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New Challenges for International Franchising

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THE FIVE MOST NEGOTIATED PROVISIONS IN INTERNATIONAL FRANCHISE AGREEMENTS

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Table of Contents

1. Introduction

Franchise agreements[1] create the legal foundation for what both parties hope will be a long-term franchise relationship. Of course, Franchisors generally prepare their form franchise agreements without a specific franchisee in mind, but they definitely do so with their ideal business and legal structures and terms in mind. These ideal business and legal structures and terms are generally designed to benefit the franchisor as drafter, with perhaps some degree of franchisee-friendly provisions included depending on the franchisor's view of its own status and bargaining power among its competitors. Regardless of the nature of the original form franchise agreement, these days for almost any significant international franchise transaction, the franchisor can expect that the prospective franchisee will have an attorney (who may or may not have franchise-specific expertise) and that the prospective franchisee and their attorney will want to negotiate a number of different business and legal terms in the franchise agreement.

There are of course myriad provisions in a franchise agreement that are the subject of negotiation, and they range from business points to legal points to drafting style to common vs. civil law format. Every prospective franchisee and every attorney who assists a prospective franchisee will have their pet issues and provisions, but this paper focuses on the key underlying issues, provisions and drafting options for five of the most negotiated provisions in international franchise agreements, namely the grant/reserved rights provision, the tax/gross up provision, the indemnification provision, the default/termination rights and the guaranty/corporate or personal undertakings.

Before diving in on the five provisions selected for this paper, we have noted below several other provisions that barely missed the cut:

- Transfer provisions
- Supply chain provisions
- Governing law and dispute resolution provisions
- Fee and general payment provisions
- Territory provision
- Damages waiver provisions
- Liquidated damages or lost profit provisions

2. Grant/Reserved Rights Provision

The grant clause of the franchise agreement is a seemingly simple provision, but through experience, case law[2] and innovation the combined grant and reserved rights provision of a franchise agreement has become one of the most hotly contested combined business and legal provision in all of franchising, and especially in international franchising where franchisors are many times granting an entire country to a single franchisee, but still wanting to reserve certain rights within the country to the dismay of the prospective franchisee.

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[1] For purposes of this paper, we use the generic term franchise agreement for all types of franchise contracts, including letters of intent, master franchise agreements, representative agreements, development agreements, multi-unit franchise agreements, single unit franchise agreements, etc.

[2] Much of the growth in this area can be traced back to a Florida case *Scheck v. Burger King Corp*. In that case, the franchise agreement contained the following provision relating to territory: This license is for the described location only and does not in any way grant or imply any area market or territorial rights proprietary to FRANCHISEE. The Scheck court held that even though the franchise agreement expressly denied a right to an exclusive territory, it didn't necessarily imply that Burger King had the different right to open additional units without considering the effect of the new units on the franchisee's operations. As such franchisee "is entitled to expect that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract."

25 years ago, the grant clause of many international franchise agreements was brief, perhaps a sentence or two stating who, what, where and how (i.e., the type of business covered, the geographic location for the business, any exclusivity, the duration of the grant and any key conditions or limitations). Something akin to the following:

"Franchisor grants Franchisee the right to develop and operate a Unit at the Unit Location."

Some of these old franchise agreements did not even attempt to expressly reserve rights beyond what was granted or within what was granted. There was simply the grant itself. However, as franchisors kept thinking up different ways to expand the brand, develop new brands, purchase or convert other brands, create alternative means of distribution and figure out how to use and monetize the Internet, these simple grant clauses and simple or non-existent reserved rights provisions were inadequate to clearly reflect the parties' rights and obligations.

These days, grant and reserved rights provisions can be multiple pages, and invoke significant negotiation. Below are some of the most negotiated points in the grant and reserved rights provisions of a franchise agreement:

2.1. Who is granting the rights?

It is not unusual for a grant clause and any related exclusivity to apply solely to the franchisor entity, but perhaps more unique in the international realm is a negotiated request that the franchisor's parents, affiliates, subsidiaries, successors, assigns and other related parties be covered by or restrained by any grant of exclusivity. In today's age of mergers and acquisition, care must be taken so as to avoid constraining not just the franchisor's current parents, affiliates and subsidiaries, but also its future parents, affiliates and subsidiaries, which is a common request seen in international transactions.

