Negotiating an International Deal – Getting to "Yes" for Long-Term Success

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I. Introduction

No two negotiations of international franchise agreements are the same. There will always be a negotiation of the terms of the international agreement and the "take it or leave it" approach that franchisors often adopt in relation to their domestic franchise agreements will not work for international deals.

A number of factors will impact on the bargaining strength of the parties. These may include:

- the franchisor's success in franchising in its home territory and in undertaking international franchising;
- the parties' evaluation of just how attractive the target market is for the relevant products/services;
- the proposed terms of the draft franchise agreement; and
- the franchisee's position including:
  - its track record in relation to the particular product/service sector and/or franchising;
  - its financial strength or weakness.
  - its access to high-quality real estate.

Many other factors will have an impact on the negotiations. They could include:

- The size and sophistication of the parties.
  - Generally speaking, larger and more sophisticated franchisees bargain harder.
  - The greater the franchisee's investment, the more likely that it will bargain hard.
- The degree of urgency.
- The parties' philosophies toward negotiating franchise transactions.

II. The Franchisee As Special Purpose Entity

A. Franchisor's Preferences

Many franchisors prefer that the franchisee entity be a newly formed company whose only activity will be the conduct of the franchised business. This might strike a prospective franchisee as an unjustified intrusion into the
franchisee's decision-making process. However, there are legitimate reasons for a franchisor to require this:

1. **No Liability from Prior or Future Activities**

   If the Franchisor grants franchise rights to an existing entity that has other operations, that entity will certainly have liabilities incurred in its other operations that could be a drag on the development of the franchised business. For example, the franchisee might be tempted to divert revenue or capital from the franchised business to its other activities, thereby risking a delay in the development of franchised outlets. There is also the risk that the assets of the franchised business could be pledged or encumbered to secure debts arising in the franchisee's other activities. Moreover, in the worst-case scenario, if the ancillary activities are unsuccessful or incur steep losses it is conceivable that those losses could render the entity insolvent, thereby ruining the franchised operations.

2. **Management Distractions**

   If the franchisee entity is a special purpose vehicle and its management and staff have no involvement in the operations of the franchisees affiliates, they will be able to focus solely on developing the franchisor's brand with the attendant benefits for both the franchisor and franchisee.

3. **Insulates Franchisors Confidential Information**

   In principle, if the franchisee is a special purpose entity, it should be easier for the franchisee to protect the franchisors trade secrets. If, on the other hand, the franchisee entity had staff involved in other businesses, it could well be more difficult to limit access of those employees to the franchisor's information.

4. **Facilitate Buy-Outs**

   Most franchise agreements give the franchisor an option to purchase the franchisee's business via a right of first refusal upon transfer of the franchisee's operation, and upon exploration or termination of the franchise agreement. Some agreements go further and give the franchisor an option to buy-out the franchisee at certain other times and under certain negotiated terms. If the franchisee is a special purpose entity, these purchases will be facilitated. For example, if the franchisor wishes to purchase the shares or other ownership interests in the franchisee he can simply buy 100% of them. If the franchisor prefers to purchase assets, he can certainly do that, whereas, if the franchisee had other operations, the parties would have the challenge of determining
which assets belong with the franchise business and would be subject to purchase by the franchisor.

B. Franchisee's Preferences

Franchisees frequently take the view that how they manage and structure their business is a matter for them and not for the franchisor. In other words, the franchisor imposing a management/corporate structure falls the wrong side of the line if a franchisee is truly operating an independent business, albeit one that is regulated by a franchise agreement.

There are many reasons why a franchisee would want to have control in this area, but they would include the limited availability of suitably qualified management. The franchisee may simply not have the luxury of a large management team with some of the members of that team devoting themselves exclusively to the franchise business. Secondly, the franchisee may believe that there are cost savings to be obtained in, for instance, amalgamating a back office function of separate businesses in one legal entity. Thirdly, the structure proposed by the franchisee, if it envisages the insertion of the franchise business into an existing non special purpose vehicle company, may suit that franchisee’s reporting requirements both in terms of management reporting to the ultimate parent company’s board of directors or external reporting to investors. Finally, franchisees may have established a group structure with, for instance, an eye to minimizing tax and would not wish to create an additional tax burden by changing the structure if that structure is less tax advantageous.

C. Possible Resolutions

1. Parent Company Guarantees

If a franchisee offers parent company guarantees in relation to the activities of the trading company operating the franchise, then concerns about the effect of other trading activities impacting on the franchise business could be reduced and, certainly, the impact of an insolvency of the franchisee arising from reasons that have nothing to do with the franchise business but are linked to its other trading activities can, to some extent, be addressed.

2. Division

It may be possible, although the drafting would be far from straightforward, to oblige a franchisee to transfer the franchised business assets in certain circumstances such as the poor performance of the other trading activities carried on by the franchisee. If this were done there would have to be reporting obligations on a franchisee in relation to the other trading activities which, of course, the franchisee may be reluctant to do on the basis that the franchisor would receive confidential information about trading activities that are not directly linked to its own business.
It may be easier for a franchisor to negotiate an obligation to create a separate franchise business entity on a transfer or termination although such an approach would add additional complications and cause delays in situations where speed may be of the essence. Further, there may be challenges from the franchisee’s bankers (whether or not they are holders of security) and local insolvency laws may also restrict such a restructuring on an insolvency.

3. **Chinese Walls**

If the franchisor has concerns about confidentiality because of the franchisee’s other trading activities, franchisees can, in addition, to the usual confidentiality obligations you would expect to find in a franchise agreement, add specific obligations to create Chinese walls by, for instance, using different accounting staff, separating office space and so on.

