master franchise agreement setting out a complex and time consuming process for involving the franchisor in such subfranchisee selection procedures if, in practice, the franchisor simply does not have the management time or inclination to be actively involved.

A master franchisee will try to limit “interference” from the franchisor for a number of reasons: First, the master franchisee has development obligations to meet and does not want a franchisor to influence the master franchisee’s ability to achieve the development schedule by challenging prospective candidates. Further, of course, the master franchisee will no doubt believe that it is better positioned than a foreign franchisor to establish whether or not a candidate would or would not be suitable.

Consequently, an alternative for achieving consistency without extensive direct control is for the parties to agree on a set of subfranchisee qualifications and site criteria which the master franchisee is contractually obligated to implement, with appropriate reports so that the franchisor can ensure compliance. One would expect the master franchise agreement to set out, either
within the agreement or, more usually within the master franchisee’s operations manual, the requirements for each prospective subfranchisee. Those requirements would relate to the prospective subfranchisee’s prior business experience, financial position and such other matters as the franchisor considers to be appropriate. Franchisors may also require certain information to be provided to it in respect of those specified areas. This allows the franchisor to retain oversight without the extensive involvement that can undermine the economic benefits of the master franchise relationship to the franchisor.

Franchisors who retain an approval right over the master franchisee’s subfranchisees may also be attracting unintentional consequences and potential liability under domestic law. For example, the five provinces in Canada that have franchise legislation have a concept of a “franchisor’s associate”, which is distinct from a franchisor’s affiliate. Certain types of liabilities under Canadian franchise legislation accrue to both the franchisor and the franchisor’s associate, namely refund and other obligations in the event a subfranchisee exercises its rescission remedy, damages for misrepresentation or failure to comply with the disclosure requirements, damages for breach of the right to associate and possibly damages for breach of the duty of fair dealing.

Whether a person meets the definition of a “franchisor’s associate” is heavily fact-based and will be determined on a case-by-case basis. It includes whether the associate controls, or is controlled by, the franchisor, the nature and extent of the associate’s involvement in the marketing or the grant of the franchise, whether the subfranchisee has a continuing financial obligation to the associate, and any day-to-day operational control over the subfranchisees. While it is clear that the corporate control of one entity by another would satisfy the “control” part of the test, some practitioners argue that contractual control can also be used to meet the control test (e.g., the controls by a franchisor over a master franchisee in the master franchise agreement).

Accordingly, applied to the master franchise business model, where the master franchisee would be the “franchisor” to the subfranchisees, there is a concern that potential liability could arise if the franchisor is determined to be a “franchisor’s associate” of the master franchisee given that (i) by retaining the right of review and approval of the subfranchisees, it is involved in the grant of the franchise, and (ii) there is legal “control” by the franchisor over the master franchisee – through the master franchise agreement. The strength of this argument has not been tested in court; however, franchisors granting master franchises in Canada should consider this as part of evaluating the extent of their abilities to review and approve subfranchisees.

This is also another example of the value of having the master franchise agreement reviewed by local counsel in any foreign jurisdiction to identify potential liability exists due to unusual provisions unique to that jurisdiction.

2. Working With Existing Subfranchisees

Master franchising is not restricted to instances where the franchisor has no experience in the target jurisdiction. In some cases, franchisors may elect to switch to a master franchising model despite having previously used another model, such as direct unit franchising, in that jurisdiction. In such cases, the franchisor has certain options with respect to how to deal with the existing subfranchisees.

The first option is for the franchisor to assign the existing subfranchisees’ subfranchise agreements to the new master franchisee (assuming that the franchisor has the appropriate
contractual ability to assign the subfranchise agreements). As subfranchise agreements would typically not require the subfranchisees’ consent to such assignment, the benefit of this option is that would likely not require buy-in from the subfranchisees. The potential downside is that the master franchisee may be reluctant to take an assignment of the subfranchise agreement, particularly if there are any disputes with the subfranchisees.

The second option is for the franchisor to offer the existing subfranchisees an incentive to terminate the subfranchise agreement with the franchisor, and enter into a new agreement with the master franchisee. The advantage of this approach is that if the franchisor obtains buy-in from the subfranchisees, the master franchisee would get the subfranchisee signed up on the current form of subfranchise agreement. A significant drawback, however, is that the franchisor may not be able to obtain consent from all subfranchisees to consent to the change. The franchisor may consider making the incentive conditional on all subfranchisees accepting the proposal.

The next option assumes that one of the reasons that the franchisor wants to use a master franchise model is that it wants to exit the day-to-day operation of the franchise system in the target jurisdiction. If that is the case, and neither of the two options above are desirable, it could achieve a similar result by engaging the new master franchisee as a service provider for the franchisor. The master franchisee would then perform the service and support functions for the franchisor in the territory. The downside, as exists anytime a franchisor engages a service provider, is that the franchisor would remain liable for any acts or omissions of the master franchisee.

Finally, the last option would be to retain the status quo. The franchisor would continue to service and support its existing subfranchisees (and would ensure that the reserved rights section of the master franchise agreement permitted the franchisor to do so without infringing the rights on the new master franchisee), but no longer solicit new subfranchisees.

