Alternatives To Master Franchising: Area Development Agreements, Area Representatives And Joint Ventures

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This article provides a comprehensive analysis of international franchising structures – direct franchising, exclusive master licenses, área development agreements, área representatives, joint ventures and hybrid arrangements – and discusses their characteristics, advantages and disadvantages. The authors discuss the various factors to consider in evaluating these stuctures and discuss the relevant practical, cultural and legal considerations in cross-border expansion. The legal issues include sanctions laws, anti-bribery laws, dispute resolution, intellectual property, recordation and the nature of the franchisors' relationship with their franchisees depending on the chosen structure.

Overview Of International Franchising Structures

1. Direct franchising

Under this method of expansion, a franchisor will franchise directly with a franchisee. The initial question is whether any particular country being considered for expansion has adopted and/or implemented franchise regulations. Over the last decade or so, many countries have adopted some form of franchise regulations. Some of this is as a result of the popularity and growth of franchising internationally. Many large U.S. based franchise chains, particularly in the Quick Service Restaurant ("QSR") arena have franchises around the world. It is not unusual to find a McDonald's in Helsinki, Finland and KFC outlets all throughout China.

Franchise regulations generally fall under one of two forms. Some countries require disclosure and/or registration, which would fall under a "pre-sale" type of requirement, while other countries may also regulate the "relationship," the on-going relationship between the franchisor and the franchisee. Countries as diverse as Mexico, France, Spain, Italy, Japan, Korea, Australia and Malaysia have adopted some form of franchise regulation that a franchisor must comply with in order to establish a franchise in any of those countries. As such, one principal consideration before electing to expand to a particular country would be the time, costs and expense of complying with franchise regulations. Does your existing disclosure work? What types of filings are required? What about the franchisor's trademarks? Is there a notice and/or registration requirement? This type of analysis should be completed in each instance before electing to expand to any particular country.

A more practical question if a franchisor elects to enter into a direct franchise relationship is, how well do you really know your prospective franchisee? Does your prospective franchisee have the necessary experience to deliver the quality and service required of the brand? Does the franchisor have the

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infrastructure to deliver the training and support needed for the brand to prospective franchisees? Many global franchise brands, particularly in hospitality and QSRs have divisional presences that may include sales (development) and operations teams in Asia, Europe, MENA nations and further afield. The benefit to a franchisor in having a sales/ development team locally or regionally is that the team understands the local market. Conceivably, the team on the ground has developed or established relationships with prospective franchisees and can conduct much of the vetting required to ensure that a prospect is a "qualified" prospect in a particular market. Further, the maintenance of a local or regional operations team is also beneficial to the franchisor, and will provide the franchisee with the necessary know-how, training and support needed to ensure that the local franchisee is operating the unit (or units) in compliance with brand standards and in the manner required by the franchisor. The lack of a regional or local sales and operations team may be a disadvantage to the franchisor if the franchisor seeks to franchise directly. Managing a franchise relationship by long distance may prove to be a detriment under a direct franchising scenario since the ability to monitor the activities of the franchisee is limited by time and distance.

Finally, while a direct franchise approach likely provides the franchisor with more control over the selection of its franchisees, it may hamper growth opportunities for a franchise system since a franchise agreement must be entered into with each and every franchisee directly.

2. Exclusive master license

An exclusive master license or franchise ("Exclusive Master License") is the most traditional method used by franchisors to expand their businesses internationally. In a typical structure, the master franchisee ("Master Franchisee") is vested with the right to sub-franchise the business in a designated geographic area. This is a key differentiating feature of an Exclusive Master License. The franchisor, typically, receives an initial fee for granting sub-franchising rights to the Master Franchisee. The quantum of this fee depends on factors such as nature of business, the duration of the Exclusive Master License, and the number of franchises to be set up. The Master Franchisee also shares with the franchisor the franchise fee as well as royalty received for every unit set up by the sub-franchisee. In addition, the Master Franchisee pays a royalty to the franchisor for units operated by the Master Franchisee. For example, an Exclusive Master License may provide that the Master Franchisee would share 30 per cent of the franchise fee received and 50 per cent of the royalty for every new unit that is set up by a sub-franchisee. There are no fixed ratios in which the fee and royalty are to be shared, this varies from agreement to agreement.

Although the right to appoint a sub-franchisee is granted to the Master Franchisee, some agreements provide that such a right is not absolute, and the appointment may require the concurrence of the franchisor. As franchisors are concerned about their brand image, this system helps them in ensuring that the prospective sub-franchisees are of repute and good standing.

Typically, the Exclusive Master License provides for a development schedule, and the Master Franchisee is expected to adhere to this schedule in terms of development of new units. The Master Franchisee may be obliged to establish its own units first, in order to inspire confidence in potential franchisees in the region by demonstrating success of the business. This has the additional benefit of the Master Franchisee becoming well-versed in the business operations of the franchisor as well as in training methods before going to the sub-franchisee.

As the franchisor's marks are used by the Master Franchisee as well as by the sub-franchisees, the franchisor typically establishes the standards with regard to use of the marks.

In this model, franchisor and Master Franchisee may have to comply with the registration process, and depending upon jurisdiction, disclosure may have to be provided.

In more ways than one, the Master Franchisee acts as a franchisor vis-à-vis the sub-franchisees, providing them with knowledge and expertise, including operational supervision, training, and guidance.

In an international environment, one of the big advantages of an Exclusive Master License, aside from quick expansion, is that a franchisor can substantially cut its cost and share its risk by appointing a Master Franchisee in a foreign territory, rather than having a joint venture or a wholly-owned subsidiary.

However, there are certain inherent disadvantages with this structure. With the franchisor not being a party to the contract between the Master Franchisee and the sub-franchisee, the franchisor has little or no effective control over the sub-franchisees. This may become a cause of considerable concern with respect to issues such as brand image and use of the trademarks. On account of these pitfalls, the Exclusive Master License model is giving way to other structures such as area development, area representation, joint ventures, and hybrid arrangements.

