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PERSPECTIVE

International Franchising Arrangements and Problems in Their Negotiation

*Warren Pengilley**

I. INTRODUCTION

In an audience from diverse backgrounds and from countries with quite different economies, it is not easy to find the right level at which to pitch a paper on international franchising. The author has, therefore, worked on the basis that this paper should begin with fundamental principles of franchising. The author apologizes to those with a more profound knowledge of franchising should he have made, in their case, an incorrect policy decision.

The material in this paper is compiled chiefly from personal experience and from the experience of others. Most opinions in this paper, even on allegedly "objective" issues, are probably subjective.

The author believes that franchising is little understood in legal circles. This is demonstrated by the various legislative approaches which have been adopted. In many countries, there is simply no law directly applicable to franchising. In some, such as the United States, Australia, and the Province of Alberta in Canada there are various requirements

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primarily based on pre-disclosure—a concept akin to that of a company prospectus.

Almost certainly the reason for the lack of any common jurisprudential approach to franchising is that franchising relationships simply do not fit neatly into any of the common law moulds with which we are all familiar. Franchising typically partakes of a number of these relationships while not totally embracing any of them. For example, it partakes of, but does not totally embrace, the concepts of (1) employer and employee; (2) distributorship; (3) licensor and licensee; (4) agency; or (5) vendor and purchaser, to varying degrees, depending upon individual transactions. As one learned American author on franchising has put it:

> only since World War II and increasingly in the past ten years has franchising achieved recognition as a distinct method of marketing . . . . [but] . . . . there is no generally accepted definition of franchising in court decisions, regulation or legislation. Further, any definition would fail to include the many functions inherent in the system, as well as its potential for abuse. . . .[1]

Given this lack of a legal definition, it is difficult to speak in terms of the law of any particular country. To study in this paper the laws of any one country rather than those of others would be an arbitrary, and unjustifiable, decision. To study the laws of all countries would be a feat beyond a paper of this length. The author has chosen, therefore, to speak in terms of broad principle because, despite the absence of a uniform legal approach to franchising, the broad economic and marketing parameters are similar in all countries in which franchising takes place.

Because of the scope of franchising, and particularly of international franchising, the basic problems involved in negotiation of franchising agreements are most frequently not inherently legal in nature. They are more likely to be problems of business, psychology, politics, and culture or problems of a technical and scientific kind. Above all, they are likely to be problems of tact, diplomacy, strategy, and tactics. Lawyers may or may not be good at solving these problems. But if the lawyer cannot look beyond the law, the lawyer will be a far greater hindrance than a help in any franchising negotiations. Unfortunately, lawyers do not necessarily receive basic training in the arts mentioned and many in the field of commerce argue that lawyers are not skilled in such arts.

II. WHAT IS FRANCHISING?

Franchising is a relationship which is very difficult to define in black

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[1] H. BROWN, FRANCHISING REMEDIES AND REALITIES 1 (1972).

letter terms—a factor which, of course, makes it so hard for legislators to write any laws about it.

It seems to be common ground that the franchising concept involves at least the following basics:

1. The use by a franchisee of a trade or quality mark or logo held by the franchisor;
2. The grant of a right by a franchisor to a franchisee to sell or use a developed system, product, or service;
3. The payment by the franchisee to the franchisor of consideration (usually an "up front" fee or a "royalty on sales" or some combination of the two).

That these basic concepts express generality is, however, readily apparent when one considers case law in the United States. In that country, economic issues have been extensively examined in the context of franchise restraints and in the application of the antitrust laws. When a trademark indicates the *source of a product*, the restraints allowed under United States antitrust laws have been markedly different to those allowed where the trademark indicates the quality of a product.[2]

In the usual case, a franchisor, under United States antitrust law, cannot "tie" the franchisee to purchase subsidiary or secondary products (in a fast food franchise, products such as napkins and table cloths for example). Nevertheless, quite extensive franchise ties have been permitted under such laws where the item being franchised is a whole system which, in the words of the court in *Principe v. McDonalds*:

> offers its franchisees a complete method of doing business (in which) . . . . its regime pervades all facets of the business from the design of the menu board down to the amount of catsup on the hamburgers nothing (being) left to chance. . . .[3]

In such a case there is, according to the United States courts, simply no subsidiary product to "tie." The whole system, complete with its totality of purchase requirements is one "product." The question of whether subsidiary product purchase requirements are illegal does not arise.

This paper is not intended to delve into the mysteries of United States antitrust law. The fact, however, that United States courts have

[2] *See generally* Hambro v. Shell Oil, 1982-1 Trade Cas. (CCH) 64,717 (9th Cir., Apr. 12, 1982); Jack Walters & Sons v. Morton Buildings, Inc., 1983-1 Trade Cas. ¶ 65,284 (E.D. Wis. Mar. 11, 1983); California Glazed Products Inc. v. Burns & Russell Co., 708 F.2d 1423 (9th Cir.), *cert. denied*, 464 U.S. 938 (1983); Power Test Petroleum Distributors v. Calcu Gas Inc., 754 F.2d 91 (2d Cir. 1985).

[3] Principe v. McDonald's Corp., 631 F.2d 303 (4th Cir. 1980), *cert. denied*, 451 U.S. 970 (1981); *Cf.* Siegel v. Chicken Delight, 448 F.2d 43 (9th Cir. 1971) and Kentucky Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977).

been able to develop totally different economic rationales for arrangements which we would all typecast as "franchises" should make us wary of too readily placing all franchise arrangements into one common mould. Within the generality of the franchising concept, there are considerable individual differences.

While franchising initially began as a method of manufacturing or distributing products, increasing sophistication in franchising has given rise to an ever increasing growth of "systems franchises." It is in this area that the greatest current expansion in franchising is taking place. The "systems franchise" trend causes considerable frustration for lawyers. Necessarily if the "system" works successfully, the parameters for negotiation of variations are narrow. It is no use, for example, attempting to negotiate with McDonalds to install a pay phone in their franchised fast food outlets. They will not negotiate on this point. It is simply not part of the "system" so loudly and judicially praised for its success in *Principe*. The negotiating lawyer, therefore, needs to know more than just the law. The lawyer has to have marketing and commercial expertise to understand the reasons for the often apparently intransigent negotiating posture of franchisors. The lawyer must be able to explain the "systems" logic to the client. Above all, the lawyer must have the capacity to distinguish that which is commercially important from that which is not and that which is of negotiating importance from that which is trivial.