H. Training and Support

1. Training by Franchisor (“Train the Trainer” Training)

Training subfranchisees is notably more expensive and complex in the international context. Distance, language barriers, and localizing and translating documents can all add to the challenges of ensuring that the subfranchisees are properly trained in the franchisor’s systems and processes. However, avoiding these challenges is one of the key reasons to use a master franchising model, as the franchisor can rely on the master franchisee’s knowledge of the local language and presence in the market to provide this training. Franchisors would then provide master franchisees with “train the trainer” training; training designed to teach the master franchisee (or its representatives) how to, in turn, train the subfranchisees on all aspects of the franchise system. With that benefit, however, comes the corollary drawback that the franchisor may not be able to perform quality control over training sessions or materials in a foreign language. Franchisors may elect to have key training material that has been translated into a foreign language translated back into English in order to ensure consistency. However, this is expensive and is typically reserved only for critical elements of the training materials.

Further, it may not be realistic to try to bestow all required knowledge about the franchise system to the master franchisee through training courses; a strictly academic process may not be sufficient to equip the master franchisee to be able to assume the training role for its subfranchisees. This is part of the reason why franchisors frequently require the master franchisees to have pilot operations, as that will result in the master franchisee having hands-on
experience with the day-to-day operation of the franchise and the skills and knowledge to address the issues and challenges that arise. That practical experience, along with the franchisor’s traditional training materials, will help the master franchisee become sufficiently familiar and proficient with the franchise system to be able to train its subfranchisees.

2. **Training Obligations by Master Franchisee for Subfranchisees**

Typically, the master franchisee is responsible for training subfranchisees as well as any financial burdens associated with doing so. Much like a domestic franchising agreement, subfranchisees will usually be required to pay for their own training and any associated costs. The franchisor may assist initially to help establish the training program, but will aim to recede into the background and allow the master franchisee to handle most training requirements. The breadth of the master franchisee’s obligations are always subject to negotiation and will bear directly on the fee structure and the franchisor’s direct involvement in the business.

3. **Responsibility for Ongoing Training**

From the franchisor’s perspective, ideally the master franchisee will provide the subfranchisees with all required ongoing training and support. However, as a practical matter, the franchisor should reserve the right to require the master franchisees to compel its subfranchisees to attend training sessions (or conferences) hosted by the franchisor. The same is true for requiring subfranchisees to complete any online training or courses offered or required by the franchisor.

4. **Initial and Ongoing Support to Master Franchisee by Franchisor**

In addition to initial and occasional training, the franchisor’s main obligation is to provide ongoing support to the master franchisee that can take the form of system support, inspections, consultation, promotional materials, technology, and anything else necessary to the administration of the business system. While the franchisor cannot personally implement the system on the ground, it is responsible for high-level management and any changes or updates to the system will need to be provided down the chain. Franchisors should not ignore the significant resources that may be required in terms of visiting local markets and monitoring all system functions. The international context creates unique problems in the provision of support, such as translation and technology transfer issues. The franchisor will want to ensure that it retains all ownership of the copyright in any modified training or operations manuals.

5. **Initial and Ongoing Support to Subfranchisees by Franchisor**

The master franchisee is typically responsible for training subfranchisees and will be the main contact in the business. However, the franchisor will want to operate in the background to ensure that the system is functioning correctly, and provide support in terms of expertise and materials where necessary. A process should be in place whereby system updates mandated by the franchisor reach the subfranchisees either directly or via the master franchisee.

6. ** Provision of Software Programs to Subfranchisees**

Many subfranchised businesses use custom software as part of their operations or business models. Franchisors adopting a master franchise model must consider the most practical way to license the subfranchisees to use the software; whether it is a direct license from the franchisor or a sublicense via the master franchisee. Some franchisors avoid a direct contractual relationship with subfranchisees at all costs, and will funnel the license through the
master franchisee. In other cases, there may be contractual restrictions on the franchisor’s use of the software which prevent the franchisor from granting the master franchisee the right to further sublicense the software. Additionally, franchisors should also consider trademark and technology transfer laws that may impact the licensing of the software to the subfranchisees, as well as any export controls on encrypted software. Local counsel, as usual, will be essential.

I. Advertising and Promotion

1. Local Advertising

Franchisors rightfully seek to control the image of the brand across all markets in which the brand operates. One way to retain control is to generate standardized advertising collateral that is provided to the master franchisee, for a charge, to be adapted for use by the master franchisee and its subfranchisees operating in the local market.

Typically, advertising materials will be provided in English, and the master franchisee will be required to translate the materials into the local language before they can be used. The master franchisee will also be responsible for ensuring that the advertising materials comply with local law.

The master franchisee is also typically required, at its expense, to develop an advertising program for the local market, including advertising materials that conform to the brand image established by the franchisor. While local market advertising should be consistent with the brand’s established image, tag lines, slogans or advertising campaigns that have proven to be successful in the franchisor’s home market may require modification in order to be successfully “translated” to the local market.

A specific financial commitment to fund the local advertising program (e.g., a specified percentage of gross sales of all units operating in the territory) is often required. If the mandatory local advertising expenditure is expressed as a percentage of operating unit sales, the parties should consider how advertising will be funded before a significant number of units are open and operating and whether the master franchisee will be obligated to sustain funding levels even if it is unable to collect advertising fees or contributions from its subfranchisees.

Master franchisees (and subfranchisees) that are required to fund an in-market advertising program directed by the master franchisee (but subject to franchisor approval), are likely to be reluctant to contribute an additional amount to a general brand fund administered by the franchisor, as discussed below.

Both advertising materials prepared by the franchisor and adapted by the master franchisee for the local market and advertising materials developed directly by the master franchisee must generally be approved by the franchisor. In order to effectively exercise its approval rights, a franchisor may require that the materials be provided in the local language, with an English translation.