3. Area development agreement

In the Area Development Agreement ("ADA") franchise model, a franchisor grants franchising rights for a specific geographic location to a single franchisee ("Area Developer"), and the Area Developer opens individual units in that area over a specified period of time.

In a typical ADA, sub-franchising is not allowed, and the Area Developer is responsible for establishing the business units in that area, and to look after day-to-day management of the units. However, the franchisor may retain the right, by direct ownership or through franchising, to set up units in special locations such as airports, train and bus stations, sports facilities, and amusement parks. Another exclusion in terms of the ADA could be on account of sale of products on the internet.

Area Developers are typically required to pay a development fee. Generally, separate franchise agreements are entered into with regard to every unit that is developed, and a royalty is charged in terms thereof.

The obvious advantage of a true Area Development franchising model is that the franchisor is not saddled with the burden of multiple franchise partners. Also, the opportunity for quick expansion of the business is available - there being only a single franchisee. The need to negotiate with multiple franchisees is eliminated.

In so far as the Area Developer is concerned, given its knowledge of local market and conditions, it will not only be able to negotiate preferred locations but also negotiate prices of supplies, so as to meet challenges from local competition. It will also have the ability to cut costs pertaining to local advertising and promotional programs. In its dealings with the franchisor, the Area Developer may be in a position to negotiate lower franchise and royalty fees.

The franchisor has to watch out for the impact of lesser control over the franchised business with the Area Developer dictating growth and expansion plans for the business. In many cases, the Area Developer makes substantial contributions to the revenues of the franchisor, and the loss of a formidable Area Developer can have a big impact on the bottom line of the franchisor.

When appointing an Area Developer, care should be taken to ensure that it is someone who has strong commitment to the business, with adequate financial resources and local clout to develop the business.

4. Area representatives

The two crucial elements of the Area Representative ("Area Representative") model are

(i) solicitation and recruitment of prospective franchisees in a defined geographic area, and

(ii) servicing franchisees, on behalf of the franchisor, such as providing training; carrying out periodic inspections; carrying out local or regional advertising, and providing periodic consultation to franchisees.

In a true sense, an Area Representative Agreement may not be classified as a franchise arrangement. It is more in the nature of contract for services, with the Area Representative being compensated for soliciting franchisees and servicing them with regard to training, etc., on behalf of the franchisor. This is one of the reasons why an Area Representative Agreement may not be subject to the stringent registration and disclosure requirements that Area Development or Master Franchise agreement are subject to.

Unlike a Master Franchisee, an Area Representative is not allowed to enter into any agreement with the identified franchisee in its territory, and the franchise agreement is executed by the franchisor and franchisee, with the Area Representative merely facilitating the identification and recruitment of potential franchisees. As consideration for soliciting and assistance with recruitment, the Area Representative is paid a share of the initial franchise fee. For servicing the franchisees, the franchisor, would be expected to pay a part of the royalties to an Area Representative- depending on the quantum and type of services provided.

In terms of the Area Representative Agreement, typically the right to approve or reject a prospective franchisee vests solely in the franchisor. In many an agreement, the Area Representative's right to exclusivity is subject to the franchisor's right to set up its own units within the identified territory. The Area Representative may not receive any revenue when franchisees directly approach the franchisor for appointment.

There are some crucial advantages associated with the Area Representative model. The franchisor retains control over the franchisee, unlike the Master Franchise model or the Area Development model. Another plus is that as compared to other franchising structures, Area Representative Agreements may be terminated with more ease. A franchisor is also relieved of the task of maintaining a training team and costs associated therewith. The franchisor and the Area Developer are both in a position to harness the local strengths and knowledge of the Area Representative.

The disadvantage of the model pertains to potential vicarious liability on account of the Area Representative servicing the franchisees. To that extent, the franchisor must adequately oversee the performance of the Area Representative vis-à-vis the franchisees.

5. Joint ventures

A joint venture is not, per se, a type of franchising arrangement, but a contractual agreement between two parties to jointly promote and carry on a business. However, it is not uncommon to use the joint venture model in international franchising, whereby the franchisor, eager to promote its brand and product in an international territory, enters into a joint venture agreement with a local company, as a first step. Subsequently, the joint venture company can either become an area developer, or a master franchisee. The joint venture company typically enters into a brand license agreement with the franchisor with respect to trademarks and brands to be used.

Being a product of two cultures, one of the key challenges that face a joint venture is the partners adapting to one other's contrasting styles of operating. Besides, the usual problems that confront a joint venture such as control of the board, deadlock, exit methodologies, and dispute resolution will also confront a franchising joint venture. On the other hand, a joint venture gives the franchisor an opportunity to make a foray into the international market with the help of the local partner, whose strength lies in exploiting local knowledge and expertise.

In a franchising joint venture, the franchisor can participate actively in the business, have a larger share in the profits of the business, coupled with a feeling of security regarding protection of its intellectual property.

Although some of the emerging markets may have restrictions on outward remittance of royalties pertaining to the brand, most jurisdictions do not have specific laws governing joint ventures. Therefore, the joint venture is typically subject to the laws governing corporations.

Unlike most other franchising structures, the franchisor has to contribute capital in the joint venture company. Combined with the fact that the joint venture company is subject to the laws of local jurisdiction, the franchisor must choose its joint venture partner carefully.

6. Hybrid arrangements

Franchisors and franchisees, while negotiating a particular type of franchise arrangement, may sometimes combine features of the different franchising structures discussed above to arrive at a hybrid arrangement.

A hybrid arrangement, may, for example, be a combination of master franchising and an area development agreement. This combination may be structured in different ways, such as:

(i) a franchisee may first have to act as an area developer, developing a certain number of units within a specified time frame and also allowed to sub franchise, either simultaneously, or after it has developed its own units, acting as a Master Franchisee would, and/or

(ii) a Master Franchisee may be allowed to enter into an area development agreement with one of its sub-franchisee to establish units in a sub-territory.

