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Gustavo Alcocer
Olivares y Compania, S.C.
Mexico City, Mexico

Amy Cheng
Cheng Cohen
Chicago, Illinois

Kevin E. Maher
Baker McKenzie LLP
Dallas, Texas

Karsten Metzloff
Noerr LLP
Berlin, Germany

David W. Oppenheim
Greenberg Traurig
New York, New York

Kerry Olson
Faegre Baker Daniels
Minneapolis, Minnesota

Mark Siebert
The iFranchise Group
Homewood, Illinois

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Going International: A guide to international franchise expansion

By Mark Siebert

While many international expansion initiatives start with optimism, a franchisor's ability to replicate the most complex components of its domestic system in a new market; in addition to navigating the legal, conceptual, cultural, and economic differences of international markets can be daunting.

The scenario often goes like this. The franchisor has some degree of success in the U.S. market. Perhaps they are expanding rapidly through franchising, Perhaps they are getting some great press. In some cases, they may not have even launched a domestic franchise program. And while they may not yet be thinking globally, an unsolicited investor emerges with promises of untapped international potential in some distant country. Knowing little about the country and even less about the potential partner, the company rushes headlong into a business endeavor they know little about, fueled by a big check and the allure of being a "global franchisor."

Educated franchisors – those with pragmatic expectations – tend to take a more rational approach. Only when they are sure the system can support international markets, in carefully vetted countries and regions, will they dive into the world of international expansion. These franchisors are careful in partner selection and understand that the training and support offered by an international partner is key to any long-term success - - the ultimate goal in global expansion.

Because there are higher risks associated with international expansion, how a franchisor approaches the process needs to be well-planned and not simply reactive. Rather than an opportunistic approach, U.S. franchisors should engage in a dedicated effort to source multiple qualified leads in a specifically-targeted country so that they can select the right candidate from a pool greater than one. But, before any of those steps progress, the franchisor must first carefully assess whether or not it has sufficient human and financial resources to establish an expansion plan – without endangering the performance of its domestic franchise efforts.

The following factors can help determine a system's readiness to franchise internationally.

Is international expansion a goal?

While there is glamour in having an "international brand," simply yearning for global market presence is not enough to rationalize it. The franchisor must first ask "Why?"

In determining whether international franchising is a reasonable short term strategy, the franchisor should start by asking some pointed questions:

- Will international expansion diminish the rate of domestic market growth by sapping human and capital resources from the domestic franchise program?
- Can an international initiative be more profitable than a targeted focus on domestic expansion?
- Can adequate support be provided to international franchisees?
- Does the franchisor's leadership and operations team have experience in international business?
- Are external factors influencing the decision to go international now rather than later? Some factors to consider might include competitive actions, developments in international markets, opportunities to partner with significant international players, etc.

Is the capital available?

Established franchisors know that supporting franchisees is a top priority for the longevity of their franchise program, and so they budget adequately to cover the cost of these resources and time. But when you spread those franchisees across the world, those costs multiply exponentially. Travel, legal costs, candidate due diligence and market research only make up a portion of the expenses a franchisor can expect to incur.

The reality is simple – launching an international franchise effort properly will require a substantial financial commitment.

One of the largest, initial expenses of international expansion is the task of finding the right local partner. That due diligence will take time and money. Multiple market visits are likely essential, as they provide valuable insight on a brand's viability, consumer preferences and expectations, supply chain, existing competition, and potential concept adaptations that may be required in entering a new market. Secondary market research should act as only a supplement to the first-hand knowledge a franchisor obtains on foreign soil.

Add to that trademark work, legal and market research, marketing expenses, letters of intent, initial drafts of contracts, disclosure documents (where required), and other expenses, and international expansion effort can easily exceed \$100,000 (sometimes much higher) before any fees (and potential commissions) are paid by the initial licensee. So those headed overseas need to be prepared for the costs of doing business internationally before making that commitment.

Is the team ready?

In addition to capital, new international franchisors must also keep in mind the number of people it will require to provide service and support to their new international franchisees. Of course, the natural inclination is to say that the domestic team can

handle international expansion, but that route can be short sighted and not without its pitfalls – the threat of cannibalization being the biggest of them all.

If employee resources are reassigned from domestic duties to fulfill newly assigned international needs, domestic expansion efforts are likely to take a hit. Also keep in mind that the domestic team may not be well-suited for an international role. International support often requires regular, extended stays overseas for training and troubleshooting, making regular travel difficult for those with young families or other obligations. And since international staff will often need to wear more hats than a domestic field support person might wear, the franchisor's existing team may not be up to the task. Additionally, a franchisor's international support team may lack credibility with franchisees outside the U.S. if they don't have any international business experience.

Assessing the international readiness of a domestic infrastructure involves a close examination of the company. From the legal and marketing teams to IT and operations, each area's current capabilities must be examined to determine what it would take to extend and, ultimately, replicate those core skills and processes across an international franchise network.

In examining international readiness, franchisors will often find that the domestic skill set of their team will need to be supplemented in order to help their international franchisees succeed.

If the franchisor will enter into a master franchise relationship, they will need to train the master franchisee how to act as a franchisor in the market – providing assistance in areas like franchise marketing, franchise sales, franchisee qualification, franchisee training, and ongoing support. Selling locally sourced products? Supply chain and vendor relationships will need to be established – along with all the diligence that would go into a similar domestic decision. And, just as the franchisor will need to adapt the concept itself, it may also need to adapt its franchise recruitment strategies – examining everything from media to messaging to target franchisee in the process.

Then there is the question of concept adaptation based on local culture, laws, or economic conditions.

Do the products and services need to be adapted? McDonald's, for example, has dozens upon dozens of market specific products that they use to localize the brand. Labor can be a huge variable across different international markets. In some markets like Canada, Australia and most of the European Union, labor can be very expensive. In some Asian and South American markets, labor can be very inexpensive. And in places like Saudi Arabia, labor may need to be imported from other countries and provided with housing – while maintaining a prescribed level of Saudi nationals on staff to comply with "Saudiazation" laws. Equipment may need to change based on availability, electric standards, or local requirements for things like hoods and vents.

Rent structures can vary substantially from market-to-market and some locales may require substantial “key money.”

The bottom line is that bringing a franchise into a new and different market requires flexibility and planning. And it can rarely be simply dropped into a foreign market without significant effort and investment.

Is the market open?

As international franchising has grown, so too has international competition. There was once a time when a U.S. franchisor could enter a foreign market and face little competition. In most markets, franchising was a relatively new form of business expansion, embraced largely by U.S. brands. But today, franchisors going abroad face a much more competitive marketplace in the countries they’re looking to establish a presence.

One obstacle franchisors will face in going into a foreign market will be competition from established domestic franchisors who are targeting the same pool of franchise prospects. And, if these existing systems are native to the market, they often have significant advantages like a better knowledge of local language and customs, a better understanding of the culture, increased access to real estate, and established supply chains that may provide advantageous pricing.

Additionally, franchisors native to the foreign market may benefit from relationships with local design, construction, and marketing firms, which give them the ability to support franchisees locally, promote their “home grown” roots, and avoid the need to adapt to local cultural and legal requirements.

Of course, a well-vetted and carefully selected international licensee may bring some of this to the table, at least in part, leveling the playing field for the franchisor.

Before expanding globally, the franchisor should also consider whether or not their concept is positioned to legitimately compete in international markets. To determine this, compare and contrast the concept’s value proposition with those of the companies with whom it will compete to make an assessment of its likelihood of success. International brokers, consultants, market research firms, and even government agencies can help franchisors gather the information necessary to determine a concept’s readiness.

The strength and longevity of an international strategy depends largely upon how the franchisor has prepared. As with any business decision of this magnitude, a great deal of research and self-assessment is required as a first step.

Where to expand first?

With nearly 200 countries in the world, a narrow focus on growth is another element that will enhance the franchisor's chances of success. Not unlike domestic franchising, a hopscotch strategy in which a franchisor attempts to develop in multiple markets that are far removed from one another will be significantly more costly and more difficult to effectively support. To avoid this approach, franchisors should instead start exploring a general region in which to focus expansion efforts as a part of their international expansion plan. In many cases, the choice of market focus will often dictate the growth strategy – and vice versa.

Identifying appropriate target markets should start with gaining an understanding of current social, political, competitive, and economic conditions in a particular region. This understanding will determine how a brand will fare in one region over another and can prepare a franchisor to overcome certain challenges. Strategically, there are a number of choices to be made for the first-time international franchisor, like market size, cultural logistics, language, distance, and support capabilities. Regardless of these strategic choices, the savvy franchisor will want to look at a variety of factors in determining market focus.

