BASIC TRACK:
EXPANDING INTERNATIONALLY

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BASICS TRACK – INTERNATIONAL: EXPANDING INTERNATIONALLY

By
Marc Mushkin, Dominic Mochrie and Robert A. Smith

1. Introduction

Franchisors, both large and small, are increasingly interested in international expansion. Indeed, some companies that have not franchised domestically have turned to franchising to fuel their international expansion.

There are many good reasons for a franchisor to expand internationally. As domestic growth slows, international expansion creates a new source of incremental revenue for a franchisor and makes it less dependent on the domestic marketplace. International growth also increases the value of the brand, leverages the brand's intellectual property and creates the opportunity to enter markets that are less competitive. Many franchisors also believe that they can expand into international markets by leveraging their existing infrastructure and resources, which would help them efficiently obtain added revenue. Some franchisors want to expand into certain international markets because their competitors already have established a presence there, or they want to do so before their competitors do.

In addition, the global environment also makes international expansion via franchising an attractive proposition. Franchising, as a way of doing business, is increasingly popular around the world. A common driving factor for international expansion is unsolicited offers to develop the brand abroad. This is not a bad reason to expand internationally, provided the franchisor does the needed research to determine that the expansion could work. Research, planning and careful execution is critical. Without that, the risk of failure increases. These failures may have lasting repercussions not only in those specific markets, but to the franchisor’s international program as a whole.

2. Assessing a Franchisor’s Readiness for International Expansion

International expansion should not be undertaken unless the franchisor can conclude that its existing operations, brand, culture and domestic performance are ready. The following are among the factors that need to be considered before beginning international expansion:

A. Adequate Financial Resources to Support Expansion

Expanding into a new international market costs money — often, much more than the franchisor initially expects. The search for an appropriate local partner and due diligence on the target territory takes time and involves the outlay of travel costs, third-party fees and other out-of-pocket expenses. Local counsel and other advisors can also be expensive. Nevertheless, a franchisor should not try to save money on any of these steps and resources, as each of them will be critical to the success of the project.
B. Senior Management Buy-In

International expansion is not easy and it becomes even harder if senior management has not collectively bought in to the idea of diverting resources to international growth. In addition, the franchisor should consider its motivation for the expansion. For example, trying to shore up the franchisor's domestic financial picture by securing an influx of cash from international master franchise or development fees may seem tempting, but is generally not a sound reason to undertake a project of this magnitude. Similarly, the allure of travel to exotic locales and the perceived prestige of having an international brand should not be the driving force for the franchisor's senior management in making this critical decision. Rather than expanding helter skelter, a franchisor should develop a strategy for where it wants to expand and then seek to execute that strategy.

C. A Good Brand Identity

In order for a brand to be of interest to a franchisee in another country, it must have a clear brand identity. The concept must also be able to be replicated in another country. How well the franchisor's concept will work in a foreign jurisdiction is in part a function of factors that are inherent to the target market and the ability (and willingness) of the franchisor to adapt its system and customer offering to take into account those local factors. However, one must assume that the overall concept and most, if not all, of its core features will not change, and so the franchisor will need to assess its ability to replicate those core features in the territory, in large measure, using domestic know-how and resources. That assessment must take into account such factors as the geographic distance between the franchisor's home jurisdiction and the target market, the level of franchisee training that must be done at home and abroad in light of the relative complexity of the franchisor's system, and the availability of domestic resources to implement the required training and to support the launch.

In addition, the brand will not be successful abroad unless the financial and development model offers the franchisee the opportunity to achieve a satisfactory return on his investment.

D. The Ability to Provide Ongoing Support

The franchisor's commitment of resources does not end at the time of a (hopefully) successful international launch. Indeed, the franchisor should expect to be required to provide ongoing advice, support and training to its franchisees in the territory, and to monitor their progress and enforce the terms of their agreements throughout the duration of the system's presence in the foreign market. This may include regular visits to the territory, the monitoring of local and electronic media and perhaps even the establishment of one or more training centers in the territory. All of this, again, will require a level of commitment of time, effort and money that the franchisor should fully appreciate and be prepared to spend before proceeding with the expansion.
3. Strategic Targeting – Selecting the Countries for Development

A. Introduction: The Never-Ending Tension Between “Opportunistic” or “Reactive” Franchising and “Strategic” or “Proactive” Franchising

It has often been noted that most companies find themselves entertaining international opportunities because of a chance encounter on a flight, a random phone call or e-mail that makes its way to the CEO’s desk, or because a new executive coming into the company from another place brings up the subject and someone gets the assignment to draft a plan. The fact is most companies back into international development without a strategic plan, and that is okay. It happens, and it is not necessarily a bad thing. Many of the biggest names in international development started out just this way.

There will always be “opportunistic” situations that come up, even for those companies that have carefully thought out international plans. Reacting to a call that happens to come in from a market that has not been targeted is not a bad thing, it is a good thing. It shows that there is interest in the brand and that somebody thinks the company should penetrate a new market. The important thing is what is done with that inquiry.

(1) Understanding Your Company’s Revenue Streams and Then Determining Where Those Sources Are in International Markets. The quick service restaurant (“QSR”) business thinks in terms of walk-in traffic, drive-thru traffic, takeout, eat-in, delivery, etc. Other businesses need to think where their revenue comes from as well. These need to be defined and understood in terms of what portion of revenue they represent and what portion of profits they yield. Only markets where enough of these revenue streams can be relied upon to reach an acceptable ROI should be considered for development.

For example, a Miami-based grilled chicken concept enjoyed huge revenues from the drive-thru and takeout that came from the large Caribbean and Latin American immigrant community in Miami. This drove sales up to very high levels compared to other fast-casual or QSR brands. The problem was that when the brand was taken to the markets from which those immigrants came sales were much lower. The company and its franchisees had made the mistake of assuming that the same revenue streams would exist in Latin America as those that existed in Miami. But they missed something important -- the homemakers who came from other countries, but were living in Miami and making large purchases of grilled chicken and beans, were not behaving the same way their relatives back home behaved. Where they came from, there was invariably a pot of beans on the stove and a chicken in the oven, all tended to by a grandmother or a housekeeper -- something they did not enjoy when they emigrated to Miami. Once they emigrated to the US, they had to adapt to the American way of life where extended family does not generally live together and where household help is generally not found in middle class homes. So, they found the food to be great for “home meal replacement,” and they made it a part of their lives, replacing the familiar foods they had enjoyed in their home countries without having to prepare it themselves, something they did not have the time to do. The same customers consequently behaved quite
differently, and a fundamental revenue stream did not exist in those international markets.

(2) Analyzing International Markets Seeking Analogous Sources of Revenue. The lesson to be learned from the above example is do not just look at demographics and income and population in your targeted (or opportunistic) market – look for consumer behavior to be sure the revenue stream you are expecting actually exists. In looking for alternate revenue streams, the same QSR became very creative in adapting the concept in one market (Venezuela) to be a full-service restaurant with a full bar, which added new revenue streams. In other markets, the opposite approach was taken, lowering the investment by creating a small food-court model that could survive on much lower revenues.

(3) Understanding Who Your Company’s Customers Are in Successful Markets and Analyzing International Markets to Find Similar Customers. Once you find out how customers behave in your successful markets, you will need to look for that same customer, exhibiting the same behavior, in new markets. In the QSR industry, if there is no drive-thru culture existing in a targeted market, you need to look for the same customer profile in other venues (e.g., shopping centers) and analogs to home-market behaviors. For example, in Central America, customers generally use drive-thru facilities at a lower rate than in the automobile culture of suburban North America. But, if you look closely, you will see the same sales being generated by delivery scooters and motorcycles, instead of the customers’ own cars.

B. Addressing the Challenges of International Brand Adaptation – Before Deciding Where to Go

(1) Determining What Elements of Your Brand are Untouchable and Which Elements Will Need to Vary by Market. It is important to have a serious discussion at the highest levels of your company about what brand elements are: (a) unquestionably essential to be who you are; (b) very important to your brand image and to sales and profitability; (c) nice to have as they have generally been favorably associated with the brand; and (d) optional and not essential to maintaining the brand.

Sometimes, brands need to seriously look at what they may have considered obvious truths. Almost everyone considers McDonald’s, one of the world’s largest QSR chains and one of the most recognizable brands in the world, as a hamburger chain. But is it really? In 2011, McDonald’s sold more chicken than beef world-wide (by weight) and the trend toward chicken continues to increase. This is driven mainly by its international locations. Did you know that Burger King in some Central American markets has over 35% of its sales in bone-in fried chicken (a la KFC)? Dunkin’ Donuts is well known for coffee in America, but in many international markets, it is known for its doughnuts. These examples abound internationally. These shifts in what were once considered “core” products is not unhealthy, but it can be very treacherous for smaller brands that do not have the marketing clout of the mega-brands. In developing an international program, it is important to establish the key “must-haves” from the outset and communicate these to potential franchisees (along with the consequences if they unilaterally start to modify things). These can include colors, uniforms, music, service
styles and other peripheral elements in addition to the obvious and critical elements like logos, product lines and marketing imagery and wording.

(2) Gaining Internal Agreement on What Resources Will be Needed to Successfully Adapt to the Targeted Markets. As with all things related to international development, the company's leaders, including those not directly involved in international, should be briefed regularly on what is going on overseas as the brand adapts to new markets and different economic conditions. It is not uncommon for international teams to manage the evolution of the brand well, only to find conflict back at the home office if they have not kept the Chief Financial Officer or General Counsel aware of new products and variations in the concept.

(3) Include These Findings in your Discussions with Candidates. Make sure that the subject of how adaptations in the brand will be managed and approved is brought up during early meetings and Discovery Day. Many franchisees get frustrated with learning after they have signed that they need to go through a formal process to add a product or service to your system that they may feel is obvious and natural for their market.

C. Creating the Basis for an International Development Strategic Plan

(1) Assembling the Results of Your Market Analyses. Once the key revenue streams and possible areas of brand adaptation are understood, it is time to begin the market-by-market analysis of possible territories to target.

(2) Creating a Set of Filters to Eliminate Unsuitable Markets. Every industry and every business needs to create its own filters to eliminate non-viable markets from the list of priority targets. For example, in the previously referenced Caribbean grilled chicken concept, the following filters were used: middle class growth rate; chicken/poultry consumption; chicken/poultry production; number of KFC units; percentage of urban population vs rural population; percentage of urban population above the poverty line; number of visitors annually to Miami; World Bank ranking on ease of doing business; and corruption index ranking.

(3) Creating a Target Market Hierarchy. These filters, when applied to all the potential target countries, will yield a set of countries that appear to have the potential to support the development of a "reasonable" number of units. From there, you can eliminate countries that are outliers – geographically not clustered with other filtered markets – and arrive at a good target list.