Another example of a hybrid arrangement is where an area developer may act not only as a Master Franchisee insofar as the right to appoint sub-franchisees is concerned, but also act as an Area Representative and solicit and recruit independent franchisees, and service them on behalf of the franchisor with respect to training, regional advertising, operational supervision and consultation. So, this type of arrangement combines features of three franchising models-master franchising, area development, and Area Representative.

Yet another example of hybrid arrangement is where the franchisor enters into a joint venture with its Master Franchisee, with the intent to establish units in some pre-identified territories, while the joint venture partner is appointed Master Franchisee with respect to other territories. This model has been adopted in the course of international franchising when a brand needs to establish credibility in a market and the initial momentum for this development is provided by the joint venture.

There are obvious advantages in combining elements from the standard franchising models and tailoring them to the requirements of the franchisor and franchisee. A hybrid structure provides the flexibility that individual models may lack, while ensuring that the business is not hamstrung by the rigid demands of some of the standard models.

Overview Of Considerations In Cross-Border Expansion

1. Cultural

Name of franchise

Feasibility of using name in another country

To avoid huge marketing mistakes, it is important for companies expanding internationally to ascertain the meaning of a trademark in the targeted country. A number of brands operate under a different name internationally to avoid offending local consumers. In the Middle East, "Church's Chicken" operates as "Texas Chicken" acknowledging the fact that the overwhelming majority of the population is Muslim. One American company was surprised that they discovered that the name of the cooking oil they were marketing in Latin America translated in Spanish as "Jackass Oil." In the April issue of "Franchise Times," there was mentioned that "Pip Printing" discovered in Denmark that the name "pip" meant "crazy in the head."

Translation issues

In most agreements, the translation is the obligation of the franchisee. However, most of the agreements do not provide for a professionally or linguistically accurate translation. It is important to provide that translation of agreements must be rendered by lawyers knowledgeable in local law and with an understanding of common law concepts. Many translators have the language capability but do not have the legal aptitude to translate common law concepts.

2. Consumer preferences

Any franchisor entering a new international market should consider whether or not to vary its system to address local preferences. For example, some restaurant concepts may need to modify their menu offerings to adjust to local taste. Portion sizes may also be affected and that can in turn require a change to the pricing structure.

In some circumstances, however, the success of the system in the new country or region is predicated on being different or on appealing to a sector of the local population that has emigrated from the franchisor's home country or has ethnic ties to it. While this may limit the success of the concept, at least initially, to this segment of the population, it can also provide a platform from which to launch development that can be adapted to local taste later, if necessary. In the meantime, there is a solid customer base with awareness of the brand. An example of this is Pollo Campero, a fast food restaurant concept that began in the early 1970s in Latin America and entered the United States through locations in the Hispanic community. There are now over 50 locations in the United States.

3. Sourcing

Availability of products, fixtures and equipment

Fixtures and equipment

Local sourcing of fixtures and equipment will be a major step in preparing to franchise in a new country. This does not merely involve identifying suppliers. It also involves the issues of the franchisor's ability to protect the look and feel of the franchised business and the instant recognition that affords to consumers. This is sometimes referred to as "trade dress" and is often an integral part of the franchise system.

While this legal concept and protection is developed in the United States, for example, it may not be recognized everywhere. If a non-U.S. franchisor is exploring the possibility of entering the U.S. market, one consideration is how to protect its trade dress in the U.S.

In any new country, even if the country's legal system does not afford the same protections for trade dress, a major consideration is how important this element is to the franchise concept. If it is of high importance, it might be necessary to import materials or equipment, which is likely to drive up the cost for franchisees and make the franchise less competitive.

Products

Proprietary Products and Recipes

Proprietary products and recipes often present challenges to franchisors embarking upon franchise programs in new countries. Franchisors may be reluctant to release recipes for proprietary products to distant manufacturers, even when non-disclosure agreements are in place. Yet, they may be forced to do so because of restrictions on importing these products and duties imposed on them. Even if legal impediments to importing products can be avoided, there may be logistical issues or prohibitive costs involved in doing so.

Non-proprietary products and recipes

Less problematic is the issue of sourcing non-proprietary products. Nonetheless, it is essential to make sure that the quality and availability of products is assured. One way to address the procurement challenge is to send a representative to the new country in advance to negotiate arrangements with local suppliers. Another is to choose a franchise structure in which the local participant is familiar with the franchisor's domestic operations and can match the business' needs with local supplies and products.

Unit and measure conversion

Most countries in the world use the metric system of units and measure, unlike the United States. Therefore, if the franchisor is introducing a concept into the U.S. or from the U.S. to another country, it will be necessary to adapt such items as the operations manual, architectural plans and specifications and recipes and to allocate the cost of doing so.

Import-export restrictions

Any goods or materials exported to another country will likely be subject to formal entry procedures and possible assessment of duties. In the United States, for example, this process is administered by the U.S. Customs Service. A key decision for non-U.S. franchisors is the choice of person or entity to act as "U.S. importer of record" in connection with imports into the U.S. The importer of record is the party responsible to U.S. Customs for the payment of duties and compliance with all import restrictions and formalities. In general, the non-U.S. franchisor will either establish a U.S. subsidiary for this purpose or rely on an unrelated third party (such as its U.S. developer).

To continue with the example of the United States, a franchisor entering this market will also need to consider any product-specific regulation which may be imposed by other federal and state agencies. Federal labeling regulations often differ depending upon the product involved, and certain U.S. states (such as California) have additional labeling requirements.

Non-U.S. franchisors also need to verify that there are no country-specific U.S. import restrictions affecting their intended exports. The United States enforces a number of antidumping and countervailing duty orders that often result in extremely high duties on products manufactured in particular countries. Franchisors sourcing product for shipment to the U.S. from outside of the country, particularly from sources in Asia, should verify that their products are not within the scope of existing trade case orders in order to avoid potential large duty assessments.

Another example is that of Canada. Despite the existence of NAFTA, the import of certain types of food products from the United States can result in a duty of 250%, effectively reducing the ability of the franchisor to mandate purchase of those types of food products (even if proprietary) from the franchisor.