Market Knowledge

Exhaustive market research should be conducted via internal and external resources in order to gain the clearest perspective about potential market opportunities before shaping an expansion strategy. Part of that knowledge must include gaining an understanding of the franchise climate in a particular country. Things like a franchisee's ability to sub-franchise, the general feelings toward franchising, size of the middle class, degree to which other franchisors have been successful in the market, the availability of financing, and more should be determined in the early stages of market research.

Socio-Cultural Differences

Another significant element to consider in market research is cultural differentiation. Just because a system performs well domestically doesn't mean that consumers abroad will respond the same way. Things like language, local/regional customs, preferences, and religious beliefs tend to shape the perspective in which target consumers embrace (or reject) a brand. If concepts are destined to succeed in a new market, franchisors must be willing to adapt when necessary. Some modifications might include altering certain product offerings to suit local tastes, altering the labor model, changing sources of supply, and adapting consumer marketing.

As an example, when Auntie Anne's Pretzels entered Indonesia, it worked with the local franchise owner to ensure its products were certified as Halal for the predominantly Muslim population. In other Asian countries, market research demonstrated that consumers tended to eat more frequently throughout the day but consumer smaller portions. Armed with this research, Auntie Anne's reduced the portion size of its

product by 25%, better aligning its menu with local tastes, while also reducing the cost of goods for franchisees in the region.

Forecasting Potential Profitability

Once a franchisor has a good idea of how the concept might need to be adapted, they should develop a financial feasibility model to determine whether the model is likely to be profitable enough to create a “win-win” for the franchisee and the franchisor. At the franchisee level, the primary focus of this financial model should account for differences in the unit economics in development and real estate; consumer buying power/pricing; costs of goods; labor, and occupancy costs. At the same time, many franchisors will ask their international franchisee candidates to conduct their own financial analysis. This allows the U.S. franchisor to further validate its assumptions about the market, while gaining a better understanding of the sophistication of the candidate and how they view the potential for the brand.

We typically recommend that franchisors employ the “market basket” approach as a part of their research. This is when the franchisor (or prospective franchisee) “shops” for a predetermined “basket” of goods or services from multiple competitors in the target market to compare prices and gain insight to unit economics in the competitive environment. This same approach can be applied to the expense side of the equation, to determine costs of labor, costs of goods, etc.

Likewise, it is an obvious best practice to develop a financial model for the franchisor company that will look at the potential revenues, staffing, expenses, and profits (or losses) that could come from its decision to embark on an international expansion strategy. By treating the decision to go international as a separate profit center, the franchisor can isolate the costs of support and can determine the levels of fees and royalties that it will need to charge in order to provide its licensees with the best chance of success while still maintaining a reasonable return on investment. So by tying these two models together under common assumptions, the franchisor can test how changes in a particular variable will impact both the franchisee and the franchisor.

From a strategic perspective, these financials should be developed based on the overall international franchise strategy (as well as a one-off market analysis) so that the franchisor can better understand the big picture. These financial models should then be subjected to sensitivity analysis to see what happens to potential returns under a variety of “worst case” scenarios (accounting for common problems like failures to meet performance requirements and lower-than-anticipated average unit volumes, as well as other political and economic risk factors) so that the franchisor can adequately assess the risk associated with international expansion.

Power, Politics and Economy

Keeping a keen eye on external factors that shape the business climate in a particular country can be critical to forecasting success abroad. A country's government structure, expressions of autonomy, and political history can be indicative of its overall stability.

If international franchisees are reliant on imported products, it's particularly important to understand what the landed cost of goods and the variances in exchange rates will be and how that will impact the franchisee's profitability. Also keep in mind import and export regulations – some goods may be subject to tariffs while others may be completely prohibited (e.g., if the government has a monopoly position on the production of certain goods).

As part of this process, the franchisor should also consider their choice of partners in a particular market. Some small franchisors, when approached by a large franchise player in the marketplace, may feel that they have nothing to worry about given their partner's stature. And while some of these heavy-hitters may have tremendous resources, they also come with their drawbacks. In many situations, these partners will completely drive the bus on concept expansion, providing a smaller franchisor partner with little input in the process. They often pay less in the way of initial fees and carve out the ability to exit non-performing investments – potentially leaving the franchisor out in the cold.

Legal Climate

While other papers will address this in much greater detail, it is important to at least point out that it is in a franchisor's best interest to investigate the legal standards of the target market as one aspect of their decision-making. Not only will the franchisor need to investigate local franchise laws, but they should also be cognizant of laws regarding registration, disclosure, aware of labor laws, anti-competitive measures, protection of trademarks and intellectual property, enforceability of in-term and post-term non-competition clauses, repatriation of profits, import restrictions, contract jurisdiction, taxation, antitrust, and other relevant laws.

Final Considerations

Though it's been said before, it bears repeating – international franchising is not for the faint of heart. And for those who pursue it, serendipity is not a strategy for success. International franchisors succeed because they take a calculated and well-planned approach to market development and then focus their efforts on the success of the franchisee. And while they can incur significant costs in the process, for those that are properly prepared, a well-executed international strategy can be a very rewarding and profitable experience.

Deal Structure – What Type of Expansion Model?

By David W. Oppenheim

I. INTRODUCTION

The decision to expand internationally through a franchise model, whether into the United States (“Inbound Transactions”) or outside of the United States (“Outbound Transactions”), is critical for a brand. Before a company can determine the proper method of international expansion, it must first conclude that it is prepared to support international operations. Assuming there is a demand for the product or service internationally and the Company has sufficient resources and infrastructure to support international expansion, it must then determine the structure of the program.

Generally, program structure can vary widely and it depends on a number of factors, including for example, name recognition in the territory, ability to replicate the business in the territory, Company resources to support an international franchise program, proximity of the proposed franchised territory to the Company’s headquarters, local laws in the territory to be developed, and capital and experience of the potential franchisee.

II. TYPES OF FRANCHISE EXPANSION MODELS

There are several potential structures for international expansion which are commonly utilized for Inbound and Outbound Transactions. This portion of the paper will focus on those types of arrangements which are generally considered to be “franchises”, including master franchises, area development or multi-unit franchises, area representative or development agent franchises, and single unit franchises. We will also discuss joint ventures, which may or may not be considered franchises depending on how the joint venture is structured and local laws, but is employed frequently for international expansion. This paper will not address certain structures which are generally not considered to be franchises, such as trademark licenses, distributorships or sales agent agreement.

While each of these models will be discussed in greater detail below, it is important to understand at the outset that control over the brand is the key distinction between the structures discussed below. A franchisor may be less willing to cede control over its brand in a domestic transaction for fear that the lack of control over the brand could harm the goodwill associated with the brand at home, and as a result, might be more likely to enter into single unit agreements or area development agreements with a single area developer. In international transactions, however, franchisors are more likely to enter into arrangements, such as master franchise agreements, which require less resources and grant a third party greater control over the brand in a territory because there is less concern over control of the brand abroad and in fact, a master franchisee who is familiar with the territory may actually be able to operate the business better than the franchisor since it is familiar with local customs and preferences.

A. Master Franchising

In a master franchise relationship, the Company (Franchisor) will grant rights to a third party (Master Franchisee) to open and operate businesses in a defined territory, either directly as “company-owned” business and/or indirectly by granting franchises to third parties (Subfranchisees) who have the right to open and operate businesses in the territory pursuant to a subfranchise agreement between the Master Franchisee and the Subfranchisee. Notably, there is no privity of contract between the Franchisor and the Subfranchisee in a master franchise relationship. The Master Franchisee is essentially the local intermediary, serving as the “Franchisor” in the territory. Under this scenario, the Master Franchisee will assume most of the duties of the franchisor, including pre-opening training, site selection services, on-going consultation and franchise sales activities.

The Master Franchisee will be required to comply with a development schedule, which will require development of a minimum number of units in the territory within a prescribed period of time. Typically, the Master Franchisee will be required to open and operate at least one “company-owned” business in the territory for two reasons. First, the Master Franchisor must demonstrate that it can successfully operate the business in the territory. After all, if it cannot successfully operate the business, it is extremely unlikely that it will be a successful “Franchisor” in the territory that is able to assist subfranchisees in establishing and operating successful businesses. Second, the “company-owned” location will serve as the flagship in the territory and will likely be used for training purposes.

1. Pros (Franchisor Perspective)

- Less capital is required. The Franchisor need not invest in infrastructure to support the Subfranchisees in the territory because the Master Franchisee is responsible for expanding the business and supporting the Subfranchisees.
- It enables the Franchisor to enter a foreign market easily since the Master Franchisee has a presence in the territory.
- The Master Franchisee likely has a better understanding of the local market and local competition and as a result there is a greater likelihood of success.
- The Master Franchisee is responsible for local compliance.