(4) Establishing Your Promotional/Recruiting Sequence. It may make sense to divide the list into short term, medium term and long term targets to make sure that you do not end up in more remote, difficult to open or service countries before the infrastructure is there to support them. The same Miami-based grilled chicken concept developed in concentric circles moving out from Miami -- targeting Caribbean islands such as Trinidad and Tobago, the Dominican Republic and the Bahamas, followed by Central American countries (Panama, Costa Rica, Honduras, Guatemala) and then the northern part of South America (Venezuela, before it totally collapsed).
4. Deciding on the Deal Structure

A. Considerations in Selecting the Structure

After a franchisor has made the decision to expand into a foreign market, it must consider the optimal commercial structure for its expansion strategy. The structure will be driven by various quantitative and qualitative factors, including the franchisor’s expansion objectives; tax considerations; the extent to which the franchisor wishes to conduct active business operations (if any) in the foreign market; capital and management resources available to the franchisor; commercial infrastructure, familiarity with the foreign marketplace and the degree of control the franchisor would like to maintain over individual franchised units. In the vast majority of cases, tax considerations, the desired degree of control and familiarity with the target jurisdiction are weighted most heavily in the franchisor’s decision-making process.

In general, there are five forms of expansion that a franchisor may consider when expanding into a foreign market:

- Direct Unit Franchising;
- Area Development Arrangements;
- Master Franchising;
- International Multi-Unit Franchise Agreements; and
- Joint Ventures.

B. Forms of Franchising Structures

(1) Direct Unit Franchising. Direct unit franchising is the simplest form of international expansion and involves the franchisor directly granting a foreign franchisee, or a foreign area franchisee, a single unit franchise in the foreign market. This form of franchising more or less resembles the franchising model in the franchisor’s domestic market. Accordingly, the responsibility for adapting the franchise system in the foreign market generally falls on the franchisor, as well as providing training and support to individual franchisees. While it is possible for a franchisor to download some obligations to adapt certain elements of the franchise system to the local market to the franchisees, in doing so, a franchisor risks inconsistent adaptation among franchisees, and may be better served by controlling the process itself.

In terms of furnishing goods and services, the direct franchising model requires the franchisor to supply products to the franchisee directly from the franchisor’s home market, or to locate sources within the foreign market. This can create significant logistical and legal obstacles, including import/export matters, nationalism and protected markets (e.g., dairy products). Franchisors must ensure that they perform their due
diligence and ensure that the intended product supply chain is not only legally permissible, but that it can be established within the franchisor’s intended timeframe to roll out and establish the system.

This structure is most often used where the franchisor wishes to retain direct control over the process, timing and geographic expansion of its franchise in the foreign market. Additionally, direct unit franchising is well suited to situations where the foreign markets’ customs, language, laws and culture are similar to those of the domestic market. It is important to note, however, that although similarities may exist between the domestic and foreign markets, the franchisor (and its counsel) must still conduct due diligence on the foreign market to ensure that the brand, system, intangible assets and proprietary technology/know-how/processes are maintained and protected.

One significant drawback of the direct franchising model is the significant time, capital and resources required to establish and maintain operations in the target market. Also, while electronic communication is increasingly shrinking the world, the franchisor will nonetheless be required to physically travel regularly to the target market, particularly in the planning and implementation stages. This may, in turn, create issues with immigration laws.

The franchisor also will have to decide whether to operate directly, through a subsidiary or a branch. These are discussed below.

Quite apart from the legal issues, subtle cultural differences can have material impacts on a franchise system. Never assume that general similarities between countries such as the United States, Canada, Australia and the United Kingdom mean that an exported business model will perform similarly to how it does in its home market. A franchisor engaging in direct franchising (or any form of franchising for that matter) must conduct the necessary market diligence to ensure the concept will be viable.

<table>
<thead>
<tr>
<th>Pros of Direct Unit Franchising</th>
<th>Cons of Direct Unit Franchising</th>
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<tbody>
<tr>
<td><strong>Control:</strong> Franchisor is able to retain control of the expansion.</td>
<td><strong>Limits on Growth Rate:</strong> Given that the franchisor will be granting a few franchises at a time in a new market, this will necessarily limit the rate at which the franchise operations can expand and grow in the foreign market.</td>
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<tr>
<td><strong>Revenue:</strong> No sharing of the royalty stream with an intermediary, such as a local master franchisee.</td>
<td><strong>Lower Fees:</strong> In line with a slower growth rate, the franchisor will receive lower fees in the short-term.</td>
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<td><strong>Testing Markets:</strong> Franchisor is provided with an opportunity to test the foreign market (and validate its initial market assessment), one unit at a time. This is achieved by initially granting limited rights to foreign franchisees, and</td>
<td><strong>Increased Due Diligence and Research:</strong> Since the franchisor will be handling all issues in the foreign market (rather than relying on a master franchisee who is likely more knowledgeable about local market conditions, for example), the franchisor will face increased due diligence and research</td>
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Making adjustments as the model is proven.

**Tiered Expansion**: The model offers a strategic lead-in to other expansion alternatives, while minimizing risk in an uncertain market with new local partners.

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<tr>
<th>Costs (monetary and time).</th>
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<tr>
<td><strong>Capital, resources and time</strong>: The franchisor commits itself to managing franchisees and expansion in multiple markets – increasing costs, legal risks, regulatory compliance, etc.</td>
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<tr>
<td><strong>Disclosure Laws</strong>: The franchisor is responsible for complying with all local disclosure laws with respect to the franchisees.</td>
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<tr>
<td><strong>Tax</strong>: The franchisor may subject itself to reporting and payment obligations in the foreign jurisdiction. The franchisees may be required to withhold taxes on amounts paid to the franchisor.</td>
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<td><strong>Exposure</strong>: The foreign jurisdiction may have laws which expose the franchisor to claims by the franchisees, even if the franchisor establishes a new subsidiary to be the franchisor in the foreign jurisdiction.</td>
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<td><strong>Missteps</strong>: Lack of familiarity with even subtle differences in the culture can challenge implementation.</td>
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(2) **Area Development.** Area Development arrangements involve the franchisor entering into an area development agreement with a foreign developer, whereby the developer typically is granted some level of exclusivity and the right to open a minimum number of franchised locations within a specified time frame and specified geographic territory.

In addition to the development agreement, the franchisor and foreign developer/franchisee execute individual franchise agreements that govern each franchised outlet that will be developed and operated by the developer/franchisee. Individual franchise agreements cover specific details of the franchise relationship for the operation of the unit franchise, such as operations, termination provisions, fee payments, site selection, etc. In many ways, a development agreement is similar to a master franchise agreement (see below), except that the developer/franchisee, is only granted rights to develop and operate outlets itself (or through its affiliates); however, an important distinction is that the developer is not granted the right to subfranchise or license others to develop and operate such outlets.

Development agreements can be used for expansion in markets where trademark laws do not allow sublicensing of trademarks. Additionally, similar to the direct franchising model, development agreement arrangements are a viable option when the
The franchisor wishes to retain control over the use of its system, growth of its franchise and operations in the foreign country (i.e., controlling subfranchising rights). However, unlike the direct franchising model, the franchisor is able to leverage the developer’s expertise and experience in the foreign market.

An additional advantage to an area development model over a direct franchising model is that there is greater potential for the franchisor to download to the area developer some responsibility to adapt the retail offering to the local market. However, as was the concern with direct franchising, if there will be a number of area developers, then the potential risks of inconsistent adaptations among area developers outweigh the benefits of this approach.

As the franchisor still has a fairly significant role in bringing the brand to the target market, the same concerns as set out above arise with respect to the commitment and resources that the franchisor would have to use with this model. Similar concerns also arise with respect to immigration and tax matters.

<table>
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<tr>
<th>Pros of Area Development Franchising</th>
<th>Cons of Area Development Franchising</th>
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<tr>
<td>Same as direct franchising, above, plus:</td>
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<tr>
<td><strong>Control:</strong> Entering into unit franchise agreements (in addition to the area development agreement) provides the franchisor with control over the growth and operation of the franchise in the foreign market.</td>
<td><strong>Unrealistic Development Schedules:</strong> It can be difficult to set realistic, rather than overly aggressive, development schedules.</td>
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<td><strong>Upfront Capital Infusion for Franchisor:</strong> The franchisor will likely receive an up-front payment at the outset of the area development agreement with the developer (though possibly in exchange for deferred or reduced royalties or other fees).</td>
<td><strong>Constrained by Capital Resources of Developer:</strong> The growth of the franchisor’s brand and system in the foreign market will be constrained by the resources that developers may have at their disposal. Accordingly, it is important to thoroughly vet the developer’s financial position and track-record (if available) to determine whether it can meet the development schedule.</td>
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<tr>
<td><strong>Leverage Local Knowledge and Expertise:</strong> The franchisor will benefit from the developer’s knowledge of local market conditions (culture/political/legal landscape, economic conditions, etc.)</td>
<td><strong>Local Disclosure Laws:</strong> The franchisor may have to comply with local obligations to supply a disclosure document for not only the development agreement, but also each unit franchise agreement – which may be a considerable financial and administrative burden.</td>
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<tr>
<td><strong>Administrative Ease of Termination:</strong> It is easier to terminate and/or replace an area development agreement within a specified territory as compared to a master franchise agreement.</td>
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- 9 -
(3) **Master Franchising.** Master franchise agreements are perhaps the most commonly used method of international franchise expansion. Under this model, the franchisor grants an entity based in a foreign country (the “master franchisee”) a franchise for all or part of the target market. The master franchisee has the right in the foreign country, or within in a designated area of the foreign country, to open and operate a minimum number of franchised locations either itself, or via subfranchising to others. Under some iterations of this model, the master franchise agreement will require that the master franchisee operate a specified number of ‘pilot' outlets (*i.e.*, outlets owned by the master franchisee or an affiliate) before further territorial expansion rights can be exercised.

Common obligations under a master franchise agreement is that the master franchisee:

- must comply with an agreed-upon development schedule detailing the number of unit franchises (usually a combination of corporate units and units owned by third-party subfranchisees) that must be open and operating by certain development milestones;

- receives a license to use the proprietary marks, system, technologies, know-how, etc. of the franchisor;

- must provide the full range of products/services to foreign subfranchisees in a manner that is substantially similar to the franchisor’s domestic market; and

- takes the obligations and day-to-day operational duties of the franchisor (*i.e.*, site acquisition, training/support, recruiting subfranchisees, maintaining compliance with local laws and regulations, etc.).

In return for the foregoing, and for successfully leveraging its local market expertise and capital resources to expand the franchise, the master franchisee and the franchisor divide the initial franchise fee, royalty fees and other fees payable by the subfranchisees pursuant to the unit franchise agreements.

