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International Franchise Expansions: Picking the Right Countries in the Right Order

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In the world of international franchising, two of the most important decisions are which countries to expand into and in what order. To make the best decisions, there are some preliminary questions to ask and issues to address.

Am I Ready To Expand Internationally?

On this question, the starting point is to examine the goals that are in mind in deciding to expand internationally. Some goals call for greater domestic development first, than other goals. For example, if the franchisor is merely interested in the prestige of being international or is concerned that competitors are gaining more credibility because of their international programs, there is less pressure to be sufficiently strong at home. Once it is clear what the desired goals are, a proper analysis of readiness can be done.

Saturation of the Home Market

Classically, international expansion has been undertaken only after the franchise system has achieved near saturation in the home country. Modern thinking, however, is that system maturity and depth of resources are more important indicators than saturation. More and more franchisors are able to develop, with modern technologies and methods, solid domestic programs along with profitable international programs.

Is Expertise in the Underlying Business Enough?

You cannot franchise mediocrity domestically and you certainly cannot franchise it internationally. So expertise in the business being franchised is absolutely crucial. However, international expansion vehicles (discussed in more depth below) often require the franchisor to export expert knowledge about the process of franchising and how to adapt it to local conditions as well. If the franchisor has not honed its ability, strength and depth of knowledge about franchising, then international franchising maybe should wait. This franchise expertise is not just about generally known and applied franchise methods, but also about the nuances of franchising in the particular industry or type of business. For example, franchise techniques are different in a service franchise than in a product franchise or in a retail franchise than a business to business franchise.

Capital Resources

There is no debating the idea that franchising is an alternative method of financing the growth of a business, as the franchisee's capital is employed in the expansion rather than the franchisor having to tap its own financial resources. However, that truth is moderated by the fact that the "pump has to be primed". As is the case in an early stage domestic franchise program, the franchisor has to invest capital before a return is realized. International expansions are no exception, even if the categories of investment are different.

Internationally, the franchisor will encounter greater travel costs, costs in establishing solid supply chains locally or across borders, greater franchise marketing costs, costs for foreign market research for adaptation issues, translation costs for agreements and manuals, legal costs to protect trade marks and comply with local laws, etc., etc., etc. Another factor affecting the capital requirements of the franchisor will be the international expansion vehicle chosen by the franchisor. Master franchising typically allows the franchisor to download a significant portion of the foreign development costs onto the shoulders of the master franchisee. By comparison, unit franchising directly into the foreign market requires the franchisor to finance all of the costs.

The bottom line is that an international franchise expansion will fail if the franchisor does not have sufficient capital to cover the necessary costs.

Human Resources

People run businesses, not machines. Having the right people to do the required jobs is critical in any business and in any type of franchise activity, whether domestic or foreign. However, the skill sets for international franchising, in many ways, are different than the skill sets for purely domestic franchising. One reason for this is that the international franchisor is dealing with cultural and possibly linguistic differences that are sometimes deep and complex. If the franchisor's people do not understand the nuances of the foreign market, the chances for disappointment are that much greater.

Strong senior management buy-in to going international has never been more important. The commitment to the strategy has to be at the CEO, 'C' level and ownership level. International expansion is both a financial and a people commitment.

Another danger exists in underestimating the amount of time that is required to sell and service foreign franchises. Usually, the cost of franchise sales and the time it takes to complete them is two to four times greater than similar domestic sales. Franchise support and service can similarly cost much more in foreign markets initially, until the system matures in that market.

Which Countries When?

All too often, a franchisor begins an international franchise expansion or jumps into another foreign jurisdiction because some eager prospect approaches them with a financial enticement.

Sometimes, such a move by a too early stage franchisor is justified by arguments like “well if it fails over there it won’t affect the system in the U.S.”, “it is easy money that is much needed at home and we are not investing in this, there will be no cost”, “our competition is over there already” or “it will enhance our image and make domestic sales easier when everyone sees we have ‘gone global’”. In reality, an international expansion has to be “pushed” by solid planning and the establishment of a sound foundation, not “pulled” by a chance encounter with an eager prospect. The drain on resources, the loss of future possibilities and the potential for bad publicity, in this electronic and ‘global’ age, of a failed international expansion may out way any perceived advantage.