Franchisors favor a process that allows them to approve local advertising materials before they are used. While this type of process gives the franchisor the greatest degree of control over brand advertising, it creates obvious difficulties for the master franchisee. A process that requires approval before the materials are used can result in delays in meeting advertising deadlines.
Master franchisees prefer a process that allows them to use local advertising materials before formal approval is given. That process is more efficient initially but creates its own set of issues. If the franchisor later refuses to approve the advertising that is already in use, the master franchisee must stop using the materials until it makes any required changes.

2. **Contribution to International Advertising Programs**

In addition to requiring the master franchisee to implement an advertising program specific to the local market, the franchisor also may require the master franchisee to contribute to an international advertising program or fund. The contribution is typically based on a percentage of gross sales of all units operating in the territory.

Similar to the use of brand advertising funds in the US, an international advertising fund gives a franchisor the ability to finance the creation and placement of brand advertising in markets outside the US, with the franchisor controlling how the funds are spent and where the advertising is conducted.

Master franchisees often resist requirements to contribute to an international advertising fund, particularly when the master franchise agreement does not require the franchisor to make advertising expenditures in the local market in proportion to the amount of contributions received from the market. The master franchisee clearly has an interest in first developing brand awareness in the local market before contributing to a more general fund, and will likely take the position that all advertising funds could be put to better use locally, particularly if the brand has limited brand recognition and goodwill in the local market.

One alternative that may help overcome that resistance is to defer the obligation to contribute to an international brand fund until the local market is established (the triggering event could be based on a threshold number of subfranchised outlets in the local market, aggregate gross revenues of the subfranchisees, or simply the passage of time). If contributions to a general international brand fund are deferred, it is advisable for the master franchise agreement to require the master franchisee to spend the amount that would otherwise have been contributed to the international fund in the local market until the international fund contribution is triggered.

When the international fund contribution requirement is triggered, the agreement may provide that the amount contributed to the international fund serves as an offset against any mandatory local advertising expenditure requirement – although it is questionable whether the master franchisee would find it advisable to abandon its local market advertising program in favor of international brand advertising even if the entire amount of the mandatory local market advertising requirement were to be offset.

Additionally, a practical approach to overcoming the resistance by a master franchisee to contributions to an international advertising fund is for the franchisor to demonstrate to the master franchise that it will receive value from the advertising initiatives supported by the fund. Even if the master franchisee is geographically distanced from the franchisor’s home jurisdiction, there still may be significant benefits in the form for the master franchisee and the subfranchisees, such as (i) online advertising and social media programs (which have no geographic boundaries), (ii) advertising and marketing materials that the master franchisee can use (subject to local laws) in the local market, and (iii) innovative promotions (such as gift-card programs) that the master franchisee can adapt for the local market.
J. Fees

1. Initial Territory Fee Paid by Master Franchisee

Master franchisees typically pay a fee to the franchisor for the right to develop the brand in the territory. This “territory fee” is in addition to the franchisor’s share of initial and on-going fees paid to the master franchisee by subfranchisees in the territory.

There is no formula for establishing the territory fee. Various factors can influence the amount of the fee, including the strength of the franchisor’s brand, competition for the market, and the development potential of the market, among others.

Extremely high territory fees were once common in international franchising, but fees have moderated over time. Master franchisees often take the position that very high territory fees can divert capital they need to develop the market and potentially undermine the possibility of the brand’s long term success in the market.

At a minimum, franchisors want to establish a territory fee that allows them to recover their up-front costs to open the market. These costs include amounts spent to secure trademark and other intellectual property protection in the territory, to conduct its due diligence on the market and the prospective master franchisee, and to develop the franchise documents to evidence the master franchise arrangement.

While a franchisor may feel the territory is more valuable than its up-front investment might indicate, it may be willing to defer payment of the additional market “premium” and recover the excess at a later date and in incremental payments by taking a larger share of the initial fee paid by each subfranchisee or by adding an separate fee payable when each subfranchisee opens in the territory. In this type of structure, the master franchisee is not forced to sacrifice valuable working capital during the initial stages of market development, but the franchisor can participate in the value of the market over time.6

2. Division of Fees Paid by Subfranchisees

Like the territory fee, there is also no established formula for determining how the master franchisee and franchisor will divide between them the initial and on-going fees paid by the subfranchisees. The primary guiding principle is that the division must allow both the master franchisee and the franchisor to earn a profit based on the level of support they provide. It should also be noted that the total fees paid must not be so excessive that the subfranchisee is unable to profit at the unit level.

One risk for the franchisor is that it agrees to a division of fees based on the understanding that the master franchisee will provide the primary support to subfranchisees in the territory only later to find that the master franchisee requires more support from the franchisor than was originally intended. The master franchise agreement can address this possibility by including provisions that specify the types and level of support the franchisor is obligated to provide and providing for payment of additional fees by the master franchisee if more extensive support is required.

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More difficult to address is the situation where additional support from the franchisor is not needed, but the franchisor finds itself unwilling to step back and allow a capable master franchisee to take the lead in the market. If a franchisor undertakes to do more than is required under the master franchise agreement, without any corresponding fee income, any profits it might otherwise make from the market will be reduced or eliminated.

3. Collection Risk

Another fee-related issue that arises in master franchise relationships concerns not how fees are set, but rather, which party bears the risk of collection if a subfranchisee fails to pay. Since payment of initial fees is typically not an issue, the biggest risk relates to a subfranchisee’s subsequent failure to make scheduled royalty fee payments.