In entering into a master franchise arrangement, the franchisor should consider whether a three-party franchise agreement (*i.e.*, franchisor/master franchisee/subfranchisee) or a two-party franchise agreement (*i.e.*, master franchisee/subfranchisee) is appropriate. However, under both options, a franchisor should require the master franchisee to use the franchisor’s prescribed form of subfranchise agreement. Doing so provides the franchisor with control and consistency in the deployment of its franchise model across jurisdictions. Additionally, a franchisor should pay close attention to the rights that it will retain (*i.e.*, approval rights; veto rights; right to audit/inspect; right to approve subfranchisees, sites and enforce individual subfranchise agreements, etc.). Franchisors should also ensure that they have the option to step into the shoes of the master franchisee, and become the franchisor directly to the subfranchisees, in the event of the termination or expiration of the master franchise agreement.
<table>
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<tr>
<th>Pros of Master Franchising</th>
<th>Cons of Master Franchising</th>
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<tr>
<td><strong>Fast Avenue to Growth:</strong> This option is most likely to offer a relatively fast path to growing the franchisor's brand and system in the foreign market.</td>
<td><strong>Unrealistic Development Schedules:</strong> It can be difficult to set realistic, rather than overly aggressive, development schedules.</td>
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<tr>
<td><strong>Risk Management:</strong> The master franchisee will bear the larger risk of loss and legal risks as it is the party contributing the majority of capital, human resources and recruiting subfranchisees on the ground.</td>
<td><strong>Territory:</strong> Many franchisors expanding for the first time make the mistake of granting too large a territory, one which the master franchisee cannot adequately service. A better option is to provide a smaller territory, with rights of first refusal for other territories, subject to compliance with the development schedule for the existing territories.</td>
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<tr>
<td><strong>Leverage Local Knowledge and Expertise:</strong> The franchisor will benefit from the master franchisee’s knowledge of local market conditions (culture/political/legal landscape, economic conditions, etc.)</td>
<td><strong>Risks from Heightened Reliance on Master Franchisee:</strong> As there is a heightened reliance on the master franchisee by the franchisor, this model can give rise to more serious down-side risks should the wrong local partner be chosen. The flip-side of rapid growth is that negative outcomes related to/brought on by the master franchisee will more quickly affect the franchisor’s brand and goodwill.</td>
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<td><strong>Reduced Investment of Franchisor’s Time and Resources:</strong> Less time and capital and human resources are required from the franchisor.</td>
<td><strong>Risks for Future Re-Entry to Market:</strong> If the master franchisee is unsuccessful, or does a subpar job of expanding into the territory (and the relationship is therefore terminated), it is more difficult for the franchisor to subsequently re-enter the market with a failed brand.</td>
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<td><strong>Economies of Scale for Subfranchisees:</strong> By scaling up franchise operations quickly, the master franchisee can pass on economies of scale to subfranchisees, helping them to operate more efficiently and profitably.</td>
<td><strong>Unavailable in Certain Markets:</strong> Certain jurisdictions will not permit a franchisor to enter into a master franchise agreement, and must instead have some “skin in the game”.</td>
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<td><strong>Upfront Capital Infusion for Franchisor:</strong> Generally, a large non-refundable master franchise fee is paid to the franchisor at the outset of the relationship.</td>
<td><strong>Failure to Handle Pilot Units and Administration of System:</strong> Many franchisors suggest that most master franchisees fail as a result of their inability to</td>
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</table>
Liability to Subfranchisees: Franchisors can attempt to insulate themselves from liability to subfranchisees by limiting direct involvement and contracts with the subfranchisees. However, see the con column.

Disclosure Laws: The franchisor may still be required to comply with disclosure laws with respect to the grant of the master franchise. If the franchisor has not previously granted a master franchise, it will have to undertake the cost and expense of doing so as part of its first expansion.

Liability to Subfranchisees: Franchisors cannot assume that the lack of contractual privity insulates them from liability from subfranchisees. Franchisors must investigate whether any local laws would provide the subfranchisees with recourse against the franchisor despite the lack of privity.

(4) International Multi-Unit Franchise Agreements. Over the past few years, and believed to be a result of stricter disclosure requirements, many franchisors expanding internationally have started using International Multi-Unit Franchise Agreements (‘IMUFA’). IMUFAs are most often used in foreign markets that have strict disclosure requirements. An IMUFA is similar to a development agreement as it provides the developer/franchisee the right to open a minimum number of franchise locations within a stipulated period and geographic location. However, IMUFAs differ from development agreements as the franchisee is granted the development rights and the right to operate every unit franchise in one agreement – that is, separate franchise agreements are not entered into for each new franchise location opened and operated by the franchisee.

Many of the legal and business issues applicable to international franchising through a development agreement are identical to those which are considered in the negotiation and completion of an IMUFA, with the exception that provisions that are specific to individual outlets (i.e., operations, site selection, franchise fees/royalties, terminations, etc.) are negotiated and included in the IMUFA itself. Accordingly, the IMUFA model requires more upfront “heavy lifting” in drafting, but benefits the franchisor by allowing it to drastically reduce the administrative burden of executing and maintaining new franchise agreement/relations and delivering disclosure documents.
### Pros of IMUFA

<table>
<thead>
<tr>
<th>Reduced Administrative Burden and Costs:</th>
<th>Loss of Control: Compared to the development agreement model, the franchisor has less control over individual franchise outlets once the IMUFA is executed.</th>
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<tr>
<td>Fast Avenue to Growth: As administrative burdens are reduced, resources can be placed towards the growth and expansion plan.</td>
<td>Unrealistic Development Schedules: It can be difficult to set realistic, rather than overly aggressive, development schedules, especially upfront.</td>
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<tr>
<td>Leverage Local knowledge and Expertise: The franchisor will benefit from the local partner’s knowledge of market conditions (culture/political/legal landscape, economic conditions, etc.)</td>
<td>Upfront Heavy Lifting: Significant foresight and heavy lifting in initial drafting is required to consider how the franchise relationship will be governed over time.</td>
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<tr>
<td>Economies of Scale for Franchisees: By scaling up franchise operations quickly, economies of scale can be passed onto unit franchisees, helping them to operate more efficiently and profitably.</td>
<td>Forms of Agreement: In the area development model, area developers typically agree to open new outlets signing the “then-current” form of franchise agreement. However, as all rights are granted up front in the IMUFA, there is no opportunity for the franchisor to require new outlets to be operated pursuant to the then-current agreement.</td>
</tr>
<tr>
<td>Upfront Capital Infusion for Franchisor: Generally, a large non-refundable master franchise fee is paid to the franchisor at the outset of the relationship.</td>
<td>Disclosure Laws: The franchisor may still be required to comply with disclosure laws with respect to the grant of the IMUFA. If the franchisor has not previously granted an IMUFA, it will have to undertake the cost and expense of doing so as part of its first expansion.</td>
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### (5) Joint Venture.

If a franchisor is establishing international operations in a foreign market through joint operations (or another commercial arrangement) with an entity based in a foreign market, establishing a joint venture between the franchisor and foreign entity may be an attractive option. International joint ventures are generally structured with the franchisor holding an equity interest (or being a partner) in a joint venture entity (i.e., a corporation, partnership or other legal vehicle) that takes the role of a master franchisee, developer or franchisee. The other owner or partner of the joint venture entity is typically a local partner that has a physical presence in the foreign market. Regardless of the form that the joint venture relationship takes, a joint venture agreement, either in the form of a shareholder, partnership or some other agreement, is negotiated to set out the rights, obligations and relative risks of the joint venture partners and/or shareholders.
Foreign investment control laws of the target market may also require equal ownership or equal control of the joint venture entity by the franchisor and its foreign joint venture partner. Additionally, it is important to note that joint venture relationships can give rise to complex disclosure considerations and corporate law issues. Accordingly, franchisors should seek sophisticated legal advice when contemplating this international franchise expansion structure.

From a drafting perspective, it also is important that the master franchise agreement or trademark and know how license should be entered into between the franchisor and the joint venture entity, and be structured in a manner that is not considered an “assignment” of the trademark/know-how/system rights to the joint venture.

<table>
<thead>
<tr>
<th>Pros of Joint Venture Model</th>
<th>Cons of Joint Venture Model</th>
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<tbody>
<tr>
<td><strong>Ownership and Control:</strong> Allows the franchisor to maintain actual ownership and control over expansion and operations via corporate mechanisms, while still requiring the foreign partner to invest the majority of capital/resources necessary to launch the franchise in the foreign market and managing day-to-day operations.</td>
<td><strong>Potential for Loss of Control:</strong> The local partner based in the foreign market may literally be the franchisor’s “partner.” As a result, the partner may have more say in how the franchise is operated and expanded in the foreign market.</td>
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<tr>
<td><strong>Flexibility:</strong> The joint venture structure can be used with either a master franchise arrangement or an area development arrangement.</td>
<td><strong>Prolonged Negotiations:</strong> Negotiating the terms of the joint venture partnership can be lengthy and involve complex issues. This is especially the case if both parties are of equal sophistication and negotiating power.</td>
</tr>
<tr>
<td><strong>Tax Benefits:</strong> With the local partner’s involvement, the joint venture entity may be eligible for tax benefits or government incentives that are available to “permanent establishments” in the foreign market. Conversely, the JV may have the opposite effect and result in the franchisor being subject to the tax laws of the target jurisdiction.</td>
<td><strong>Exposure:</strong> Under this expansion structure, the franchisor is exposed to more liability stemming from the laws of the foreign market (e.g., franchise-specific laws, general corporate law including tax, ownership structure).</td>
</tr>
<tr>
<td><strong>Potential for Greater Share of JV’s Profits:</strong> The franchisor may benefit from receiving a greater share of the economic benefits generated by the joint venture entity as, in addition to royalty/license payments, the franchisor may be eligible to share in the entity’s profits (e.g., via dividends or distributions).</td>
<td><strong>Disclosure Laws:</strong> Depending on how the joint venture is structured, the franchisor may still be required to comply with disclosure laws with respect to the agreement.</td>
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</tbody>
</table>
C. Who is the Franchisor?

When expanding into a foreign market and contracting with unit franchisees, master franchisees, developers and/or local partners, the franchisor will also need to determine what legal vehicle it will use to enter into these contractual relationships. Alternatives include the franchisor directly contracting with foreign entities itself, establishing a branch in the foreign market or incorporating a subsidiary corporation. If a branch or subsidiary option is preferable, then these vehicles will take primary responsibility for performing the majority of services in the target country that are generally performed by the franchisor in its home country, including: granting franchise rights to develop and operate outlets directly in the target country, franchise recruitment, site selection, training, field service operations, marketing and advertising, and other administrative services.

Ultimately, whether a branch or a subsidiary will be utilized (and if a subsidiary is the chosen option, the choice of the jurisdiction in which it will be incorporated) will depend on the application of the tax laws of the foreign country, any treaties between the target jurisdiction and the franchisor’s home jurisdiction, jurisdictional issues and other legal risks. For example, a branch operation will generally subject the franchisor to the jurisdiction of the courts of the foreign market and will likely subject the franchisor to taxes in the target country. Accordingly, it is usually recommended that an international franchisor incorporate a subsidiary in the target country to insulate the franchisor from foreign income tax and direct commercial liability in the target country.

Due to the complex corporate legal issues that arise with establishing branches or subsidiaries in foreign markets, the franchisor should engage local counsel and thoroughly review foreign investment laws, regulations of the foreign market, as well the corporate, tax and other laws pertaining to doing business in the foreign country.