The choice of which foreign markets and in what order is absolutely critical in succeeding in an international franchise expansion. Some obvious factors are closeness geographically to the home market and linguistic and cultural similarities. Although, Mexico, for example, meets one criteria, but not the other. Grouping countries in natural blocks, i.e. the Middle East, Eastern Europe, South America, may also prove to be more efficient than to direct limited resources to more wide ranging markets.

Many franchisors are unaware of the worldwide proliferation of franchise specific legislation or legislation that affects franchising. The following countries have some form of legislation that needs to be understood and complied with: Australia, Belgium, Brazil, Canada (provinces of Ontario, New Brunswick, Alberta, and Prince Edward Island), China, France, Indonesia, Italy, Japan, Kazakhstan, Lithuania, Malaysia, Mexico, Romania, Russia, South Korea, South Africa, Spain, Sweden, Taiwan and Vietnam.

Not all of these countries require a registration like the US registration states, but many have disclosure requirements, and some require the filing of the executed franchise agreements. Some of these are merely franchise relationship laws, like in Kazakhstan, others are only disclosure laws, like in Ontario or Taiwan. Others, however, require a filing/registration prior to being able to sell franchises in those countries, these include, Brazil, Indonesia, Malaysia, South Korea, Vietnam and Japan. Penalties in some of these countries can be significant, while others may not be, but could prevent or delay the relationship. The existence or not of such laws is a factor to consider when deciding upon an expansion strategy.

Acceptance/demand for the products and services of the franchise system should also be an important factor. This is a point not lost on the Wal-Mart company, when it closed its operations in Germany. Also, these days there are many more competing franchises available around the world that are local or from countries other than the US. There can be strong local brands that will be fierce competition to the system's franchisees.

There are dramatic differences, one country to the next, as to the number of business people who will be accepting of the franchisor's terms and financial proposition. To put it more directly, on average, prospects in countries like Canada and England, for example, are more likely to negotiate strenuously and over longer periods of time, than would typically be the case in say Mexico or Bahrain.

There are any number of additional matters that should be considered in deciding upon which countries to expand to and in what order including:

1. The existence of exchange controls;
2. The degree of adaptation which may be required for the success and public acceptance of the concept; and
3. The cost of supplying franchisees with the appropriate type and quality of goods and supplies.

Which Franchise Vehicle is Most Appropriate?

The franchisor has a number of choices of vehicles for international expansion. Each one carries with it its own set of issues, challenges and advantages, which can have a dramatic impact on the choice of expansion territories and their order. Within each vehicle type there are different approaches that can be taken and hybrids can be constructed to suit the particular needs of the franchisor.

Direct Unit Franchising

Granting unit franchises directly to foreign franchisees will be the slowest, most expensive and, in some ways, riskiest expansion method. In direct unit franchising, the franchisor shoulders the entire burden of selling franchises and supporting the franchisees. In foreign markets, the franchisor also has to figure out what adaptations would be required to be made to the business model. However, if the franchisor has a reasonable level of knowledge of the foreign market and sufficient resources, establishing a few unit franchises directly first may prove to be an invaluable learning experience for the franchisor before granting the more substantial development or master rights.

Development Arrangements

Multi-unit franchises, area development arrangements and territorial development arrangements are some of the names applied to situations where a single franchisee is given the right to open up two or more franchises in a given territory. Sometimes a franchisee will acquire multiple units by evolution, as the franchisee grows and prospers. Sometimes franchisees acquire multiple units by operation of rights of first refusal originally granted to the franchisee for additional units within areas contiguous to the franchisees original territory. Often, rights of first refusal are granted by the franchisor as inducements to sell franchises. However, there is one school of thought that it is dangerous to grant rights of first refusal, until the franchisee has proven himself to be capable and trustworthy. Otherwise, the franchisor is permitting the unit franchisee to become a multi-unit franchisee solely because of the interest of another party in purchasing a franchise. The granting of multiple franchises to the same franchisee should never be done unless the franchisee fundamentals are strong.