4. Legal issues

While virtually every business consideration involving cross-border franchising gives rise to myriad legal issues of both the outbound and the inbound jurisdiction, the following five categories warrant particular attention because of potential consequences of either running afoul of applicable law, ignorance of applicable law, or failure to take applicable law into consideration. This list, however is by no means exhaustive. For example, restrictions or prohibitions on currency transfer; direct/indirect foreign ownership restrictions; agency laws; anti-trust laws; and (perhaps the most obvious) franchise laws of the inbound jurisdiction (all of which are beyond the scope of this discussion) may be critical considerations and may have an impact on whether internationalization will take the form of a master franchise agreement or an alternative structure.

Sanctions laws (anti-terrorism laws, anti-boycotting laws, etc.)

Pursuant to the mission statement of the Office of Foreign Assets Control ("OFAC") of the U.S. Department of Treasury, OFAC "administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States." As such, OFAC's primary function is to administer and enforce economic and trade sanctions. Further, OFAC has authority to "impose controls on transactions and freeze assets under U.S. jurisdiction." The jurisdictional reach of OFAC is broad and applies to all U.S. citizens, wherever located (including permanent residents), entities formed and organized under U.S. law, and subsidiaries of U.S. entities that are foreign organized.

As such, a U.S. based organization expanding internationally must comply with OFAC requirements and cannot conduct business with any sanctioned countries (i.e., one that the U.S. restricts doing business with unless authorized by OFAC) such as Cuba, Iran, North Korea and Syria. This list is updated on the referenced OFAC website and should be checked periodically by a franchisor to confirm compliance with OFAC's current requirements. Additionally, the OFAC website maintains a Specially Designated Nationals List ("SDNL"), a list of nationals and entities that act for, or on behalf of, countries that are sanctioned. U.S. entities are prohibited from conducting business transactions with the nationals and entities contained in the SDNL. Once again, a franchisor should review this list frequently to confirm that the entities or individuals that the franchisor may seek to enter into a franchise relationship with is not on the list. OFAC also has investigatory powers and can impose civil sanctions for violations.

Compliance by a franchisor with sanctions laws is critically important and lack of compliance may translate into substantial financial penalties. However, in light of the complex structure of many organizations, a franchisor may have to expend much effort and resources to confirm that the entities and/or individuals all up or down the chain of any particular organizational structure are compliant with OFAC requirements. Some franchisors rely on third party investigators to conduct the necessary due diligence to confirm OFAC compliance. A franchisor seeking to expand internationally would be wise to have adequate procedures in place to confirm compliance with OFAC requirements.

Anti-bribery laws

One of the greatest schisms between a legal team and the sales/development group is in the area of bribery, particularly if anti-bribery laws of the U.S. or the U.K. may be implicated, as both the laws and the application of those laws in such jurisdictions have become more aggressive in recent years. Liability under applicable law may involve criminal and administrative sanctions imposed on individuals, as well as corporations, along with possible injunctions and jail time.

- In the U.S., the Foreign Corrupt Practices Act prohibits any U.S. person, U.S. company, issuer, or person acting on their behalf (whether a U.S. person or not), from bribing a foreign official or foreign political party for the purpose of obtaining or retaining business, and imposes accounting and record-keeping requirements on companies (including foreign companies) trading on a U.S. stock exchange or that are required to file reports pursuant to the Securities Exchange Act.
- The United Kingdom recently enacted the United Kingdom Bribery Act 2010, which establishes criminal liability for active or passive bribery of foreign public officials or for failure to prevent bribery; liability for failure to prevent bribery may apply to non-U.K. companies if they do business in the U.K., with far-reaching implications for international franchisors.
- International treaties also have been enacted, requiring countries to implement domestic anti-bribery laws, including:

  (iii) The United Nations Convention Against Corruption;

  (iv) The Organization for Economic Cooperating and Development Convention on Combating Bribery of Foreign Public Officials in International Transactions;

  (v) The Inter-American Convention Against Corruption; and

  (vi) The African Union Convention on Preventing and Combating Terrorism

While best practices may help reduce the likelihood of violating applicable anti-bribery laws, or reduce the penalties if a violation occurs or is claimed to have occurred, the ability to dictate or control the conduct of other parties to international franchise arrangements (whose conduct may be imputed to an otherwise innocent party) should not be assumed. Often, the arrangement that creates the greatest opportunity to impose best practices also creates the greatest nexus between the bad actor and the innocent franchisor.

- The level of exposure to the FCPA and other anti-bribery laws for a franchisor in the context of an Area Development Agreement may depend largely on the extent of control and oversight exercised by the franchisor. As is true with all structures, as the level of control over the operation increases, so does the potential liability and, in many cases, the ability to manage the risk of such liability through a tight and strictly enforced compliance program.
- Master franchising may expose a franchisor to violations by a Master Franchisee, but should reduce the exposure for conduct from the unit franchisees. A delicate balance must be struck between establishing best practices for both the Master Franchisee and the unit franchisees (as part of the franchise brand standards) and autonomy that will allow the master franchisor to disclaim liability for conduct of the unit franchisees.

- Because a joint venture often provides the foreign franchisor with the greatest level of control over the foreign operations, it often provides the greatest exposure to liability under applicable anti-bribery laws. Participation in the joint venture through a separate subsidiary or affiliated entity should not be viewed as any meaningful measure of protection.

- Because direct franchising involves the most control and hand-on operations on the part of the foreign franchisor, it also involves the greatest risk of violating the FCPA and other anti-bribery laws. In addition to potential liability for the conduct of the franchisor's employees and other agents in the country, the franchisor may also be liable for the conduct of the franchisees and their agents. At the same time, however, this model may give the franchisor the greatest ability to manage those risks by requiring the implementation of a strict compliance program and direct training of personnel, if the franchisor is prepared to commit the necessary human and financial resources.