III. **Franchisee Group's Involvement in Competing Activities**

It sometimes happens that the franchisee is a substantial group of companies with existing businesses that are competitive with the franchisor's concept to a greater or lesser degree. For example, the franchisor’s concept might be a quick service hamburger restaurant and the Franchisee group may have both a chicken sandwich change and a casual dining business that sells hamburgers. Or the franchisor's concept might be a blue jeans boutique and the franchisee group might own department stores that sell jeans.

A. **Franchisor's Preferences**

1. **Special Purpose Vehicle**

   As discussed above, the franchisor would likely prefer that the franchisee form a new special purpose entity to act as the franchisee in order to insulate the franchisor's hamburger/blue jeans expertise from the franchisees casual dining/department store business. The franchisor would want a franchisee’s personnel involved only in the franchised operations and not in the Franchisee group's competing operations.

2. **Confidentiality**

   The franchisor might want to bolster its standard confidentiality provisions to make explicit that there must be no "leakage" of the franchisor's know-how into the franchisee's competitive operations.
3. **In-Term Non-Competition Clause**

The franchisor will be concerned about the competition from the franchisee group's of other operations and so will want the broadest non-compete that is enforceable.

4. **Post-Term Non-Competition Provision**

As with the in-term non-competition clause, the franchisor will want the broadest possible post-term restrictive covenant as well.

B. **Franchisee's Preferences**

Franchisees take the view that existing knowledge and involvement in the relevant market is an advantage to the franchisor because it reduces the period of time it will take the franchisee to get up to speed in terms of that particular market. Further, the franchisee will be able to use existing trade contacts which may include suppliers, landlords, property consultants and so on to speed up the roll out of franchise outlets. Franchisees also argue that if they are experienced in that particular market sector and yet they are willing to take on and expand the franchise business in their territory, this is a clear indication that a knowledgeable operator believes that the franchise business will fill a gap in the market. As a result franchisees do view an existing market involvement as an advantage to franchisors and franchisees seek to minimize any of the perceived disadvantages to the franchisor in such existing involvement so that:

1. **Confidentiality**

As previously indicated creating a special purpose vehicle with reporting obligations to a parent company does not protect a franchisor's confidential information which could be dealt with by way of Chinese walls. Having said that franchisees would generally argue that all that is required are confidentiality obligations that apply only to the dissemination of confidential information outside the franchisee group and that Chinese walls would unnecessarily restrict the sharing of information and experience within the franchisee group.

2. **Competition Provisions**

Very few franchisees would be willing to take on a new franchise business on the basis that their existing involvement in a similar or competing business was abandoned/transferred and clearly if this was required this would be likely to be a deal breaker.
C. Possible Solutions

1. **Limited Future Competition**

Franchisees with existing competing or similar businesses may be prepared to accept restrictions on future expansion with competing concepts provided that such concepts are narrowly defined.

2. **Options to Purchase**

Franchisees who wish to have a free hand to be involved in whatever similar business they choose may be prepared to accept an option in favour of the franchisor to increase the development obligations on the franchisee if it becomes involved in a competing obligation or may agree to a purchase option in favour of the franchisor based on a pre-agreed formula.

IV. **Exclusivity**

A. **Franchisor's Preferences**

In order to preserve maximum flexibility for other business models and methods of distribution in the future, most franchisors prefer to grant only a narrow exclusivity for only the precise business model being franchised. Thus, a franchisor’s preferred position would include:

1. **Exclusivity limited to the licensed brand only**

   The Franchisor would be free to operate, or license a third party to operate, under the franchisor’s other brands, or brands of its parent or affiliates.

2. **Exclusivity only during active development**

   A franchisor may only be willing to grant territory-wide exclusivity while the franchisee is still actively opening outlets. If the development schedule expires, the franchisor may want the area-wide exclusivity to be terminated and replaced with limited exclusivity around each outlet.

3. **Limited to the licensed distribution channel / operation format**

   For example, if the franchise is only for dedicated, branded bricks-and-mortar outlets, the franchisor would want to limit the exclusivity to that business model, thereby retaining for itself other distribution channels such as department stores, and e-commerce.
4. **"Special venue" carve-outs**

The franchisor may want to carve out from the exclusivity granted so-called "special venues." These would include food service locations in airports, food courts, along limited access highways or on college campuses. For a retail concept, the franchisor might carve out "shop-in-shop" locations in department stores.

5. **"Acquisition and re-branding" carve-out**

It is not uncommon for a franchisor to retain the right to acquire a competing chain in the franchisee's territory and to have the right to re-brand those purchased outlets, which would then operate in competition with the franchisee's outlets.

### B. Franchisee’s Preferences

Franchisees do not want to incur the very substantial costs of creating and developing a new market to find that the franchisor has reserved to itself elements of the offer which would simply "piggy-back" on to the franchisee’s efforts. Moreover, the franchisee does not want to be in competition with its franchisor.

1. **Covers all franchisors and its affiliate brands**

While few franchisors would, as part of their strategy, create new brands simply to compete with their overseas franchisees, that possibility should be addressed in the franchise agreement. The relative ease of creating a new competitive brand was demonstrated by Burger King’s creation of the Hungry Jacks brand in Australia and the success of that brand – although that was done because a "pirate" had prior rights to the "Burger King" name in Australia, not for the purpose of competing with its Australian franchisee. A more likely scenario is where the franchisor has a number of brands in the same market sector. The franchisor will have access through the franchisee to valuable market information. Franchisees will, no doubt, argue that development schedules and other obligations would have been accepted by the franchisee on the basis that those brands were not competing in the franchisee's territory. Further, in some jurisdictions "good faith" obligations may make it difficult for a franchisor to take steps that would reduce the franchisee’s ability to comply with contractual provisions by becoming an active competitor.