III. THE MARKETING RATIONALE OF FRANCHISING

To the franchising enthusiast, the franchising marketing rationale is both simple and self evident. The points made by such an enthusiast are:

1. The small independent business has the benefit of the franchisor's expertise on matters such as site selection, operating manuals, and building plans. The small entity does not, therefore, have to conduct research on these matters. The small business probably could not afford the research and lacks the expertise in any event.
2. The large business can expand by its use of a unifying concept or idea. The franchisor does not have to find the immense capital required to establish its own outlets. The franchising enthusiast argues that, in the absence of franchising, the expertise of the large business would either be unexploited or exploited imperfectly.

Employing this logic and various extensions of it, it is argued that the proven systems and more sophisticated business procedures of the larger enterprise can be combined with the individual motivation of the smaller owner-operator franchisee. Some argue that the franchise is the most feasible alternative to vertical integration and thus represents the

most promising hope for the preservation of the independent small business in many societies today. Furthermore, a proven franchise system inspires confidence in consumers who are assured of the quality of product and service regardless of the particular outlet which is patronized.

There appears to be little doubt that franchising does have a favorable track record in terms of business success, although there have been some dramatic failures.[4] Furthermore, franchising accounts for an increasing quantity of sales—especially retail sales[5]—and continues to expand into an ever-increasing range of goods and services, as is witnessed by studies in the United States, Australia,[6] Britain,[7] and Canada.[8]

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4 *See* Ziedman, *Regulation of Franchising by the Federal Trade Commission*, 17 BUS. LAW. 135 (1972); SELECT COMMITTEE ON SMALL BUSINESS, UNITED STATES SENATE, THE IMPACT ON FRANCHISING ON SMALL BUSINESS, S. DOC. No. 91-1544, 91st Cong., 2d Sess. 5, 6 (1970); J.O. VON KALINOWSKI, ANTITRUST LAWS AND TRADE REGULATION (1969); Hunt, *Franchising: Promises, Problems and Prospects*, 53 J. RETAIL 3 (1977); B.L. JOHNS, W.C. DUNLOP & W.J. SHEEHAN, SMALL BUSINESS IN AUSTRALIA (1978); REPORT OF THE TRADE PRACTICES CONSULTATIVE COMMITTEE INTO SMALL BUSINESS AND THE TRADE PRACTICES ACT (Canberra 1979). *See also* Brown, *supra* note 1, at 30.

5 For example, in the United States "[f]ranchising accounts for one out of three retail dollars spent in the country according to the United States Department of Commerce. One estimate has been made that there were about 471,000 franchised outlets growing at the rate of 2 percent per annum. Franchised retail outlets accounted for about 13 percent of retail employment and 28 percent of retail sales." *See* Cady, *Structural Trends in Retailing: The Decline of Small Business*, 5 J. CONTEMP. BUS. 71 (1976). Franchised businesses were said, in 1976, to account for $239 billion in United States annual sales, 20 percent of the gross national product and over 35 percent of retail sales. *See* UNITED STATES DEPARTMENT OF COMMERCE, FRANCHISING IN THE ECONOMY 1975-1977 (1976). The United States Commerce Department predicts that over one half of retail sales will be through franchised outlets by the year 2000 and that franchised sales have increased fourfold from 1969 to 1984. *See* AUSTRALIAN FINANCIAL REVIEW, Feb. 5, 1985.

In Australia, an estimate by Ibis Corporate Services concluded that in the fast food industry sales were $560 million in 1979 of which "old style operators" accounted for 55.6%. By 1983-84 estimates were $760 million and 35 percent. By 1990, they anticipated that "old style operators" would have less than 10 percent of the market. *See*, AUSTRALIAN BUSINESS, Nov. 20, 1980. In Australia, estimates have been made that franchising may account for 20 percent of retail trade though this might be conservative *see*, W.J. PENGILLEY, FRANCHISING—WHAT IMPACT, WHAT PROBLEMS, WHAT SOLUTIONS, (Monash University 1982).

In Canada, franchising is estimated to exceed $30 billion annually or one third of all retail sales. *See* Zaid, The Canadian Franchise Market Trends and Challenges—Legal Considerations (Paper given at a Franchising Seminar by The Board of Trade of Metropolitan Toronto on Nov. 17, 1983) [hereinafter Zaid].

The British Franchise Association says that its members account for 280 million pounds of sales each year. Combined sales outlets have doubled from 2,000 in 1979 to 4,000 in 1981 and member companies employ 20,000 people—a 24 percent increase since 1978. *See* THE SUCCESSFUL FRANCHISE (1984) [hereinafter SUCCESSFUL FRANCHISE].

6 *See, e.g.*, W.J. PENGILLEY, *supra* note 5. Franchising was noted in the following industries (and the list was not claimed to be exhaustive): fast foods, nursery care for toddlers, dentistry, quick printing, hairdressing, computer stores, car tuning, home building, photography, lighting shops, funerals, day care schools, sewing machine centers and film retailing.

7 For example, window blinds and associated services, driving tuition, car hire, parcel delivery, interior decorations, fast selling kitchen gadgets, pipe cleaning, restaurants, hotels, car tuning, print-

Especially with the growth of "systems franchising," the industries to which franchising methods can be adapted are seemingly endless. The basic requirements appear fairly minimal. All that is required is that there be a "system" which generates customer goodwill and acceptance and that the "system" can be shown to fulfill a marketing need more efficiently than a cold-start operation.