Dispute resolution

Regardless of the structure selected for internationalizing a franchise, the very nature of the transaction is the establishment of a long-term relationship. Accordingly, contemplating the resolution of disputes in an international franchise arrangement is often seen by non-lawyers as more distasteful than in the case, for example, of the cross-border sale of goods, and is frequently analogized to the pessimism of a prenuptial agreement.

Not only is it important for lawyers to contemplate the manner by which disputes will be resolved, but this exercise also can be productive for the business teams, as an opportunity to lay the foundation for their relationship. For example, will failure to adhere strictly to a development schedule give rise to termination, or will the parties be required to meet and discuss the reasons for the failure with or without, the assistance of a mediator? Will an arbitrator be empowered to grant injunctive relief, perhaps relieving an Exclusive Master Licensee of its exclusivity for a period of time? In a direct franchise between an Indian franchisor and Italian franchisees, will requiring the franchisees to submit to the jurisdiction of the courts in India have a chilling effect on franchise sales?

For the most part, the same considerations regarding dispute resolution will apply regardless of the structure of the internationalization:

- What law will govern a potential dispute? In the case of a joint venture, the laws of the country in which the joint venture is formed usually will pertain, but in a hybrid relationship in which a license or master franchise is granted to a joint venture to which the licensor also is a party, whether the license should be subject to the laws of the licensor's jurisdiction must be considered. Bear in mind that courts in certain jurisdictions will ignore the parties' selection in favor of domestic laws. Although this can sometimes be addressed by choosing an exclusive forum outside of the inbound country, if the other party wins the race to the courthouse and the court accepts jurisdiction despite the parties' written agreement to the contrary, those negotiated provisions may be thwarted.

- How will a potential dispute be resolved? Must arbitration or mediation be attempted prior to litigation? If arbitration will be invoked, will it be institutional or ad hoc? If it will be institutional, under what institution's rules (e.g., American Arbitration Association's International Commercial Dispute Centre's rules, the rules of the Singapore International

Arbitration Centre, or the London Court of International Arbitration ("LCIA"))?

- What will be the forum, or seat, of the dispute resolution mechanism? If institutional arbitration is selected, the forum will often be where the institution is located but it is preferable to identify the location, rather than leave it to chance. Recently, for example, the Dubai International Financial Center partnered with the LCIA to create an arbitration and mediation center. Agreeing to have a dispute resolved pursuant to the LCIA rules might result in a proceeding in Dubai, if London was not expressly stated in the agreement.

- Will the arbitrators be empowered to grant injunctive relief? Will there be one arbitrator, two part-selected arbitrators and one "neutral" arbitrator, or some other process?

- How will the recognition of a foreign arbitral award be ensured? For example, if a panel of arbitrators enters an award before the Singapore International Arbitration Centre, how will recognition and enforcement in India be ensured?

- In what language will the dispute resolution mechanism be conducted? If this is not specified, it usually will be the official language of the jurisdiction, which may not be the parties' intention and may be a disadvantage to one of the parties (or both, if a jurisdiction that was perceived to be neutral at the time of contracting was selected).

Finally, if a dispute involves not only the contractual relationship between the parties as franchisor/franchisee or principal/agent but also as parties to a joint venture (or other relationships created by statute, such as shareholders or partners or members of a limited liability company), the law governing the dispute and potentially the resolution of the dispute may be prescribed by the country in which such joint venture (or other statutory relationship) was formed. For example, while the parties may have some latitude in negotiating the applicable law and dispute resolution process governing a license to a Chinese licensee, if the licensee is a Sino-foreign joint venture (and one of the joint venture partners is the licensor), disputes among the joint venture parties may be exclusively subject to resolution under Chinese law and/or in Chinese courts.

Intellectual property issues

An analysis of whether to register a franchisor's intellectual property in the target county is beyond the scope of this paper, although it must be noted that it would be very rare for a potential franchisor not to seek to register its intellectual property and risk reliance on contractual confidentiality provisions and trade secret laws. It also must be noted that many countries have a "first to file" rule with respect to trademark protection, making it imperative for a potential franchisor to file at the earliest opportunity. If another party has filed first, especially if that filing was for a proposed use (as opposed to actual use), many countries with a first-to-file rule will nevertheless give priority to a well-established mark that was registered in other jurisdictions and where the investments in and the value of the mark can be shown.

Assuming, for the sake of this discussion, that the intellectual property of the franchisor has been registered in its home country and registration has either been obtained or sought in the target country, some additional considerations when franchising abroad may be appropriate.

- *Anti-Dumping:* Anti-dumping concerns typically address two distinct issues: the attempt to import goods or services (usually goods) at a price that is lower in the foreign market that in the domestic market; and selling obsolete technology, often to third-world countries. In the context of international franchising, both aspects of anti-dumping may be implicated, although the latter may be more likely to occur, particularly if a franchisor has enhanced its product or service in his home country and seeks to enter the new international territory with an earlier iteration of its system. A master franchise agreement may require that the franchisor provide its most recent system and any upgrades to the Master Franchisee, while area development agreements and Area Representative agreements are more likely to be limited to the specified intellectual property at the time of the agreement.

- *Translated marks:* Any agreement covering the perpetuation of a franchisor's service marks or trademarks in a new jurisdiction must cover the ownership of any translated marks and newly-developed marks. This often is the subject of much debate among the business people during the formation of a new relationship, as the Master Franchisee or Area Representative views the "local" mark as their property, particularly if it is expected that their sales and marketing efforts will establish market recognition for the new marks. If a joint venture is employed, or if the parties otherwise agree to co-ownership of any marks, the agreements must clearly articulate the parties' respective rights to own and/or use the new marks following the termination of the agreement and whether the circumstances surrounding the termination (i.e., cause, no cause, expiration of term) affect those rights.