2. Cons (Franchisor Perspective)

- The Franchisor is required to share the revenue stream. Typically fees (initial and on-going) will be split between the Franchisor and the Master Franchisee.

- The Franchisor cedes a lot of control, including privity of contract, to Master Franchisee who may not share the same passion and commitment as Franchisor.
- It can be difficult to control quality of product or services, with little Franchisor oversight.
- It can be very difficult to terminate the relationship.

B. Joint Ventures

A joint venture can be an appealing model for expansion for a Company that does not have name recognition in a territory that it wishes to exploit. It could be difficult to find a master franchisee willing to invest substantial capital in an unproven brand. In a joint venture, the owner of the concept and a partner or partners in the territory will typically enter into an agreement or form an entity in which they each own an interest. The Company which owns the business concept becomes one of the joint venture partners. The other joint venture partner or partners typically contribute capital and labor.

The Company will typically license the intellectual property to the joint venture entity which, in turn, will open and operate businesses within a defined territory. Depending on the terms of the license agreement and the applicable law, it is possible that the license agreement between the Company and the joint venture entity could meet the definitional elements of a franchise under local law, requiring the Company to comply with franchise laws in connection with the formation of the joint venture and entering into the license agreement with the joint venture.

In the joint venture model, the joint venture entity could expand in a territory by developing “company owned” locations through unit franchise agreements or multi-unit development agreements. The joint venture entity can also serve as a master franchisee in the territory with subfranchise rights.

1. Pros (Franchisor Perspective)

- Requires less capital to expand as compared to expansion through Company owned outlets. The investment can be divided between the joint venture partners.
- The joint venture partner typically has a presence in the territory.
- The Franchisor can maintain control over the brand because the joint venture will contract with the Franchisor or an affiliate.

2. Cons (Franchisor Perspective)

- The Franchisor is required to make a significant capital investment.
- The structure is much more complicated and there could be negative tax consequences.
- The Franchisor has potential liability and risk as owner of the operator company.

C. International Area Development Agreements

In the development agreement or multi-unit development model, the Franchisee is granted the right to open a certain number of outlets within a defined territory pursuant to a prescribed development schedule. Typically, each unit opened under the Development Agreement is operated pursuant to a separate Unit Franchise Agreement or a rider to the Development Agreement. The area developer will usually have an exclusive territory, provided it is in compliance with its development obligations. Notably, unlike the master franchise model, the area developer must develop the outlets by itself (or through separate affiliates). It has no subfranchise rights.

1. Pros (Franchisor Perspective)

- The Franchisor maintains privity of contract with the area developer/multi-unit operator.
- The Franchisor need not split fees with a third party.
- It is easier to terminate an area developer than master franchise relationship because there are no third party subfranchisees.
- The Franchisor has greater control over the brand because the area developer will contract with the Franchisor or an affiliate.
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2. Cons (Franchisor Perspective)

- The Franchisor has no presence in the territory and as a result, oversight is difficult.
- The Franchisor is required to devote resources in the territory.
- It can be difficult to find developers with sufficient capital and resources to develop an entire country or region.

D. Area Representatives or Sales Agents

In an area representative arrangement, the franchisor grants the area representative the right to perform services on behalf of the Franchisor in a defined territory in exchange for a fee. The area representative will typically be required to commit to a development schedule in the territory. Additionally, the area representative will often be required to open and operate at least one “company-owned” business in the territory in order to demonstrate that it can successfully operate the business in the territory before it offers and sells franchises to third parties on the franchisor’s behalf. Similar to the master franchise arrangement, if the area representative cannot successfully operate the business, it is extremely unlikely that it will be a successful agent for the franchisor in the territory.

This model is similar to the master franchise model in that the area representative will perform services typically performed by the franchisor in exchange for a fee. These services include the sale of franchises to third parties and providing on-going support to franchisees in the territory. The key distinction between an area representative franchise and a master franchise, however, is that in an area representative franchise model, unlike a master franchise model, the franchisor will enter into the contract with the franchisees. There is no privity of contract between the area representative and the franchisee.

1. Pros (Franchisor Perspective)

- Area Representative has a presence in the territory.
- Franchisor needs fewer resources because Area Representative is performing pre and post contract services on its behalf.

2. Cons (Franchisor Perspective)

- The Franchisor has less control over Franchisee operations (can result in harm to the brand).
- The Franchisor makes less money (fees are typically split).
- The Franchisor is liable for acts of its agent.
- The loss of an area representative in a market can be damaging to operations in the entire market.

E. Single Unit Franchise Agreements

The single unit model is very rare in international franchising. The Franchisee is granted the right to use the Franchisor's trademarks and system of operation in a single outlet or business, typically in a defined location. The Franchisor performs services in exchange for a fee. The Franchisor maintains direct control over the brand because it has a contractual relationship with the franchisee and it is responsible for providing support and oversight.

1. Pros (Franchisor Perspective)

- The Franchisee is not highly leveraged (only operating a single unit).
- The Franchisee is likely the operator with a personal stake in the business.

2. Cons (Franchisor Perspective)

- There is substantially slower growth as compared to other models.
- It requires more franchisor resources, especially in international transactions.

III. CONCLUSION

There are several options for structuring an international franchise program. A franchisor must find the appropriate balance between its desire to protect its brand, maintain control over operations and realize a profit with the significant cost and risk associated with operating internationally. As a result, master franchise, joint ventures and to a lesser extent, area representative arrangements, are attractive models for international expansion.

Key Deal Terms in an International Deal

By Kerry Olson

Given all the unique business goals to consider and varied legal structures that can come into play when a franchise company decides to expand internationally, there is no uniform franchise agreement that will work across the board for all franchisors. There are certain key provisions in an international deal, however, that should be considered carefully when structuring a franchise agreement to best protect the brand, set the boundaries of the relationship and put in place mechanisms to, in the best case, facilitate successful operation of the concept and in the worst case, to have a meaningful and enforceable exit plan.

International franchise agreements are more commonly subject to negotiation between a franchisor and prospective franchisee than a domestic deal, and often these key provisions are at the center of the most heated discussions. Rarely, if ever, is a franchisor able to have a “take it or leave it” approach to the franchise agreement. Counsel may find that they need not only to justify their legal and business position, but also to explain clauses considered relatively standard in the United States.

This section of the paper is by no means exhaustive of all key points, particularly when you keep in mind that certain topics such as dispute resolution merit a substantive paper on just that topic alone. Further, certain systems may dedicate far more attention to other areas of the agreement and consider such areas just as critical as ones outlined here. By way of example, a restaurant concept may go to great lengths to describe the supply chain design and management for food and beverage, but such industry-specific discussions are beyond the scope of this chapter. Finally, please note that there are key contractual terms that are addressed elsewhere in this paper, such as the deal structure and considerations of local law. The section will therefore focus on a high level review of some of the key terms most commonly considered (and often negotiated) in an international deal.

Territory

A franchise agreement’s section relating to exclusivity (or non-exclusivity) of the franchisee’s rights is a classic example of competing franchisor and franchisee business objectives. Few areas of the franchise agreement generate more conversation and concern in the development and negotiation phase than this provision. This provision also illustrates an instance where franchisors and franchisees may have a different desire for the structure and detail of the provision and therefore may approach the negotiation from very divergent angles. The franchisee likely will push for a provision that simply and unambiguously states that its rights to the territory are exclusive and, further, unlimited. A sophisticated franchisee may have lots to bring to the negotiating table in this regard, as international deals often involve large territories, high fees, lofty development obligations and a lengthy term. Franchisees will argue that they are bearing the financial burden and risk of bringing the brand to a new market and therefore should have the rights to such brand in all its forms. On the flip side, the

franchisor's goal should be to have a detailed section regarding the franchisee's territory rights and, perhaps more important, its restrictions in the territory to help set expectations of the parties and consider the many possibilities of how the business may change over the course of many years.

From the franchisor's business perspective, the territory provision exemplifies the difficult balance that it must strike when considering the attractiveness of the franchise offering and the desire to attract large, well-funded, and experienced franchisees versus the need to reserve control and flexibility over the expansion of the brand. Franchisees with these qualities will push hard in the negotiation process to maximize their business and profit potential in the market. The language of the franchise agreement must consider all of these objectives, and clearly state the franchisee's rights and limitations as it develops and operates in the territory.