2. **Covers all of the distribution channels and operation formats**

In the absence of good reasons, franchisees will struggle to accept that the franchisor should retain the benefit of the franchisee's activities in a territory. Those good reasons may be existing relationships, pre-
existing contracts or a desire by third parties to deal only with the head office – perhaps because of the size of the potential contract.

3. **No carve outs**

Franchisees will want to benefit from all possible uses of the brand and similar brands because they have created the market in that territory albeit with the franchisor’s brand and know-how.

C. **Possible solutions**

1. **Tailored carve out/differentiation**

   Carve-outs for "special" venues are common in the United States because the market for operating foodservice facilities in special venues such as airports, food courts and sport venues is dominated by a small number of large companies. Many airports will only deal with these major players and so in many instances a franchisor may only be able to place its brand in an airport if it grants a franchise to the large, national foodservice operator who has received the exclusive right to conduct all foodservice operations from the airport authority. In those cases it would make no sense for the typical independent franchisee to have an exclusive territory that includes the airport.

   Outside the United States, however, the market for foodservice in such special venues is not nearly so dominated by major companies and so this topic takes on a different aspect there.

2. **Right of first offer – Refusal**

   A franchisor would be most concerned about agreeing either to exclude competing brands/other brands from a particular market or to offer those brands only to the franchisee. The franchisor wants the franchisee to stay focused on making brand A a success and not be distracted by brand B unless, of course, the franchisor is persuaded that the franchisee has been:

   (a) Successful with brand A;

   (b) Has the financial wherewithal to succeed with other brands; and

   (c) Has the managerial wherewithal to succeed with other brands without having a negative effect on brand A.

   It is, in practice, unlikely that a franchisor would offer an incumbent franchisee a right of first offer/refusal without conditions relating to the above. Further, franchisees who decide not to take up the franchisor's
offer may seek to include in the franchise agreement a reduction in continuing fees/development obligations.

In relation to alternative distribution channels which a franchisor wants to carve out, again a compromise position may be to offer franchisees a right of first offer.

3. **Revenue sharing**

A franchisee may accept, for the reasons set out above, that the franchisor is better placed to develop other distribution channels, but would seek recognition for the efforts that the franchisee has made in creating/enhancing the market in that territory by way of either fixed payments or, more likely, a percentage of the revenue earned by the franchisor. The franchisee is in a stronger position to achieve this if the franchisor requires the franchisee’s supply chain contacts and information to assist in the alternative distribution channels it reserves to itself. Clearly in this scenario the franchisee would want to be reimbursed for services it provides to assist the operation of the alternative distribution channels. These services could, for instance, include dealing with product returns and excessive inventory disposal for the franchisor.

V. **Development Obligations**

A. **Franchisor’s Preferences**

If a franchisor is to grant exclusivity to the franchisee, in return it will demand a minimum level of development by the franchisee in the territory, usually expressed in a development schedule requiring cumulative minimum numbers of outlets to be open and in operation at various check points, usually during the term of the franchise agreement. In that case, the franchisor would normally be looking for:

1. **Fixed time periods**

That is, periodic deadlines throughout the agreement term by which specified cumulative minimum numbers of outlets must be open and in operation. In addition, some franchisors will require that the franchisee meet certain minimum gross revenue targets as well and, in a product distribution franchise, there may also be a requirement to purchase minimum amounts of the franchisors branded products for resale.

2. **Consequences for failure to develop**

Since the development schedule would normally be drafted as a covenant to achieve the minimum level of development, failure to do so would be a breach of the agreement. Depending on how the agreement is drafted, that failure may be grounds for termination or it may simply give
rise to a claim for breach of contract. Some agreements will provide lesser-included remedies for the franchisor. These might include the franchisor's right to shrink the exclusive territory or to withdraw exclusivity altogether.

B. Franchisee's Preferences

Many franchisees are aware of the frequency with which development schedules are not met. The negotiation process itself encourages an overly enthusiastic approach to what, in development terms, can be achieved. Franchisors are much more attracted to franchisees who believe that a large number of outlets can be opened in a relatively short period of time than a franchisee who adopts a more cautious approach. Further, a franchisee's willingness to accept challenging development schedules will be influenced by a number of factors:

- its level of confidence based on its development track record with other brands;
- the availability of suitable real estate; and
- the consequences of failing to achieve the development schedule. The more negative to the franchisee the consequences are, the more "realistic" the franchisee will want the targets to be. Deeply unattractive to franchisees are provisions which envisage that the franchise agreement will be terminated for failure to achieve the development schedule and/or the franchisor will be entitled to damages for any such failure.

1. Agree on the end result, but flexibility for interim targets

International franchise agreements usually last for ten to twenty-five years and, as a result, predicting development schedules over such a period of time is, at best, likely to involve a fair degree of guess work. This means that from a franchisee's point of view the failure to achieve, in any one year, that year's development schedule should not give rise to rights in favor of the franchisor. Franchisees will argue that such rights should arise only after two to three years of failure to achieve the contractual development obligations.

2. Higher bar to constitute development failure

Franchisees have no objection to having target development schedules or, indeed, obligations on franchisees to use their reasonable endeavors to achieve the target development schedule, but the rights in favor of the franchisor in relation to a failure to achieve the development schedule should only kick in if either the franchisee is not using its reasonable endeavors to achieve the development schedule or the failure is by more than a stated percentage of the required development target.
3. **Opportunity to cure**

The opportunity to cure can either be to roll over any failure into the following year or to pay compensation for the failure usually based on what the franchisor would have received in terms of continuing fee payments in respect of the unopened outlets. The latter is usually unattractive to franchisees who argue that any payments to the franchisor in such a scenario simply reduces the capital available to the franchisee to expand in the target territory.