A cautious approach should always be taken when considering granting to one franchisee the right to open multiple franchise units in a system. Multi-unit franchisees are usually financially stronger and more sophisticated business people. This can be an advantage in good times and a disadvantage when trouble arises, as such a franchisee will be a more formidable adversary and a more demanding “customer”. Area or territorial development arrangements will be most advantageous where the area or territorial franchisee has deep knowledge and extensive connections in a market that is more distant from the markets in which the franchisor is already present.

The agreements that support such arrangements need to be carefully constructed. Some important considerations are:

- The territory should be no larger than is manageable by the franchisee;
- There should be clear and appropriate performance criteria that must be met by the franchisee to maintain exclusivity in the territory;
- There should be cross termination provisions among the agreements for each unit;
- The support commitments of the franchisor should be appropriately adjusted, given the greater resources and responsibilities of a territorial franchisee;

Any special arrangements with suppliers, given the territorial franchisee’s greater purchasing power, should be addressed.

Master Franchising

When done properly and timed correctly, master franchising can be one of the most effective means of expanding a franchise network. This is particularly so when the expansion is into foreign markets. In fact, master franchising is the most frequently used vehicle for international franchise expansion. Nonetheless, it remains one of the least understood and most poorly implemented expansion strategies in franchising. It is even difficult to arrive at a consensus on the definition of master franchising, as it is used to describe an array of relationships and arrangements, including sales agencies, multi-unit agreements with no sub-franchising rights and

arrangements by which the franchisor grants exclusive rights for the development of the system within the territory to the master franchisee with the right to sub-franchise.

It is always a challenge choosing the best unit franchisees, but that process pales in comparison to the difficulties in choosing good master franchisees. The mistakes made in choosing master franchisees are often the result of insufficient time and effort being taken to thoroughly investigate, not only the financial capability of the master, but the master's personality strengths and weaknesses and business philosophies as well. Too often a candidate is chosen who has had some prior business success, and thus can finance the franchise expansion and, perhaps more importantly, write a sizeable cheque for the front-end franchise fee for the master rights, without regard to the "fit" with the franchisor and the goals and philosophies of the franchise system. In these situations, the master rights are being viewed too much as investments by both parties.

On the other hand, fatal errors have been made in selecting master franchisees who do not have sufficient financial resources to weather the initial difficulties encountered in establishing the franchise system in the foreign territory. The franchisor may have forgotten how long it took before the system became self-financing initially or, more likely, may underestimate how long it takes someone else to get sufficient revenues flowing in the particular territory. Often the master franchisee cannot perform at the same level of productivity and efficiency as the franchisor and the franchisor is better off planning for a more mediocre performance from a master franchisee.

Joint Venture Franchising

Joint venture franchising occurs when the franchisor takes an equity position or a partnership role in the franchisee entity. Joint venture franchising can be used in virtually any franchise vehicle, from unit franchises to master franchises. Joint venture franchising has two distinct levels of contractual relationship. At the franchisee level, the franchisor will want to have either a shareholders agreement, partnership agreement or joint venture agreement. In addition, the franchisor will want to have in place its customary franchise documentation between itself, as franchisor and the franchisee entity in which it has an interest. The reasons for creating a joint venture structure include:

- The franchisor's desire for greater control/influence over the franchisee entity;

- The franchisees need for temporary or permanent capital from the franchisor;
- The franchisor's desire for a greater return from the operations of its franchisees.

Sometimes, joint venture franchising is used as a transition towards the full implementation of one or another franchising vehicle, as the franchisee assumes full ownership of the franchisee entity.

Acquisition

The acquisition of a competitive business can be one of the quickest ways to expand a franchise system internationally. The target company may be another franchisor or a multi-unit business that is capable of being converted into a franchise network. While the rewards in this type of expansion strategy are great, the challenges and risks are even greater. Such acquisitions raise issues of territorial exclusivity and encroachment, re-branding, changes in business culture and management transition. The franchise issues are overlaid on top of the usual and customary issues in any business acquisition.