Reservation of Rights

The reservation of rights provision is a critical compliment to the grant of exclusivity. A franchisor should identify clearly the *franchisor's* rights in the territory granted to the franchisee. As mentioned above, international deals often involve large territories for a lengthy term, so franchisors need to be disciplined to consider carefully all the potential for additional and alternative business under the banner of the brand. Franchisors should anticipate and draft for the possibility of merging with, acquiring or being acquired by another company, which is happening with increased regularity as we see consolidation across industries. A franchisor interested in selling in the future should take care in drafting this provision, as the ability to be flexible with its brand and any franchised locations at the time of sale may prove to be critical in the evaluation by a potential buyer. Franchisors should also consider the global reach of many companies with which it may like to partner on alternative distribution. Entering into such deals will be hampered if territories are excluded based on existing franchise agreements without thoughtfully crafted provisions related to reservation of rights. Although it may cause consternation for the prospective franchisee and result in difficult discussions for those on the franchise development side of the business, it is critical to clearly "call out" the respective rights (or the limitation on such rights, as the case may be) related to territory. A highly negotiated provision that limits the franchisors rights to just these two examples, is below:

Company, its affiliates, and its parent company have the right, during and after the Development Term (and any applicable Renewal Term), to develop and operate or license third parties to develop and operate competing businesses identified by other trademarks, service marks, trade names and commercial symbols in the Territory, except that during the Development Term, Company's operation of, or association or affiliation with businesses in the food and beverage sector (including restaurants) through franchising or otherwise in the Territory will only occur in connection with some form of merger or acquisition. In addition, during the Development Term and the remainder of the Operating Term of this Agreement, Company and its affiliates have the right to sell and distribute

and license third parties to sell and distribute products identified by the Trademarks and other trademarks, service marks, trade names, and commercial symbols in the Territory through any other distribution channels or methods, including the Internet (or any other existing or future form of electronic commerce), pre-packaged retail sales, and catalogue sales.

Development Schedule

The development obligation is central to a franchise deal, particularly when the obligations cover a significant scope (both in number and geography), which is often the scenario of international franchise deals. Much of the “homework” to get a realistic development schedule should be done long before the attorneys put pen to paper, yet it is critical to revisit at the time of negotiating the full deal. Too often in the early development phases, franchisee prospects are eager to please and to show their ability and experience and wherewithal to canvass a large territory. Development representatives with the franchisor may be similarly willing to paint an overly optimistic picture and aggressive target, as that may drive certain economics and decision makers on the franchisor side of the deal. There is far too much data over the course of recent history, however, that shows that development schedules are commonly missed in the international context. Entire papers are dedicated to the challenges of terminating a franchisee’s territory. Worse yet, a franchisor may have difficulty getting with trademarks and/or subsequent development after a deal goes south in certain countries. As a franchisee’s failure to meet development obligations is not only common but likely cause for termination, franchisors must take care to set realistic targets and meaningful, enforceable consequences should an international developer falter on its obligations.

The development obligations are typically set forth in a schedule that calls for a specific number of units to be developed within a set time frame (often set as a calendar year). The schedule should also clearly state the number of cumulative units that must be open and in operation, to clarify any confusion or double counting in situations such as a unit’s relocation. These are the building blocks of a development schedule, from which counsel may work to include more specificity for added certainty (for example, defining how long a unit must be operating to be considered “open” in accordance with the schedule or if and under what circumstances closures may be permitted). These are likely to be addressed in other, related provisions in the agreement, which tie back to the developments schedule. Another key provision to draft in connection with the development schedule is what happens at the conclusion of the schedule, particularly if the schedule is a period of time that is less than the development term, discussed below. Often the development schedule is not set for the entirety of the development term, given the uncertainty of the marketplace’s capacity for more units. Often a franchisee will seek a long development term (and the attendant exclusivity) but not want to commit to a schedule upfront, for the full term. The challenge for drafters at that point is to devise a roadmap for the parties to negotiate subsequent schedules that fall within the development term.

Term

Two types of term must be considered and included in international deals – the development term and the operational term. Generally the development term is a shorter amount of time, with the operational term usually set to expire or terminate on the date upon which the last unit level agreement expires or is terminated. Particularly if the development and operational rights are all under one agreement as is sometimes the case, drafters need to ensure that appropriate rights and obligations survive, even if the development term expires or is terminated.

Intellectual Property

Various provisions that can nearly be deemed boilerplate in domestic agreements call for much more consideration in the international context. That is not to say that any language needs to change from what may be included in the franchisor's domestic agreement, and to the contrary, much of it should remain exactly the same. It is an area, however, that may draw unanticipated negotiation if not prepared. Franchisors may get push back from sophisticated franchisees who feel that their investment in the brand results in broader rights in relation to intellectual property than what would ever be asserted by a franchisee in the same market as the franchisor, particularly if the brand is established in the home market. International franchisees may take issue with not being able to enforce against infringement, register marks in connection with the franchised business, or have outright ownership in any innovations.

As the franchisor's most valued asset, the trademarks should be addressed thoroughly in the franchise agreement and franchisors should hold firm on many of the protections as set forth in domestic agreements, even when abroad. The franchisor should not waiver from any provision regarding outright ownership in existing marks, should clearly state that the franchisee is prohibited from registering other related marks, and should not delegate any of its authority to act as the sole decision maker of when and how to bring enforcement actions against infringers. Franchisees may be well intentioned in their efforts, such as wanting to expand a portfolio to more cover more classes of goods and services or to bring an enforcement action against infringers because they feel they are better suited to do so, having connections in the territory. Franchisors should not permit any of these efforts by franchisees, and should take the time to carefully explain these provisions and ensure there is not disagreement on the parties' respective rights and obligations.

A franchise concept often needs to make necessary local adaptations to its product offerings, service style, build-out, etc. to succeed in different international markets and the franchisor must find a balance between allowing franchisees to contribute to such innovation, while maintaining clear ownership of any such innovations. Franchisees may take issue with the concept and in some jurisdictions there may be local laws to consider relating to such ownership. The use of innovations across a system has been a fundamental component of several well-known product offerings at famous brands, and needs to be guarded in the franchise model. Although changes may be necessary based on local law as noted above (in which case the franchise agreement should

contain an automatic transfer of the intellectual property, as illustrated by the sample provision below), the franchisor should not waiver on this provision.

Licensee must fully and promptly disclose (at the moment of its or their creation) to Company, all copyrightable and patentable deliverables, as well as any other intellectual property deliverables, including, but not limited to, ideas, plans, improvements, concepts, formulas, recipes, methods and techniques relating to the development or operation (including marketing, advertising and promotions) of its Business or any similar business conceived or developed by Licensee, any Owner or Licensee's employees during the term of this Agreement ("Innovations"). Effective as of the moment of the creation of any Innovation, Licensee hereby transfers, without any compensation to Licensee, any Owner or Licensee's employees, all rights in and to such Innovation to Company and its affiliates. Such transfer shall cover all fields of exploitation, including, but not limited to, those fields specified in [reference to local law]. Licensee also hereby transfers to Company the exclusive right to permit the exercise of Licensee's derivative copyright. For the avoidance of doubt, Company and its affiliates shall be entitled to modify the Innovations without Licensee's consent. Licensee hereby acknowledges and agrees that Licensee shall not, and shall cause its Owners and employees not to, raise any claims or exercise any moral copyrights against Company or its affiliates in connection with the Innovations.

Marketing

Although the nature and extent of the local marketing expenditure may vary based on the market and the franchisees ability, local marketing is much more of a necessity in foreign markets where the franchisor does not have an established presence. In contrast to the common structure in domestic franchising, the scale is likely to tip in the favor of the franchisee controlling the marketing with relatively little coming back to the franchisor by way of a fee. The rights and the obligations must be considered and carefully drafted in the franchise agreement, however, to still clarify the obligation of the franchisee to spend the funds and to give the franchisor flexibility to shift the expenditures when and if it institutes more robust global initiatives, regional cooperatives and the like. In connection with the any local marketing ability and or obligation, the franchisor is well served to continue to incorporate provisions that require approval of advertising and initiatives.

Guarantee/Additional Security

The guarantee is brief in language (perhaps only a few sentences) but long in the amount of time it generally takes to negotiate and draft in the context of an international franchise agreement. Although a guarantee is commonplace in domestic agreements – even with multiple unit franchisees – these are far more difficult to include as part of an international deal, particularly with a sophisticated, often well capitalized franchisee.

Such franchisees may come to the table with the opinion that the significant outlay of funds required to develop and operate units overseas is in itself a guarantee and may even take it as an insult that a franchisor wants additional security or protection should the deal go south. Often the investors start at a point in negotiation where they want *no* part in signing any document that obligates them personally, which may lead to the consideration of other options such as letters of credit or bank guarantees. These often involve more complication, time and expense, which can sometimes lead to a franchisee coming around to the concept of a personal guarantee.