Franchisors typically want their share of the royalty paid on the aggregate gross sales made in the territory, regardless of whether one or more subfranchisees pay the royalties they owe. Master franchisees prefer to pay the franchisor’s share of the royalty only after they receive payment from the subfranchisees.

Since in a master franchise structure the master franchisee is responsible for selecting and supporting the subfranchisees and for enforcing their payment obligations under the subfranchise agreements, it seems that they should bear the primary risk of collection.

That said, there may be situations where a franchisor may be willing to share in the risk of collection – especially where the master franchisee has proven itself to be a good steward of the brand in the territory. For example, if a good master franchisee makes a business judgment that a limited royalty fee waiver is appropriate for a particular subfranchisee, the franchisor might show its support by agreeing that its share need not be paid on the royalties that are waived. Similarly, if the master franchisee has agreed to defer a subfranchisee’s royalty payments for a period of time or is actively working to collect delinquent royalties through an enforcement action, a franchisor might agree to wait for its share until the deferred royalties are paid or until the delinquent royalties are recovered.

K. Transfer Restrictions

Other than the termination provisions, the transfer sections of a master franchise agreement present some of the most difficult issues to negotiate and document.

As an initial matter, one has to consider the multiple types of interests that may be the subject of a transfer. These may include: agreements for company-owned units held by the master franchisee or its affiliates; transfers of controlling or non-controlling interests in the master franchisee; and transfers of the master franchise agreement itself or a substantial part of the assets used in the operation of the business. And, while a “transfer” means the sale of an interest for consideration, the term is often broadly defined to include other types of dispositions as well as the encumbrance or pledge of a covered interest.

In addition, one also must consider the stakes involved. As discussed above, a master franchise arrangement is generally entered into for territories where the franchisor cannot legally or practically operate directly. Finding a qualified master franchisee that is a good fit for the franchise organization is often no easy task. And, since the master franchisee operates as a surrogate franchisor for the market, its role is far more than just the development and operation of franchised units – it holds all the subfranchise agreements and performs all franchisor
functions for the market, including sales, support (including supply chain management) and enforcement.

While master franchise agreements typically give the franchisor a right to consent to some or all of the types of transfers identified above, if a master franchisee wants to exit the business entirely, a franchisor may have few good options.

1. **Transfers to Affiliates**

   Master franchisees routinely want to reserve the contractual right to transfer some or all of their rights and obligations under the master franchise agreement to affiliated entities. This gives the master franchisee flexibility to restructure its business interests.

   If the master franchise agreement covers multiple jurisdictions, some of which have local foreign investment restrictions, the ability to transfer to an affiliate that satisfies local legal requirements may be necessary in order for the master franchisee to fulfill its obligations in those parts of the territory.

   Franchisors may agree to a more relaxed standard for transfers to affiliates as long as certain basic contractual protections remain in place. For example, a franchisor may not insist on a pre-sale consent right if the transfer is to an affiliate and the franchisor receives: (i) reasonable prior notice of the transaction; (ii) sufficient information regarding the affiliated entity and its other owners to permit the franchisor to perform any necessary background checks; (iii) covenants from the master franchisee that the affiliate and its owners are not engaged in a competitive business and do not violate certain legal standards or norms (e.g., are not felons and are not on any international list of persons involved in terrorist activities); and (iv) the master franchisee and any existing guarantors affirm their commitments to guarantee the affiliate's performance.

2. **Transfers of Non-Controlling Interests**

   Similar to the affiliate carve out from a franchisor’s standard consent requirement for transfers, master franchisees also often want the right to transfer non-controlling ownership interests in the master franchisee entity without having to seek prior consent from the franchisor.

   As with transfers to affiliates, franchisors may agree to forego consent to the transfer of non-controlling ownership interests as long as contractual protections similar to those for affiliate transfers are put in place.

   Franchisors should, however, carefully define what constitutes the transfer of a non-controlling interest in the master franchisee. Any such definition should make clear that transfers of non-controlling interests over time that, in the aggregate, exceed the limits for a non-controlling interest are instead subject to the franchisor’s right to consent to the transfer of control.

3. **Transfer of Control**

   If the subject of the transfer involves substantially all the assets of the business, the master franchise agreement, or a controlling interest in the master franchisee, master franchise agreements will typically give the franchisor a pre-sale consent right. The agreement may
provide that the franchisor will not unreasonably withhold its consent to the transfer but state that it may condition its consent on the satisfaction of certain specified conditions.\footnote{Although beyond the scope of this paper, the authors note that a franchisor’s ability to withhold or condition its consent to a transfer may be restricted by local laws. For examples, see Lee Plave, Penny Ward, Francesca Turitto & Will K. Woods, supra note 6, at 27 nn. 17-19.}

Such conditions may include not only the types of contractual assurances listed in subsections 10.a.(i) through (iii) above, but also conditions regarding: (i) the operational experience and financial capability of the proposed buyer, (ii) its undertaking to assume the master franchisee’s obligations under the master franchise agreement (or to sign a new master franchise agreement) and related subfranchise agreements; (iii) its ability to assume or make satisfactory arrangements with the selling master franchisee to continue management of the supply chain; (iv) an undertaking by the buyer’s owners to guarantee its future performance; and (v) a general release of the franchisor by the master franchisee.\footnote{Local laws may impose other requirements that a buyer must satisfy. See Lee Plave, Penny Ward, Francesca Turitto & Will K. Woods, supra note 6, at 27 nn. 20-21.}

One of the intangibles that a franchisor faced with this situation must evaluate is the impact of the proposed change on the subfranchisees. The proposed buyer should be able to demonstrate to the franchisor that it has conducted its due diligence and that it has a solid business plan for managing the existing subfranchisee relationships.