Intellectual Property

Intellectual Property, particularly trade marks, but increasingly copyright in software, is one of the most valuable assets of a franchise system. Increasingly, with the growth of the internet and global communications, U.S. brands have value in other countries long before the products and services are available there. Certainly, if a franchise brand is successful in the U.S., the marketing of the franchises in the system will be that much easier in other countries. In fact, it is arguable that the first point of investigation before entering a foreign market should be with respect to the availability of the system trade marks for use in that market and the ability to protect and grow the brand there. Franchisors that wish to expand their horizons beyond the United States by offering their products or services through franchisees in foreign markets, must consider the selection of their trademark carefully, as the same mark can be received differently by foreign consumers and intellectual property offices.

Distinctiveness is a basic requirement for registration of a trademark in most countries. However, some countries may permit registration of a mark that may become distinctive when used over a

number of years so as to create a sufficient reputation and be recognized by consumers. However, these marks that are only “capable of being distinctive” are usually more difficult and costly to register, and for countries that follow British law, may even be put on a separate register.

The following list offers general requirements and suggestions for the selection of an international trademark:

- The name of a company, individual, or firm may be registrable but may be required to be presented in a special or particular manner or may not allow registrations of designations such as “Inc.” or “Co.”
- Invented words constitute the best kinds of trademarks because they are *prima facie* distinctive. However, what constitutes invented is always a matter of debate between the trademark office and the applicant and its final adjudication is a question of fact.
- If a mark is a geographical name, it may not qualify for registration. However, the mere fact that a proposed mark also denotes some location or geographical feature may not cause objection unless it appears that the goods have some connection with the particular place.
- A surname may also be excluded from registration unless the mark is both a rare surname and an ordinary word with a specific meaning that is much more commonly known.
- Words that are clearly laudatory or descriptive do not qualify for registration.
- Pictorial or design marks and graphic designs may be distinctive if they do not reference to the character or quality of the goods they identify. Design marks are especially useful in countries with low literacy where consumers may recognize a device more easily than a word mark.
- Ordinary letters and numbers may not be registrable even though it may be common practice among traders to use their company initials.

- Marks must not be offensive to morality.¹
- A mark must not contain a negative connotation within a particular jurisdiction.²

Tax

Needless to say, the tax analysis of any potential international expansion is essential, especially, if according to the tax effects or consequences that may derive from payments to be made by franchisees, franchisors' budgets and estimated earnings could be affected. Likewise, if a franchisor is willing to develop company owned units in a foreign country, the tax system of that country must be carefully studied to determine the most effective tax structure to be used.

The most common problem for U.S. franchisors operating in foreign countries is the requirement placed on franchisees in those countries to withhold a percentage of any royalty payments to the franchisor and to remit that amount to the local government as a tax on the franchisor's revenue. Sometimes these amounts are reduced by treaty, as is the case between the U.S. and Canada. Usually, the franchisor will receive a U.S. tax credit for such foreign deductions, but this should be carefully checked or the royalty should be increased to take such tax into consideration.

Deal Points of Importance

As master franchising is the most common form of franchising used in international franchising, the reader's attention is drawn to the following important deal points to consider when structuring and negotiating master franchise agreements for foreign jurisdictions.

The Territory

Most master franchising arrangements provide that the rights are granted, often on an exclusive basis, for a specific territory. Master franchisees frequently attempt to negotiate the broadest possible territorial rights, which is understandable. One of the most common mistakes made by franchisors, however, is to grant exclusive rights to territories which are far too large, with the consequences that the territory remains underdeveloped and/or the franchisor realizes much less

¹ For example, the OPIUM trademark for perfume was initially considered scandalous but was eventually accepted in most jurisdictions except Hong Kong.