Deal Flow and Using Local Counsel

By Gustavo Alcocer and KevinE.Maher

I. Introduction

You've just received an e-mail from your internal client and they want to do a multi-unit franchise deal outside the U.S. Both the target franchisee and your internal sales team want to move forward on a very aggressive timeline. Your company has been wildly successful in the U.S. but up until now it has not sold any franchises internationally. As a result, there is little to no experience on the business side on international deals. To complicate matters, you've never worked on an international deal before either. Where do you start?

This is not an uncommon situation for companies who are just beginning to consider international expansion. In this paper, we will examine the typical steps in an international franchise transaction and how to effectively and efficiently utilize international franchise counsel and local counsel.

II. Typical Steps in an International Franchise Deal

A. Market and Franchisee Due Diligence

In the real world, the selection of target markets and the identification of franchisee prospects are often already decided by the business team before the legal department is made aware of a proposed transaction. Nevertheless, there are certain best practices for market and franchisee selection that should be proposed by the legal team to give discipline to the international deal process—after all, not all markets or franchisee prospects are created equal.

All too often, a franchisor that is new to international expansion will receive inquiries from all over the world about possible franchise opportunities. It is often difficult to maintain focus and discipline in the face of a flurry of seemingly easy opportunities to expand your brand. However, franchisors are well-advised to be wary of chasing what seems to be the “low-hanging fruit” of international deals. Indeed, the legal department can and should speak up about market due diligence and franchisee due diligence early and often to promote the idea of a disciplined approach to international expansion.

The idea behind market due diligence is that a franchisor is making a well-considered business decision based upon market research, local tastes, demographics, regulatory landscape, compliance risks, local labor and real estate costs and other factors to determine what countries are the best match for the brand at that time. By contrast, brands that don't perform disciplined market research often end up following an *ad hoc* process of “lead chasing” based primarily on opportunities presented by interested parties. The latter approach often leads (though, of course, not always) to less profitable deals or deals that the franchisor does not have the resources to fully or effectively support.

Similarly, after a market has been carefully selected, choosing a partner also requires significant due diligence. Often, preliminary due diligence is carried out at a very early stage to vet a proposed franchisee while more detailed due diligence is carried out later in the deal process before a definitive agreement is signed. The preliminary due diligence should include financial due diligence to determine upfront whether the prospect is financially capable of supporting the franchise, as well diligence on the prospect's background to confirm that the franchisee has the right experience to run the franchise. This early stage due diligence should also include preliminary checks against terrorist watch lists maintained by the U.S. and foreign governments.

More detailed due diligence often occurs later in the deal process after a letter of intent or term sheet has been signed. This level of due diligence entails incurring a greater level of out-of-pocket cost and therefore, when feasible, is often completed only after a deposit has been taken from the prospect. This deposit is often used to defray the cost of detailed due diligence, such as third party background checks, litigation searches, credit checks and corporate/legal diligence. This level of due diligence is strongly recommended to ensure compliance with U.S. law and best practices.

B. LOIs and Term Sheets

Once the market and franchisee prospect have been identified, the next step is usually to enter into a non-binding letter of intent (LOI) or term sheet. A sample of a typical LOI for an international franchise transaction is attached to this paper as Exhibit A. The main purpose of a term sheet or LOI is to ensure alignment on the key commercial terms of the transaction before engaging in the more costly and time-consuming steps of localizing the template agreements for local laws and negotiating the definitive agreements.

By definition, the letter of intent should be non-binding. However, in many jurisdictions it's imperative to be very clear about the non-binding nature of an LOI. Many non-U.S. jurisdictions include the concept of a "pre-agreement" or a "promise to contract." Use of a pre-agreement in these jurisdictions may give rise to regulatory obligations (such as disclosure) or liability to the other party if the transaction is not consummated. For these reasons, an unsigned term sheet is sometimes used in lieu of a signed LOI. A term sheet often has less detail than an LOI and can be more easily negotiated by a business person without unintentionally resulting in a binding arrangement. A sample term sheet is attached to this paper as Exhibit B. In addition, the execution of a standard, binding non-disclosure agreement prior to entering into an LOI or term sheet is highly recommended to preserve any confidential information that may be revealed to a prospect during negotiations and discussions of an LOI or term sheet.

C. Deposits

Once an LOI or term sheet has been signed, collecting a refundable or non-refundable deposit is a practical next step. Deposits are often required upfront as a condition to signing a non-binding LOI or are required within a certain number of days after an LOI is signed.

However, it is not always permitted to collect a deposit for international franchise transactions. In many cases, collecting a non-refundable deposit (or any deposit at all) may be sufficient evidence that an agreement has been made (even without complying with applicable disclosure obligations) or may be restricted by the franchise laws of the target country. In these cases, the franchisor risks bearing the entire cost of structuring the deal and related due diligence if the franchisee backs out or the franchisor decides not to move forward. As discussed further below, this is also a key reason why consulting international franchise counsel or local counsel before signing a letter of intent is crucial.

D. Disclosure Requirements and Draft Agreements

After finalizing the LOI or term sheet, the next steps are generally to deliver a franchise disclosure document (if required by local law) and to prepare a draft agreement using your template international franchise agreement. If you do not have an FDD or a set of international franchise agreements, then converting your domestic FDD and franchise agreements into template international agreements is a necessary next step. Creating a customized set of international franchise documents can be a time-consuming process and is a step that should be considered earlier in the process (at the due diligence stage if not sooner), especially if your company does not franchise domestically or if you will be using a model that your company does not use in its domestic franchise program (e.g., master franchising or area development). If you haven't done so already, this is the time to engage experienced international franchise counsel to guide preparation of your new template agreements and FDD for use internationally. There are a number of elements of an international agreement (both legal and practical) that will need to be thoughtfully considered and having international franchise counsel to guide you through this process is crucial.

Once the draft FDD and agreements have been prepared, it is now time to have the agreement reviewed by local counsel as will be discussed further in Section III below.

E. Negotiation

Once the franchise documents have been prepared and reviewed by local counsel, the next step is to negotiate its terms with your proposed partner. A greater level of negotiation should be expected for international deals than you may normally experience for domestic transactions. There are many reasons for this, but often it is due to the fact that international franchisees sometimes take on a much larger territory and are required to make a much larger investments than typical domestic franchisees. In addition, the international franchisee may request changes to the agreement that they believe are required by local law or market practice in their home country. Often, these proposed revisions will need to be vetted with your local counsel to confirm that the claims are true or whether less extensive changes may achieve the same end.

III. Using Local Counsel

A. Selecting Local Counsel

How does one select local counsel for a franchise transaction in a different country? There are many resources for selecting local counsel with appropriate experience in nearly every jurisdiction through franchise industry groups, such as the IFA. For countries that have franchise laws, it's important to find local counsel who actively represents franchisors in their market and has strong familiarity with the local franchise laws. However, with the exception of the U.S., Canada and Australia, it is rare (though not unheard of) to find local counsel who has a practice solely dedicated to representing franchisors, particularly in countries that don't specifically regulate franchising. Rather, selecting local counsel with a strong commercial contract background who has meaningful experience with franchise transactions is often the best approach.

It is also important to understand the role that local counsel plays in the transaction. As noted above, while your local counsel may have experience with franchise agreements, they may not have intimate familiarity with your brand, your structure or your industry. However, local counsel brings a number of critically important components to the table for completing your franchise transaction, including advice on the following:

- compliance with local franchise disclosure or registration laws and any currency control laws;
- drafting and reviewing a locally compliant FDD, if required;
- the effect of local country laws on the enforceability of your agreement;
- the availability of key remedies in the event of a breach of your agreement;
- local market custom and practice;
- tax-efficient structuring;
- translation of your FDD or agreements, where required or recommended;
- corporate and other due diligence on the franchisee;
- compliance with appropriate execution formalities; and
- negotiation of provisions considered to be issues of local law or market practice.

For these reasons, selection of the right local counsel is key to the success of your international franchise deal.

B. When to Involve Local Counsel

One question that often arises is at what point in the deal process should you involve local counsel? While engaging local counsel will cost money, it would be ill-advised to proceed with signing an LOI without first involving local counsel at least for a preliminary check on applicable franchise laws. This initial touchpoint also allows you to

clear conflicts with your chosen counsel early on. However, this initial involvement, at the LOI or term sheet stage, does always not need to be a deep dive. A “high-level” review of the LOI together with a brief introductory phone discussion with local counsel are typically all that is needed to get started. However, foregoing this important early step can cost you more in time and legal fees later on in the transaction (even in cases where the transaction is terminated).

C. How to Effectively Utilize Local Counsel

As discussed, engaging local counsel early is crucial. However, it’s also important to understand how to best engage with your local counsel to get the best advice in an efficient and effective manner.