5. Franchise Recruiting – Choosing the Right Franchisee

Ask any experienced international franchise executive what is more important -- being in the right targeted markets or signing the right franchisees? (Granted, it should not be an either/or question in real life.) Invariably, you will get the answer that the right franchisee makes all the difference. Figuring out what that “right” franchisee is like and how to recruit and qualify them is one of the most important features of a successful international franchising program (and a domestic one, to be sure).

A. Introduction: Follow the Rules and Be Disciplined (Important Note: There Are No Rules)

1. Understanding the Drivers of Success in Your Franchise System and Adapting to International Conditions. In the QSR business, in addition to looking for candidates who have the resources to be able to afford the costs involved in launching, operating and expanding the business in their market, there are two more important criteria: experience or skill in developing commercial retail real estate; and chain restaurant operating experience. While restaurant operating experience can be brought in with hired professionals, both domestically and internationally, there is a factor (at least in the QSR industry) that is much more pronounced than in the US -- connections with the government. Understanding that difference is the key to signing more successful franchisees. While a domestic franchisee may be successful without having an influential family or circle of friends, in
most international markets, especially in the developing world, it is these connections that prove vital to successful development.

(2) **Creating Criteria to Guide Your International Recruiting Team.** Be sure that your franchise sales team establishes a set of clear criteria that can be used to “score” candidates. This can be as simple as a checklist including net worth and liquidity requirements and a set of boxes to fill with the other requirements or more elaborate with scoring for various business skills and operational experience criteria. Whatever the criteria, it is important to always couch the language in your company’s promotional pieces and on its website with language clearly stating that the decision also takes into account the results of interviews and background checks.

(3) **Staffing Your International Recruiting Team.** There is no substitute for direct personal interaction with international candidates and market visits, tours and the inspection of in-country operations and other businesses. For that reason, your international team must be composed of recruiting directors or a recruiting Vice President who are comfortable traveling a good percentage of their time. A single franchise recruiting/sales person with skills and experience can handle as many as 25 (or more) candidates at any one given time in various stages of the qualification and sales process, provided he or she is not also responsible for operations, real estate or related areas. It is tempting in small, start-up companies to combine responsibilities in one person for obvious payroll reasons, but there is no escaping the reality that adding responsibilities reduces time needed for recruiting, building relationships and negotiating deals.

(4) **Aligning the Interests of Your Recruiting Team for Long Term Success.** A company needs to keep its development goals aligned with its dedicated human resources and give the sales generators the time and resources to do their job. Otherwise, there will not be new deals in the pipeline for future growth. This means, for start-up companies, the flow-through on franchising revenue in the early stages can be much lower than the figures one usually hears about regarding franchising profitability (in bigger companies being as much as 60 or 70% of royalty and fee income). It is often half or just a third of that in small companies (and negative at the very beginning if starting from scratch).

**B. Establishing and Following a Process.**

(1) **Applications/LOIs/Term Sheets -- Creating the Right Forms.** Clearly, there is a need for consistent forms covering the main points of negotiating any franchise deal, either international or domestic: the initial submission of identification, qualification and plans (usually in the form of an application), reaching understandings about the size and scope of the deal (the Letter of Intent and a Term Sheet), and any confidentiality agreements, ethics statements, background check authorizations, and whatever forms or statements covering issues specific to your industry.

(2) **Establishing the Protocols of Approval.** It should be very clear how your franchise recruiting team gains formal approval from your company: whether it is a checks-and-balances approach (where finance or legal outside the international department, for example, can veto deals) or a voting approach (where, say, three out of four company leaders – finance, operations, legal and executive – need to vote yes to get a deal approved) or even if it is just a single approval (e.g., the CEO) that is required to move forward with a deal, your team should not be guessing or dealing
with changing rules to get deals done. This is not to say that subjective factors cannot be used. If the executives find that a candidate is not convincing in their presentations or if there are doubts about the candidate's character or work ethic, the CEO or other key executives must be able to hold deals up until such doubts are resolved.

(3) **Being Prepared for the Nuances of Financial Approval in International Markets.** Your finance team must be educated about the differences in how wealthy investors behave in international markets. In many developing countries, it would be foolish to keep large cash holdings because of instability in currency values. Also common in developing countries is the holding of assets in the names of family members who do not appear on franchise applications. It is not necessary to lower your company standards with respect to financial requirements, but it is definitely necessary to prepare finance analysts in your company for the fact that in some developing countries wealth must be hidden to avoid kidnapping and extortion.

(4) **Aligning Accounting and Finance in the Approval Process.** Introducing candidates to finance and accounting leaders in your company during Discovery Day can go a long way toward making them understand how candidates show their holdings in the qualification process. Conference calls, when requesting financial documentation, should include the finance or accounting person responsible for giving the approval whenever possible. Too many international deals get scuttled by not getting financial approval when the documentation is presented “cold” to finance for approval.

C. **Covering Your Bases**

(1) **Learning All You Can About Your Candidates, Their Existing Businesses and Their Families.** When vetting international candidates, use the US Department of Commerce (“USDOC”) and the American Chamber of Commerce whenever possible to find out about business reputations and creditworthiness. An “International Company Report” is often available from the USDOC Commercial Specialist for a reasonable fee. The franchise recruiter or salesperson responsible for the candidate should also acquire all available online reviews about a candidate’s existing businesses.

(2) **Using Background Checks.** There are numerous companies available to perform criminal, credit and terrorist watch list checks. This is money well spent, and no international deal should be signed until satisfactory reports from credible agencies have been received on the principals and guarantors.

(3) **Understanding the PATRIOT Act and Other US Laws and How They Affect International Partner Searches.** Usually the background check company can include the appropriate PATRIOT Act checks as well as sanctions “excluded party” lists checks. Some of this can be done online as well.

(4) **Understanding and Accepting the Possibility of Making Recruiting Mistakes.** Whatever the process, it is important to get buy-in from all company leaders once the decision is made. There are few situations in franchising more annoying than after-the-fact declarations around the management meeting table that “I never liked that guy” or “we should never have gone into that country.” Make sure everyone understands that franchising is never 100% successful in signing all top notch franchisees or selecting all viable markets, and that the occasional miss is acceptable. Not accepting a certain amount of failure in franchising will only lead to an
aversion to risk taking and, in the end, much lower recruiting success leading to slower growth.

6. Negotiating the Deal

While extensive negotiations are rare in domestic franchise deals, that is not the case internationally. That is particularly true where the franchised brand is not known in the geographic area being granted. In these circumstances, the local partner will often view itself as more than just a franchisee.

The franchisor may also be willing to give up more when negotiating an international deal based on the belief that the franchisee will have a better grasp on how the infrastructure for the brand will work in the territory (where the prospect is located and has often already conducted substantial business). Accordingly, the franchisor’s counsel must recognize the sensitivities of the prospect and the practicalities surrounding the relationship when drafting the documents that will govern that relationship, while also protecting the franchisor’s rights.

A. Territory Granted and Scope of Rights Granted

One of the first issues that must be determined and agreed upon in negotiating and preparing an international franchise agreement is the territory in which the franchisee will have the rights granted. The scope of the territory and the actual rights granted will often drive the initial fee paid to the franchisor and also help put counsel on notice as to what jurisdictional-specific issues might arise. The principal considerations associated with the grant of territorial rights include:

(1) Degree of Exclusivity. Typically, the franchisor will be granting at least some exclusive territorial rights to a master franchisee or large-scale area developer for purposes of international development. The scope of the exclusivity that the franchisor is willing to grant is often determined on a case-by-case basis depending on: (a) the franchisor’s interest to develop its brand in alternative channels of distribution; and (b) the resources and ability of the franchisor to do this alternative development. Of course, the international franchisee will expect to obtain an area in which the franchisor will not own or operate, or license a third party the right to own or operate, the same brand. The franchisor’s decision as to which carve-outs from exclusivity it will demand may well set the tone for the negotiations.

In a master franchise or a large area development relationship, for example, the franchisor will more often than not retain the right to: (a) offer and sell its branded products within the area via the Internet and other alternative channels of distribution; (b) own, operate, offer and franchise other brands within the area that may sell similar goods or services to the brand that is being licensed to the local partner; and (c) otherwise use the proprietary marks to promote the licensed brand, system and franchisees generally in the area.

(2) Territory Size. The size of the territory granted should take into consideration: (a) the demographics of the geographical area, including target population and saturation levels for the concept; (b) the number of units the franchisee will be required to open and operate; and (c) the resources and ability of the franchisee to establish, maintain and possibly expand the infrastructure needed to develop the brand. A franchisor should conduct this analysis as part of its due diligence to avoid a situation where the franchisee controls this aspect of the
negotiations and ends up with more territory than he can reasonably develop. This situation can be avoided by granting a smaller territory initially and then granting an option or right of first refusal for additional contiguous territory conditioned on compliance with his obligations in the initial territory.

B. Fees and Payment Terms

One of the first questions a franchisor must answer is how to determine the fees and other amounts that the franchisee will pay. Under a direct franchising or area development model, a franchisor often charges fees similar to those charged domestically. Under the master franchise model, the goal is to find a split of the fees that adequately compensates both the franchisor and the franchisee.

(1) Initial Fee. Typically, the franchisee will pay the franchisor a lump sum initial fee as consideration for the grant of exclusivity and development rights. While there is no hard and fast way to determine this fee, the following factors typically drive the parties' negotiations: (a) the size and demographics of the territory, including competitors; (b) the number of units the franchisee commits to develop; (c) the development term; (d) the strength of the franchisor’s system; (e) the franchisee’s financial strength and resources; and (f) regulatory limitations on lump sum payments.

While these factors provide somewhat objective and measurable guidelines, the mindset of the parties also is important. The more the franchisee wants to develop the franchisor’s brand in the territory, the greater the control the franchisor will have in negotiating the business terms of the relationship. Conversely, if the franchisor becomes enamored with the idea of expanding its brand internationally, the franchisee may have more control over how much will be paid at the outset.

(2) Payments in Connection With Franchises Sold to Third Parties. In the master franchise model, the franchisee can meet its development obligations by selling franchises to unaffiliated third parties. Accordingly, the agreement must detail how the parties will allocate the payments made by these third-party franchisees under their respective franchise agreements.

Typically, the franchisor and franchisee will agree to split the initial franchise fee and royalties paid by third-parties on a 50/50 basis. While some agreements will call for a 60/40 split (in favor of one party or the other), the fee allocation does not usually vary much more than that. Initial franchise fees and royalties are typically split by the parties even though it is the franchisee that is doing all of the work to get the third-party signed up. This fee split is predicated on the fact these two fees are typically paid as consideration for the proprietary marks and system being licensed under the franchise agreement, which is still intellectual property owned by the franchisor (even if the local partner will have a license to use and sublicense this intellectual property within the territory). Applying this same analysis, it follows that the franchisor and franchisee will typically share any renewal or transfer fees paid by third-parties on the same basis.

That is not necessarily the case with marketing and training fees. In the master franchise model, the franchisor typically does not receive any portion of the training/assistance fees or marketing/brand fund contributions (other than for cross-border marketing funds) that are paid by franchisees. These fees are typically paid
directly to the franchisee as consideration for training and other services that are provided by the franchisee.