4. **Carve out for landlord/construction delays**

In some jurisdictions such as the United Kingdom, the availability of suitable sites/premises and obtaining planning permission (zoning consents) is a frequent cause for delay. Franchisees may seek to argue that if they have a site which has been approved, that site can be provisionally added to the development schedule because the franchisee has no control over the speed at which the landlord/planning department works.

5. **Carve out for economic downturn/civil unrest**

Clearly issues relating to civil unrest are of more significance in some jurisdictions than others, but franchisees are always uncomfortable about rights, especially rights to terminate or to seek damages, that can arise through circumstances beyond their control and will generally seek comfort that causes beyond a franchisee's control which have a negative impact on the achievability of the development schedule should result in a decrease in the development schedule, perhaps with an additional proviso in favor of the franchisor that the decrease only applies if the franchisee continues to use its reasonable endeavors to achieve the schedule.

6. **Preservation of the developed units if development rights terminate**

Generally speaking all well drafted franchise agreements contain a distinction between the termination of the development rights and termination of the franchise agreement itself. A failure to achieve the development schedule normally results in the withdrawal of the ability to open additional outlets, but does not remove the already opened outlets from the franchisee's ownership which you would expect to arise only if the franchise agreement itself were terminated.
C. Possible Solutions

1. Fewer firm targets with additional "soft" targets

As discussed above increasingly more flexible development schedules are being introduced so that annual development targets are inserted for the first three years and then those schedules move out thereafter. Often, this approach is reinforced, from a franchisor's perspective, by continuing obligations on the franchisee to use its reasonable endeavors to continue to open outlets and to meet the objectives of the development schedule.

A further variation is to have different levels of "failure" which lead to different results. If "substantial" failure, then termination of exclusivity or of the agreement follows but if "close but not 100% failure," then additional cure periods are given.

2. Crisis trigger that will lead to discussions/renegotiations and immediate termination.

Clearly, in view of the frequent failure to achieve development schedules in international franchise agreements, an approach that simply ignores the likelihood of such failure makes little sense. The reality is that the termination of the franchisee's development rights is likely to have negative consequences for the franchisor as well as the franchisee. As a result, inevitably discussions take place and if that is indeed the case the agreement should reflect what is likely to happen in practice. The difficulty particularly from a franchisor's perspective is how to capture the commercial reality of a discussion and renegotiation in a legal document and also not to thereby lessen the franchisor's rights to take action against a franchisee that is not in fact devoting sufficient resources to achieving the development schedule.

3. Equitable treatment of the developed units: Continue operating with store based exclusivity only.

In the authors' experience, this is a common and sensible approach that represents a fair way to address the admittedly very legitimate interests of both franchisor and franchisee.

4. Modified/reduced exclusivity if fall short of development schedule

As with many of the topics addressed in this paper, the nature of a good resolution will depend on the specific reasons for the shortfall in development and all the facts and circumstances. It may be that the parties have come to realize that exclusive territory is simply too large for a single franchisee and that it needs to be divided into two or more parts.
That would require withdrawing some part of the territory from the existing franchise agreement and awarding it to a new franchisee. If the pre-existing franchisee has outlets in the area being hived off, perhaps those units could be sold to the new franchisee.

If, on the other hand the shortfall is due to insufficient resources on the part of the franchisee, reducing the franchisee's territory might again be a solution.

VI. Dispute Resolution and Governing Law

A. Franchisor's Preferences

There are any number of reasons why a franchisor is attracted to the law and courts of its home territory applying to a proposed international franchise agreement. The franchisor has worked closely with its own internal and external lawyers and developed a strong rapport with them. Those lawyers will understand the franchisor's business and have substantial experience in understanding the franchisor's approach. No franchisor wants to incur the cost of re-educating lawyers. Further, the franchisor and its legal team will know the law of the home territory but not of the target country. Also franchisors may not want their international agreements to be governed by the law of multiple jurisdictions because this causes administrative issues. Finally, of course, the franchisor is usually entirely happy that the courts of its home territory will be fair and may be less persuaded about the courts in the target country.

The international franchise agreement is, of course, the franchisor's document and the use of a document in the franchisor's mother tongue emphasizes that and facilitates the franchisor's ability to work with the document.

Nevertheless, the involvement of target country lawyers cannot be avoided. In all cases even a franchise agreement subject to the laws/courts of the franchisor's home territory should be reviewed by local franchise counsel to ensure that it does not breach any mandatory rules in that jurisdiction and conforms to that country's approach to franchise agreements.

As a result a franchisor will often have very fixed ideas on the subject of dispute resolution and governing law. These frequently include the following:

1. Exclusive (or sometimes non-exclusive) jurisdiction of specified courts in the franchisor's home country

While some of the franchisor's motivation here may be a knee-jerk reaction to insist that it's home country law govern the agreement, there are also legitimate legal reasons for taking that position. First, the form of agreement will have been drafted under that law and, if the franchisor were to agree to the franchisee's home country law, the franchisor would need to have an in-depth review of the agreement done by counsel in the franchisee's country. Furthermore, franchisors usually wish to have all of
their agreements governed by the same country’s law so there would be, in theory, a common interpretation of all of its franchise agreements, as opposed to having each one of its franchise agreements governed by the various laws of its franchisees’ home countries.

2. **Arbitration/Litigation on franchisor’s home turf**

   Many franchisors shrink from the idea of having to conduct a legal proceeding in a foreign country to enforce their rights against the franchisee. They will often have a fear of the unknown when contemplating going in front of a judge or arbitrator in a foreign country. That fear may or may not be justified in any given case. Most franchisors, if well advised, will consider and indeed include in their franchise agreements an arbitration clause. This is especially true for U.S.-based franchisors because the United States is not a party to any treaty for the enforcement of U.S. court judgments. Therefore, an American franchisor who obtained a court judgment in the United States would have no assurance that that judgment would be enforced in the franchisee’s country. On the other hand, the United States and most of the countries in the world are parties to the United Nations Convention on the Recognition and Enforcement of International Arbitration Awards. U.S. Code / Title 9 – Arbitration / Chapter 2 – Convention on the Recognition and Enforcement of Foreign Arbitral Awards (§§ 201 to 208). That convention provides that an arbitration between two residents of two different countries which are parties to the convention will have the resulting awards enforced in the losing party’s jurisdiction with only limited exceptions, such as lack of due process or public policy considerations under the laws of the country of enforcement.