IV. WHY FRANCHISE INTERNATIONALLY?

In addition to the reasons for franchising domestically (which are applicable to a greater or lesser degree internationally) the following reasons may be given for franchising internationally:

1. To utilize local management personnel and thus overcome problems of language and culture;
2. To overcome problems of detailed supervision often otherwise insuperable because of distance;
3. To leave compliance with local laws to those familiar with such laws and thus be able to market a product in a target country without incurring liability under the laws of such country;
4. To avoid laws which may inhibit or control foreign direct investment in particular countries. Franchising enables a product to be marketed in a country with restrictive direct investment laws without a direct investment being made by the franchisor in that country;
5. To overcome political difficulties such as the possibility of expropriation of overseas investment. The franchisee will normally be a resident of the target country and probably less vulnerable to such threats. In any event, if the property is expropriated, it is the franchisee's and not the franchisor's loss;
6. To take advantage of revenue, tax planning and similar financial considerations too complex to be discussed here. One of the more common reasons for franchising is to avoid the tariff imposts which, notwithstanding a veritable barrage of international agreements, still inhibit world trade. A franchise operation can avoid such tariffs.[9]

ing and photocopying, marine product retailing, print shops, formal wear hire, curtain cleaning, carpet repairs, hairdressing, confectionary retailing. SUCCESSFUL FRANCHISE, *supra* note 5, at 125-26.

[8] *See* Zaid, *supra* note 5. Zaid notes Canadian franchise operations in personal care services, home cleaning operations, manpower support services, energy conservation planning, leisure time hobbies, computer services, restaurants, lodging institutions, fast print shops, automobile repair facilities, car rental agencies, and personal grooming centers.

[9] To these reasons must also be added the activities of United States agencies such as the Department of Commerce. In some cases, franchising has been spread by emigrant franchisees taking their known business system with them. For example, the Kentucky Fried Chicken and Pizza Hut franchise systems both came to Australia, not directly from the United States, but via Canadian franchisees.

V. The Contents of International Franchising Agreements and Lawyer Involvement in Their Negotiation

The most important point of negotiation in international franchising agreements is the negotiation of the first document—usually a Master Franchise Agreement or the first of a number of direct franchise agreements. After this agreement has been negotiated the die is cast and the basic rules are established. Subsequent agreements will depend upon the initial document. If the first agreement is not properly negotiated, disaster will almost certainly follow in subsequent arrangements. The first agreement is thus often far more important for its "follow up" effects than for its *inter partes* effect. It is imperative that the first agreement be properly drafted. Some deceptively elementary questions have to be decided initially. These questions are so elementary that they are not infrequently overlooked or given proper consideration.

A. Nature of the Type of Desired Arrangement

The most fundamental issue to be considered involves a consideration of the general nature of the franchising arrangement.

1. Direct Franchising

The franchisor franchises individual outlets direct from the home country to the target country. Generally, this system only operates between proximate countries with similar societies and legal systems. There is, for example, a good deal of direct franchising from the United States into Canada and from Australia into New Zealand, and *vice versa* in each case.

2. Establishment of a Branch Office or a subsidiary in the target country

Often decisions as to the actual method of conducting business (branch or subsidiary) will be based on financial and taxation considerations. The advantage of establishing a physical presence in the target country is that the franchisor can directly control the franchisees in the target country. The major obstacle is that the franchisor becomes committed in a number of countries around the world in which it would prefer not to have a direct presence. To some extent, the franchisor may believe it is losing the benefits of the franchising concept by having to establish subsidiaries in a wide variety of overseas countries.

3. Joint Venture Arrangements

A decision to operate by joint venture necessarily involves physical presence in the target country. Many of the advantages of international franchising (stated above) may not be realized for this reason. The chief advantage to a joint venture is that there is a sharing of risk. But the corporate problems of the franchisor are all too often overlooked. Not infrequently equal representation on boards and equal shareholdings may lead to inefficient decisionmaking. There are also complex problems which may be caused by foreign investment legislation in the target country if the franchisor is required to increase its investment there. Above all, it should be recognized that a joint venture involves a very active and continuing participation in the project by the franchisor.

4. Master or Area Franchise

The franchisor gives the franchisee a specific area (usually a particular country or a significant part of it) to exploit, usually with the right to subfranchise. The advantage of such a system is less franchisor involvement. Master franchising particularly suits franchisors who are without substantial financial or managerial expertise. Moreover, it is a particularly useful form of franchising in situations involving long distances or different cultural and legal systems. For example, there are many "Master" franchises into and out of Australia for reasons of distance.[10]

These issues should never be considered without thinking of alternative methods of conducting business. Frequently it is assumed that franchising is the best business method although the point may not have been fully debated. Often the best business decision is not to do business at all. Some "cross-examination" questions by the lawyer for a franchisee may be valuable in focusing the franchisee's thoughts on the difficulties and advantages in doing business in various organizational forms.[11]

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10 This author's experience has been that Master Franchise Agreements are particularly difficult to negotiate. Master Franchise Agreements can work very well. The chief downside is if the Master Franchisee goes bad financially or in performance. In such a case, a Master Franchise Arrangement is a commercial disaster whereas, in other types of arrangements, something can often be salvaged. Obviously, therefore, Master Franchise Arrangements should be looked at with a cautious, conservative, and doubting eye.

11 Commercial reasons should be the prime consideration in choosing the method of conducting business. If the franchise will not work commercially then all the lawyers and accountants with all their tax planning and other advice are completely unable to make a profit for either franchisor or franchisee. Lawyers, however, can be of great assistance in advising on the method of doing business and at least as regards the basic methods of doing business, legal advice should be sought very early.

B. Important Points in the Agreement

Assuming a franchise arrangement of some sort is desired, the next point is the negotiation of the actual agreement.