4. \textbf{Rights of First Refusal}

Master franchise agreements commonly include a right of first refusal in favor of the franchisor to purchase the interest that is being transferred at the same price and on the same terms as the proposed buyer.

The usefulness of such a provision is debatable, particularly in territories where the franchisor cannot operate directly, either because of legal restrictions or practical considerations. Nevertheless, in an appropriate situation, such a provision could be useful if a franchisor is looking for an alternative to the proposed buyer. Its utility may be increased if the provision states that the option to purchase the interest may be exercised not only directly by the franchisor but also by any assignee or designee of the franchisor.

5. \textbf{Enforcement}

While negotiating and drafting the transfer sections of a master franchise agreement may prove challenging, enforcing them is likely to be still more of a challenge. In many cases a franchisor may not learn that a transfer has taken place until after the fact, particularly where it is a transfer to an affiliate or of a non-controlling interest.

Even if a franchisor has notice of a proposed transfer, its ability to refuse consent may be limited by local law and/or by the absence of any practical alternative to the proposed buyer.

And, even if consent is withheld and an alternative presented, the franchisor may find itself engaged in a lengthy and uncertain legal battle in the master franchisee’s local courts in an effort to enjoin the master franchisee from proceeding as it had planned.
L. Taxes and Withholdings

1. Assessing the Tax Burden

U.S. Approach

The U.S. imposes tax on a worldwide basis, so if a U.S. individual or legal entity earns or receives income from non-US sources, that income is taxable in the U.S. regardless of whether it has already been taxed in the foreign country of origin. This means that initial and continuing fees payable to a U.S. franchisor by a foreign master franchisee are usually subject to tax in both the master franchisee’s country and also in the U.S, because the master franchisee’s country will apply (more usually) withholding taxes or (less usually) income taxes on such fees. However, the gross amount of income payable to the U.S. franchisor will be taxed in the US. In practice, the master franchisee is required to pay the tax either by withholding or income tax first, before it is remitted to the US. After deducting such tax the foreign master franchisee is, because of the franchisor’s desire to avoid a double taxation charge, generally required to obtain confirmation from the tax authorities in the master franchisee’s country that tax has been withheld/paid. The U.S. franchisor then reports the full amount of the payment (without deducting the foreign country’s tax) but would claim a U.S. foreign tax credit for the amount deducted.

In order to simplify international trade, numerous reciprocal tax treaties are in force. The U.S. has entered into approximately 68 tax treaties. These treaties generally result in reduced withholding taxes on payments between the two countries and recognition that tax deducted in one country will give rise to a tax credit in the other country.

2. Structuring to Minimise the Tax Burden

Permanent Establishment

A crucial element of international taxation is whether a franchisor has a “permanent establishment” in a foreign country. What constitutes a permanent establishment will vary but if a U.S. franchisor has a permanent establishment in a foreign jurisdiction, the U.S. franchisor will be required to file tax returns locally and generally to pay tax on its local income. Each country has its own definition of permanent establishment which needs to be reviewed, but the term typically envisages a place of management, branch or office in that country.

Generally, but not always, a subsidiary company is not treated as a permanent establishment. The creation of joint ventures, however, does give rise to specific issues which require detailed planning.

3. Pricing

Generally, the intra-company pricing of products is subject to transfer pricing regulation so as to ensure that the prices charged for products is fair and reflects the arm’s length price. Transfer pricing rules prevent the creation of an artificial profit, on the sale of products, in a low tax jurisdiction to avoid paying tax in a high tax jurisdiction. Transfer pricing issues do not arise in international franchising where the value of products and services supplied by a franchisor to a foreign master franchisee is a matter of negotiation between unrelated parties and is, therefore, by definition an arm’s length transaction. Nevertheless, franchisors should investigate whether in the target country there are different rates of tax applicable to, for instance, royalties and/or payments for services or goods. If the latter is charged at a lower rate, then franchisors
may wish to differentiate between the two and allocate a greater percentage of what they will receive from the master franchisee to payment for services or goods.

4. **Affiliates**

If the franchisor has affiliates in other jurisdictions, and those other jurisdictions do not impose withholding tax or impose reduced levels of withholding tax, then it may be possible to licence the franchisor’s intellectual property rights to such affiliate and have the affiliate enter into the master franchise agreement with master franchisees. This is clearly an area where further advice should be obtained at an early stage by a franchisor planning to expand overseas.

5. **Contractual Provisions**

Franchisors need to know whether they will receive the full amount of the payment which the master franchise agreement stipulates, or a payment that has been reduced by withholding tax. In some agreements there is an obligation on the master franchisee to gross up such payments so that if, for instance, the franchisor was expecting to receive $100, but there is a 10% withholding tax so that the franchisor only receives $90, the master franchisee must pay $111 from which withholding tax of $11 is charged so that the franchisor receives $100. This, however, is potentially unfair to the master franchisee and, as a result, the great majority of master franchise agreements require master franchisees, after deducting withholding taxes, to provide the franchisor with all certification and documentation to enable the franchisor to claim a tax credit and it is only if the franchisor is unable to obtain such a tax credit that additional payments are required.

6. **Guarantees**

1. **Personal**

It is extremely unusual in an international franchise context for a master franchisee not to be a limited liability entity. If such an entity has recently been incorporated and/or is a special purpose vehicle which has been created specifically to operate the master franchise business, it may, at least in the early stages, have very limited assets.