2.2 What exactly is covered by the grant of rights?

The scope of the rights in an international franchise agreement are crucial. In the minds of most franchisors, the grant is for a very specific type of bricks and mortar Unit (i.e., a restaurant that bears specific marks, prepares and serves food for on-site consumption, is of between 2,000 and 2,100 square feet and is outside a non-traditional venue). Many international franchisees think they are buying "the brand" for their country, including all possible iterations of the brand. This results initially in negotiations regarding the nature of the Unit (size, range of products and services, bricks and mortar, etc.…), Marks (all marks bearing some semblance of a core name or are uses such as [Unit] Express excluded) and System (broad reflection of the brand, or specific to the Unit that is using the specific Marks).

From there, the touch points for a particular franchisee are numerous and varied. Each franchise system will have its own potential variances and offshoots to discuss and negotiate around. For restaurants, touch points could be express and non-traditional units, food trucks, catering, delivery, third party delivery such as Uber Eats, to go ordering, online ordering, etc.… For hotels, it could be affiliates using different marks but the same reservation system. For service-based businesses, it could be outside of territory service.

2.3 Is Exclusivity Granted/What is the Geographic Scope of Exclusivity?

Some franchisors have had success with Unit location-only grants, but most franchisors of bricks and mortar locations find they need to grant some form of exclusivity to sell franchises and placate franchisees. The actual size of the geographic scope of the territory is low hanging fruit but can be complex in multi-unit transactions where a franchisor might be loath to grant X mile radius around each Unit if one Unit might be located in central London and another in a small country side village. Negotiating a high and low range at the outset is a fairly common option to avoid issues on a Unit-by-Unit basis. One author mentioned that they have seen structures that tie all exclusivity to continuing development. If the franchisee is no longer developing, they have no exclusivity for their existing units.

2.4 Carve-Outs for Similar Businesses Using Other Marks?

Franchisees routinely raise concerns that a franchisor of a successful brand that is being purchased will replicate the brand with a different trademark and compete directly with the franchisee in their market. While the likelihood of such an action is exceedingly low (but in truth it has happened), some franchisors have granted rights of first refusal or rights of first offer to bring different brands to the territory. Of course, from a negotiation standpoint, the scope of the different brand and the timing and limitations on the rights of first refusal or rights of first offer are ripe for negotiation, and franchisors need to consider what happens if the core or other brand is divested.

(i) Carve-Outs for Non-Traditional Outlets?

As noted above, most franchise agreements today provide franchisee exclusivity carve-outs for so called "non-traditional outlets" such as airports, military bases, stadiums and other captive audience locations, including in some instances shopping malls. Franchisees naturally think that any geographic area in their "territory" is theirs, but franchisors disagree.

Many times, these non-traditional outlets require contracting with a government or quasi-government entity, or an entity with special rights and privileges to contract with the government. Other times, the contracts are subject to requests for proposal (RFPs) that may only be open to certain groups. Finally, in many cases, RFPs have already been conducted and won, and the only way the franchisor can locate a Unit in the particular non-traditional outlet is to contract with the party that won the RFP, which is more than likely a large concessionaire such as Delaware North, Compass, Aramark and their international counterparts. Of course, many prospective franchisees are loath to the concept of a non-traditional outlet in their territory and may attempt to negotiate either a right of first offer to see if they can develop and operate a non-traditional outlet themselves if the opportunity arises or a non-exclusive grant so that the franchisor and the prospective franchisee are essentially in a race as to the development of a non-traditional outlet. In many instances the compromise to grant a form of right of first refusal or right of first offer that only applies if there is a realistic opportunity for the local franchisee to win, and not where there is already an existing concessionaire that will only deal with the franchisor.

(ii) Carve Outs for "Alternative Methods of Distribution"?

Alternative methods of distribution is a catch-phrase that means different things in different industries, but whether the alternative is sales through the internet, mall kiosks, wholesale product distribution networks, product sales in Walmart, Costco or 7-11 or even old-school telephone sales or catalogues, the one constant is that innovation will continue to bring new alternative methods of distribution that franchisors want to retain and franchisees want to obtain.

Negotiations in this area range from franchisee's seeking either sole rights to do X or Y (or express prohibitions on franchisor from doing X or Y) to compromises such as rights of first refusal similar to those discussed above with respect to non-traditional outlets or shared revenue provisions that permit the franchisor to pursue the alternative method of distribution in the territory itself so long as the franchisee receives some type of revenue stream from sales in the territory, many times couched as a reverse royalty.