International franchising agreements, like domestic franchising agreements, have a certain number of matters which *must* be considered. It is essential that broad agreement be reached on these issues before any attempt is made to "fine tune" the franchising arrangements. The most basic questions are:

—What is being franchised?
—What are the franchisor's obligations?
—What are the franchisee's obligations?
—What marks, including logos and patents, are involved and what is their legal status?
—What is the length of the franchise?
—What exclusivity provisions (product, territorial, or customer) are applicable? Of prime importance will be the question of territorial exclusivity as such security is often the basis upon which the franchisee makes a commitment.
—What are to be the payment arrangements? Is payment:
  —"up front," based upon a royalty, or a combination of both?
  —subject to minimum royalties?
  —to be made in the franchisor's currency, the franchisee's currency, or a third currency?
  —to be subject to agreed limitations on exchange rate variations?
  —to be made exclusive, inclusive or otherwise of certain taxes and imposts of the target country?
  —to be made monthly, quarterly, semi-annually, or at other designated times?
—Are royalties to be scaled up or down with the age of the franchise?
—Are there minimum performance provisions?
—What competition restraints (during the agreement and after termination) will exist?
—Are there to be any "buy out" or "buy back" options?
—What provisions apply relating to choice of law?

C. Lawyer Involvement in Negotiations

When should lawyers become involved in franchise negotiations?

Lawyer involvement in negotiation is desirable at an early stage. Lawyers must recognize, however, the needs of the commercial community.[12]

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[12] One franchising consultant with whom the author discussed a draft of this paper said that the best thing a lawyer can do is to put it to the client at the beginning of negotiations: "Are you sure you couldn't develop a similar system yourself? What is it that you see gives you the advantage in franchising? Is it worth the premium?" This is a different role to that in which many lawyers see

Lawyer involvement in franchising negotiations requires the lawyer to give immediate advice so that the negotiations can head down the right track. Although they are brought into negotiations early, lawyers should not think that they can or should run the negotiations or control the commercial direction of the proposed deal. Regrettably, this occurs all too often and there is thus a real client reluctance to involve lawyers until a later, often too late, stage.[13]

D. One Who Controls the Draft, Controls the Negotiation

A basic rule of thumb which has been demonstrated on numerous occasions is that: "One who controls the draft controls the negotiation." It is tempting for a client to agree to allow the other party's lawyer to draft the agreement. This decision saves money. Nonetheless, this is often a short-sighted view. As a lawyer, it is easy to draft provisions favorable to your client and include clauses which are never deleted from the final agreement. Often such clauses are not even discussed as they are viewed as subsidiary items.

Often, however, the ability to control drafting is limited by the comparative power of the parties involved. A well-established franchisor will frequently have a Master Franchise arrangement which will be offered on a "take-it-or-leave-it" basis. Similarly, traditional etiquette will often be important. Commonly, the party which conveys rights will present the first draft.

VI. POTENTIAL FRANCHISING PITFALLS

Set out below is a limited selection of potential franchising difficulties; most are of a commercial nature. Commercial factors are the most obvious pitfalls and a lawyer should be aware of the more common ones.

Some pitfalls are legal. These primarily involve delay, obfuscation, and annoyance at the administration of laws by government bureaucrats. One can normally ascertain prior to the conclusion of a franchising arrangement the existing state of the law. But how long it may take governments to act is completely unpredictable.

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themselves, i.e. as a passive recipient of instructions. Almost as important was the comment of another franchising consultant who said with some frustration:

> My advice to any franchisor is to have a lawyer on the team who truly understands franchising, otherwise the learning curve can be expensive!

[13] Lawyers do appreciate being part of a negotiating team. Membership on such a team can make one more interested, more informed and more enthusiastic as to the whole activity. When a final agreement has to be drawn up, a lawyer involved in the negotiations from the beginning will be far more successful in expressing the intent of the parties than one who comes late to the scene.

A. Commercial Pitfalls

1. Selection of the wrong target country

The fundamental motivation of the franchisor in entering into a franchise is to make a profit. Most worldwide franchises are based in the United States. Why should a franchisor incur the difficulties of a franchising deal with its ongoing commitments unless there is an assurance of being adequately compensated?

An American Bar Association Survey supported by the United States Department of Commerce, the International Franchise Association, and other organizations ascertained the twenty most desirable countries from the viewpoint of United States franchisors. These were (in alphabetical order):

Australia, Belgium, Brazil, Canada, Denmark, France, Germany (Federal Republic), Hong Kong, Italy, Japan, Mexico, Netherlands, New Zealand, Philippines, South Africa, Spain, Sweden, Switzerland, Taiwan, United Kingdom.[14]

Factors which are of chief importance in a target country include minimal government interference with the provisions agreed to by the parties and the capacity to remit profits back to the franchisor. Political stability of the target country is also a prime consideration. For these reasons, and perhaps for marketing reasons, it is likely that many franchisors have not shown great interest in the countries of Africa and Asia and have steered clear of many countries in South America. A recent discussion held by the International Bar Association described franchising in Colombia, Mexico, Venezuela, and Chile as disappointing from a franchisor viewpoint.[15] For the franchisor, the ability to reach an agreement, withdraw funds, and deal with a politically stable country is quite fundamental. Selection of a target country which does not share these characteristics may be disaster for a franchisor and it is frequently a reason for the commercial failure of franchises.

2. Not recognising local differences

Some countries might appear to have identical characteristics to those of the franchisor's home country but, in fact, have quite basic differences. An exclusive territory of two-thirds of Australia may look impressive when the area is circled on a map in New York, but that area

[14] Zeidman, *Survey of Foreign Laws and Regulations affecting International Franchising*, 1982 ABA SEC. ANTITRUST L.

[15] *See International Bar News* Jan. 1985—Report of Discussion of International Franchising Committee at 35.

may well have a population less than that of a reasonably sized United States city. It is surprising, but such elementary errors occur.[16]

Franchisees, in particular, should be careful in looking at impressive figures or systems from a country other than their own. Even countries similar on their face may be different enough to make it impractical to franchise the product or systems of one to the other.

3. Not knowing what is being franchised or what the parties are required to do

The first question raised in the basics of a franchising agreement is: "What is being franchised?" This is not meant in jest. Many arrangements fail simply because the parties (franchisees in particular) never really seek to answer this question.[17] Franchising literature is full of cases where there has been inadequate definition of the product being franchised or what the parties are to do.