If the master franchisee entity has been created by individual owners as opposed to forming part of a substantial group of companies, the standard procedure is to seek personal guarantees from the individual owners. Clearly, if the master franchisee is a larger entity or part of a substantial group, personal guarantees will not be available from the managers who are actively involved with the project, because they may not have an ownership interest in the master franchisee, and instead the franchisor will seek parent company guarantees.

Whether a guarantee will be required is an issue that tends to be raised early in the negotiation process. For understandable reasons, master franchisees and their owners resist giving personal guarantees and franchisors do need to ensure that a request for a personal guarantee is appropriate to that transaction. If, for instance, a franchisor requires products to be purchased from it or its affiliates, and those products form a significant element in a master franchisee’s turnover, and/or the master franchisee or its subfranchisees simply would not be able to continue to trade without the supply of these products, then by rigorous credit control a franchisor may be able substantially to reduce the risk of non-payment such that either no guarantees would be necessary or only limited guarantees would be sought. If no payment is
received for the products those products would not be shipped or the franchisor would be in a position to cease further supplies without payment “up front”.

Because of the likely “push back” to unlimited guarantees, whether personal or corporate, guarantees sometimes have monetary caps, or are time limited. Alternatively, a master franchisee may negotiate that, once the master franchisee has established a number of outlets, the amount due under the guarantee will be reduced, because by then the master franchisee will have substantial assets which would be available to the franchisor should it bring a successful claim against the master franchisee.

2. Alternatives

Once the franchisor has obtained the guarantee, there may still be challenges and restrictions in enforcing the guarantees in foreign jurisdictions, so franchisors should consider alternatives. Further, of course, from a franchisor’s point of view, the availability of personal or corporate guarantees may lead the franchisor to adopt a less rigorous approach to none or late payment by a master franchisee. If a franchisor adopts a policy of careful monitoring and enforcement concerning payment, the need to enforce personal guarantees or any other payment protection for the franchisor will be reduced.

Sometimes franchisors seek letters of credit from master franchisees. Unfortunately, these, as well as other forms of bank guarantee, are expensive for master franchisees. Generally, banks require the comfort of knowing that there are sufficient funds in the master franchisee’s bank accounts to cover the bank’s liability under any letters of credit or guarantee. As a result funds have to be deposited with banks and those funds will not be available to the master franchisee in order to develop the system.

Another alternative is that an upfront payment is paid to the franchisor which is retained by the franchisor in its bank account and will be available to the franchisor in respect of non-payment. This is an arrangement that is used in relation to some Far Eastern countries, but is subject to the same potential disadvantage referred to above in relation to letters of credit and bank guarantees.

An alternative that is usually much more attractive to master franchisees is giving security over its assets. This approach does not reduce the master franchisee’s available cash resources to develop the franchise. The difficulty is that master franchisees may have borrowed substantial sums from financial institutions which have already taken security over the master franchisee’s assets and, at least in the early days, there will be relatively few assets over which to take security. Franchisors argue that taking security does not give them additional protection, because it is likely there will be provisions in the master franchise agreement to the effect that on termination of the master franchise agreement the franchisor has the ability to take over a master franchisee’s business on advantageous terms.

N. Indemnities

Franchisors often seek indemnity provisions from master franchisees. Franchisors are, of course, able to bring breach of contract claims if a master franchisee breaches the terms of the master franchise agreement and may also bring claims for the tort of negligence. Where franchisors are exposed is in relation to the acts and defaults of third parties with whom they have no contract or who do not owe them a duty of care.
Master franchisees are often concerned about giving broad indemnities in respect of acts or omissions of those persons for whom they have no legal control or responsibility. Whilst master franchisees may be prepared to indemnify a franchisor in respect of their own breach of contract or negligence and thereby provide additional protection to a franchisor in areas where the franchisor would already have a claim, master franchisees generally resist further indemnities (e.g., in respect to acts or omissions of their subfranchisees) especially when given to U.S. franchisors for fear that they will incur U.S. type damages if claims are brought against the franchisor in the U.S. courts. From the franchisor’s perspective, however, it wants the indemnity under the theory that as between the parties, the master franchisee, not the franchisor, is in the better position to monitor the subfranchisee’s activities.

It is important to bear in mind that generally the difference between a breach of contract claim and an indemnity claim is that in relation to indemnity claims it may not be necessary for the claimant to establish that the loss was reasonably foreseeable, the claimant may not have to mitigate its loss, and the claimant would be entitled to all of its legal costs.

Undoubtedly, master franchisees will argue that franchisors are already protected and need no further indemnity type protection or, alternatively, seek from the franchisor mutual indemnities. These often are sought in relation to the IP rights and know how that are being licensed because if either of these two elements are, for whatever reason, not available to the master franchisee, then it is likely to have a direct and material impact on the master franchisee’s investment. As a result master franchisees argue that an indemnity should be provided by the franchisor in respect of these issues.

At the very least a franchisor would expect a master franchisee to argue that no indemnity should be given if the damages arose due to the master franchisee following the system or complying with the franchisor’s instructions.

A further challenge for a master franchisee may be that a franchisor, in receipt of an indemnity has little incentive to either defend or to seek to compromise claims on attractive terms. As a result, if an indemnity is given, master franchisees often seek the ability to control the investigation and defence of any claims. While a franchisor may be generally amenable to this, there are typically carve-outs for topics that are of fundamental importance to the franchisor, such as its intellectual property, including brands and trade-marks, for which the franchisor will always maintain control of investigation and defence.