2.5 Continuing Obligations to Retain Exclusivity?

It is fairly typical that the franchisor caveats franchisee exclusivity with statements that the exclusivity is subject to the franchisee's continued compliance with the franchise agreement, but in reality the provision is drafted so that the franchisee and all entities and individuals associated with the franchisee in any way must be in strict compliance with all franchise agreements and other agreement that any of them have in place with the franchisor and all entities and individuals associated with the franchisor to maintain the exclusivity. This leads to negotiations relating strict vs. material or substantial compliance and limitations on the parties and/or agreements that must be in compliance, regardless of whether from a practical situation a franchisor could locate a new Unit in the territory within a default period in the underlying franchise agreement.

Some franchisors (particularly those with no grant of exclusivity in the franchise agreement or a significant grant of exclusivity) may supplement their system expansion standards with site clearance procedures, rights of first refusal, minimum performance quotas, impact policies, and so forth. Such additional considerations are also ripe for negotiation, especially in the international context where a franchisor may not have the necessary data and experience to consider appropriate quotas or other triggers.

2.6 Rights of First Refusal for Additional Territory?

Most international franchise agreements clarify that they reserve the right to establish, operate and license others to establish and operate Units, non-traditional locations, alternative methods of distribution located anywhere outside the Territory's physical boundaries, and franchisees of course would like rights of first refusal for neighboring areas, whether a city, region, country or even perhaps a continent.

As with non-traditional locations and alternative methods of distribution as noted above, although definitely not the norm, some franchises will negotiate standstills, rights of first offer and/or rights of first refusal to allow the franchisee to have the first opportunity to develop Units outside their negotiated territory. These rights can be free or paid for separately and can be for a short or longer period of time, but in most instances the franchisee must be in compliance to exercise any such right. These are clear business points, but many times the legal structure is key and subject to much negotiation.

2.7 Rights related to Mergers and Acquisition?

Franchise agreements typically include franchisor-friendly reservations relating to mergers and acquisitions that result in other brands, other owners and other parties coming together and potentially having directly or indirectly competitive operations in the Territory. This is an area of the franchise agreement that is ripe for both abuse by the franchisor and compromise between the parties. In an ideal world for the franchisor, franchise systems can be bought/sold without contractual limitations, but no franchisee would consider it fair that its long-time franchisor could potentially purchase or be purchased by a rival competitor and then have the existing rival brand convert to the same system and compete with the franchisee in the Territory it thought was exclusive. Very few, if any franchisees, would consider it a positive result even if those rival brand stores were now under the same franchisor or parent umbrella as their franchised store. Thus, this is an area where franchise drafting for ultimate flexibility must be weighed against fairness and salability.

3. Withholding Tax Gross Up Provisions

There are myriad cross-border financial issues that arise in international franchise transactions, and there are no one-size-fits all approaches. However, one issue that is almost always at the forefront of negotiations is the allocating of the burden of paying withholding taxes and addressing currency risks, and there are not that many ways to split the baby in negotiations.

The basics are fairly-straight forward. Each country wants to hold and retain tax revenue from business conducted in their country. In a typical international franchise transaction involving a US franchisor, the franchisor will be paid initial fees and continuing fees for the rights to use the operating system and trademarks, and for certain initial and continuing services, some of which is inarguably occurring in the local country. The two underlying constants are that the money paid by the local franchisee was generated in the local country but will leave the local country to go to the franchisor, who in most cases does not have a place of business or other business in the country to which the home taxing authority can exercise rights. So, the local country makes the local franchisee the local taxing agent for the franchisor, and requires the local franchisee to deduct from the payments it will make to the foreign franchisor an amount equal to the withholding tax rate set in the country and then pay the franchisor the remainder, which results in the franchisor receiving less money than it expected and then having to pay U.S. tax on that reduced amount.

Thus, in practice, foreign withholding taxes subject the foreign franchisor's income from foreign sources to a higher cumulative tax burden than the franchisor pays on its U.S. source income. That is, the amount of tax withheld abroad from foreign source income, plus the U.S. income tax on net foreign source income (with or without the benefit of a foreign tax credit), may exceed the amount of U.S. tax the franchisor would have paid on an identical amount of U.S. source income. Further, a franchisor loses the use of funds that are withheld from its foreign source income between the time the taxes are withheld and the time its U.S. taxes are due.

3.1 Gross-Up?

Experienced franchisors often use two techniques to avoid the distortion that foreign withholding taxes can cause. The first is the so-called "tax gross-up" technique that involves shifting the burden of foreign withholding taxes to foreign franchisees. As noted above, most countries impose their withholding tax on the franchisee as the foreign franchisor's tax agent, who must withhold and pay the tax on its royalty and other obligations before remitting payment to a foreign franchisor. Through the tax gross-up technique, franchisors pass the withholding tax's economic and cash flow burden to their franchisees by requiring that franchisees both pay the withholding tax and pay royalties at the full contract rate.