4. Inadequate market research and other commercial failures

Some common commercial causes of franchising failures are:

—Inadequate market analysis;
—Product defects;
—Higher costs than expected;
—Inadequate definition of exclusivity arrangements, particularly in relation to territorial exclusivity;
—Poor timing;
—Prohibitively high franchise fees;
—Inadequate support from franchisor;
—The "tyranny of distance" which may result in adequate information flow and lack of communication;
—Lack of appreciation of local customs;

[16] *See* AUSTRALIAN FINANCIAL REVIEW Oct. 10, 1985. A fairly large ice cream franchisor recently caught a cold in Europe because Europeans did not share the United States appetite for ice cream all the year round. Similarly, the Wendy's Burger Chain, which recently failed in Australia, attributed one of the reasons to the construction of top quality snowproof buildings, necessary in North America, but, as one Director commented, "it so happens that we don't have heavy snowfalls in Melbourne."

[17] A classic case was the Ziebart rust proofing franchise in Great Britain. Franchisees thought they were buying a unique formula sealant and gave a ten-year guarantee to customers. The sealant was a dud and franchisees were left high and dry with a number of warranty claims. The franchise document excluded recourse against the franchisor. Apparently no one had asked whether the franchised item actually worked.

In some countries, the law would probably give a right of indemnity against the franchisor though the franchisor will, no doubt, attempt to limit liability where possible. For a relevant discussion of the United States position, see Schwartz, *Licensing and Products Liability*, 20 LES NOUVELLES 41 (1985).

—Personality clashes between franchisor and franchisee;
—Franchisee dissatisfaction with a franchise after working for a period of time.[18]

The remedies for the prevention and solution of these problems are obvious. They include:
—Better screening and research;
—Reorganised responsibilities;
—Improved communication facilities. There is nothing improper, for example, in the requirement that a franchisee maintain a telex link.[19]
—Better support, especially in the start-up period. Such support should be specified in detail in the agreement negotiated between the parties. In particular, the agreement should state where and how much support is to be given and at whose cost;
—Avoiding franchisee dissatisfaction. Frequently this can be done by the franchisor requiring the franchisee to work for the franchisor for a reasonable period of time (with an option out available if dissatisfied) thus giving the franchisee the "lay of the land." It is fundamental to any franchise operation that the franchisee know the extent of all obligations. Some franchisors object to such an arrangement, arguing that it costs them money. Often this may be true. But allowing a franchisee to opt out on a basis previously agreed to will generally be far cheaper to the franchisor than establishing the franchise, only to find the franchisee disgruntled within six to twelve months.

5. Too much, too soon

Franchises always take much longer to put into place than parties initially anticipate. If this fact is not realized and taken into account in planning, there will be cash flow problems.

Commercially speaking, there are other timing problems. Frequently a commercial marketer will fail to see why a trademark cannot be franchised even if an application for registration has not been filed or, if filed, not considered. To explain that government bureaucracies can take two to five years to deal with trademark registrations is not easy. The marketer may simply fail to understand why bureaucrats can take so

[18] The real work in franchising arrangements commences after the basic agreement is reached. A franchisee may well grumble that "[f]ranchising may mean freedom—freedom to work 16 hours a day, 6 days a week for at least a good number of years". If the franchisee is not fully aware of what is involved and is not the right type of person to operate a franchise, the operation will fail dragging down both franchisor and franchisee.

[19] One should be prepared for trade union stoppages, mail strikes, or other labor union problems in the target country.

long to decide something as simple as a trademark registration.[20] Similarly, although the marketer will defend the uniqueness of the trademark, its value in the marketplace and its importance as the basis of a franchise operation, the marketer will, nonetheless, often want to push on with an arrangement notwithstanding the fact that the franchisee may ultimately receive no tradename protection. Doubts of the franchisee, and the lawyers, in relation to tradenames are dismissed as unfounded.

Franchisors should not even think of negotiating a franchise overseas prior to the registration of relevant tradenames, logos, and marks in the target country. In many countries, "stealing" a trademark is not only not unethical, but an approved business practice. It can place franchisees in difficulty and can be both embarrassing and expensive if a franchisor has to "buy back" a trademark from a local registrant should it be "stolen" and, therefore, impossible to franchise in the target country.

A problem similar to "too much too soon" occurs in relation to Master Franchise Agreements. The Master Franchisee may have to make a considerable up-front payment to the franchisor and may have to fund this payment by sub-franchising. The problem which occurs is that the Master Franchisee may not have been a franchisee in the target country prior to signing up the Master Franchise Agreement. The franchisee may be having problems while, at the same time, subfranchising to franchisees who need guidance with their difficulties. The problem is one of overoptimism and greed. The combination can lead to all sorts of miscalculations.[21]

A Master Franchisee should be required to run a franchise for some extended period before being permitted to subfranchise. Only in this way may the necessary experience be gained. Of course, such a requirement often goes against entrepreneurial spirit and cash-flow desires. But it does ensure a commitment by the Master Franchisee to deliver to subfranchisees what they expect.

Perhaps the greatest disaster in a Master Franchise arrangement is the nonperformance of the Master Franchisee. Ensuring that this does not occur is quite basic to the operation of the system. Frequently the reason for such nonperformance is the desire to subfranchise too quickly in circumstances where the Master Franchisee is both unaware of franchisee problems and is unable to service the proliferating outlets which

20 The writer similarly has difficulties in comprehending many of the bureaucratic delays which often cost private entrepreneurs vast amounts of money.

21 An example of what can happen is the failure of the Wendy's Burger Chain in Australia despite its success both in the United States and Southeast Asia.

have been established.[22]

Franchisors generally are people with expansive ideas which, more often than not, need moderation. They believe in the explosive capacity of their creations. At a conference run by the International Franchising Association in Atlanta, Georgia on November 9-10, 1983, franchisors were asked their expansion plans for the next two years. An average figure revealed that participants expected an 81% growth in their franchise businesses in this period. The nub of many franchise problems is that growth of the order planned by franchisors often cannot occur. Many franchisors feel a sense of urgency. Some say: "We have a great idea and we must make up for lost time." Commercial mistakes often occur because of this attitude. Lawyers, by making probing inquiries, can often assist clients in avoiding such mistakes.