² For example, "Mist" is acceptable in English markets but means "manure" in German.

from the territory than would have been the case had the one large territory been broken up into smaller territories. Sometimes this occurs because of the lack of knowledge, on the part of the franchisor, of the potential of the system in the territory and sometimes it occurs because the franchisor feels it would be easier and more cost effective to deal with just one master franchisee in a larger area. While there is some validity to these latter considerations, the franchisor will most often have a stronger, and arguably a more profitable system ultimately, if territories can be kept as small as possible.

By having more master franchisees, rather than less, say in one country or region, the franchisor has some maneuvering room, if a master franchisee fails or fails to perform adequately. One of the other master franchisees in the country or region can, either temporarily or permanently, move in to fill a void left by the failed master franchisee. It is also less likely that a particular master franchisee, “bites off more than he can chew”. The franchisor is also able to exert more control or influence over the performance and conduct of a number of less powerful master franchisees than would be the case with one very powerful master franchisee.

Even if a franchisor is tempted to deal with only one master franchisee in a country or region, careful drafting of the master franchise agreement can help to limit the potential problems. For example, the franchisor can grant to the master franchisee a smaller initial territory, which will increase in size as the master franchisee is proven to be competent and committed and impose performance quotas, which will allow the franchisor to reduce the size of the territory, if they are not achieved in the future.

The Term

Similarly, it is a common mistake on the part of franchisors to grant indefinite terms or terms that are too long. With a shorter initial term and more frequent and shorter renewal terms, the franchisor can more easily control the actions of the master franchisee and the quality of development in the territory. At the very least, there should be very clear performance criteria and thresholds which the master franchisee must meet for a variety of things, including the right to renew, the maintenance of exclusivity, the extent of the territorial rights, and the degree of independence of the master franchisee in directing the system in the territory.

Initial Payments for Master Rights

One of the most difficult numbers to ascertain in all of franchising is the amount that should be charged for the front-end franchise fee or territorial rights fee for the grant of master franchise rights. This number will be influenced by many factors, including the length of the term of the grant, the history of success of the franchise system, the amount of training and initial support to be provided by the franchisor and the level of additional investment required of the master franchisee. Drawing analogies to other existing systems, with master franchise structures, can be helpful in deciding upon the amount to charge, but it is best to relate the fee to the potential for profit and return on capital of both parties.

From the franchisor's point of view, the most common mistake made in this area is to set the fee too low. One way to alleviate this problem is to set a minimum amount and calculate the final fee based upon the performance of the master franchisee, either by number of units opened or percentage of sales or some other basis that increases the front-end fee as the system is expanded within the territory. Master franchisees often pay too much for such fees upfront, which can drain the master franchisee of much needed capital during the critical early stages of development of the territory. For the master franchisee, the best approach is to fix the amount of the front-fee, but have its payment dependent upon the number of franchises opened over an extended period of time.

Dividing up the Spoils and Job Allocations

Without a doubt, the most poorly handled issue in master franchising is the division of the frontend franchisee fees and continuing royalty fees, for the unit franchises in the territory, between the franchisor and the master franchisee. It is not unusual for the franchisor to base its decision on the allocation of these fees on its anticipated or desired return from the development of the system in the territory without serious or careful regard for how the master franchisee will finance the necessary development and support services for the unit franchisees. Mistakes with this issue will either ensure the demise of the master franchisee or reduce the quality and performance of the system in the territory.

For example, if the continuing royalty is 6% of gross revenue of the unit franchisee and the franchisor decides it is entitled to 3%, when it costs 3% to do a proper job of developing and supporting the system in the territory, the master franchisee is faced with either making no profit on royalties or reducing the level of support to the unit franchisees. If, however, the franchisor keeps some of the responsibilities for administering the system, such as field support, the 50-50 split on royalties might work. The problem is even more apparent in the division of the front-end fees. Such fees are often, at best, compensatory to the franchisor for the costs of properly setting up the unit franchisee. Therefore, where the master franchisee assumes all of the responsibility for establishing the franchises, but the franchisor takes a percentage of the front-end fee, something has to be compromised. The point is that the responsibilities for the development and administration of the system should be decided first as between the franchisor and master franchisee. Then the division of the various fees should be based upon the costs of discharging those responsibilities and only after that should the parties divide up the remaining “profits”.