By way of example, if the royalty due is 100, and the withholding tax rate is 10%, if there were no gross up the franchisee would take out 100 from its bank account, pay 10 to the taxing authority and then pay the remaining 90 to the franchisor. If a full gross up was negotiated into the agreements, if the royalty due is 100, and the withholding tax rate is 10%, then the franchisee would take out +/- 111 from its bank account, pay +/- 11 to the taxing authority and then pay the remaining 100 to the franchisor so that the franchisor gets the full benefit of the original payment.

3.2 Full or Partial Gross-Up?

Since the underlying delta in a withholding tax situation is a financial point and the rate itself can fluctuate in a given country over the length of a franchise agreement, sometimes franchisors and franchisee agree to split the baby, and perhaps agree that there will be a 25%, 50% or even 75% gross up as opposed to a 100% gross up. The authors have also seen percentage caps on the gross up to protect against rate increases over the life of the agreement. Again, these are generally business points that the lawyers end up drafting.

3.3 U.S. Credit?

Even if a franchisor failed to consider the withholding tax or was unable to negotiate a gross up, not all is potentially lost. The U.S. tax code is set up so that some U.S. tax payers can take a credit against their U.S. tax burden based on their payment of foreign source taxes such as withholding taxes. The nuances of foreign tax credits and the historical and future changes to the U.S. tax code are outside the scope of this paper, but from a practical negotiation standpoint some franchisors buffer a gross up's financial impact on franchisees by providing that if and when the franchisor receives the benefit of a tax credit against its U.S. income taxes for the withholding taxes a franchisee paid, the franchisor will refund or credit to the franchisee an amount equal to the tax credit the franchisor received. Of course, a franchisor that owes no U.S. income taxes on account of current or accumulated net losses cannot take advantage of foreign tax credits, so its foreign franchisees may ultimately receive no benefit from the tax refund provision in their franchise agreements. Care must be taken when considering tax credit offsets that no specific guarantees are provided, and in all cases, franchisors must consider the time value of money lost if they believe they can take the credit and therefore do not insist on a gross up clause in the franchise agreement. The authors have seen instances of where franchisors who were able to take advantage of a tax credit for many years lost the ability to do so after a merger, acquisition or other investment transaction restructuring their corporate framework.

3.4 Currency?

It is important to remember that international franchise agreements should have payment and currency provisions addressing three principal issues: the currency in which the franchisee must pay its royalties and other fees, the exchange rate and conversion date the franchisee must use to purchase the required currency, and the consequences of a change in local law or government policy concerning the purchase or remittance of the required currency. The authors have seen currency devaluations in Mexico, Indonesia, Argentina and elsewhere cause havoc on transactions, and have also seen both franchisors and franchisees attempt to manipulate currency fluctuations when making or requiring payments under the agreements, especially when there are delinquent payments and there is a wide discrepancy between the conversion rate that was applicable at the time the original payment was due vs. the time with the franchisee was actually going to make the payment. All of these points are ripe for negotiation, with the level of focus in part a product of the history of currency fluctuation and issues in the given country.

4. Indemnification Provisions

Some of the most animated and interesting negotiations on international franchise agreements arise in the context of indemnification provisions. Many international franchisees have an extremely exaggerated picture in their head regarding the frequency and cost of litigation in the U.S., with the McDonald's coffee case and other extreme cases generally coming to the forefront in negotiations. While the prevalence and cost of litigation in the U.S. is outrageous to even the most seasoned U.S. attorneys, when it comes to indemnification U.S. franchisors must combat concerns of such unlikely scenarios as U.S. patrons of company owned Units suing an international franchisee or even U.S. patrons of the international franchised Unit suing the franchisor and international franchisee in the U.S.

4.1 Scope of the Indemnification?

Most franchise agreements contain broad franchisee indemnifications in favor of the franchisor and all its related parties that cover harm and related costs from the origination of the underlying triggering event (such as a franchisee customer being hurt on the franchisee's premises). The franchisor of course takes the position that the franchisee owns and operates the Unit and that any harm that occurs at the Unit or related to the franchisee's operations is the franchisee's sole responsibility and that the franchisor and all its related parties should be indemnified. However, it is fairly common to receive franchisee-originated negotiated changes limiting the indemnification scope to just the franchisor, or only to matters for which the franchisee was grossly negligent or acted intentionally, or perhaps only to matters where the franchisee is actually liable after any appeal rights are exhausted.