(3) Payments Associated With Franchised Locations Owned and Operated by the Franchisee. The franchisee in the master franchise model will also have the ability (and often the obligation) to open and operate its own locations. In these situations, the franchisor typically seeks to get the same fees paid by these units as that which the franchisor receives in connection with fees paid by third-party franchisees. The franchisor may, however, agree to reduce the fees, at least initially, for pilot units developed by the franchisee in order to help ensure its success and to compensate the franchisee since this unit may serve as a training center.

(4) Training Fees and Expenses. Like domestic franchise agreements, many international franchise agreements state that the franchisor will provide the franchisee with the initial training necessary to commence operations, with the franchisee being solely responsible for all expenses associated with attending and successfully completing this initial training.

Over the term of the agreement, however, the franchisor must be able to require the franchisee to attend a reasonable amount of additional/refresher training each year. While franchisors are often tempted to charge their then-current training fee for any additional training that they may require (similar to the domestic franchise agreement), the increased travel costs/expenses and time that the franchisee is likely to incur in connection with training due to the distance between the territory and the franchisor should be raised and considered when determining whether or not to impose an additional training fee. The agreements also can provide that the franchisor is willing to provide such training in the territory, provided the franchisee is willing to cover the franchisor’s costs and expenses. The agreements should clearly provide that the franchisee will be responsible for all its costs and expenses associated with attending the training.

(5) Product/Inventory Purchases. If the franchisee will be required to purchase inventory, supplies or products from the franchisor on an ongoing basis, the agreement should clearly memorialize this obligation and include provisions designed to address related issues such as import duties and customs control.

C. Development Schedule

As previously noted, the presence of an overly aggressive development schedule is perhaps the biggest trap in negotiating an international franchise agreement. While the franchisor may have the right to terminate the franchisee if it does not meet the development schedule, more often than not this termination will adversely affect or destroy the franchisor's brand in the territory. On termination, the franchisor often finds itself in a situation where it does not have the resources or knowledge to take over the franchisee’s units or administer the system in the territory (under the master franchise model).

To help ensure that development schedules are reasonable, a franchisor should conduct meaningful due diligence and get in-depth business plans from the franchisee before any agreements are signed. Even with this information, however, it still may be difficult to determine what is reasonable. As such, it is often prudent for the parties to specifically provide for the franchisee's right to timely seek an extension in good faith if
the franchisee is unable to meet its development obligations in a given development period, along with language providing that the franchisor will not unreasonable withhold its approval of such an extension request provided the franchisee timely submits the extension request, and has demonstrated diligent efforts to meet the development.

Regardless, when setting a development schedule a franchisor should not lose sight of the fact that both parties have a practical incentive to develop and open units due to the increased revenue that both franchisor and the franchisee will realize. This practical incentive to develop can sometimes help the franchisor stay "grounded" when setting the development schedule.

The one thing a franchisor should not do is to let key development schedule deadlines go by without taking any action. This can lead the local partner to believe that they have been granted an extension. Even if a strong anti-waiver provision is set forth in the international franchise agreement at issue, this language may not be enough to preserve the franchisor's enforcement rights in the territory. As such, a franchisor should adopt a policy regarding the enforcement of development schedules, including consideration of alternative penalties for missing deadlines (other than termination), which may include penalty fees, loss of exclusivity, or loss of some portion of territory.

D. Approved Suppliers and Products

Like domestic franchise agreements, an international franchise agreement should clearly define the franchisor's right to require the franchisee to use only those products, supplies and other items that the franchisor designates or has approved and to designate and approve suppliers from whom the franchisee must make any required purchases.

In international relationships, the issues of product sourcing and supply chain logistics should generally be at the forefront of the due diligence analysis initially undertaken by both parties. While the franchisor should always have the right to reject the franchisee's proposals regarding alternate suppliers and/or products, from a practical standpoint the franchisee is often in a better position to seek out and secure relationships with local vendors within the territory that meet the franchisor's standards and specifications (for both the supplier itself and the products/services at issue). Of course, the agreement should specifically detail the procedure for the franchisee to make proposals for alternate suppliers/products and the franchisor should be prepared to provide the franchisee with some criteria and standards/specifications for an approved supplier and the products that must be purchased from such a supplier.

In addition to lower shipping and other logistical costs that could potentially result from approving the use of a supplier in the territory that the franchisee proposes, the use of a local supplier might also help address: (1) restrictions imposed on foreign goods being imported into the territory; (2) antitrust and tariff laws in the territory; and (3) problems stemming from the time it otherwise takes the franchisor's designated supplier (often based in the United States) to ship the product to the territory.

E. Required Menu/Localizations

Another issue that needs to be considered is the extent to which a brand will need to be localized in order to be successful in another county and who decides (and pays the cost associated with) the localization of the brand. The
international franchise agreement should clearly address these issues and provide a process for reaching agreement on the changes that need to be made.

F. Tax Responsibility

While the provisions related to tax obligations are fairly straightforward in domestic franchise agreements, the existence of different types of withholding taxes and/or foreign income taxes in various jurisdictions can greatly impact the economics of a particular international franchise transaction. If each party’s respective tax obligations are not specifically set forth in an international franchise agreement, then the payments the franchisor ultimately receives under the agreement may be dramatically different than what was intended or expected. When discussing these issues, both parties should seek the advice and counsel of an accounting firm that has branches in the territory.

Many foreign jurisdictions have a withholding or other tax that is imposed on payments made by the party in that jurisdiction (the franchisee) to a third party located outside that jurisdiction (the franchisor). Not surprisingly, these types of taxes can skew the economics of the deal, and a prudent franchisor should make sure that the franchisee is aware of these obligations to help ensure that it is developing an appropriate business plan and budget. While the franchisee will take the position that its payments will be net of withholding taxes, the franchisor obviously would prefer that the payments made by the franchisee be grossed up to include the withholding tax so that the franchisor receives all of the monies owed. Where there is a tax treaty with the country at issue, a compromise position often is that the franchisee can deduct the withholding tax from its payment as long as the franchisor can get a credit on its domestic taxes for the withholding taxes.

G. Governing Law, Venue and Dispute Resolution

In domestic franchise relationships, the franchisor will almost always find itself in a position where it can dictate the governing law and venue provisions of the franchise agreement. Typically, the standard agreement used by U.S.-based franchisors will provide that the agreement will be governed by the law of the state where the franchisor’s corporate headquarters are located, and that all disputes must be resolved by a dispute resolution method that takes place at or nearby these headquarters.

With international franchise deals, however, the franchisor more often than not is relying on the local franchisee to establish and administer its system in the territory. This reliance can weaken the franchisor’s negotiating position on what law will govern and in what venue the parties’ disputes will be resolved. From a practical perspective, the franchisee is usually making a much larger investment in order to establish and expand the franchisor’s brand in the territory and this means that a franchisor must be more open to its demands regarding these provisions. From a legal perspective, the franchisor’s argument that governing law and venue must be uniform to protect the integrity of the system is weakened by the fact that there is no established system in the territory and the applicable laws of the territory will likely govern and impact the franchisee’s day-to-day operations.

Similar to governing law and venue, the franchisor should not assume that it will be in a position to — or even that it should — demand that the franchisee resolve all disputes arising out of its international franchise agreements the same way provided in
the franchisor's domestic form of franchise agreement. In deciding how to approach these issues, a franchisor should consider the following:

(1) **Arbitration vs. Litigation.** Domestically, franchise agreements often use litigation to resolve disputes because: (a) litigation and the court system generally involve precedent and established procedures that can provide the franchisor with a greater degree of certainty than arbitration; (b) if a court issues an opinion that is not favorable to the franchisor, the franchisor can most likely appeal that decision to an appellate court; and (c) the cost and duration of an arbitration proceeding, which used to be touted as some of the primary advantages of arbitration over litigation, have become more comparable to what the parties might experience in a traditional court proceeding.

In the context of international franchising, however, there is increased uncertainty as to how a court will apply the governing law selected by the parties and analyze the dispute at issue. Even if a court within the parties' agreed-upon venue does issue a favorable holding, the franchisor still faces the risk of the franchisee appealing the decision resulting in additional travel and legal costs that are often unpredictable and/or not being able to actually enforce the court's judgment against the franchisee because the courts located in the territory refuse to recognize or uphold the decision. While substantial costs and expenses are difficult to avoid in enforcing the terms of an international franchise agreement, regardless of whether arbitration or litigation is used, a carefully crafted arbitration provision can provide the franchisor with some relief in this area, as well as some certainty regarding the process.

The foregoing points demonstrate the flexibility that an arbitration provision can provide counsel in crafting a dispute resolution procedure that will be used to resolve all, or a specific scope of, disputes arising out of or related to an international franchise agreement. At the same time, the franchisor's counsel can often dictate the terms of how the arbitration proceeding will be conducted since the franchisor will normally prepare the initial draft of the agreement at issue, thereby removing (or at least) decreasing some of the uncertainty surrounding litigation in a foreign court and jurisdiction. For this reason, franchisors should note that while arbitration is not advisable for every dispute, arbitration is commonly perceived as the international resolution mechanism of choice for franchisors.

(2) **Governing Law.** Many franchisors will push for an agreement that is governed by the laws of the state where they are located. The franchisee will often push back on the grounds that such a provision is one-sided and demand that, at the very least, the laws of a more mutual jurisdiction govern the international agreement. At the same time, the franchisee’s counsel is likely to argue that the laws of the jurisdiction where the local partner resides should govern the international agreements since many of the remedies the franchisor might eventually seek in the event the local partner breaches the agreement will need to be enforced by and, in some cases sought from, the courts where the local partner is located.

The goal for the franchisor’s counsel should be to have the parties agree to use the governing law of a jurisdiction that provides the franchisor with a substantial level of certainty that there are no unfavorable laws, regulations and precedent that will be influential in future decisions regarding issues such as termination, non-compliance, franchise sales and use of the proprietary marks and that courts in the territory are
likely to enforce the decisions of the court/arbitrator (as applicable) based on that governing law.

(3) Venue. The question of venue is often one of the most contested provisions negotiated in an international franchise agreement, as neither party wants to feel as if the provision is one-sided or otherwise creates an unfair burden in connection with enforcing their respective rights under the agreement. Venue can greatly impact the proceeding itself, as well as the parties’ respective costs and the degree of certainty that the award/judgment will be enforceable within the Territory. While there are many issues to consider when selecting venue, if the agreement calls for arbitration to resolve disputes then the franchisor will typically select a site that is a party to the New York Convention and is located somewhere between the franchisor and the territory. If an arbitration award is granted through a proceeding conducted in one of the jurisdictions that a parties to the New York Convention, that award will typically be recognized and enforced by courts located in any other jurisdiction that is a signatory to the New York Convention.