B. **Franchisee’s Preferences**

   1. **Home jurisdiction law**

      Curiously, franchisees may not have strong objections to using the franchisor's home jurisdiction law, but much will depend on the reputation of that jurisdiction’s laws. In relation to the United States, for instance, there is substantial fear in relation to costs, the litigation culture, the extent of discovery/depositions, jury trials and the level of damages awarded.

      Further, franchisees would have to appoint lawyers in the franchisor's home jurisdiction to advise and for precisely the reasons set out above in relation to a franchisor working with a new and foreign legal term, that may be unattractive.

      The major benefit from a franchisee’s perspective of litigating/arbitrating using the franchisor’s home jurisdiction is that it may make bringing proceedings against the franchisor easier and conversely
the bringing of proceedings against the franchisee harder. Unless one of
the parties has assets in the jurisdiction in which the dispute is to be tried,
the court's decision would have to be enforced by separate proceedings in
the jurisdiction where the losing party has assets.

2. **Arbitration/litigation on the home turf**

Franchisees will often have the same "knee-jerk" reaction that
franchisors have on the subject of choice of law/courts applies to a
franchisee although that reaction is not necessarily the most sensible.

C. **Possible solutions**

1. **Contractually-mandated settlement meetings**

Customarily, international franchise agreements envisage that the
senior executive officer or equivalent person from both parties should
meet initially in order to seek to resolve issues. The venue of such
meeting can cause much discussion and, very often, a neutral location is
agreed, but this may give rise to logistical problems in terms of organizing
the meeting. In view of the importance of resolving issues that can lead to
litigation at an early stage, a better solution may be for alternative venues
to be chosen so that in relation to the first face to face meeting to resolve
a dispute it is at the franchisor's premises, subsequently at the
franchisee's premises for the second and so on. An alternative is that face
to face meetings are arranged at the franchisor's premises but the
franchisee's travel, accommodation and other costs are reimbursed. When
a meeting takes place at the franchisee's premises the franchisor's costs
are reimbursed.

2. **Mediation in a neutral jurisdiction**

In many jurisdictions mediation to resolve disputes is strongly
encouraged as part of the civil procedure in that jurisdiction. In the United
Kingdom, for instance, a party who fails to participate in mediation is at
risk of having adverse cost orders awarded against it if litigation ensues.
In Australia the Franchising Code sets out how disputes are to be resolved
which gives the parties to a franchise agreement the right to refer the
dispute to mediation if the parties cannot agree on a suitable resolution
within three weeks. Mediation can also give rise to practical issues.
There could be a language problem with the mediator who would either
originate from the neutral territory or would have to be flown over from
another jurisdiction.

Here again, alternating from the franchisor's territory to the
franchisee's territory and/or payment of travel costs may be a better
solution.
3. **Arbitration in a neutral jurisdiction**

Clearly in considering arbitration it is important that the parties are aware of whether such arbitral awards are enforceable in the other party's jurisdiction whether pursuant to the U.N. Arbitration Convention or otherwise. If they are not then arbitration does not offer any advantages to the parties.

4. **Law of neutral jurisdiction as governing law**

Often in international franchise transactions involving on the one hand US parties, and on the other non-US parties, there is a fear, already discussed, concerning US litigation. In respect of franchise partners from common law jurisdictions, there may be a willingness to agree on the law of a neutral territory – very often the laws of England & Wales – but careful consideration has to be given to the implications of doing so. First, initial input is required, on behalf of both parties, from English lawyers in terms of the drafting of the documentation. Secondly the costs of litigation in England or any other jurisdiction has to be assessed. Litigation in England & Wales, for instance, may not be any less expensive than litigation in the US because generally the winning party is entitled to 60 or 70% of its costs losing litigation in England & Wales is an expensive business.

If a civil law jurisdiction is chosen, then a totally different approach to the drafting of the international franchise agreement is required which may prove challenging for a franchisor based in a common law jurisdiction.

**VII. Transfer Restrictions and Other Related Issues**

A. **Franchisor's Preferences**

A prudent franchisor will select its franchisees carefully, given that they are entering into an intimate and long-term commercial relationship. For that reason, franchisors are very uncomfortable with the prospect of a franchisee selling its business or assigning the franchise agreement to a third party whom the franchisor does not know. This leads logically to the typical franchisor’s position on the topic of such transfers:

1. **All transfers of ownership interest in the franchisee or of the franchisees rights under the agreement are subject to franchisor's approval**

The franchisor's approval would be in the its sole discretion.
2. **Certain preconditions must be satisfied**

Frequently the minimum conditions to the franchisor's approval would include payment of a transfer fee, certain minimum criteria to be met by the franchisee (e.g. financial resources, good character, no competing activities). Another condition that is frequently imposed is that the transferring franchisee would provide a release to the franchisor.

3. **Right of first refusal**

Virtually all franchisors provide that, where the franchisee proposes to sell its business or assign its franchise agreement, the franchisor will have a right of first refusal whereby it would have the option to purchase the franchisee's business rather than approving it for sale to a third party.

B. **Franchisee's Preferences**

As with any franchise arrangement franchisees are operating independent businesses albeit subject to contractual restrictions and obligations in the franchise agreement. Franchisees look to make operating profits from their franchised business as well as seeking the opportunity to make a capital gain on a sale. Franchisees, as a result, view restrictions on their ability to sell to a willing purchaser with caution.