4.2 Franchisor's Indemnification of Franchisee?

The most likely negotiation point to be raised in the franchise agreement is to make the indemnification mutual. Most franchisors reject this point outright, but the authors have certainly seen mutual indemnification provisions. More likely, especially where the franchisor's trademarks are not yet registered or have certain issues attached to them, the franchisor may provide a limited indemnification as to the franchisee's right to use trademarks. Similarly, if the franchisor's system is product-based with a product manufactured by the franchisor, the franchisee may request a limited indemnification related to the use, offer and sale of the product. Franchisors need to take care to consider the scope of, and ideally monetary caps for, any franchisor indemnity to avoid finding oneself under water on the overarching transaction due to indemnity obligations.

4.3 Relationship with Insurance?

In a perfect world, all matters that might be covered by indemnification are covered by insurance and neither party comes out of pocket beyond a reasonable deductible, but that does not mean that a typical request that indemnification only applies where insurance applies is a reasonable or practical negotiation point for a franchisor to consider, even though it is often brought up as a limitation on the franchisee's indemnification obligations.

4.5 Who Controls Litigation/Has Settlement Authority?

The core issue of who decides when to settle and for how much is at the heart of all indemnification negotiations. The franchisor always wants to be able to control settlement when it is part of a matter than is covered by indemnification, and the franchisee always envisions the franchisor making bad deals with their money. In some instances, the franchisor considers itself more business savvy and experienced in connection with litigation, but in other instances the franchisor may be comfortable with deferring to a franchisee that may be larger, more experienced and wealthier than the franchisor. Ultimately, the worst general solution is a mutual agreement provision because there is no perfect deadlock solution, but in lieu of mutual agreement provisions the authors have seen compromises that allow the franchisor to settle without franchisee consent up to a certain dollar amount or with respect to matters that relate to the marks or trade secrets, and then requires mutual agreement with some form of deadlock solution if the settlement is over a certain dollar figure after application of any available insurance.

4.6 Mitigation of Damages?

Franchise agreements typically have statements that the franchisor or other party for which indemnification is owed does not have an obligation to mitigate damages. This is mainly because any insertion of a mitigation requirement is ripe for dispute.

4.7 Comparative Negligence?

One of the more common indemnification negotiation points is the concept of comparative negligence. The concept is fairly simple, but the drafting can be complex. In a perfect indemnification world, the franchisor has no blame and is fully covered. However, in the real world, the franchisor may have some blame, and a court or arbitration might find the franchisor to be X% to blame for the underlying harm. Should that blame be ignored when it comes to indemnification, or should that negate the franchisor's right to indemnification? One compromise is a comparative negligence provision that would ideally state that the franchisor is covered from the outset of the matter, BUT if a court or arbitrator with jurisdiction over the underlying matter ultimately finds that the franchise was X% at fault and the franchisor was Y% at fault, then franchisor's indemnification coverage from franchisee would be reduced by that Y% so that the franchisor bears its own burden for the underlying action.

5. Default and Termination Provisions

Almost all international franchise agreements contain fairly detailed one-sided default and termination provisions. Some are more onerous than others, but the intent is clear -- the franchisee is on a short leash, and there are certain types of defaults that are so vile that if they occur there is no ability to cure or rehabilitate the relationship. In some franchise agreements, there may be a laundry list of upwards of 15 or 20 non-curable defaults, with others that might permit only a 10 to 30-day cure. Given that larger international franchise transactions can require tens or even hundreds of millions of dollars of capital and generate similar millions of dollars in revenue, franchisees are generally unlikely to take a franchisor's word that the franchisor will not act maliciously or arbitrarily when considering default and termination provisions.

Below are some of the key default and termination provisions that are routinely negotiated:

5.1 Franchisor Default Provisions?

Similar to the indemnification provision noted above, many franchisees will start with the premise that the default and cure periods should be mutual and mirrored. It is exceedingly rare that a franchisor agrees to such a negotiated change. Instead, it is more common that a generic franchisor default provision is added that provides for a comfortable (90 to 180 days?) cure period and perhaps even a right to resort to a form of "declaratory judgment" action before termination might actually be permitted. This in some ways gels with the tenets of civil law training franchisee attorneys who find it unimaginable that there is no franchisor default provision in the franchise agreement.