H. Termination and Post-Term Obligations

An international franchise agreement should clearly provide for the franchisor’s right to terminate the relationship and the grounds on which the franchisor can terminate. In domestic franchise agreements, the franchisor’s grounds for termination are often broken down into three categories based on the severity of the default committed by the franchisee -- defaults that are grounds for automatic termination without notice from the franchisor, defaults that are grounds for immediate termination upon written notice from the franchisor and defaults that are grounds for termination only if the franchisee fails to cure the default within a defined period of time after the franchisor provides written notice of that default to the franchisee.

In international franchising, the practical and legal issues involved with terminating the franchisee often warrant a more conservative approach to termination. Simply put, the franchisor may not be able to timely and efficiently enforce the termination of the franchisee in the territory (which is often halfway around the world) and, as a practical matter, the franchisor may not be in a position to take over the franchisee’s operations in the territory even if the termination can be effectuated. The latter is especially a concern where the franchisor is using the master franchise model because the franchisor will often be forced to deal with the subfranchise agreements that the franchisee entered into with franchisees in the territory.

While there are certain actions on the part of the franchisee that should always be grounds for automatic termination of an international franchise agreement (e.g., bankruptcy or attempted illegal transfer) or termination by the franchisor without an opportunity to cure (e.g., abandonment, serious criminal conviction, violation of in-term covenants against competition and/or violation of franchise sales laws), the franchisor should be careful as to how it treats other defaults under the agreement given the increased costs and uncertainty involved in terminating an international franchise relationship — especially if the franchisee is responsible for administering the system in the territory and the franchisor is not in a position to take over that system.

The post-termination obligations of the franchisee under an international franchise agreement should require that the franchisee: (1) immediately cease all offers
and solicitations of subfranchisees, as well as all franchise sales, in the territory; (2) promptly de-identify itself from the franchisor's proprietary marks and cease holding itself out as a former or existing licensee of the franchisor or the system; (3) pay all amounts due and owing the franchisor under the agreement as of the date of termination, which may include reimbursing the franchisor for the legal costs it incurred in terminating the agreement; (4) return all proprietary materials and materials that display the franchisor's proprietary marks to the franchisor, which includes the translated version of any documents that the franchisee may have translated for use within the territory; (5) immediately cease all use of the materials listed in (4); and (6) comply with all post-term covenants against competition.

7. Understanding Local Laws, Including Franchise Registration/Disclosure Obligations and Trademark Requirements

It is crucial for franchisors expanding internationally to fully consider the general laws and regulations in the foreign market. Such laws and regulations underpin the legal documentation that is needed to successfully expand into foreign markets and also dictate the modifications/changes needed to adapt the franchise system in the target jurisdictions. For example, many countries have recently introduced legislation that: outlines specific (and at times onerous) disclosure document requirements prior to the execution of franchise agreements, requires registration of disclosure documents and franchise agreements, and governs the relationship between franchisor and franchisee. Other jurisdictions have enacted self-regulated or voluntary disclosure requirements that are indirectly enforced via association with franchise associations.

When investigating foreign laws and regulations, franchisors should consider how these legal frameworks impact their expansion plans, including:

- timing of expansion (e.g., by requiring the franchisor to obtain licenses, permits and other such authorizations);
- costs of expansion, particularly in countries that stipulate a number of corporate stores before franchising is permitted;
- trends in courts that would favor domestic franchisees over foreign franchisors; and
- obligations can be passed on to the local franchisees.

Although each country has its own set of laws that may be applicable to the given franchise system, below we summarize examples of some of the most common local laws/considerations that international franchisors are likely to face:

- Franchise-specific legislation;
- Common law and Civil Code;
- Industry-specific regulation;
• Foreign Investment Laws;
• Banking and Finance considerations;
• Customs and Importation issues;
• Trademarks and Other Intellectual Property and Intangibles;
• Tax and Repatriation of Funds; and
• General Commercial Law Principles.

A. Franchise-Specific Legislation

Some foreign markets have enacted franchise-specific legislation. This can impose pre-sale disclosure requirements on the franchisor, a duty of good faith and fair dealing on the parties to a franchise agreement and a protected “right to associate” for franchisees. In some jurisdictions, such as the Canadian provinces of Alberta, Ontario, Prince Edward Island, New Brunswick and Manitoba, failure to follow franchise-specific laws can give rise to significant remedies for franchisees. The legislation also restricts a franchisor from obtaining a waiver from franchisees of the rights granted to them under the legislation.

A true “trap for the unwary” is the extent to which certain obligations in the legislation may be extended and/or interpreted by local courts. Franchisors should ensure to have local counsel review all agreements – and the sale processes – to ensure compliance not only with the black-and-white text of the legislation, but also of the interpretation of the legislation by local courts.

B. Common Law and Civil Code

Countries such as Canada present unique challenges to franchisors as, effectively, one of two systems of law may govern depending on the province that the franchise outlet is to be located. In particular, the province of Quebec is regulated by civil law, whereas the remaining provinces are regulated by common law. Civil law requirements can place an additional administrative burden on franchisors by, for example, requiring that all corporate entities doing business in Quebec conduct their business and inform and service Quebec residents in French.

C. Industry-Specific Regulation

The availability of suitable premises for unit franchisees, in desirable locations and at reasonable costs, is critical to the ultimate success of a franchisees expansion in a foreign market. In addition, the franchisor should satisfy itself as to any significant development hurdles that may arise due to local real estate, construction and zoning or
development laws. Certain franchisors also may find that the industry they operate in is subject to specific regulatory regimes, such as environmental and privacy regulations.

D. Foreign Investment Laws

Countries that have foreign investment laws may require registration, government review or approval of the franchise model, as well as the payment of fees to government agencies in order to enter into franchising arrangements. Additionally, technology transfer legislation in some countries may be sufficiently broad to capture franchise arrangements and therefore prescribe maximum terms for the franchise agreement, maximum royalties payable, or require that trademarks developed in the target country be owned by the local franchisee.

E. Banking and Finance

Banking and finance issues will play an important role in all models of international franchise expansion. In particular, the franchisor should consider the availability of credit/capital resources in the foreign market, stability of the banking sector and laws and regulations that may affect the franchisor’s ability to roll-out financial lending programs. These factors can significantly affect the rate of expansion of the franchise system in the foreign market. From a risk management perspective, the franchisor may also consider registering security in some, or all, of the local partner or franchisees’ assets in the foreign market, and doing so will generally require engaging with local counsel and personal property regulatory regimes.

F. Customs and Importation

In order to expand the franchise internationally, the franchisor must consider how best to deliver key inputs (e.g., ingredients, inventory, technology, promotional materials, etc.) to foreign markets. In doing so, the franchisor may consider using its existing supply chain; however, it will likely face import hurdles such as the legal restrictions, import costs/duties, general cross-border government policy that is intended to protect local industry players and imposition of local ownership and supplier requirements. The import hurdles and exchange controls can drastically change the economics of deploying the franchise model in the foreign market.

The franchisor’s ability to buy and sell the currency in circulation in the foreign market may also be an important factor when acquiring required inputs, calculating and paying fees and other amounts under the franchise agreement and other contracts, as well as during the repatriation of funds to the franchisor’s home country. Impediments to currency exchange should be identified and considered by local and domestic counsel in the early stages of the expansion plan. Alternatives in markets where there are impediments to currency flow, may include retaining funds in the foreign currency, or in the foreign jurisdiction, over the short or extended periods of time.

G. Trademarks, Other Intellectual Property and Intangibles

Value in franchise systems is based on “exclusivity” – of the trademarks, brand, proprietary technology, know-how, confidential information and the system. It is
important to protect and strategically manage the use of these intangible assets during international expansion as they can be subject to different intellectual property regimes in foreign markets. For example, franchisors may need to consider when to register their trademarks in the foreign market, as well as conduct due diligence on the distinctiveness of their marks as compared to the marks of other local market players.

Additionally, franchisors will want to protect their proprietary technology, know-how and confidential information in order to ensure that they do not dilute their competitive advantages during expansion. For example, local laws may impose restrictions on how long proprietary technology may be exclusive (i.e., patent terms) or how long a party to an agreement can be expected to keep information confidential (i.e., survival obligations related to confidentiality).

H. **Tax and Repatriation of Funds**

When considering the economic potential for expanding internationally, a franchisor must also consider the impact of withholding taxes and other government payments required in the foreign market. For example, the franchisor should consider what affect withholding taxes may have on its domestic tax liability (e.g., foreign tax credits, equivalent to withholding taxes paid, may be available in the franchisor’s domestic market) and to structure the expansion so as to minimize its overall tax bill. While tax treaties may help alleviate double taxation to a degree, this is not always the case as tax treaties do not always exist with foreign jurisdictions and the prescribed credits in may not fully offset the foreign tax burden.

In Canada, for example, when a Canadian resident (which includes a franchisee, master franchisee and developer) makes a payment to a non-resident (including a foreign franchisor), the Canadian resident is required to withhold and remit withholding tax under Canada’s *Income Tax Act*. Franchise fees, royalties, interest and rent paid to the franchisor are generally subject to a 25% withholding tax gross amounts (subject to reduced rates established through tax treaties between Canada and the franchisor’s home country, such as the *Canada-United States Tax Convention (1980)*, which reduces the rate of withholding on royalties to 10% and eliminates the withholding tax on interest). Moreover, if a U.S. franchisor operates through a Canadian "permanent establishment" (typically, a fixed place of business, such as a branch, factory or office), the franchisor will be required to file a Canadian tax return and be subject to Canadian income tax on the income earned through that permanent establishment (although, withholding tax will not be payable).

I. **General Commercial Law Principles**

A franchisor also should have a grasp of general commercial law principles when expanding into foreign jurisdictions, as they may lead to modifications to the franchised system and the manner in which franchisor-franchisee relationship progresses. For example, a recent Supreme Court of Canada decision held that all parties to a contractual relationship (not just franchisors) owe each other a duty of good faith in contractual performance. Although the Court’s pronouncement is fairly recent, it is believed that these duties may come in play when negotiating new franchise arrangements and terminating or renewing existing franchise arrangements.
Additionally, in protecting against competition and ensuring competitive advantages are not eroded, franchisors should consider how the enforceability and scope of non-competition provisions in domestic franchise operations may differ in international markets. For example, in the Canadian context, in-term noncompetition covenants are generally enforceable; however, courts will only enforce post-term non-competes where their terms are no broader than is necessary to protect the franchisor's legitimate business interests and where they do not unduly limit the former franchisee's ability to make a living using his or her existing skills and experience. In other words, the restrictions must be reasonable. Further, Canadian courts will also not modify an overly broad noncompetition covenant in order to make it enforceable. If the covenant is too broad, it will be stricken out in its entirety. Finally, the franchisor would be well-advised to consider whether a covenant restricting the ability of the former franchisee to solicit employees or customers of the franchised business post-term would be sufficient to meet the franchisor's legitimate needs. If so, a well-worded non-solicitation covenant should be used in favor of — or at least in addition to — even the least restrictive non-compete, in order to assure that some level of post-term protection will be available.

Other common commercial considerations include: laws governing the sale of goods or services, consumer protection laws, insolvency and bankruptcy (in the case the franchisee, developer or master franchisee fails in its expansion plans) and security registration considerations.