1. **Limited to franchisee level transfers (i.e., no restrictions on ownership interests and especially indirect owners)**

International franchisees may be part of a multi-national group where the franchise business is operated by a subsidiary company. Clearly no substantial group (whether or not its shares are publicly traded) would be willing to accept any restrictions on the sale of the group and would consider such restrictions as potentially "the tail wagging the dog". Franchisees would, in such circumstances, invite franchisors to take a commercial view balancing, on the one hand, the advantage of an arrangement with a substantial and powerful group with, on the other hand, the possibility that such group may be subject to a takeover bid.

In relation to restrictions on the transfer of direct interests, any such restrictions would prevent, at the group parent company level, commercial decisions being taken for the benefit of the group. Within substantial groups the ultimate decision on investment returns and where commercial opportunities lie are made at the level of the ultimate parent company which must have a free hand on such matters.

2. **Limited to "controlled transfers"**

While franchisors have an interest in ensuring that their franchisees are ultimately owned by persons/businesses with whom they would wish
to have commercial dealings, all sorts of practical issues arise from restrictions on non-controlling transfers. Franchisees may, for instance, wish to incentivise/reward managers with shares and/or may wish, for perfectly understandable and respectable commercial reasons such as tax planning, to change shareholdings both within and outside the group. Franchisees, while recognizing the needs of the franchisor to approve ultimate owners believe that transfers of minority shareholdings, provided that cumulatively they do not amount to a transfer of control, should not be of concern to the franchisor.

3. **No precondition other than maintaining compliance with the agreement**

Franchisees may argue that all that a franchisor should be concerned about is compliance with the terms of the franchise agreement, operations manual and any other franchisor produced documentation. These documents contain detailed and specific obligations and provisions such that the franchisor is able to take action should a new franchisee take over and fail to maintain standards. The provisions in such documentation will continue and those provisions will not only protect the franchisor from operational poor performance but will retain the existing development obligations as well as provisions which would prevent the franchisee from damaging the franchisor's reputation. The reality is that that is all that the franchisor would need and that some arbitrary and subjective provisions which generally give franchisors a very broad discretion as to whether to approve or disapprove an incoming franchisee/owner are unnecessary.

4. **No right of first refusal**

The great majority of franchise agreements allow franchisors to match any offer received by a franchisee for their franchised businesses. On the face of it such provisions appear unobjectionable but can give rise to substantial practical challenges.

Options usually provide that the franchisor has a certain period of time in which to match any offer, often 30 days or more and that any changes to the offer received from the third party prospective franchisee has to be re-offered to the franchisor at which stage further periods of 30 or more days apply. This process makes the negotiation of a sale challenging and would, inevitably, act as a deterrent for an incoming franchisee.

A prospective purchasing franchisee may be reluctant to undertake the preliminary due diligence and other legal aspects required to enable the prospective franchisee to be in a position to put in an offer, knowing
that the franchisor was in a position either, on subjective grounds to withhold consent or to match any offer made.

5. **IPO rights**

Franchisees often seek to persuade franchisors that the downside of public ownership – the inability to be able to control take overs, whether hostile or friendly - is outweighed by the favorable publicity arising from an IPO and the opening up of avenues to additional funding routes which are not available to private companies. As a result franchisees argue that restrictions in relation to IPOs are inappropriate.

C. Possible solutions

1. **Differentiating between different owners**

With individual owners there is less concern about the restrictions on transfers given an individual owner's generally limited exit opportunities but at the other end of the spectrum with private equity owners – there is considerably more concern given their typical exit strategies.

2. **Focusing on control**

The key issue here becomes how "control" should be defined, and whether it should reach all the way up to the individual owner level. The answer will depend largely on the franchisee's profile and what it can "tolerate."

3. **Less restrictive with regard to inter-owner transfers**

If a franchisor has approved the initial owners the precise shareholdings within the approved shareholders would, on the face of it, appear to be something in respect of which the franchisor may not be terribly concerned. Equally, franchisees may seek to argue that precisely which company within a substantial group is the franchisee for the purposes of the franchise relationship, provided always that the financial stature of such company is equivalent, should be of no interest to the franchisor.

VIII. Guarantees

A. **Franchisor's Preferences**

Most franchisees incorporate a limited liability entity to sign the franchise agreement and conduct the franchised business. In many cases those entities are newly formed solely for the purchase of operating the franchised business. That is true whether the franchisee is an individual or a large sophisticated company. In the latter case, many franchisors prefer that the franchisee parent
company form such a special-purpose subsidiary that is dedicated to the franchisor’s brand. In both of those cases however the newly formed franchisee entity may be thinly capitalized and, in any event, the franchisor would be relying on the character and resources of the owners of the franchisee, be they individuals or a parent company. Consequently, the franchisors position often looks like the following:

1. **Personal/spousal/parent company/sister company guaranty**

Where the owners of the franchisee entity are individuals, most franchisors will require personal guarantees from the individual owners. This is true in purely domestic transactions, as well as in international transactions, although it is far less common for franchisees in international deals to be individuals. Where the franchisee is a larger entity, the franchisor would want a guarantee from the franchisee entity’s ultimate parent company so as to have the "deepest pocket" liable for the payment or performance defaults of the franchisee. In the case of a small "mom and pop" franchisee, the franchisor would want not only that back stop, but would also want personal guarantees to insure that the individual owners are deeply focused on the conduct of the franchised business.

2. **Bank guarantee/standby letter of credit**

Some larger franchisees will propose, in lieu of personal or parent company guarantees, a bank guarantee, whereby a reputable bank will guarantee payment of monies owed by the franchisee up to some fixed amount. Presumably, any bank that would consider such a guarantee, would require the franchisee to maintain on deposit with the bank an amount equal to the full face amount of the guarantee. Although bank guarantees are often discussed in this setting, the authors have not actually seen one used and so they do not seem to be a practicable solution. A far more common and more practicable solution is a standby letter of credit.