5.2 Who can Cause the Default?

The more sophisticated the franchisee, the more likely negotiations arise as to whether the franchisee must be the cause of the default vs. a rouge director, officer or one of perhaps thousands of employees. Franchisors of course care less about the source of the harm, and more about the harm itself, but franchisees want to make sure that the errant actions of a Unit-level employee or even a rouge officer does not result in an overarching termination of the transaction and loss of the investment. One compromise that the authors have seen is a provision that states that if the specific act, error or omission of default can be traced to an individual (generally not the controlling owner) and that person is timely removed then a cure is possible.

5.3 What are the Cure Periods?

Most franchise agreements provide for both a list of defaults that cannot be cured because either the "cat is out of the bag" in terms of harm or the harm and underlying act, error or omission is so egregious to make the relationship irreparable and then a list of defaults that can be cured along with a specific cure period. Many franchisees first want to add a cure period to each non-curable default. This creates issues because in many cases there is no legitimate cure. Many franchisees also want to increase the cure period for curable default. By way of example, most franchisor agreements will have a cure period of approximately 30 days for curable defaults (except perhaps for monetary defaults that might be 10 or 15 days and defaults that may cause harm to persons or property that might be 48 hours), and it is fairly common to see the franchisee double the cure period only to have the franchisor cut that doubling in half as a compromise. Care must of course be given to avoid using too broad a brush to revise all defaults when a more refined focus on one or two defaults that might be of most concern can be done.

5.4 Are there Cross Defaults?

The greater the size of the deal in terms of Units, the greater the concern arises for franchisees regarding cross defaults. Every franchisor has listened to a franchisee doomsday scenario where one low level employee causes a default under one agreement that is then used in a predatory manner to cross default and terminate a master franchise or development agreement and over 100 or more franchise agreements. At the same time, every experienced franchisee has listened to the franchisor state first that they would never act in such a predatory manner and then state that the franchisor should not have to continue with a relationship with a habitual offender. Compromises normally include splitting apart master and development rights from franchise rights when it comes to cross defaults, or perhaps providing 1, 2 or even 3 bites at the apple in transactions with multiple Units so that one or perhaps two slips does not jeopardize the franchisee's entire business, but the franchisor still has cross default rights if the franchisee becomes a habitual offender.

5.5 Does the Franchisee have a Unilateral Right to Terminate?

Most international franchise agreements lock in the franchisee to develop a specific number of Units or to operate the Units for the full initial term. However, some franchisees will attempt to secure the right to stop development for any reason or perhaps if they are losing money on their open Units and avoid any type of penalty or other repercussions. Some will request the right to cease development of new Units with the sole remedy being the franchisor's right to retain any prior development fees that were paid for unrealized Units.

At the Unit level, Franchisees may seek the right to close Units if they promptly replace them, or perhaps the right to close underperforming locations so long as they can prove up their losses and properly terminate.

5.6 Are there any Special Termination Rights?

Master franchise agreements create special issues in the default and termination area. Most franchisors use a master franchise program because they loath the idea of having multiple franchisees in each international market, but in most instances the franchisor would likely inherit the existing subfranchisees if the master was terminated for cause. The authors have seen master franchise agreements negotiated in a manner that the master must provide in each subfranchise agreement that it will terminate at the franchisor's election if the master franchise agreement is terminated.

While the various negotiation points that arise in transfer provisions are not covered here, the authors are increasingly seeing international transactions where a franchisee is a part of a multi-billion dollar company and the parties reach an impasse on transfer restrictions where the larger company wants to sell its entire business or perhaps an entire line of business and is incredulous that the franchisor believes it should have pre-transfer approval rights when perhaps the franchise is only a small fraction of the franchisee's larger transaction. While again a compromise that neither side really loves, the authors have seen provisions negotiated where such an overarching transaction would be permitted to occur without franchisor consent, but the franchisor would have the right to receive notice of the transfer, access to the new controlling parties and then a right within a reasonable time after the transfer to ratify the transfer (if the new party is not objectionable), terminate the franchise (if the new party was so objectionable as to make continuing infeasible) or even purchase all the Units (normally in preparation for a refranchising transaction) at an agreed price.

5.7 Liquidated Damages and Lost Profits?

As noted above, most international franchise agreements lock in the franchisee to develop a specific number of Units or to operate the Units for the full initial term, and the underlying deterrent and enforcement mechanism is either an express liquidated damages provision or an express or inferred lost profits right.

Liquidated damages provisions (penal clauses in some jurisdictions) are the most common approach, but their use in standard form franchise agreements and the manner in which they may be negotiated varies widely. Franchisors may include liquidated damages clauses for franchisee abandonment and all manner of terminations, or perhaps only for breaches related to transfers, confidentiality or noncompetition. Others may focus liquidated damages on post-term harm such as carrying over, or post-term noncompetition. While the scope of the liquidated damages provision is certainly ripe for negotiation, even more so is the amount and calculation, and whether it is a sole remedy or one possible remedy.