1. Preliminary Advice and Due Diligence

As noted above, it’s important to receive preliminary advice early on from local counsel regarding the possible franchise law requirements, the ability to take a deposit and other regulatory requirements, such as disclosure or registration, that may affect the cost or timing of your deal.

Local counsel can also provide invaluable insight to you when conducting initial market research or conducting diligence on your proposed franchisee. Often, local counsel can offer non-legal intelligence regarding a prospect (e.g., market reputation, prior dealings/relationships, references, etc.). This information can be highly valuable to you in the due diligence stage.

Local counsel should also be consulted for confirming corporate matters relating to the franchisee, including, for example, confirmation that the ownership of the franchisee entity is consistent with what has been represented by the franchisee and confirmation that the individuals signing the agreement have the power to bind the franchisee.

2. Agreement Review

Assuming that your template agreements will be governed by U.S. law and call for arbitration of disputes in the U.S., a common approach is to instruct local counsel to review your agreement for mandatory points of local law that will apply regardless of the choice of law and venue. This instruction helps your local counsel to appropriately tailor their review to the points in your agreement that will need to change to be enforceable. While U.S. law may govern your agreement, it is often the case that certain local laws in a given country will apply as a matter of public policy despite a choice of U.S. or other foreign governing law. Examples of public policy issues and local general principles of law that often control over a choice of U.S. law are franchise disclosure and relationship laws, competition laws (particularly in relation to franchisee compliance/enforcement and non-compete covenants and resale price maintenance), intellectual property laws, industry regulatory compliance, currency control laws, real estate and corporate laws, and usury laws. It will be key for local counsel to point out and, where necessary, modify, provisions of your template agreement that would be unenforceable under local law. In some cases, failure to make certain changes could render your entire

agreement void. Whereas, in other cases, failing to make the change may be acceptable with the knowledge that local enforcement may not be feasible.

3. Negotiation

As noted above, local counsel can also be critical to the negotiation process. If the franchisee prospect or its counsel do not speak English, then local counsel may play a heavy role in negotiation or interpreting comments from the franchisee. In addition, it's often necessary to rely on local counsel to confirm whether comments made by the franchisee are legitimate issues under local law as opposed to negotiating tactics. This type of local counsel "gut check" is often crucial to avoid making critical mistakes or concessions during the negotiations stage.

IV. Other Local Considerations

A. Generally

Often, issues or contract points that are commonplace in U.S. franchise deals will have different meanings, be more limited or simply do not exist in foreign jurisdictions. Examples include: vicarious liability; joint employer liability; class actions; punitive and consequential damages; and conduct standards (e.g., "reasonable discretion", "best efforts," "commercially reasonable efforts"). Understanding these differences will put you one step ahead in your deal and will focus your negotiations on the issues that are truly important. For example, local counsel may be helpful in modifying customary indemnification provisions to be locally enforceable or more effective by ensuring that the right types of local law claims are covered, that there are appropriate exclusions and carve-outs, and that the parameters around the duty to defend will apply to local actions.

B. Translations.

Having local language translated franchise documents is mandatory in certain jurisdictions and is expected as a market practice in other jurisdictions. Specifically, if there is a local registration requirement, a translation of the agreement is often required even if the translation will not control over the English version. For jurisdictions where disclosure is required, providing disclosure in the local language is a particularly good practice if the franchisee prospect's English is limited to avoid claims of ineffective disclosure under local law.

C. Execution Formalities.

Another area that will affect your timeline and cost for international deals is compliance with execution formalities, such as initialization, notarization and apostille, or legalization/consularization. These formalities are often required for the enforceability of your agreement, for the ability to register the agreement with local authorities or for admissibility of the agreement as evidence in local court proceedings.

V. Conclusion

Preparing for and closing an international franchise deal is generally a more complicated and prolonged process than entering into a typical domestic transaction. The use of experienced international franchise counsel is key to helping you complete appropriate due diligence on the chosen market and the prospective franchisee and in preparing agreements and disclosures that are suitable for international use. Involving local counsel in a target jurisdiction is also indispensable to completing the appropriate due diligence and to ensuring that your agreement is valid and enforceable, contains necessary and desirable provisions for local enforceability or practice and is not subject to attack for failure to comply with local requirements.

EXHIBIT A

SAMPLE LOI

[Month] [DD], 2018

[Name]
[Address]
[Attn]

Re: Letter of Intent relating to a proposed development transaction relating to the operation of [●]

Ladies and Gentlemen:

Pursuant to our discussions, we submit this non-binding letter of intent relating to the proposed development transaction between [●] (“Franchisor”) and [●] (“Developer”) for the purpose of developing [●] (“Franchised Units”) in the Territory (as defined below). Developer will enter into the Development Agreement (as defined below) with Franchisor and, pursuant to the Development Agreement, Developer will enter into separate Franchise Agreements (as defined below) for each Franchised Unit on the terms set forth below.

I. THE DEFINITIVE AGREEMENTS

1. Definitive Development Agreement. Franchisor and Developer shall enter into a definitive agreement on Franchisor’s standard form of international development agreement (the “Development Agreement”), subject to such changes as may be necessary to comply with mandatory provisions of law in the Territory, by no later than the LOI Termination Date (as defined below).

2. Territory. The territory to be developed under the Development Agreement will consist of [●] (the “Territory”), as the same is geographically constituted on the date hereof.

3. Term. The term of the Development Agreement shall begin as of the effective date specified in the Development Agreement and shall expire on the date on which Developer successfully and in a timely manner completes the Development Schedule.

4. Development Schedule. The Developer must timely open and continuously operate Franchised Units in the Territory pursuant to separate Franchise Agreements in accordance with the schedule set forth in Schedule A (the “Development Schedule”).

5. Territorial Exclusivity. Subject to Developer's compliance with the Development Schedule and the terms and conditions of the Development Agreement, Developer shall have the exclusive right to develop Franchised Units in the Territory during the term of the Development Agreement. Accordingly, subject to certain rights reserved to Franchisor as set forth in the Development Agreement, neither Franchisor or its affiliates shall open or operate, or license others to open or operate, Franchised Units in the Territory during the term of the Development Agreement.

6. Franchise Agreements.

(a) Each franchise agreement shall be on Franchisor's standard form of international franchise agreement (each, a "Franchise Agreement"), subject to such changes as may be necessary to comply with mandatory provisions of law in the Territory. Each Franchise Agreement shall provide for, among other things:

- (i) an initial fee in the amount of US\$[●];
- (ii) an ongoing royalty fee of [●]% of the Franchised Unit's gross sales;
- (iii) a marketing fund contribution not to exceed [●]% of gross revenues if Franchisor establishes a global or regional marketing or brand building fund;
- (iv) a required local advertising expenditure of [●]% of the Franchised Unit's gross sales;
- (v) a tax "gross up" provision calling for the upward adjustment of payments under the Franchise Agreement to account for [GST/VAT], withholding taxes or other assessments applicable to any such payments;
- (vi) a term of [●] years together with a renewal option for [●] additional period[s] of [●] years [each]; and
- (vii) Franchisor's prior right to review and approve the site for each Franchised Unit.

7. Franchise Territory Fee. The Development Agreement shall require payment of a franchise territory fee (the "Franchise Territory Fee") in the amount of US\$[●].

8. Governing Law. The laws of the State of [●], U.S.A. will govern all matters arising out of the Development Agreement and each Franchise Agreement and any and all controversies arising from or related to the Development Agreement and each Franchise Agreement will be submitted to binding arbitration in [●] administered by the International Centre for Dispute Resolution under its International Arbitration Rules.

10. Guarantee. The terms and conditions of a guaranty of the Development Agreement and each Franchise Agreement by Developer will be further defined and discussed in the Development Agreement based upon the final investment structure to be utilized by Developer.

II. OTHER PROVISIONS

1. Deposit. Within 10 days following Franchisor's and Developer's execution of this letter of intent, Developer shall remit to Franchisor a non-refundable deposit in the amount of US\$[●] (the "Deposit"). If the Development Agreement is executed by each of Franchisor and Developer before the LOI Termination Date, the entire amount of the Deposit shall be credited against the Franchise Territory Fee. If the Development Agreement has not been executed by each of Franchisor and Developer before the LOI Termination Date and the parties have not otherwise agreed in writing to extend the LOI Termination Date, then Franchisor shall be entitled to retain the full amount of the Deposit in consideration of the administrative and third party costs incurred by Franchisor.