8. Understanding the Applicability of Domestic Law and its Impact on the International Franchise Agreement

A. United States Laws

(1) The Foreign Corrupt Practices Act (“FCPA”). Under the FCPA, U.S. companies, their officers and employees, as well as third party representatives or persons acting on their behalf, may not corruptly give or offer to give anything of value to a foreign government official for the purpose of influencing that individual in his official capacity, or causing that official to influence the foreign government in order to obtain or retain business. The law also imposes certain accounting and recordkeeping requirements on “issuers” (corporations that have issued securities registered in the U.S. or that are required to file periodic reports with the Securities and Exchange Commission).

To violate the FCPA’s antibribery provisions, an offer, promise, or authorization of a payment, or a payment, to a government official must be made “corruptly” – there must be an intent to induce the recipient to misuse his or her official position in order to obtain or retain business. The FCPA also prohibits corrupt payments to foreign officials through third party intermediaries. Companies cannot avoid liability by remaining deliberately ignorant of the actions of third parties that may violate the FCPA.

Franchisors must themselves abide by the FCPA's antibribery provisions, like other covered companies. While there is no specific guidance on franchisor FCPA liability for franchisee actions, in light of the increased enforcement of the FCPA and the nature of the franchise relationship, franchisors could potentially be found liable under the FCPA for actions taken by franchisees, given franchisors’ control over franchisees,
particularly if there is a failure to exercise due diligence with respect to franchisees.

Although FCPA liability depends on a corrupt intent, a lack of knowledge may not be enough to avoid liability, because the FCPA can be enforced against entities that are “willfully blind” to violations. Franchisors’ claims of lack of knowledge (and corresponding lack of intent) arguably could be strengthened by pointing to controls and policies in place set to deter and discover FCPA violations. To minimize potential risk, the following should be considered: an appropriate FCPA compliance program (including compliance manual, education, and internal enforcement to ensure corporate compliance with FCPA requirements); due diligence of business partners, whether of agents, representatives or franchisees (particularly in jurisdictions where FCPA risks are heightened); inclusion of strong contractual language in franchise and other agreements regarding FCPA prohibitions and obligations; and implementation of an FCPA reporting and monitoring system.

(2) **Antiboycott Laws.** Antiboycott laws prohibit or penalize U.S. companies for participating in foreign-initiated boycotts and embargoes that the United States has not sanctioned. The main boycott that the laws are designed to counteract is the Arab League boycott of Israel. However, these laws extend beyond the boycott of Israel, and apply to any boycott unapproved by the U.S. government. U.S. companies are subject to two antiboycott laws, the Export Administration Act ("EAA") and the Ribicoff Amendment to the Tax Reform Act ("TRA"). The TRA and the EAA are separate regulatory regimes which vary in their structure, application, penalties and prohibited activities. Generally speaking, the following activities are prohibited: refusals to do business with a boycotted country or with a blacklisted United States person; discriminatory actions on the basis of race, religion, sex, or national origin; furnishing information about race, religion, sex, or national origin; and furnishing information about business relationships with boycotted countries or blacklisted persons.

Boycott requests can assume many forms – some of which may not be obvious. Training of relevant staff therefore is critical to help identify red flags. The EAA and TRA not only restrict compliance with boycott requests, but also require companies to report any request to support an unsanctioned boycott (even if there is no intent to comply with the request). Although countries party to the Arab League (Algeria, Lebanon, Syria, Bahrain, Libya, United Arab Emirates, Iraq, Oman, Yemen, Jordan, Qatar, Kuwait and Saudi Arabia) are the predominant source of boycott requests, other countries have also asked U.S. companies to participate in a boycott (e.g., Bangladesh, Malaysia, Pakistan, Iran, and Nigeria).

Franchisors, like other covered companies, must ensure that their direct actions do not run afoul of the U.S. antiboycott regime. Regarding liability for franchisee behavior, there is no direct statutory or regulatory language or agency guidance that addresses the liability of franchisors for franchisees’ violations of antiboycott laws. Franchisors seeking to avoid liability for franchisees’ actions would note that a franchise is independently owned and operated, and that franchisors do not exercise requisite control over franchisees’ routine business activities – particularly those that may be implicated by boycott laws (e.g., franchisee purchase orders). Being able to document such separation, coupled with a strong compliance program tailored to the franchisor’s
own activities, would be the best approach for franchisors.

Franchisors may lessen their potential liability by considering an appropriate compliance program designed to uncover any violations of antiboycott laws; educating key employees; and making clear to franchisees, in franchise agreements and otherwise, that the franchisor cannot – and will not – take actions in violation of U.S. antiboycott laws. Franchisors also should consider voluntarily disclosing any known violations.

(3) Economic Sanctions Imposed by the U.S. Office of Foreign Assets Control. The U.S. Office of Foreign Assets Control (“OFAC”) administers and enforces economic sanctions, which are intended to deprive targeted countries, groups and individuals of access to their property in the United States, as well as the benefits of trading with the U.S. and using the U.S. banking system. OFAC administers two types of sanctions: individual and country-specific.

Individuals. OFAC maintains a list of Specially Designated Nationals (“SDN”) with whom U.S. persons are prohibited from doing business. SDNs include terrorists, drug-traffickers, and entities associated with hostile governments. Transactions also are prohibited with SDN-owned or controlled entities, which may not appear on OFAC’s list of SDNs. OFAC frequently updates the SDN list.

Countries. OFAC maintains country-specific sanctions. Sanctions programs vary, but the broadest sanctions prohibit U.S. persons from engaging in nearly all business operations in or involving the sanctioned country. Countries subject to comprehensive sanctions are Iran, Syria, Cuba and Sudan. OFAC also employs country-specific sanctions that prohibit only limited transactions within the country – not all transactions. OFAC’s website [http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx](http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx) includes extensive information about country-specific sanctions, including a list of sanctioned countries and the specific prohibitions against doing business with such countries, which is periodically updated.

In conducting their direct business activities, U.S. franchisors are responsible for complying with the sanctions established by OFAC. In other words, franchisors should not engage in business with persons on the SDN list or in prohibited business with sanctioned jurisdictions. U.S. franchisors face the potential of liability for transactions between a foreign franchisee and a sanctioned entity. OFAC has not issued any guidance on liability in the franchise context, but it is likely that, if the agency found that the franchisor had control over the franchisee, the franchisor would be liable for the franchisee’s conduct in violation of OFAC sanctions. Risks are greater to the extent that the franchisee engaged in business with a sanctioned person or entity in furtherance of its franchised operations and/or if the franchisor controlled the actions, policies or personnel decisions of a franchisee. Franchisors could note the elements of the franchise relationship that make the franchisee independent of the franchisor, and further point to their own policies designed to comply with U.S. sanctions. Nonetheless, OFAC enforcement is aggressive, particularly in the case of dealings with Iran.
Because sanctions regulations create a strict liability regime, U.S. companies should consider conducting a risk assessment and establishing appropriate compliance controls. Controls could appear in franchise agreements, screening programs, and processes for making goods, services and software available to franchisees. If franchisors provide any type of financing, guarantee, insurance or management service to a foreign franchisee, enhanced review and controls may be appropriate. Franchisors can consider taking steps to reduce potential liability, including performing due diligence on business partners; demanding compliance from franchisees and other partners; creating a compliance program; and responding promptly to suspicious activity.

(4) **Anti-Money Laundering.** Money laundering is the process of disguising proceeds from illegal activities or funding illegal activities by mixing those proceeds with legal funds. In the United States, money laundering is investigated and prosecuted by several agencies, including the Department of Justice, the Internal Revenue Service, the Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”), and the Department of Homeland Security. Many of the anti-money laundering (“AML”) laws are collectively known as the Bank Secrecy Act (“BSA”) and are administered and enforced through regulation by FinCEN. Violations can trigger civil and criminal penalties.

Generally applicable AML laws prohibit laundering money or aiding and abetting money laundering. Money laundering generally requires intent and knowledge of illegal activity, though willful blindness can suffice to show intent. These laws also require reporting certain activities, such as transactions of over $10,000, or bringing the same amount into or out of the United States. Generally applicable AML laws apply to franchisors, like other businesses. For example, a franchisor may not knowingly engage in financial transactions with funds of property acquired through illegal activities, or engage in financial transactions designed to avoid transaction reporting requirements. Franchisors could incur liability if they intentionally launder money, intentionally aid and abet a franchisee’s money laundering, or are willfully blind to receipt of illegal proceeds. The more removed franchisors are from the illegal activity, the more attenuated liability is likely to be.

Because financial institutions will scrutinize franchise accounts and transactions for signs of money laundering, franchisors should consider implementing compliance programs to both govern their own business activities in compliance with AML laws and also minimize the risk of franchisee misconduct. Compliance measures to consider include: identifying compliance officials; screening potential business partners; educating key personnel regarding AML laws and compliance requirements; conducting continual risk assessment, and being aware of potential red flags in proposed and existing business relationships; requiring compliance from business partners and franchisees; and conducting internal audits.

(5) **Export Controls.** Export controls regulate the transfer of certain U.S. goods, technology and services to particular foreign countries, entities and end users that are seen as a threat to the national security and foreign policy of the U.S. The U.S. limits the export of certain items, depending on the type of export and the
identity of the recipient. Violation of export control rules could lead to civil and criminal penalties, as well as reputational injury.

The Export Administration Regulations ("EAR") govern the export of certain "dual use" items, technology and software that could be used for commercial as well as military purposes. In contrast, the International Traffic in Arms Regulations ("ITAR") control the export of certain U.S. hardware, technical data and services that are "defense articles and services" appearing on the U.S. Munitions List. For restaurant franchisors, restaurant items and equipment, if governed by U.S. export laws, would very likely fall under the EAR and not the ITAR given the non-military nature of such goods.

The EAR regulate exports and re-exports (the transmission of an item from one foreign country to another) of covered items, and apply to all items physically present in the U.S. or of U.S. origin, wherever located, and to certain foreign manufactured items. Further, any communication with a foreign national that transmits controlled information is considered a "deemed export" – for example, deemed exports could occur through proposals, emails or meetings with non-U.S. nationals.

The EAR contain a step-by-step guide for determining whether a specific export is subject to export control laws and whether licensing is required. There are four main factors that affect an export item’s status: the item’s classification (category of goods/products); the country of ultimate destination (the most restricted destinations are Cuba, Iraq, Iran, North Korea, and Syria); the ultimate end user of the item (items may not be transmitted to certain prohibited users); and the ultimate end use of the item (certain uses – e.g., military uses – may be prohibited entirely). Most exports and re-exports of controlled items do not require a license, or are eligible for a license exception. If no license exception is available, the exporter must submit a written license application to the U.S. Bureau of Industry and Security ("BIS") within the U.S. Department of Commerce.