Negotiations over lost profit damages rights generally focus on whether lost profit damages are expressly provided for, or expressly waived. Some franchisors attempt to draft one-sided or narrower damages waivers so as to leave the door open for lost profits damages as some form of compensatory, direct or general damages available under the chosen governing law. Ultimately, the concepts are intertwined in the negotiation of agreements and available remedies for breach.

5.8 Any Special Post-Termination Buyout Restrictions?

Franchisors generally include language in their franchise agreements that franchisors can take assignment of leases and buy Units or related assets upon expiration/non-renewal or earlier termination for cause, but franchisees may own their properties and not want to be forced to sell, or they may be mall developers putting locations in their malls and not want to assign leases. Sometimes the franchisee will argue that they will not be required to sell real estate, assign leases or sell other assets if the end of the relationship occurs because or expiration or non-renewal at the franchisor's election. Or the franchisee negotiates a premium on the pricing for these items if purchased at expiration or non-renewal.

6. Guaranty/Corporate or Personal Undertakings

International franchise transactions tend to be larger size and dollar figure transactions with more sophisticated and well-heeled franchisees. The more sophisticated the franchisee prospect, the more likely that the entity that will be proposed to be the franchisee entity will be newly-formed and lightly capitalized, which leads to the franchisor requesting some form of additional security both for peace of mind and for deterrent factors.

Historically, franchisors sought full personal guarantees from some or all of the franchisees direct and indirect owners. This is still very common as an initial request and is still frequently provided when the franchisee is a family-owned or closely-held company, but there are many times franchisees that are public companies or large conglomerates find full personal guarantees to be untenable. Below are some of the key areas of negotiation.

6.1 Personal Guarantees and Undertaking/Corporate Guarantees?

As noted above, many franchisors start with the premise that all direct and indirect individual owners of the franchisee (and their spouses) will sign a personal guarantee and perhaps also a separate undertaking related to key legal provisions such as confidentiality, non-competition, transfer, indemnification and dispute resolution. However, since as noted many times the need for the guarantee is based on the use of a newly formed, bespoke franchisee entity, there are many times a corporate parent or holding company that has been in existence for a longer period, has established businesses and related revenues, and in some instances audited financial statements. Some franchisors navigate the security issue by requiring/relying on corporate guarantees, but care must be given to perform the necessary due diligence to understand the corporate structure so that the corporate guarantees are not provided by equally weak corporate entities.

As to the personal guarantees and undertakings themselves, many franchisees balk and compromises occur after study of the franchisee’s ownership, leadership, structure, assets and cash-on-hand, such as the following:

- Personal guarantees are only required of the controlling owner or of any owner who directly or indirectly holds more than X% of the franchisee and all others sign an undertaking regarding confidentiality, non-competition, transfer, indemnification and dispute resolution.
- Spouses are not required to sign personal guarantees but may be required to sign an undertaking that they will not cause or permit any type of fraudulent transfer designed to circumvent the personal guarantee.
- Personal guarantees are limited to accrued fees only.
- Personal guarantees are limited to a specific dollar figure.
- Personal guarantees are several such that an owner is limited to the percentage of their ownership.
- Personal guarantees will burn off after a period of time if no default occurs.
- In lieu of personal guarantees, all individuals must sign an undertaking of the type described above.
- Personal guarantees are available if the franchisee itself cannot pay or perform.

6.2 Letters of Credit/Bank Guarantees/Deposits?

While perhaps not as common as 10 to 15 years ago, another way franchisors can guarantee payment and other contractual obligations (e.g., for instance a requirement that the franchisee not register the agreement as an agency agreement) is to require a letter of credit or bank guaranty throughout the term of the franchise agreement. A letter of credit or bank guaranty can also be used in lieu of a personal guaranty where the franchisor's ability to enforce the guaranty is dubious.

A letter of credit or bank guaranty permits a franchisor to take specific action – that is, draw down on the letter of credit – without having to pursue formal litigation or other dispute resolution activities. In some instances, a letter of credit is tied to liquidated damages amounts for specific breaches that might not otherwise lend themselves to quantifiable damages, including breaches of confidentiality, non-competition, transfer and non-solicitation provisions as well as premature termination/lost profit damages or improper post-termination operations.