**B. Franchisee’s Preferences**

The issue of guarantees is often an issue that arises late in the negotiations. Franchisors’ commercial teams, when negotiating with international partners, focus on the operational issues and may not address what they consider to be technical legal issues either in those discussions or in the letter of intent.

The approach by franchisees to personal or corporate guarantees will, of course, to some extent, depend on the type of owner of that franchised business. Personal guarantees are most unlikely to be available from substantial groups although parent/sister company guarantees may be available.

Some franchisees will not wish to provide any guarantees to a franchisor
for any number of reasons. Care should be taken to ensure that a guarantee, which generally franchisors demand without considering the commercial realities, is appropriate either in light of the type of owner of the franchisee or the commercial relationship envisaged by the franchise agreement. If, for instance, the franchisor requires products to be purchased from the franchisor or its affiliates and those products form a significant part of the franchisee's business, without which the franchisee is simply not able to trade, then the franchisor is in a position to enforce credit terms which protect the franchisor. In such circumstances a personal guarantee may not be relevant so that, for instance, in the early part of the franchise relationship, a relatively short period for payment by the franchisee are imposed but, subject to continuing prompt payment, those payment terms are extended. An alternative is to emphasize in the franchise agreement that any failure to pay within payment terms will lead in the withholding of supplies unless payment is made with the purchase order. A yet further alternative approach, is to agree a guarantee period during the early part of the relationship after which the guarantee would fall away. The argument in favor of this approach is that the franchisee will, after an initial period of training, have sufficient assets available for the franchisor to take over on a termination of the franchise agreement so as to make a guarantee unnecessary. However, that would require legal proceedings in the franchisee's country.

1. No guarantees/phasing out guarantee after credit is established

Undoubtedly franchisees will argue against personal guarantees on the "standard" basis that when they operate a business through a limited company/corporation one of the advantages of doing so is to limit their personal liability. In addition, franchisees sometimes argue that incurring personal liability makes the franchisee less entrepreneurial and less willing to take risks in terms of opening outlets and other aspects because of the potential for personal liability if things go wrong. An argument frequently used is that in the target country personal guarantees are somehow not known or not given!

Whatever the arguments franchisors must face, almost inevitably franchisees will resist personal guarantees whether in relation to the financial aspects of the franchise or more generally, liability for breach of all operational obligations in the franchise agreement.

2. Monetary guarantee with a cap, with no performance guarantee

Franchisees also frequently argue that a performance guaranty (as opposed to a payment guaranty) is not appropriate or necessary in a franchise agreement – if the franchisee doesn’t perform, why should a franchisor expect its owners to?
Monetary guarantees with a cap as opposed to unlimited guarantees are likely to be much more acceptable to a franchisee. In this scenario franchisors need to establish what they consider to be their likely maximum exposure for products that they supply and unpaid continuing fees before which they would terminate the arrangement. The cap could be set at that figure.

3. **Guarantee of the franchisor's obligations**

Franchisees may well argue that if they are required to give a guarantee then so should the franchisor, especially if the franchisor is a thinly capitalized special purpose entity with all the post-sale services/products effectively being provided by the franchisor's parent or affiliates.

C. **Possible Solution**

1. **Focus on practical enforceability**

   As a practical matter enforcing guarantees in foreign jurisdictions can be challenging and alternatives to this need to be sought out. The danger from a franchisor's perspective of personal guarantees is that it may lead to a lack of financial vigilance on the basis that the franchisor has the backup of a personal guarantee. Instead, strict enforcement of the financial terms with a zero tolerance policy, linked with the ability to change credit terms if products are supplied and/or perhaps the ability to take security over the franchisee if payments are in arrears, may be a more effective approach.

2. **Standby letter of credit with modest amount with vigorous monitoring of on-going performance**

   This solution is essentially an enhanced version of 1 above. The challenge with letters of credit is that they are often expensive for franchisees on the basis that banks require the comfort of knowing that there are sufficient funds in the franchisee's bank account to cover any liability under the letters of credit. This usually entails franchisees paying or pledging assets for the amount of the letter of credit to the bank.

3. **Security deposit to cover purchases and royalties**

   Franchisors may instead be prepared to accept an upfront payment from the franchisee which the franchisor will set aside in a separate bank account, and will only use to off-set overdue amounts if needed. This is a not uncommon arrangements in some Far Eastern countries. The disadvantage from a franchisee's perspective is that its money is in effect "lost" to it in the sense that it is no longer available to the franchisee.
Further, the franchisee would have to have confidence that the franchisor will not simply help itself to the funds.

Another alternative is the giving of security over a franchisee’s assets whether at the beginning of the relationship or if sums become overdue. This is usually much more attractive to franchisees than personal guarantees or making a payment upfront to a franchisor. The challenge for franchisors is that, in reality, there may be relatively few valuable tangible assets for a franchisor to take security over. Further, a franchisor may take comfort from the fact that it would have the ability to take over a franchisee’s business or assets at an heavily discounted price on termination so security affords them no real advantage.

4. Upfront payment for goods

If product purchases from a franchisor are a significant element of the franchise offer the franchisor may reduce the risk of substantial unpaid continuing fees by lowering the level of the fees, increasing the price for the products and demanding payment for the goods with receipt of purchase orders. However this would likely increase the customs duties paid by the franchisee.