- *Website ownership:* Internationally, outbound master franchisors may have some of the same concerns about franchisees establishing unique websites as they do in their home countries. Such concerns may include whether to require or permit franchisees to establish their own websites or to use a franchise-approved website, or whether to prohibit any franchisee-specific websites altogether. In the context of an international franchise arrangement, these concerns are part of larger issues involving the creation of a foreign website; the language or languages of that website; the ownership of the website; the ownership of the content of the website (especially if some content is developed by the franchisee); the ownership of the domain name; and the identity of the administrative and technical contacts.

- In addition, the agreements must specify what happens to the website or websites on termination of the agreement. In some cases, the ownership of the domain may be dictated by the jurisdiction of the registrar. For example, ".eu" domains (for the European Union) are only available to natural residents of the E.U., an organization established within the E.U., or an enterprise with a registered office, central administration, or principal place of business in the E.U. Accordingly, it appears that a joint venture with a principal place of business in the E.U. would be eligible to register a .eu domain name. In contrast, China (which until recently did not permit foreign ownership of a .cn domain name) permits a party with a Chinese "Branch Business License" to register a domain name, provided it has at least one employee who is a Chinese citizen who will sign the application form. A Branch Business License, however does not appear to be available to joint ventures, but may only be available to a wholly-owned or majority-controlled subsidiary of a foreign entity that registers in China and that uses the same name as its parent. An example frequently given is that "IBM" would use "IBM China" to register IBM.cn.

Recordation consideration

Although often overlooked, many jurisdictions require the recordation, or registration, of a license in order for it to be effective. The cost and complexity of recordation varies greatly from country to country, and the consequences also vary greatly. Because each of the alternatives to a master franchise (other than the option of direct franchising) involves granting of a license and may be construed as appointing a commercial agent, it is critical that a local attorney be consulted to assist in evaluating whether recordation is required; if it is not, whether it is desirable; and how to mitigate the potential negative aspects of recordation, whether by altering the contemplated structure or through artful drafting.

In several countries, such as the Benelux countries, recordation is only necessary to protect the licensee against claims by third parties; in other countries, including several in Asia, failure to record the license may invalidate the trademark registration itself. In the Middle East, while recordation may be mandatory in some jurisdictions, it also may be encouraged by franchisees, licensees, and others who seek to acquire greater rights that are afforded to commercial agents if a licensing agreement is recorded, even though recordation may not be mandatory. For these purposes, Master Franchisees and area development agents may be construed as commercial agents, depending on the country and depending on the rights and obligations conferred. For countries such as Israel, recordation is important to prevent the licensee from claiming greater rights, and compensation on termination of the license, as a result of goodwill that may have accrued in the territory during the time of the license. In Brazil, recordation of an international franchise agreement is required to make the agreement effective against third parties, to permit payments to the foreign franchisor and to qualify the franchisee for tax deductions.

In countries where recordation/registration confers additional rights on commercial agents, these rights can be meaningful and unintended by the licensor, such as the right to receive compensation on termination and the continuation of the agreement beyond the expiration of its term. In those countries, if recordation is not required, it may be sufficient to expressly state that the agreement may not be registered, although some countries permit the commercial agent to register the contract without the principal's consent.

While there are steps that may be taken by a franchisor to minimize the undesired outcome, the ability to take those steps may be greater depending on which structure (master license, area development agreement, joint venture, or other structure) is contemplated. Although a joint venture in which the franchisor maintains control over critical decision-making through the joint venture agreement may appear, on its face, to be the most practical solution, it is not always feasible or may be undesirable for other reasons. In all cases, the following may assist in mitigating some of the risk to the principal/licensor:

- Appoint the agent on a non-exclusive basis
- State in the agreement that it may not be registered (but note that this may be ignored by courts in some countries, particularly in the Middle East)
- Clearly articulate the specific duties, obligations, performance and reporting
- Establish clear boundaries of the scope of the agent's authority and ability to delegate
- Specify precisely the financial terms applicable on termination of the agreement or if they vary depending on whether the termination is for cause, without cause, and upon expiration of the term, include specific instructions for post-termination obligations

5. Whose franchisees are they?

It often is very useful to distill the discussion of alternatives to master franchising down to the issue of "whose franchisees are they." In short, this inquiry highlights the differences among some of the alternatives, through an analysis of the parties' respective rights and obligations to one another.

Direct franchising

As one would expect, in a direct international franchise, the foreign franchisor is in privity with the extraterritorial franchisees. Often, this is accomplished through the use of a subsidiary or affiliate of the franchisor (because of tax reasons, asset protection concerns, legal requirements of the franchisee's jurisdiction, or otherwise), but the core relationship remains the same: the franchisor is responsible for training the franchisees in its systems and methodology and the franchisee is responsible for carrying on its business in accordance with the franchise system, and paying its royalty and other fees to the franchisor.

Exclusive master license

By contrast, in an Exclusive Master License, the party on the receiving end of the license, the Master Franchisee, operates as the franchisor in the territory. While the master franchisor supports the Master Franchisee with respect to the franchised business and trains the Master Franchisee both in its underlying franchise system and in the systems necessary to support the franchisees, the Master Franchisee supports (and is in contract with) the franchisees in its territory.

In a typical Exclusive Master License, the master franchisor establishes the criteria for franchisee selection, site selection, and brand standards that must be maintained by each franchisee of the Master Franchisee. In an international context, the Exclusive Master License often will include agreed-upon variations from the domestic franchise requirements necessary or appropriate for the market. For example, a hotel brand standard of a franchisor based in India that requires franchisees to offer a garland of flowers to their guests on arrival might be replaced by cookies and lemonade in the U.S. In that scenario, the U.S. Master Franchisee would be required to ensure that its franchisees were adhering to the master franchisor's brand standards as modified for the U.S. While a franchisee's failure to adhere to brand standards could result in the termination of its franchise by the Master Franchisee, failure to ensure that the franchisees in its territory adhere to the brand standards could result in the termination of the Exclusive Master License by the master franchisor.