O. Restriction on Competing Activities

1. Scope

As in any franchise relationship the franchisor would want the master franchisee to concentrate its activities on the brand and system that is being licensed. Accordingly, it is standard practice to ensure that the master franchise agreement contains both in-term and post-term non-compete covenants.

Challenges arise where the master franchisee is already actively involved in the business area which is being franchised – and indeed has been selected by the franchisor because of its trade knowledge, or if the master franchisee forms part of a substantial group that would not wish to restrict its ability to undertake such activities in future either itself or following a potential acquisition or merger.
Master franchisees may be prepared to accept restrictions on future expansion with competing concepts if the competing concept is narrowly defined. Generally, master franchisees will seek to identify the particular product which is the subject matter of the master franchise and limit the non-compete covenant to that particular product so that, for instance, in a fast food burger chain, the master franchisee would be prepared to agree to exclude itself from being involved in another chain where burgers represent more than 50% of the product offering, but the master franchisee would not agree to exclude itself from fast food businesses offering, for instance, principally pizzas but only incidentally burgers. The franchisor, on the other hand would view the situation differently and would perceive pizza restaurants as potentially taking customers away from its burger outlets. This is clearly an area where there is likely to be substantial negotiation. An alternative is that the master franchisee may be prepared to accept that any such outlets must not be within a specified distance of its franchised outlets.

Another alternative is to grant the franchisor the right to modify the development schedules upwards if a master franchisee is involved in a competing business or to give the franchisor the option to purchase the franchised outlets, if a master franchisee wishes to be involved in a similar or competing business. If the franchisor fails to exercise the option, the master franchisee is free to proceed with its competing activities.

P. Termination and Post-Term Obligations

All master franchise agreements contain termination provisions entitling the franchisor to terminate the agreement in relation to serious breaches by the master franchisee. The issue is what, in practical terms, happens following any such termination. Usually, the termination of a master franchisee with a large network of subfranchisees gives rise to very substantial challenges for the franchisor, because the franchisor simply will not have the management structure and capabilities within the master franchisee’s territory to continue to support the subfranchisees. Nevertheless, franchisors generally reserve to themselves the right to terminate and in such scenarios to have the subfranchise agreements transferred.

As part of the process of ensuring that a franchisor is able to have a direct contractual link with subfranchisees on termination, franchisors generally require the subfranchise agreements to contain a provision which will enable the franchisor as, for instance, the master franchisee’s attorney to ensure that a transfer can be implemented without the master franchisee’s involvement which in practice, in the circumstances of a termination, is unlikely to be forthcoming. Alternatively, the subfranchise agreements can provide for an automatic transfer of the subfranchise agreements, although franchisors may seek to improve their position by giving themselves the option to decide which subfranchisees to take over on termination of the master franchise agreement. If the franchisor adopts this approach there is an obvious challenge for the master franchisee who still retains contractual obligations to subfranchisees which the franchisor does not want to take over, but is prevented from performing those obligations because it no longer has the right to use the franchisor’s brand or know how and is, in any event, prevented by post termination non-compete covenants.

In relation to corporate outlets, master franchisees will be reluctant to accept that, at least for certain types of franchises, such as fast food franchises, those outlets cannot, following a termination, be used for a fast food business. They are likely to have been designed with the provision of fast food services in mind and there may only be limited scope to change their use. If that is indeed the case then franchisors may be prepared to allow those outlets (if the franchisor does not wish to take them over) to be used as a fast food outlet, but avoiding the core products previously offered at the outlet.
Master franchise agreements will generally retain a distinction between the termination of the development rights and the termination of the agreement itself. A failure to achieve the development schedule normally results in the master franchisee ceasing to have the ability to open additional outlets, but does not prevent the master franchisee from continuing to operate under the franchisor’s brand those outlets that have already been opened.

Q. Dispute Resolution and Governing Law

1. Choice of Law

Franchisors generally seek to ensure that the master franchise agreement is subject to the laws of the franchisor’s home country. The reasons for this are obvious. The franchisor has worked with its own lawyers to develop strong agreements based on its legal team’s knowledge of its franchise business. The franchisor and its legal team know the laws in its home country and know the approach of its home courts. Franchisors are generally wary of entering into agreements where they simply do not know how the courts will approach enforcement and will have to rely on lawyers with whom they have no existing relationship. Further, of course, in some jurisdictions the local courts are less likely to enforce contractual obligations against their own citizens. In practice, those jurisdictions are relatively small in number.

From a master franchisee’s perspective there may be less concern about using the franchisor’s home jurisdiction although there are particular challenges, if the franchisor is based in the U.S. where entering into agreements which are subject to U.S. law and courts with the perceived litigation culture in the U.S. and jury trials in commercial cases is likely to concern a prospective master franchisee. If the franchisor’s jurisdiction is adopted, master franchisees should, of course, obtain local advice from lawyers in the franchisor’s home jurisdiction. That may be an additional cost that master franchisees are simply not prepared to incur. Nevertheless, the advantage from a master franchisee’s perspective of litigating/arbitrating using the franchisor’s home jurisdiction is that a master franchisee may thereby find it easier to bring claims against the franchisor – even if in practice such claims are rare - and, conversely the franchisor may find it harder to bring claims against the master franchisee. Unless the master franchisee has assets in the franchisor’s jurisdiction, then even if the franchisor was to be successful the court’s decision would have to be enforced by separate proceedings in the jurisdiction where the master franchisee has assets. This substantially increases the costs and delays enforcement.

It is of course possible to select the law of Country A and refer disputes to the courts in Country B. That is generally a recipe for disaster because the courts in Country B would have to receive, at considerable expense to the parties, detailed legal guidance on the applicable laws in Country A.