B. Legal Pitfalls

While the lawyer must be aware of the commercial pitfalls in international franchising in order to be a competent advisor, it is critical that the lawyer also be aware of the legal pitfalls which can occur in these arrangements. It is fundamental that competent local legal advice be obtained and that the correct questions are asked. In order to demonstrate this point, set out below are examples of a few of the potential pitfalls which are likely to be encountered.

1. Assuming the general similarities of legal systems

Many Australian businesses have assumed the similarities of legal systems in entering the United States market. Australia and the United States are akin in many ways in relation to competition laws. But the Australian franchisor entering the United States market may be harassed by legal tactics which were not aniticipated and are not understood. Treble damages under the antitrust law, the innovative actions brought by United States attorneys, and that an action successfully defended gives no right to costs, are but a few of the unexpected aspects of the United States legal system. Frequently the only way to avoid such problems is to opt for a Master Franchising Arrangement and avoid direct franchising or the establishment of a presence in the target country. The client, especially if a franchisor, should have an outline of the whole

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22 A good example of a failure of a franchise for this reason was the failure of the Wendy's Burger Chain in Australia in 1985. Mr. Gregory Morgan, a Director of the Chain said:

> . . . while Wendy's had enjoyed a good market acceptance in Australia with minimum advertising, it had been forced under the franchise deal to open outlets in locations without the opportunity to fully research the market area.

The cost of establishing a Wendy's outlet was about $500,000. *See also supra* note 16.

legal system explained by a competent target country lawyer. It is well worth the franchisor travelling to the target country purely for a conference of a few hours on this subject if the franchisor is unable to obtain competent advice in the home country.

2. *Not believing that the position is as different as one has been told*

Franchisors and their lawyers, coming generally from developed countries, are likely not to believe some situations even when meticulously explained. Sometimes the situation in the target country is so different that it is simply incredible to lawyers trained in a different legal environment.[23]

The advice to all lawyers when told of systems operating quite differently to their own—especially in relation to industrial property protection, competition laws, and bureaucratic consents—is: "Believe it if it comes from a credible source." Never judge the systems of other countries by preconceptions based upon a legal system with which you are familiar.

3. *Failing to understand the difficulties in antitrust and similar types of laws*

Local competition laws create special problems for many franchise

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[23] One example will shortly illustrate this point. Richard Faletti, a senior partner in a United States law firm, recently commented as follows in relation to a lawyer's problems when advising as to investment in Nigeria:

> To inform potential investors and to make a statement of government policy, the Nigerian government has issued a [*Guidelines*] pamphlet. . . . Potential investors should be aware, however, that neither the *Guidelines*, nor any of the extensive other literature prepared by banks, lawyers and accountants mention all the requirements for investors in Nigeria. In addition, some of the requirements which the *Guidelines* mentions do not exist. . . .
>
> . . . . When it published the *Guidelines*, the Ministry of Industries recognised that the Ministry of Internal Affairs had jurisdiction to issue business permits . . . . Two staff members of the Ministry of Industries advised . . . that an application for a business permit . . . now must be made to the Ministry of Industries as well as the Ministry of Internal Affairs. These staff members were not bothered by the fact that no existing act or decree imposed this requirement. Apparently, they made the assumption that the National Assembly would change the applicable law in due course . . .
>
> . . . . Presidential Decree 70 of 1979 created Nigeria's National Office of Industrial Property (NOIP). Any technical assistance or trademark licensing agreement must be registered with the NOIP within sixty days after its execution . . . . Registration is essential, because no one may receive payment of fees pursuant to any agreement until they acquire a NOIP registration and present a registration certificate to Nigeria's Central Bank.
>
> In June 1981, this writer made numerous inquiries about the NOIP to determine whether it actually existed, and found that most Nigerian officials did not know about [it]. . . .

Faletti, *Investing in Nigeria—The Law, Good Intentions, Illusion and Substance*, 5 NW. J. INT'L L. & BUS. 743, 744-45, 749 (1985). All bureaucracies have innovative interpretations of the law. Lawyers often simply refuse to believe that an agency of such importance as NOIP in Nigeria is unable to be located (it did in fact appoint a Director in 1982) or that officials could implement laws which have never been enacted by the appropriate legal processes.

arrangements. On this issue, advice from target country lawyers is absolutely imperative. In some instances, local registration will be required.

It is impossible to encapsulate world antitrust laws in this paper, nonetheless, their parameters are broad. In many countries (such as the United States, Canada, and Australia) a wide variety of restraints (primarily price fixing and resale price maintenance) are banned *per se*, but no specific government examination of agreements is required. In others (such as the Andean Pact countries), individual arrangements are examined by government agencies and approval must be obtained. Among other things, competition will be considered in granting consent. Chief among these are tying practices, time periods involved, resale price maintenance, export restrictions, and territorial restraints.

4. Failure to appreciate the impact of laws specifically relating to franchising

If a franchisor in the United States fails to comply with predisclosure laws, dire results follow. Not only are federal laws applicable, but a number of states also have disclosure laws or "prospectus-type" registration requirements. Canada maintains a fairly liberal attitude towards franchising (subject to compliance with antitrust laws), and has no general federal franchising legislation. However, registration and prospectus requirements exist in Alberta.

Australia has similar requirements under its Companies Code (State and Territory legislation uniform on a national basis). The legislation prevents individuals from publicly franchising. It allows only public franchising by certain classes of companies and requires prospectus-type registration for such publicly-offered franchises. The National Companies and Securities Commission ("NCSC") stance is based upon a two-page decision of a single judge in Western Australia[24] which is now subject to great doubt.[25] Despite this, the NCSC vigorously asserts its position.[26] The current state of the Austrialian law is in doubt and some local advice on this highly relevant problem is clearly a necessity if one

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24 Hamilton v. Casnot, [1981] 5 A.C.L.C. 279 (Wallace, J., Supreme Court of Western Australia).