Although the direct contractual relationship between the territorial franchisees and the franchise is really with the Master Franchisee, franchisees usually view themselves as being affiliated with the franchisor. Often, it is the well-recognized foreign brand that attracted the franchisee to the business opportunity, and not the Master Franchisee. Master franchisors often require (and savvy franchisees may prefer to know) that in the event the Exclusive Master Franchise is terminated for any reason, and especially if it is terminated by the master franchisor for cause, the franchisees will be deemed to be (either by automatic assignment or otherwise) direct franchisees of the master franchisor.

Area development agreement

For purposes of the "whose franchisees are they" discussion, ADAs are no different from a direct franchise. However, care must be taken in the ADA to address the transfer of a unit by the party holding the area development rights to a third party, whether and under what circumstances it would be permitted, and whether and under what circumstances the Area Developer would effectively become a Master Franchisee. In other words, if the transfer of a unit to a third party is allowed by the franchisor, all concerned should address such issues as who will be responsible for ensuring that the franchise system is adhered to and brand standards are maintained, and who will be responsible for providing appropriate support and training to the third party.

Area representatives

As the name implies, an Area Representative acts on behalf of the franchisor in the territory, and, as one would expect, the franchisees are contractually tied to the franchisor. Unlike a direct franchise without an Area Representative, however, the franchisor delegates many of its responsibilities to the Area Representative, such as responsibility for identifying potential franchisees, negotiating with them on behalf of the franchisor, providing services to the franchisees, ensuring that the franchisees comply with the franchise system requirements, and taking action in response to defaults under or breaches of the franchise agreement.

Although the franchisees in the territory are direct franchisees of the franchisor, their day-to-day relationship is with the Area Representative, for better or worse. Over the years, this may lead to loyalty between the Area Representatives and the franchisees that creates either a real or perceived shift in the leverage between the franchisor and its representative. Many international franchisors that use Area Representatives make a special point, therefore, of regularly communicating with their foreign franchisees to establish a connection and sense of community between the franchisees and franchisor, or hosting periodic franchisee conferences in the territory or region.

At the end of the day, although the agreement between the Area Representative and the franchisor requires the Area Representative to be the eyes and ears of the franchisor in the territory, the franchisor is responsible for delivering the support and services to the franchisees and is liable to the franchisees if they are not provided by the Area Representative.

Joint ventures

As mentioned above, a joint venture may be established for the purpose of becoming an exclusive Master Franchisee, an Area Developer, or otherwise. If a franchisor grants an exclusive license to a joint venture in which it is a joint venture partner, the joint venture would be the franchisor in the territory. Similarly, if a franchisor enters into an area development agreement with a joint venture in which it is a joint venture partner, the franchisor would remain the franchisor in the territory.

One of the most difficult aspects for novices in this area is separating their roles at any given time, an often esoteric exercise. While far more manageable in the context of an area development agreement (because the joint venture is the only franchisee), franchisors who also are part of a joint venture must manage their very distinct roles and responsibilities and remember that the franchisees in the foreign territory are franchisees of the joint venture.

Factors In Evaluating International Franchising Structures

1. Ease of entry

The possible structures of international franchises vary greatly in terms of the amount of effort a franchisor will have to devote to developing its brand in a new region.

Direct franchising

For a franchisor to engage in direct franchising in a new country or region, significant resources have to be devoted to creating an infrastructure including establishing a location or locations in the country and hiring personnel, in addition to the necessity of learning about the market itself. Any franchise laws have to be dealt with directly by the franchisor and there is no independent person or group to rely on with experience in franchising a new concept in the country.

If the franchisor already has a worldwide presence or has established company-owned businesses in the country or region, then there will be less difficulty for the franchisor to establish a presence and begin franchising directly. As noted below, the advantage of doing so may be increased reward in terms of retaining the financial benefits of operating the system. It may also lessen the impact of fluctuations in the currency exchange rate.

Joint ventures

In the continuum of the amount of effort necessary to enter a new market, the next most burdensome structure would be a joint venture with a local business group to operate and franchise the concept. This will likely reduce the capital investment that the franchisor has to make. It also create greater incentives for the local participants in the joint venture by creating an equity structure in which the local party participates. In contrast to direct franchising, in which the franchisor hires knowledgeable personnel, participating in the profits generated by the joint venture may create greater incentives to the local party.

The burden of complying with applicable law and establishing a physical presence in the country will still be borne at least in part by the franchisor. Therefore, while this structure may make it easier to enter a market than direct franchising would, it will still involve the necessity of establishing a local presence and picking a knowledgeable partner.

Area representatives, area development agreements, exclusive master licenses and hybrid arrangements

In all of these structures the franchisor is relying on a third party to be its "feet on the ground". Often, the local developer will bear most of the expenses of creating a presence in the market, adapting the program for the local market and hiring and training sales and operational personnel. In some structures, the local partner will also be developing the individual franchise businesses. Therefore, the franchisor's capital investment is greatly reduced. The due diligence necessary to select the third party with which to enter into the relationship may be the most crucial decision to make and involve the most effort and expense on the part of the franchisor.

This is one of the reasons that Exclusive Master Licensing has been so prevalent in international franchising. Indeed, even if the relationship between the franchisor and a third party is structured in another manner, the parties will frequently refer to the local party as the "Master Franchisee." These other structures, which are increasingly used in the international context, reflect the increased sophistication of franchisors expanding internationally and their analysis of structures that may work better in some regions than others.

2. Ease of operations and quality control

The structure of the relationship between the franchisor and its in-country operator can affect a number of operational issues that may arise internationally. Following is a list of some of them and the impact different structures can have on them.

Currency fluctuation

In administrating international franchise expansion it is important to consider the volatility of a currency in a country in which franchise operations are targeted. Factors that can contribute to demand for currency include inflation, interest rates, the economic outlook for a country's economy, its monetary policies, selling activities of speculators and the strength of the country's domestic economy.

Of course, with long term relationships in the international market, a currency may be stable at the initiation of a franchise relationship but destabilize over time. Due to the long term nature of many development contracts the concern may be that during the next 10 to 20 years the situation may change and the currency may destabilize.