A further option is to choose a neutral law/jurisdiction but, if this is done, legal advice would have to be obtained by both parties on the applicable laws in the neutral jurisdiction when the master franchise agreement was being negotiated and, if a dispute is litigated in that jurisdiction, “logistical” issues with preparing for trial would be likely substantially to increase the cost of resolving the dispute.

2. Mediation

As a result, alternatives to litigation are often set out in the master franchise agreement so that, for instance, a senior executive of the franchisor and master franchisee, agree, should a dispute arise, to an initial meeting with a view to seeking to resolve the issue. Often face to face
meetings are arranged at, for instance, the franchisor’s premises, but the master franchisee’s travel, accommodation and other costs are reimbursed by the franchisor.

In some jurisdictions mediation is a required step in any dispute resolution procedure. For instance, in the United Kingdom a party who fails to participate in mediation is at risk of having adverse cost orders awarded against it even if ultimately successful in litigation. In Australia the franchising code gives the parties to a subfranchise agreement the right to refer a dispute to mediation.

In relation to mediation a neutral venue can give rise to practical logistical issues. There could, for instance, be language issues with a mediator if a neutral country is chosen where English is not used. Further the mediator would have to have knowledge of the laws applying to the contract.

3. Arbitration

In international franchising, arbitration is often used as a method of resolving disputes to avoid selecting a dispute resolution venue which favors one party although, of course, that does not absolve the parties of the need to choose the appropriate law or to address, in the agreement, injunction (or the equivalent emergency relief under civil law) issues. Franchisors should be in a position to obtain injunctions before the courts in the master franchisee’s territory applying the law of that territory and not the law of the contract, if different. In practice, it is unlikely that a court would grant injunctions based on foreign law without detailed and expensive information to that court being provided about the approach of such foreign law. It is normally considered desirable therefore for non-compete covenants and provisions relating to trade mark infringement and breach of confidence to be drafted or reviewed by a lawyer in the master franchisee’s territory so as to ensure that those revisions are enforceable in that territory, if the law of that country were to apply.

If arbitration is being considered it is, of course, essential to establish whether arbitral awards are enforceable in both parties’ jurisdictions whether by virtue of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards which is also known as the New York Convention\(^9\) or otherwise. If that is not the case then arbitration does not offer advantages to the parties.\(^{10}\)

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\(^9\) Copies of the Convention and information about it can be obtained from www.newyorkconvention.org.

IV. CONCLUSION

Master franchising has been, and continues to be, a popular model for international franchise expansion, but it is not without its challenges. Before electing to use a master franchising structure, franchisors should carefully consider their objectives and available resources, the characteristics of the target market, the pros and cons of the master franchising structure, and the various alternative structures for expansion into the target market. Only then can a franchisor make an informed decision as to whether master franchising is the right vehicle for expansion.
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Ann Hurwitz is a Partner in the Dallas office of Baker McKenzie. Representative clients include leaders in the hotel, hospitality, restaurant and retail industries. Among other honors, Ms. Hurwitz was recognized in 2011 by the International Who's Who of Franchise Lawyers as one of the “10 most highly regarded individuals internationally.” She is ranked in Chambers Global 2015 and has been listed in Chambers USA every year since 2007 and in The Best Lawyers in America every year since 1995. She has also been recognized repeatedly for her work in franchise law by Dallas’ D Magazine, has been named as a Texas Super Lawyer every year since 2009 and was featured in the September 2014 “Winning Women” issue of Texas Lawyer. She is a two time winner of the International Law Office Client Choice Award for Franchising. Ms. Hurwitz is a former member of the Governing Committee of the American Bar Association’s Forum on Franchising (1997-2000), a former Editor-in-Chief (1993-1997) of the Forum’s Franchise Law Journal and co-editor of The FTC Franchise Rule: Analysis and Commentary, American Bar Association Forum on Franchising (Second Edition).

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Dominic focuses on franchise and distribution, retail, product marketing and trade practice laws. He provides practical and business-friendly advice to clients engaged in all distribution and franchising matters, from domestic start-up franchisors working to launch a new franchise system, to large, multi-national franchisors expanding into Canada. Dominic also assists clients with establishing and managing distribution systems, including drafting and negotiating distribution agreements and product supply agreements. Dominic supports clients in respect of various retail and trade practice matters, including consumer protection, privacy, anti-spam and marketing matters.

Dominic is a former member of the American Bar Association's International Division, a past co-chair of the Canadian Franchise Association’s Law Day and former member of the Law Day committee, past member of the Canadian Franchise Association’s Annual Conference committee, and current co-chair of the Ontario Bar Association’s 2015 Franchise Law Conference. He is listed in the Canadian Legal Lexpert Directory: Franchising Law; the Best Lawyers in Canada: Franchise Law; Who’s Who Legal: The International Who’s Who of Business Lawyers: Franchise; and Who's Who Legal: Canada.

John H Pratt - Hamilton Pratt

John obtained his law degree from Oxford University and successfully completed a doctorate in comparative law at the Université d’Aix-Marseille. Before starting his own law firm – Hamilton Pratt - in 2004 John Pratt was managing partner at Pinsents, one of the largest law firms in the UK. John Pratt was, until recently, the Legal Advisor to the British Franchise Association. He has been chair of the International Bar Association’s International Franchising Committee and the American Bar Association’s International Franchising Division. John is the author of the UK’s text book on franchising – Franchising: Law & Practice as well as other publications and lectures on international franchising throughout the world.