25 Butterworth v. Lezemo Pty Ltd., [1983] 1 A.C.L.C. 1306 (Nicholson, J., Supreme Court of Victoria); Streeter v. Pacific-Seven Pty Limited [1985] 3 A.C.L.C. 430 (Supreme Court of Queensland—Full Court). *See also infra* note 26 and accompanying text.

26 The present administrative view in Australia is contained in NATIONAL COMPANIES AND SECURITIES COMMISSION, RELEASE NO. 118, COMPANIES, CODES, AND THE EXERCISE OF EXEMPTION POWER FOR FRANCHISING SCHEMES (Effective Feb. 24, 1984). This statement is "predicated on the assumption that the *Casnot* decision will continue to be accepted by the Courts throughout Australia."

wishes to franchise in Australia. The first draft of an Australian franchise law, promised for four years, is said to be available in March 1986.

The chief point concerning laws specifically applicable to franchises is not that they pose too many problems for reputable franchisors, but that they pose problems of delay in timing the launch of a franchise. Such delays must be anticipated. If such laws are ignored, dire results may follow. Even if one believes that conviction will not occur (the belief of many in Australia at the present time), the inevitable investigation, delays, and executive time involved in battling governmental authorities can mean that one may have no option but to comply with bureaucratic directives, rather than to take the risk on the point.

5. Failure to comprehend the importance of other relevant laws

There is a whole host of individual laws which, on their face, have nothing to do with franchising, but which can result in significant problems. Local advice on these types of laws is also of basic importance.

a. State laws in federal systems

All too frequently franchisors from unitary government countries do not appreciate the problems caused by state or provincial laws in federal systems such as Australia, the United States, or Canada. These laws are often crucial. Some simple examples from these countries illustrate how vital this point can be.

In Australia, nearly all packaging and labelling laws are state or territory laws. A Report by the Australian Trade Practices Commission[27] concluded that such laws were administered by a host of different ministers and state bodies. While there was some uniformity, manufacturers selling nationally often were unable to obtain the benefits of common labelling. In some cases, labelling legal in one state was illegal in others. Such diverse laws at the state level must have an impact upon any "system franchise."

In the United States, one of the most significant pieces of legislation is the so-called "franchise tax" of various states, the most well known of which is that of California. This state law taxes the profits of a company doing business in California on the basis of its worldwide profits regardless of whether it made a profit in California. Similarly, the California

[27] PACKAGING AND LABELLING LAWS IN AUSTRALIA, REPORT BY THE TRADE PRACTICES COMMISSION TO THE MINISTER FOR BUSINESS AND CONSUMER AFFAIRS (Aust. Govt. Pub. Serv., Canberra 1977).

authorities claim to have the right to inspect records wherever they are placed in the world, thus causing not inconsiderable administrative problems. Double tax treaties with the United States are simply irrelevant when state laws can have such effect. The California law, which has been upheld by the United States Supreme Court[28] precludes a foreigner establishing some type of permanent presence in California by way of subsidiary or joint venture and effectively compels either direct franchising (very difficult from a distance) or a Master Franchise Arrangement.

Initially, the California franchise law applied only to United States companies with subsidiaries abroad. But the California Franchise Tax Board is now applying the legislation to California taxpayers with foreign nation parents where neither the foreign nation parent nor any of its other subsidiaries is located in California or doing business in California.[29] It is understood that steps are being taken in the United States to ban states imposing unitary taxes on foreign enterprises.[30]

In Canada, one is likely to run afoul of the Charter of the French Language legislation in Quebec, if franchising there. The Charter is drafted in less than precise language and, of course, ruins the English language franchise precedent which the franchisor probably uses elsewhere in the world. The legislation is said to be unconstitutional as to large aspects of its operation. This legal point is irrelevant for all practical and commercial purposes. The Charter establishes the *Commission de surveillance de la langue Francais* to enforce the legislation. One of the provisions of the legislation is that every person who has the right to have firms doing business in Quebec communicate in French. Some firms require certificates which stipulate that only French be used. Cata-

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28 *See* Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983).

29 To take an extreme example which must strike fear into any foreigner contemplating doing business in California, Shell Petroleum was assessed by the State of California on "California income" of 46 million dollars over a four year period because of the fact that there was a California taxpayer, "Scallop Nuclear Inc. a subsidiary of the Royal Dutch/Shell Netherlands and United Kingdom parent company and a 50 percent partner in a partnership operating in California." This nexus enabled California to assess California tax by bringing into account the income of over 900 worldwide Royal Dutch/Shell group companies. In fact, the actual partnership had made a loss on its California operations. *See also* Allen, *The Container Corp. Case: The Unitary Tax in the United States and as Perceived by the International Community,* 18 INT'L LAW. 127 (1984).

30 *See* AUSTRALIAN FINANCIAL REVIEW, Nov. 11, 1985, under heading "Reagan agrees to Bill banning Unitary Taxation." Details of the Bill and its legislative fate were not available to the writer prior to the writing of this paper. The article notes that, of the twelve original states with such legislation, six have repealed it because of heavy pressure from multinationals. The only state in which there is any significant representation of Australian Companies and which retains the unitary tax system is California. (The others are Alaska, Idaho, Montana, New Hampshire and North Dakota). Threatened British retaliatory measures are said to be important in United States policy making decisions in this field, as is the pressure of Japanese firms which have threatened to take investments elsewhere if state unitary tax laws are not repealed.

logues, brochures, and folders must be in French. Clearly such a provision has enormous impact upon any "system franchise" and the costs of franchising in Quebec—particularly when the Quebec operation is small.

b. Other laws

Licensing controls and production regulations abound in various forms in all countries. Revenue laws are of fundamental importance. What one wants is to make everything tax deductible to the franchisee and nonassessable to the franchisor. Of course, it is rarely that simple.[31] Stamp duties, sales tax, customs duties, receipt duties, often both at the state and federal level, are also fundamental to the viability of franchising arrangements. Foreign investment laws are quite significant.