2. Conditions. Consummation of the territory development transaction contemplated hereby (the "Transaction") will be subject to satisfaction of the following conditions:

(i) Board Approval. Approval of the Transaction by Franchisor's board of directors;

(ii) Compliance with Local Laws. Compliance with the franchise registration and disclosure laws in effect in the Territory, if any, and any other laws applicable to the Transaction;

(iii) Background Check. Franchisor's receipt of a satisfactory background check of Developer and its principals as may be necessary to comply with U.S. law and Franchisor's internal policies; and

(iv) Credit Check. Franchisor's receipt of financial statements and other information from Developer and Guarantor evidencing to Franchisor's satisfaction that Developer and/or guarantor have the financial capacity to satisfy Developer's obligations under the Development Agreement and each Franchise Agreement.

3. Expenses. Except as set forth in Section 1 of this Article II, each party will bear its own fees and expenses incident to the Transaction and this letter of intent, whether or not the Transaction is consummated.

4. Confidentiality. The parties have entered into a Mutual Confidentiality and Non-Disclosure Agreement effective on [●], 2018 (the "NDA"), with respect to discussion

and negotiation of the Transaction. All information obtained by either party as a result of the negotiation and execution of this letter of intent and the negotiation and execution of the Development Agreement (the “Confidential Information”) shall be held in complete confidence by it, except to the extent that (i) disclosure is required by law or governmental authorities, (ii) such Confidential Information becomes publicly available through no fault of such party, or (iii) disclosure of such Confidential Information by either party is necessary to perform its obligations pursuant to this letter of intent or the Development Agreement (provided that such disclosure is limited to facts reasonably necessary to complete such performance). Developer shall not issue a press release or otherwise publicly announce the Transaction contemplated by this letter of intent without Franchisor’s prior written consent.

5. Legal Effect. It is understood that this letter constitutes a statement of the intentions of the parties with respect to the Transaction, does not contain all matters upon which agreement must be reached in order for the Transaction to be consummated and, therefore, does not constitute a binding commitment with respect to the Transaction itself. A binding commitment with respect to the Transaction itself will result only from the execution and delivery of a definitive Development Agreement, subject to the conditions expressed herein. Notwithstanding the two preceding sentences, the agreements of the parties set forth in this Article II are binding and legal obligations of the parties hereto. Except for such paragraphs, no other term or provision of this letter shall constitute a binding legal obligation of any party hereto and no such party shall have any liability to another if the parties shall not complete and execute the Development Agreement or consummate the Transaction, regardless of the reason therefor.

6. Term. Unless the parties have agreed in writing to extend the term of this letter of intent, this letter of intent shall terminate on [●] (the “LOI Termination Date”). This letter of intent shall also terminate upon execution of the Development Agreement. The parties may terminate this agreement at any time if they mutually agree in writing that the Transaction cannot be consummated. In the event of a termination of this letter of intent for whatever reason, the undertakings set forth in Article II, Section 4 shall survive such termination.

7. Governing Law. The internal laws of the State of [●], U.S.A. (without giving effect to any choice or conflict of law provision or rule (whether of the State of [●] or any other jurisdiction) that would cause the application of the laws of any other jurisdiction) shall govern all matters arising out of or related to this letter of intent and the Transaction that it contemplates, including its validity, interpretation, construction, performance and enforcement and any disputes or controversies arising therefrom.

8. Dispute Resolution. Any and all controversies arising from or related to this letter of intent shall be submitted to binding arbitration to be administered by the International Centre for Dispute Resolution under its International Arbitration Rules. The number of arbitrators shall be one and the arbitration shall take place in [●]. The Development Agreement and each Franchise Agreement shall contain more

detailed arbitration provisions providing for arbitration of disputes by similar means in the same venue.

9. Compliance with Laws. Developer shall adopt and implement anti-bribery, anti-money laundering and trade compliance policies and programs, including ensuring compliance with all applicable sanctions laws, including the sanctions laws administered by the U.S. Department of Treasury, Office of Foreign Assets Control.

10. Counterparts; Facsimile Signatures. This letter of intent may be executed in one or more counterparts, provided that each counterpart shall be deemed to be an original for all purposes, and all of such counterparts shall together constitute one and the same document. The parties agree that signatures sent by facsimile transmission shall be binding.

12. Expiration. This letter of intent shall be deemed automatically withdrawn and of no further force or effect if not accepted by Developer by 5:00 p.m., Eastern time, on [●], 2018.

[Signature Page Follows.]

EXHIBIT B

SAMPLE TERM SHEET

This non-binding summary of terms is being provided strictly for informational and discussion purposes to provide preliminary guidelines for negotiations between the parties for the terms of development of franchised [●] in the Territory identified below. This summary of terms is not intended to be interpreted to constitute a contract, or an offer to contract, by [●] or any of its affiliates to any third party. Definitive terms and binding agreements may only be approved by an executive officer of [●] with appropriate board of director approval.

1.	Developer:	[Developer name and jurisdiction of incorporation]
2.	Territory:	[Country], as geographically constituted on the date hereof.
3.	Development Term	_____ (__) years
4.	Development Schedule:	<p>Grand total of _____ (__) units open within the term of the International Territory Development Agreement.</p> <ul style="list-style-type: none"> • _____ (__) new franchised unit opened by end of _____ • _____ (__) new franchised unit opened by end of _____ • _____ (__) new franchised unit opened by end of _____ <p>Specific cities for each franchised unit to be agreed upon by the parties in advance and specified in the Development Schedule set out in the Development Agreement.</p>
5.	Non-refundable Deposit:	US\$_____ payable upon execution of a non-binding letter of intent.
6.	Franchise Territory Fee:	US\$_____
7.	Franchise Agreement Term:	Initial term of __ years. __ renewal terms of __ years each.
8.	Initial Franchise Fee	US\$_____ payable upon execution of the Franchise Agreement.
9.	Royalty Fee:	___% of gross sales.
10.	Local Advertising Expenditures:	___% of gross sales.

11.	Marketing Fee:	___% of gross sales.
12.	Currency:	All payments under the Development Agreement to be in U.S. Dollars.
13.	Tax Gross-Up:	If withholding taxes or other assessments are imposed on any payments to Franchisor, the amount of such payments shall be increased so that the net amount received by Franchisor will be the same amount as what would have been received by Franchisor had no such tax or assessment been imposed.
14.	Guarantor:	[•]
15.	Governing Law:	[•]
16.	Contract Language:	English, unless otherwise required by local law.
17.	Dispute Resolution/Venue:	Arbitration in [•] administered by [•]

THIS PRELIMINARY SUMMARY OF TERMS DOES NOT CONTAIN ALL ESSENTIAL TERMS OF A DEVELOPMENT AGREEMENT OR FRANCHISE AGREEMENT FOR A [•].

Typical Local Legal Issues

By Amy Cheng and Karsten Metzloff

INTRODUCTION

Franchising as a business-format for expansion has grown in many countries around the globe. Less than 30 years ago, only the United States and Canada had regulations offering the sale of franchising. Now, over [30] countries have enacted franchise legislation. While the laws were enacted to protect franchisees, and many of them have similarities, the forms the laws take are not uniform. Practitioners advising clients entering into international transactions must be cognizant that these laws exist, and seek the advice of counsel in the local jurisdiction when appropriate.

In addition to complying with franchise laws, practitioners also have to confront other laws of local jurisdictions when negotiating a cross border transaction. Even if the parties agree that the laws of a state of the United States applies to a transaction, there are certain local laws that will preempt the parties' choice, such as laws governing the franchise relationship, intellectual property laws, privacy laws, and competition laws. Therefore, simply understanding the enforceability of the contract under the parties' choice of law will not be sufficient.

1. Franchise Disclosure/Registration Laws

The reasons for the increase in legislation of the franchise sector include the recognition of franchising as a unique business model that requires unique legislation and a model that has a higher prospect of generating market value than non-franchised businesses. The increase in the complexity of the regulatory scheme that governs franchises in over 30 countries makes it more challenging for practitioners advising on cross border transactions.

The following countries currently have franchise legislation: Canada (6 of 10 provinces: Alberta, British Columbia, New Brunswick, Manitoba, Ontario, Prince Edward Island); United States, Mexico, Australia, China, France, Belarus, Belgium, Estonia, Brazil, Georgia, Italy, Lithuania, Macau, Moldova, Romania, Russia, Spain, Sweden, Ukraine, People's Republic of China, Indonesia, Japan, Kazakhstan, South Korea, Malaysia, South Africa, Vietnam, Taiwan, and Australia. Most of the laws require pre-contractual disclosure and many of those countries' legislation have been influenced by the US disclosure requirements. While some countries require disclosure as few as 10 days prior to entering into the contractual relationship, some require as much as 30 days. Some jurisdictions also require some sort of cooling off period after the execution of the franchise agreement during which the franchisee can withdraw from the relationship. In a few countries (e.g., Russia, Belarus and Ukraine), the cooling off period is given to both the franchisor and the franchisee.