U.S. franchisors that export or re-export covered items, like all other companies, must comply with export control laws. These laws may apply to franchisors that are exporters or re-exporters. They do not apply to a franchisor where a third party exports equipment that the franchisor has approved, unless the franchisor somehow had knowledge that the export or re-export was unlawful. Franchisors should review their exports, re-exports and deemed exports of goods and software to ensure that they comply with the EAR and any licensing requirements. A franchisor should carefully examine whether the equipment it exports and any software made available to foreign franchisees is consistent with the EAR. Even enterprise software that facilitates secure communications and transactions between a franchisor and its foreign franchisees potentially could raise EAR issues. Encrypted software is of particular concern; encryption embedded in software may be covered by the EAR, but would be subject to a general license. Ultimately, the applicability of export controls on encrypted software depends on the nature and extent of the encryption.
Where the EAR applies, franchisors may wish to consider developing a tailored compliance program to promote compliance and establish a strong mitigating factor in case of any violation.

B. Canadian Law

(1) Corruption of Foreign Public Officials Act (“CFPOA”). The CFPOA imposes serious criminal penalties for Canadians found to have engaged in bribing foreign public officials and/or falsifying books and records, including doing so to secure competitive advantages in conducting their business. It applies to both Canadian individuals – citizens and permanent residents - and corporations, even if all of the activities related to the alleged bribery or falsification of books and records occur outside of Canada.

The anti-bribery prohibitions outlined in the CFPOA are broadly drafted, and include offenses that extend beyond the giving of actual bribes. Examples include:

• offering bribes, conspiring to give/offer bribes and/or giving/offering anything of value, including loans, rewards, advantage or other such benefits;

• using direct and/or indirect means of paying bribes; and

• engaging in practices considered to be the falsification of books and records in order to bribe foreign officials and/or concealing bribery.

Note, however, that in order for these offenses to fall within the CFPOA, they must also be accompanied by “intent”; that is, the accused would have to had committed the offenses “intentionally” or in a manner that amounts to “wilful blindness”.

Offenses under the CFPOA are punishable by up to 14 years in prison. Additionally, both individuals and corporations face monetary fines at the court’s discretion and which are not subject to maximum prescribed amounts. Aside from criminal penalties, companies found to have breached the CFPOA may be prohibited from bidding on Canadian (or international) public sector contracts.

In recent years, after being criticized by the Organization for Economic Co-Operation and Development for the lack of prosecutions under its foreign anti-bribery legislation, Canada has enhanced its enforcement of the CFPOA. In particular, Canada has imposed significant fines over the past few years, including a $9.5 million and 3 year probation against Niko Resources Ltd (2011), and a $10.35 million fine against in Griffiths Energy International Inc. (2013). Canada also has multiple ongoing investigations.

(2) Economic Sanctions. Canadian economic sanctions laws are generally applicable to all persons resident in Canada (including individuals and corporations), as well as all Canadians (individuals or corporations) outside of Canada. Compliance with Canadian sanctions legislation must be addressed in the context of
every economic undertaking, which includes the provision of financial services, securities dealings, the making of investments or completing M&A transactions. Sanctions are primarily imposed by the Canadian government through six statutes:

- **Criminal Code**: Prohibits Canadians (in and outside of Canada) from dealing with property connected to terrorist groups, including entities listed in the Regulations Establishing a List of Entities. The Criminal Code imposes asset freeze obligations and reporting requirements for such property and also includes offenses related to money laundering and financing of terrorism.

- **United Nations Act**: In line with the economic sanctions imposed by the UN Security Council, Canada imposes sanctions with respect to various jurisdictions through the United Nations Act. Among other things, the sanctions include arms embargoes, trade restrictions, prohibitions against dealing with property owned/controlled by certain designated persons and prohibitions against provision of financial services (e.g., investment, brokerage or other services) related to the provision, manufacture, maintenance or use of arms and related materials or military actions.

- **Special Economic Measures Act**: Pursuant to the Special Economic Measures Act ("SEMA"), Canada can impose sanctions on foreign jurisdictions and persons in order to implement a decision of an international organization, or where the Canadian government believes that a grave breach of international peace and security has occurred and is likely to cause a serious international crisis. Sanctions have been imposed against Burma, Iran, North Korea, Russia, South Sudan Syria, Ukraine and Zimbabwe and consisted of: imposing arms embargoes, prohibiting dealing in any property (including financial assets) of designated persons, asset freeze requirements, ban on exporting, selling, supplying or shipping goods.

- **Freezing Assets of Corrupt Foreign Officials Act**: The Freezing Assets of Corrupt Foreign Officials Act provides the Canadian government with the authority, in situations of internal turmoil or uncertainty in a foreign state, to issue orders that direct the Canadian property of a politically exposed person to be seized, frozen or sequestered. The regulations to the Freezing Assets of Corrupt Foreign Officials Act provides a list of “politically exposed foreign persons” ("PEFP"), and provides that a person in Canada must not:

  (a) deal, directly or indirectly, in any property, wherever situated, of any PEFP;

  (b) enter into or facilitate, directly or indirectly, any financial transaction related to such a dealing; or

  (c) provide financial services or other related services in respect of any property of any PEFP.

1 Côte d’Ivoire, Democratic Republic of the Congo, Eritrea, Lebanon, Iran, Iraq, Liberia, Libya, North Korea, Somalia and Sudan. Additionally, sanctions are in place against al-Qaida and Taliban.
• **Foreign Extraterrestrial Measures Act**: The Foreign Extraterritorial Measures Act provides the Canadian government with the authority to protect Canadian interests against foreign jurisdictions that would like to apply their laws to Canada. In particular, the attorney general has been authorized to issue orders that relate to measures by foreign jurisdictions that impact international trade or commerce.

• **Export and Import Permits Act**: The Export and Import Permits Act imposes trade controls on goods being imported from or exported to certain countries or goods of a certain category. The controls are mainly administered through the use of three regulations: (a) Area Control List (provides a list of countries that the government deems necessary to control exports with); (b) Export Control List and (c) Import Control List (both lists of goods deemed by government to be controlled for certain enumerated purposes).

Failure to comply with the above mentioned sanctions laws is considered offenses in Canada and may result in fines and/or imprisonment or both.

(3) **Anti-Money Laundering.** Canada’s AML is intended to detect and hinder money laundering transactions and is applicable only to “reporting entities”, and not to all entities at large. Generally, Canadian AML applies to financial institutions, casinos, businesses involved in money services and financial intermediaries (e.g. lawyers, accountants, securities dealers, life insurance brokers, etc.). However, Canadian AML can also extend to institutions that are not necessarily involved in managing financial assets. For example, given that criminals may at times use precious metals and gems to launder money, authorities have held that precious metal and stone retailers are subject to AML legislation.

Should an institution be subject to Canadian AML, it is, among other things, required to do the following:

• have a compliance policy in place that complies with Canadian AML requirements;

• comply with legislative reporting (e.g. filing suspicious transaction reports with the Financial Transaction Reports Analysis Centre of Canada (FINTRAC));

• comply with legislative record-keeping requirements; and

• comply with identification requirements (e.g., ascertaining the identity of anyone with whom the entity conducts a transaction).

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2 In recent developments in Canadian AML, the Supreme Court of Canada struck down certain sections of federal terrorist financing and money laundering law because it violated solicitor-client privilege. The Court found in Canada (Attorney General) v Federation of Law Societies of Canada, 2015 SCC 7 that the search, seizure, record-keeping, retention of information and identification provisions of the Proceeds of Crime (Money Laundering) and Terrorist Financing Act and the Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations to be unconstitutional, insofar as they applied to the legal profession.
(4) **Export Controls.** The Export and Import Permits Act imposes trade controls on goods from specific countries, or goods that fall within certain categories through the use of the Area Control List and the Export Control List.

The Area Control List identifies countries to which no Canadian resident can export items without first obtaining an export permit. The countries on this list are established by the Governor-in-Council and have been deemed necessary to control the export of any goods. According to Foreign Affairs, Trade and Development Canada, there are currently two countries on the Area Control List, including Belarus and the Democratic People’s Republic of Korea (North Korea).

The Export Control List, on the other hand, sets out multiple categories of items and technologies that require permits for exports, regardless of their export destination (with the exception of some goods destined for the United States\(^3\)). The ECL includes a broad range of commercial “dual use” goods, such as hardware and software using encryption, UAVs, optical sensors, and testing equipment. Additionally, the Export Control List imposes restrictions on exporting certain products of U.S. origin to certain destination countries or identified terrorist individuals or groups (without first obtaining the appropriate export permits). It is also important to note that even if the products and technologies being exported are not for military purposes, they may still be subject to the Export and Import Permits Act.

If a Canadian resident exports items that are subject to controls under the Export Control list or Area Control List without the appropriate export permit, he/she/it can be subject to significant penalties, including:

- On summary conviction: a fine not exceeding $25,000 and/or imprisonment for a term not exceeding 12 months;
- On an indictable offense: a fine in an amount in the discretion of the Court and/or imprisonment for a term not exceeding 10 years;
- Where a corporation commits the offense: any officer or director of the corporation who directed, authorized, acquiesced in or participated in the offense can be held personally liable;
- Administrative Monetary Penalty System: authorizes the Canadian Border Services Agency to impose monetary penalties for non-compliance with custom laws and non-compliance ($1,000 for first violation, $4,000 for second violation, $8,000 for subsequent violation)\(^4\).

\(^3\) Pursuant to a bilateral arrangement with the US, export permits are generally not required for most items identified in the Export Control List when shipped to a final destination in the US. However, if such items are not intended to be ultimately consumed in the US (e.g. they are only being transported through the US), then export permits will be required. Additionally, certain military and strategic items (e.g. chemical, biological and nuclear weapons and related technology) require export permits irrespective of the final destination.

\(^4\) At times, AMPS penalties in excess of $1 million have also been imposed.
C. International Treaties

The United States is a party to various international treaties, such as the Madrid Protocol, the Hague System for the International Registration of Industrial Designs, the New York Convention and the United Nations Convention on Contracts for the International Sales of Goods ("CIS"), that may positively affect a franchisor's international franchising transactions. The Madrid Protocol allows companies with a registered or pending U.S trademark to take advantage of a streamlined procedure that allows for reciprocal registration of the same trademark in countries that have signed the Madrid Protocol. Through a simplified registration process, companies reap the benefits of trademark protection without having to spend time and money filing country-by-country.

Under the Hague System for the International Registration of Industrial Designs ("Hague System"), which is similar to the Madrid Protocol, companies may register designs using a single, integrated system run by the World Intellectual Property Organization that registers that same design across signatory countries. It is not necessary that a company register its design with any national design office prior to registering, and similarly offers the benefit of avoiding duplicative registration regimes.

Since the passing of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the New York Arbitration Convention, companies that obtain an arbitration award in one signatory country may enforce that award in any other signatory country. The Convention helps avoid unnecessary litigation of disputes by allowing for recognition of a settlement in the vast majority of countries.

Finally, the United Nations Convention on Contracts for the International Sales of Goods, also known as the Vienna Convention, allows for a uniform standard of international sales laws that apply to the international sale of goods. Under this Convention, parties who enter a contract for the sale of goods who each have a place of business in a different signatory country will automatically have their contract covered under the Convention unless they expressly opt-out of having the Convention apply to their contract.