Also important, but frequently overlooked, are immigration laws. The franchisor may promise to assist the franchisee by placing staff in the target country, only to find that an appropriate work permit will not be granted. This can work in reverse, too. If the franchisee is to work for or to be trained by the franchisor, immigration authorities in the home country may resolutely refuse to allow entry. Similarly, some countries have quite stringent laws relating to ethnic origins and job reservation.[32]

6. Problems of Jurisdiction and Applicable Law

There is never a satisfactory resolution to the choice of law problem unless the franchisor and franchisee are geographically proximate. In the case of franchises into or out of the remote antipodes of Australia and New Zealand, there is difficulty in making the jurisdiction of the country of either the franchisor or franchisee exclusive. This author has never seen a reasoned approach to the issue in negotiations. Usually, the franchisor wins the day because of superior bargaining power although, generally speaking, the laws of the target country have the better claim to jurisdiction. It is in that country that the relevant activity is being conducted. In patent, trademark, and antitrust matters, the target country's laws will be applicable regardless of what the agreement says. Furthermore, one cannot opt out of the target company's bureaucracies by simply declaring the agreement subject to the laws of another jurisdiction.

The choice of law problem cannot, however, be simply ignored. To leave the question to the courts is to invite further litigation. In practice what seems to happen is that the franchisor wins or a compromise is

[31] For an excellent study of these aspects in Australia, see Allen, Revenue Aspects of Franchising (Paper presented at the State Convention of the Queensland Division of the Taxation Institute of Australia Apr. 19-21, 1985) (Published by the Taxation Institute of Australia).

[32] Such laws are not confined to countries such as South Africa.

reached whereby the party initiating litigation is required to litigate in the courts of the other party. This at least does have the benefit of discouraging litigation.

The lawyer in this field can do little but advise. It is the negotiating strength and skills of the parties which will determine the issue. Clients are, regrettably, too willing to accept the law of unknown jurisdictions. This tendency of commercial parties must be anticipated. Similarly, clients should be warned that target country laws must generally be obeyed regardless of what the agreement may say.

Some countries will not approve agreements unless there is a submission to the jurisdiction of the courts of the franchisee. While generally speaking, specific governmental interference in the terms of *inter partes* negotiated agreements is somewhat deplorable, one admirable aspect of such control can be the resolution of the choice of law problem. Andean Pact countries simply will not approve agreements which take away the jurisdiction of the courts of the relevant Andean Pact country. If the agreement is not approved, then no royalties can be remitted. Similar authoritarianism on this issue in other countries might solve many jurisdictional problems. The present position is that franchisees rarely obtain a reasonable arrangement of this issue by the processes of *inter partes* bargaining.

Jurisdiction clauses are always a potential pitfall, particularly in long-distance arrangements. They are not negotiated on their merits by commercial negotiators, but are regarded as trivial by the parties. Should a dispute arise, however, this often-overlooked provision of the agreement may take on a new significance.

VII. Concluding Comments

Franchising is never short of its share of problems in either domestic or international agreements. But it is a fascinating subject for lawyer involvement. The lawyer is part negotiator and part marketing adviser, in addition to fulfilling the traditional role of legal advisor.

For a franchisor to consider operations in a target country, that country must be politically stable, with an appropriate market, where funds can be remitted, and where there is a minimum of governmental interference with the parties' franchising agreements. Most governments, for various reasons, have laws which both harass and tax franchise arrangements. This comment applies to the developed countries as much as to lesser-developed countries. Various examples given in this paper illustrate this point.

Lesser-developed countries merit sympathy in the franchising game.

The many laws controlling most overseas arrangements in such nations certainly deter franchisors from considering franchising operations in those countries. Such laws frequently prevent them from receiving technology and business systems which would enhance their development. However, there is a significant danger of exploitation of lesser-developed nations through unscrupulous business practices. One must be sympathetic to the necessity to create various roadblocks to control such activities. Unfortunately, these roadblocks, when erected, also have the effect of hindering honest businesses attempting to set up arrangements beneficial to all.

The message to lawyers advising on international franchising arrangements is:

—Understand what franchising is about commercially because only then can one advise competently. If necessary, confer with marketers and reputable franchising consultants to sharpen these skills.
—Make inquiries in all matters and take local advice. Despite exhaustive inquiry, nearly every international franchise arrangement overlooks some important legal or commercial consideration.

Above all, the cardinal rules in any evaluation of international franchising transactions are these:

—Take the maximum time possible for negotiation.
—Take the maximum time possible to comply with government requirements.
—Assess the maximum possible legal and other costs which will be payable.
—Then, *at least* double all factors!

Even engaging in such a cynical exercise, one may still find oneself well short of the ultimate timing and costs involved.

Finally, this author must acknowledge the assistance of a number of non-lawyers in compiling this paper—in particular, a number of persons involved from the commercial viewpoint who negotiate franchise arrangements. One franchising consultant commented on a draft of this paper—perhaps somewhat cynically, but undoubtedly correctly—as follows:

> In your opening remarks you point out that franchising is not well understood in legal circles. You also mention that lawyers are not very good at dealing with the issue of marketing, but nowhere in your paper do you suggest that lawyers should establish good working relationships with reputable firms who can provide these skills.
>
> Why not give the franchise consultants a plug? We are just as important as the negotiating lawyers in the early stages!
>
> Franchising is alive and well around the world not due to good legal agreements, but because both the franchisor and franchisee want the deal to work and constantly change the rules to ensure that it does, even though this gives their lawyers nightmares.

> It only fails if they do not compromise. No agreement ever written can possibly cope with all the commercial hiccups their relationship is going to encounter over that ten-to-twenty year period.

My franchising consultant friend is correct. Lawyers must learn the market realities and franchising consultants can be of valuable assistance to lawyers in imparting the commercial message. Regrettably, he is also right in that no agreement will completely cover all the hiccups. Despite this, lawyers must still try to put together a workable agreement—often covering problems no one at the time of the agreement can contemplate. Such an obligation is not lightly discharged. It has been the purpose of this paper to demonstrate the difficulties and problems in discharging that obligation.