Some jurisdictions require franchisors to register relevant information about the franchisor and the franchise program in order to be able to sell franchises. Others require registration of the signed agreement.

Some jurisdictions go as far as requiring certain provisions to be included in the franchise agreement. Indonesia, for example, requires the following provisions to be included in the franchise agreement:

- Name and address of all parties
- Description of intellectual property rights
- Business activity
- Rights and obligations of parties
- Term
- Assistance, facilities, operational counseling, training and marketing provided by the franchisor
- Dispute resolution
- Procedures for extending and terminating contract

2. Relationship Laws

The rise of relationship laws recognized that while disclosure laws provided protection to the franchisee prior to entering into a franchise agreement, they were, to some extent, a disparity in bargaining power that extended beyond contract formation. Franchise relationship legislation was intended to restrict franchisor's discretion in certain areas of contract performance which the regulators thought were of critical importance to franchisees, such as terms, termination, renewals, procurement, and encroachment on franchisee territories. Today, with a handful of exceptions which are "disclosure only" regimes, the majority of franchise laws and regulations around the world contain both pre-contractual disclosure and on-going relationship elements (however, a few countries opted for the "relationship only" approach).

Franchise relationship regulation takes on numerous forms varying from jurisdiction to jurisdiction. To give you some examples:

2.1. *The Cooling-Off Period*

The cooling-off period allows the franchisee to terminate the franchise agreement within a specified period after entering the agreement, or prior to the payment of any non-refundable money. Some jurisdictions take the view that a cooling-off period is a necessary protection that gives a franchisee the chance to "back out" of an executed franchise agreement. Example: Australia, China, Malaysia, Mexico, South Africa, Russia, Belarus, and Ukraine all require some sort of cooling-off period after the execution of the franchise agreement during which the franchisee can withdraw from the relationship. These periods range from a thirty day cooling-off period in Mexico to seven days in Australia. In some countries (e.g., Russia, Belarus, and Ukraine) the cooling-off period is given to both the franchisor and franchisee.

2.2. ***Minimum Term***

Some countries impose a minimum term for the franchise agreement. A minimum term ensures that the franchisee has a chance to recoup its initial investment into the franchised business. Example: In Malaysia, the franchise agreement must be for a minimum period of five years, whereas in Italy the term is three years.

2.3. ***Territorial Protection***

At the beginning of the cooperation, franchisees often ask for exclusive distribution rights for a specific territory. However, under the applicable antitrust regulations, which are often mandatory, it may not be allowed to absolutely prohibit sales outside the territory completely. Example: In the European Union, active selling into other territories can be prohibited under certain circumstances by the franchisor, but franchisees need to remain free to passively sell to end users and other franchisees regardless of said customer's or franchisee's location. "Passive" sales are unsolicited requests from individual customers.

2.4. ***Internet Sales***

In some countries, a prohibition of sales via internet is not a problem at all. Examples: USA and Canada. However, in some countries, a (general) ban on sales via internet is not permissible. Example: European Union.

2.5. ***Resale Price maintenance (RPM)***

Basically, every form of direct or indirect price fixing is often prohibited by national laws. Thus, a franchisee must be free to determine at what price he or she wants to sell his or her products or render his or her services. In some jurisdictions, the franchisor may be sometimes entitled to set a maximum price at which the products or services of the franchise system are to be sold. In some situations, RPM might be permissible. Example: In the European Union, the franchisor is allowed to determine the resale price in promotion campaigns for two to six weeks.

2.6. ***In-Term and Post Term Competition Bans***

Lots of jurisdictions have enacted relationship laws explicitly restraining in-term and post term competition. In most jurisdictions, non-compete clauses must be reasonable—while others prohibit them all together. Example: In Albania, Moldova, Georgia, and Malaysia, once the relationship has ended, the franchisee is prohibited from competing with the franchisor in the local market. The period of restraint ranges from one year (e.g., Albania, Moldova, and Georgia) to two years (e.g., Malaysia).

2.7. ***Restrictions on Termination***

Some jurisdictions have enacted specific relationship laws governing the requirements for termination. Termination of a fixed term may be only allowed

under particular circumstances. Example: In Australia, Malaysia, Vietnam, and some of the U.S. states, termination is permissible where: (1) the franchisor has good cause as a basis for termination; or (2) the situation falls within certain circumstances as enumerated in the legislation, i.e., bankruptcy, voluntary abandonment, insolvency, fraud, or criminal conviction. The franchisor must also then comply with certain procedural requirements, such as providing written notice, reasons for termination, and an opportunity to cure the default.

In some jurisdictions, upon termination the franchisor is required to do things such as repurchase inventories, marketing materials, fixtures, and compensate for loss of goodwill. Example: Under the *California Franchise Relations Act*, where a franchisor terminates a franchise other than in accordance with the *Act*, the franchisor shall offer to repurchase the franchisee's resalable current inventory at the lower of the fair wholesale market value or the price paid by the franchisee.

2.8. *Restrictions on Arbitrarily Refusing Renewal*

Some jurisdictions have included in their franchise legislation a franchisee's right to renew the agreement. Absent such legislation, and where no renewal provision is explicitly included in the franchise agreement, the franchisee's rights would expire at the end of the agreed term with little or no compensation to the franchisee who developed the business at the location. Conversely, the franchisor could appropriate the location and goodwill through the award of another franchise or operation of a corporate site. Some jurisdictions have found the need for statutory intervention to protect franchisees from renewal provisions drafted in the franchisor's favour. Example: In Russia, there is an automatic right of renewal if the franchisee has not been in breach of the franchise agreement and the renewal takes place on the same terms as the original agreement.

2.9. *Compensation Claim Upon Termination*

Some countries, particularly in the European Union, grant the franchisee under certain conditions a claim for compensation upon termination. Example: In Germany, the Federal Court of Justice has repeatedly clarified that a right to compensation by analogous application of Sec. 89b of the Commercial Code arises if (1) the authorised dealer is included in the sales organisation of the franchisor to the extent that is comparable to that of a commercial agent, and if (2) the franchisee is contractually obliged to transfer his customer base to the franchisor at the latest at the ending of the agreement.

2.10. *Language Requirements*

Generally, relationship laws do not have express language requirements. Only four jurisdictions have explicit language requirements—namely, Italy, Vietnam, Indonesia, and the Province of Quebec. In Quebec, however, while the *Charter of the French Language* compels the use of the French language, parties can agree in writing that another language be used. The practical reality is that using the

language of the jurisdiction (alongside with the franchisor's native language) is often necessary to comply with the disclosure requirements, to obtain government registration or approval, or to enforce the contract in the franchisee's jurisdiction when the time comes. Further, drafting franchise agreements in the language of the jurisdiction is prudent due to an inability, in most instances, to otherwise enforce the contract.

2.11. *Good faith, Standard Terms Law, and Other Hindrances*

Simply put, the duty of good faith and fair dealing is a positive obligation on the parties to deal with each other honestly, fairly, and in good faith, so as to not destroy the right of the other to receive the benefits of the agreement. It requires each party to act with due regard for the reasonable interests of the other party, and exercise its discretion honestly, fairly, and reasonably. Where a party to an agreement breaches that duty, the other party has a right of action for damages. Depending on the jurisdiction, the right will apply to the performance and enforcement of the agreement and may, in some instances, extend to the exercise of any right under the agreement. The duty has made its way into various pieces of legislation worldwide, and in civil law jurisdictions such as in Germany, it applies to the relationship by virtue of the fact that a distribution agreement is a type of commercial contract governed by the country's Civil Code.

3. Taxes

Franchisors must review the tax requirements of not only the jurisdiction in which it establishes its business, but also the jurisdiction from which it expects to receive income. If the franchisor and the franchisee are located in different jurisdictions, the parties must pay close attention to the applicable tax treaty between the countries, if any. Franchisees in most countries will have to withhold taxes from amounts payable to franchisor. Therefore, many franchise agreements contain a "gross-up" provision which allows the franchisor to receive the amount it would have been entitled to receive under the contract, as if no withholding tax in the franchisee's country applied. This is often a heavily negotiated provision because it could result in a significant difference in the amount a party is out of pocket.

4. Conclusion

The increase in franchising activities worldwide results in the increase in franchise regulations. While there appears to be some consistency in these regulations, there clearly are some differences in each jurisdiction. Not only do practitioners need to understand the pre-disclosure and registration requirements that govern the sale of franchises, but they also need to understand laws that govern the relationship between franchisors and franchisees. It is important to seek the advice of local counsel in the applicable jurisdiction to understand the impact that local law may have on your contract. While the parties can choose to have the laws of a certain jurisdiction apply to the contract, laws of a local jurisdiction may still impact the enforceability of certain provisions.