IX. Indemnities

A. Franchisor’s Preferences

In international transactions especially, franchisors typically desire a full indemnity from the franchisees for any third-party claims made against the franchisor or its personnel or affiliates that arise out of the franchisee’s operation of the franchised business and any actions the franchisee takes under the franchisor’s trademark. The franchisor’s view is usually, "We have granted you franchise rights and fully trained you and provided you our operations manuals. It is your responsibility to know the law, customs and culture of your country and to operate business properly according to our standards and in compliance with applicable law. Under these circumstances, any third party claims against us arising out of your (the franchisee’s) business are, virtually by definition, your responsibility and not ours and therefore you must indemnify us."

B. Franchisee’s Preferences

Franchisors, especially US based franchisors, attach considerable importance to indemnities from franchisees. Those indemnities can vary in scope and the extent of the indemnities will, undoubtedly have a major impact on a franchisee’s willingness to accept them.

Franchisees may be prepared to accept that they will indemnify a franchisor in respect of their own breach of contract or negligence although it is by no means clear the extent to which indemnities in that scenario add significantly to the franchisor’s ability to bring a breach of contract claim or a claim in negligence. As a matter of
English law, at least, the only difference between a contract/tort claim and an indemnity is that under an indemnity issues of causation may be of less significance so that the franchisor would not, for instance, have to prove that the loss was reasonably foreseeable and the franchisor may be in a stronger position to recover the payment of its legal costs.

Less desirable for a franchisee is an indemnity in favor of the franchisor for the actions of its agents, employees and sub-contractors. In this scenario an indemnity is potentially valuable for a franchisor who will have no contractual link with those third parties but franchisors argue that they have no control over those parties and so an indemnity is simply not appropriate.

1. **No indemnity**

   It is by no means clear why, in a franchise relationship, as opposed to any other commercial relationship, indemnities are appropriate. If a franchisor suffers loss as a result of the fault of the franchisee then the franchisor should bring a claim but there is no need to reinforce the franchisor's position with an indemnity.

   Further, franchisees may be particularly concerned about giving a US franchisor an indemnity in view of the potentially large awards made against franchisors by virtue, amongst other things, of the availability of class actions.

2. **Mutual indemnity including for trade mark claims**

   From a franchisee's perspective, the franchisee is buying a right to use a brand and access to know-how. If either of these elements is not available or is challenged by third parties, then franchisees argue that the reason for the substantial investment which they have undertaken ceases to exist and that such an eventuality is potentially so serious for a franchisee that it should be protected by an indemnity.

   Clearly, if a franchisor demands and indemnity it may be more challenging for that franchisor to resist a franchisee's request for an indemnity whether in similar terms to the indemnity proposed by the franchisor or for specific issues.

3. **No indemnity based on franchisor's negligence or complying with the "system standards"**

   Franchisees believe that all aspects of how they operate their franchise business are governed by the franchisor's operations manuals, instructions, legal agreement and know-how and that if the franchisor is simply complying with those obligations then it is wholly inequitable for the franchisor to be indemnified from effectively getting it wrong.
4. **Right to control defense and settlement**

A big risk for franchisees is that with an indemnity franchisors have no incentive to either defend or seek to compromise claims on beneficial terms. Indeed, franchisors may well see a benefit in being generous with any such claims in order to protect their reputation with third parties such as customers or suppliers. Franchisees will wish to have protection from this with the usual and largely standard provisions allowing the franchisee to control the defense and settlement of such claims.

C. **Possible solutions**

1. **Mutual indemnity but only for specifically enumerated types of claim**

   Blanket indemnities covering all possible losses that either party may suffer as a result of the other party’s actions or failure to act or the actions or failure to act of that party’s associated persons such as employees, are potentially so far reaching that it is unlikely that the parties would be willing to agree to such indemnities. Specific indemnities in relation to specific issues, however, are likely to be much less challenging for franchisees to accept.

2. **Limit franchisor's right to control defence and settlement**

   For certain claims, especially those that do not affect the brand image or the validity of the licensed marks, it would seem appropriate to give the franchisee the right to control the defence and settlement (as long as the settlement does not obligate the franchisor beyond any monetary payments, which the franchisee will pick up).

X. **Conclusion**

As this paper demonstrates, there is much for a franchisor and a prospective foreign franchisee to disagree about in a franchise agreement. In a typical transaction, the franchisee would be taking the risk of making a very substantial investment to establish the franchisor’s brand and develop outlets in what is typically an entire country. In that scenario, it is perfectly understandable that the prospective franchisee would push back on the franchisor’s form agreement. That is especially so in the instances where the franchisee is an established, substantial business that is not used to be told to “take it or leave it.” Thus, as was stated in the Introduction, negotiation in the international sphere is the norm and not the exception.

Given that reality, the challenge for counsel is twofold: to be a “zealous advocate” for your client, but at the same time, if your client really wants the deal, to find practical, businesslike resolutions to the issues that will inevitably crop up. That requires creativity, patience and persistence.
As this paper also demonstrates, there is no "one size fits all" resolution to the issues covered here and to the myriad of other issues that lurk in these transactions. Rather, the solutions that make sense in a given transaction will be dictated by the limitless variables that the parties may bring to the table:

- Is the franchisor small and unsophisticated and the franchisee substantial and savvy?
- Does the franchisee already operate in the sector?
- Will the franchisee sell online or only through physical outlets?
- What sector is involved? Lodging, retail, quick-service restaurant, car rental, etc.?
- Are operating costs in the franchised territory high or low?
- Are there political risks in the territory?
- Is either party under any financial constraints?

Each case is unique and the clever compromise devised for your last transaction may be dead on arrival at the next one because of vastly different circumstances.

Therefore, to be successful, franchise counsel must have the ability to study the peculiar landscape of each transaction and to be able to spot areas for potential compromise and creative solutions in order to help the parties to see why they might be able to flex on a particular issue without taking on undue risk. The goal being to complete the bargain in a way that the parties can feel good about; in other words, to help get to "Yes."