The approach of many franchisors in response to this issue is to do nothing. Many development and franchise agreements provide for the conversion of currency for payments on a date certain relative to the due date for that payment and with reference to a bank rate or other published rate that is easily accessible. This is predicated on the belief that the ups and downs of the positions of the relative currencies will even out over time. Theoretically the parties could also agree upon a fixed exchange rate for a portion or all of the term of the contract.

Another approach might be to increase global involvement to expand into a number of markets so that no one market will affect the franchisor's bottom line materially. Owning assets abroad can obviate the need of the franchisor to convert currency until a favorable rate is available. Long term contracts with suppliers in local markets can also fix the costs of doing business and establishing banking relationships with financial institutions in the country in which the franchisee is operating is another possibility if it makes business sense.

The structure of the franchised operations can be a factor in addressing currency fluctuation. For example, the company engaged in direct franchising will likely have assets and a presence in the country or the region in which the franchised activity is taking place. Therefore, this franchisor will be able to time currency conversion to periods of time within which the conversion rate is favorable to the franchisor. It can structure the franchise so that no conversion is necessary in order to make payments to the franchisor. Conversely, relying on Area Representatives or Area Developers may make entry into the market easier initially, but it would raise long-term issues such as currency fluctuation. This could have a serious effect on the profitability of international franchise operations for the franchisor.

Quality control

Maintaining quality control is more difficult if the international franchise system is structured to rely on multiple layers of operators. Therefore, the structure that poses the most difficulties in policing quality control is establishing an Exclusive Master Licensee which in turn subfranchises the right to operate the franchised businesses. Although it is easy to deal with these issues contractually, from a practical point of view it is difficult to exercise control over the subfranchisees if the master licensee is not enforcing operational standards to the franchisor's satisfaction. Moreover, the resources necessary to enforce brand standards effectively and the possibility of facing dispute resolution procedures in order to force the operators and the master licensee to comply with standards may reduce the desirability of this traditional structure.

The impact of failure to enforce brand standards can be devastating. The damage to the brand that does not maintain its reputation in a region may have a deleterious effect not only in that particular geographic region but in other areas as well.

Quality control is most easily enforced in the direct franchising or joint venture settings since the franchisor can plan to have active control over any operations the joint venture conducts. The franchisor can also establish a direct privity of contract with any franchisees operating in the region, thus making enforcement of standards easier.

Expectations of the parties

As noted above, no matter what the structure ultimately chosen by the parties, there is a tendency to refer to international participants as "partners" or "Master Franchisees". The business people who begin negotiations are likely to be discussing business issues such as the length of the relationship, the territory to develop, the fee split and who will be doing what. It is unlikely that they will concentrate on the specific structure that the legal relationship will take. Thus, when it comes time to document the relationship, one party may have a very different idea of how the arrangement should be structured than the other party.

Compounding this issue is the frequent desire of a local developer to set up the relationship in a structure with which the developer has experience and is comfortable, rather than exploring whether a different structure is warranted. The franchisor, on the other hand, may also bring its experience to bear and often simply wants to replicate its domestic structure in the international market. The legal climate of the country or region may also make one structure more desirable than another because of the local regulatory structure, the ways local courts have dealt with franchises in the past and tax considerations.

3. Knowledge/application of territorial preferences

Knowledge of territorial issues on an international basis is an area crucial to the structure of the international franchise system. Ethnic and political conflict and the potential for this conflict is one of the prime considerations.

Analyzing the ethnic makeup of a country, the history of conflict among ethnic groups, the organization and structure of the ethnic groups and the history and propensity for unrest can be very important in structuring a franchise. For example, structuring a development territory along ethnic lines so that only one group or tribe populates the territory may be preferable to defining the territory by more traditional means such as by state, province, county or other political demarcation. An indigenous developer ownership structure will likely permit operations with less disruption than if a territory contains potentially warring groups. It may even mean cross border territories involving portions of two or more countries since political boundaries may not be the same as the ones binding ethnic groups.

The effects of ethnic conflict can be devastating. Conflict can lead to fractionalization of a society which in turn can weaken the institutional organization of a country's government and economy. A weak infrastructure may mean that it is difficult to locate suppliers and to source items necessary for the business. The absence of paved roads or the failure to maintain those roads, rail lines or other methods of transportation can make supply difficult or unduly expensive, affecting the ability of the franchisees to conduct financially efficient businesses. In addition, instability can lead to the risk of expropriation. While dealing with language and cultural issues with an overseas franchisee can be challenging, consider the implications of dealing with a franchisee that is a government entity as a result of its seizure of a franchisee's business.

The effects of ethnic conflict are not just internal. Since political boundaries do not necessarily define ethnic groups, the mistreatment of a group in one country can affect that country's relations with its neighboring country in which members of the group are also living.

All of these considerations may influence how the parties structure their relationship. If it is important to observe ethnic and cultural traditions in the region, it may make more sense for the local party to be the face of the franchise, and to represent the franchisor. As a result, the parties may opt for an area development agreement or a hybrid structure.

In other areas, the presence of a "foreign" franchisor may help avoid local tensions by having a neutral third party represent the concept. A joint venture or direct franchising may be more desirable in those circumstances.

4. Risk/reward

Ultimately, the goal of the franchisor in expanding internationally is to generate more revenue, both by operation of the business and by expanding awareness of its brand. If revenues from operation of the business in the new territory are of paramount importance, the franchisor may be more likely to want to expand through direct franchising in which it does not have to share its revenues with any third party. However, as noted above, this will likely involve a greater investment at least in the beginning, and, therefore, create more of a risk if the effort fails.

Less risky is relying on a third party to expand operations. The local party can reduce the initial investment by the franchisor and secure the efforts of a knowledgeable local operator to introduce and grow the franchisor's concept in the new market. One of the consequences of obtaining this assistance is that the franchisor shares the revenue with this party, making the venture less attractive from a financial perspective. Creating international awareness of the brand may create other international opportunities, however, which can in turn generate additional revenue for the franchisor in other markets.

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