The core initial negotiation point is of course whether a Letter of Credit or Bank Guarantee will be made available by the franchisee. In our experience, large international franchisees that have some type of product-based operation are used to Letters of Credit and are OK with them. Franchisees that perhaps don't have much international experience or have always been more focused on service or brand based business will be very resistant to Letters of Credit or Bank Guarantees.

If the parties agree to the use of a Letter of Credit or Bank Guarantee, then some of the key negotiation points that arise when negotiating an Irrevocable Letter of Credit or Bank Guarantee include the following:

- Which banks will be used?
- What is the amount of the Letter of Credit or Bank Guarantee? Does the amount change over the life of the relationship?
- What types of defaults can trigger a draw on the Letter of Credit, and what are the relevant cure rights?
- Must a separate notice and demand regarding the Letter of Credit be made with separate cure rights?
- What proof must the franchisor present regarding amounts due?
- What are the penalties for failure to obtain or maintain the Letter of Credit?
- Whether a Letter of Credit is required at the outset of the relationship or is instead an option for the franchisor to demand upon repeated default?
- As to a deposit, does the franchisor hold the amount itself or through a third party "escrow agent"? Who benefits from the interest?

6.3 Cash-on-Hand/Net Worth Covenants?

Borrowed from banking and loan covenants, some franchisors will negotiate cash-on-hand or net worth covenants that are normally used to stave off application of personal guarantees or letters of credit. By way of example, a franchisor might agree that so long as the franchisee entity maintains X amount of cash on hand or Y net worth, then the personal guarantees will be tolled. Care must of course be given to ensuring that the franchisee has specific reporting requirements (in an accounting standard that can be verified apples to apples) and that the franchisor be vigilant in requesting appropriate verifications from time to time.

Biographies

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Jay Huh is Assistant General Counsel, International for Little Caesar Enterprises, Inc. in Detroit, Michigan, USA. He is responsible for all international legal affairs for Little Caesars, including franchising, development, transactional, regulatory, intellectual property, supply chain and compliance matters. He also is responsible for all technology and data privacy legal matters for Little Caesars. Prior to joining Little Caesars, he was an attorney in the emerging companies, venture capital and technology transactions practices in the Silicon Valley office of an international law firm. Jay has a B.A. from Wheaton College and a J.D. from UCLA School of Law.

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Robert A. Lauer is a Partner in the Austin office of Haynes and Boone, LLP, and a member of the firm's Franchise and Distribution Practice Group. Mr. Lauer's practice focuses on all aspects of domestic and international franchise transactions. Mr. Lauer was named to Chambers, Global Franchising, Band 3, 2011, Band 4, 2012 and Band 3, 2013 to 2019; Chambers USA, Franchising (Nationwide), Up and Coming, 2012 and Band 4, 2013 to 2018; the International Who's Who of Franchise Lawyers, Law Business Research, 2010 through 2019; The Best Lawyers in America® for Franchise Law in 2008 through 2019; and a "Texas Rising Star" by Law & Politics Magazine and Texas Monthly for 2005 and 2007 through 2012. He is a member of the ABA Forum on Franchising's Governing Committee through August 2022 and current officer of the International Bar Association's International Franchising Committee through 2020. Mr. Lauer is a 1997 cum laude graduate of the St. Mary's University School of Law where he served as an Associate Editor of the St. Mary's Law Journal, and a 1994 graduate of Trinity University in San Antonio, Texas.

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Graeme is a partner in Bird & Bird's international Franchising, Licensing & Multi-Channel Strategies Team, based in London. Graeme's practice focuses on the retail, leisure, food & beverage, services and healthcare sectors. He is retained as counsel by a number of leading and up and coming brands in these sectors. He has particular expertise in advising businesses on the use of franchising as a tool for strategic growth and expansion. In addition to advising on appropriate multi-channel expansion strategies, Graeme advises on intellectual property ownership, protection and exploitation structures, technology transfer licensing and general commercial contracts including agency, distribution, wholesale, supply, confidentiality and know-how agreements together with domestic and international terms and conditions of sale. Graeme's clients range from individual entrepreneurs, early-stage ventures and SMEs to multi-nationals. He has particular experience in assisting businesses expand into new markets including India, the Middle East, the Far East, South East Asia, Russia and South America. Graeme has written numerous articles for "Franchise World", and has spoken at a number of national and international franchise seminars/retail seminars and British Franchise Association conferences and workshops. Graeme has contributed to a number of text books including: "Alternative Corporate Re-engineering – Building Businesses Through Third Party Relationships and Expansion Into New Markets"; "How to Franchise a

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