Selection of Unit Franchisees and Locations

Often, one of the principal motivations for the franchisor in choosing to expand in a foreign market by means of master franchising is to pass on to the master franchisee the responsibility for finding quality franchisees and locations within that market. However, it is a common mistake for the franchisor to abdicate the responsibility for final approval of franchisees and locations, before the master franchisee has proven itself capable in these crucial areas. The end result being that, if the master franchise arrangements fail, which happens most often in the early stages of the relationship, the franchisor may be saddled with inadequate franchisees and second rate locations. It is advisable then, that the franchisor contractually retain the right of final approval for franchisee and location selection, and exercise it in the early years, even if this right is later passed on to the master franchisee. Even if the master franchisee ends up with the de facto right of final approval, the franchisor will want to be able to step in and assume those responsibilities if circumstances change.

Governing Law

The franchisor is understandably more familiar and, therefore, more comfortable with the legal regime in its home jurisdiction. This leads many franchisors to provide that the governing law of

the master franchise agreement is to be the law of that jurisdiction. However, it is not uncommon for the law in the franchisor's home jurisdiction to be less favourable to the franchisor than the law of the master franchise territory. This often occurs when a U.S. franchisor embarks upon a master franchise expansion in a foreign jurisdiction, because of the dearth of franchise law outside of the U.S. An additional consideration is the locus of the enforcement of any court order. The franchisor may simply be placing an unnecessary additional layer of complication upon the problem of enforcement against the master franchisee. Certain remedies, such as injunctions, may be delayed, while the local judge ascertains the rights of the parties under the franchisor's home jurisdiction.

Commercial Agency

While not wide-spread, in select countries, especially those in the Gulf Cooperation Council (GCC), "dealer protection laws," also known as Agency Laws can affect the ability of the U.S. Company to terminate the relationship.

These laws were created in response to the concern that the independent contractor relationship, commonly used in these arrangements, didn't afford the same level of protection as between an employer and employee. Thus, many countries, through legislation, sought to grant independent distributors and representatives relief similar to the relief granted by the local labor laws to employees faced with an unjust termination of their employment.

In the jurisdictions where there are no Agency Laws, the termination or non-renewal of a franchise agreement is generally governed by the terms of the agreement itself. However, in countries with Agency Laws, a franchise agreement that is deemed to fall within the purview of the applicable Agency Law, would be subject to the local requirements of the Agency Laws if such differ from the terms in the franchise agreement.

Most Agency Laws will differ from a franchise agreement with regards to the grounds for termination. Typical Agency Laws do not allow for an agent to be unilaterally terminated by the principal, or franchisor, without "just cause." Agency Laws will narrowly define what would constitute "just cause," and it is likely that that definition will be subject to local interpretation by a ministry or tribunal and often be difficult to prove.

These and other types of local laws and regulations require thorough research and document strategy before opening the market.

The Unit Franchise Agreement

Considering the importance of the unit franchise agreement to the control of the system in the master franchise territory, it is surprising how many franchisors do not insist upon the use of the franchisor's form of franchise agreement for unit franchises in that territory. Even if the local law requires some amendments, it is still better for the franchisor to start with its pro forma agreement and make the necessary changes to comply with the local law. In a similar vein, the master franchisee should be required to obtain the consent of the franchisor to any changes to any unit franchise agreement. This approach avoids the problem of the franchisor inheriting an array of different agreements or agreements with unsatisfactory provisions, if the master franchise arrangements have to be terminated.

The franchisor, in a master franchise situation, is often surprisingly reluctant to require three party unit franchise agreements to be used, where the franchisor, master franchisee and unit franchisee are all parties to the agreement. This fear is most often rooted in the misplaced belief that it will create more liability for the franchisor. Any such increase in liability may be easily alleviated with proper drafting. Further, the advantage of having direct privity with unit franchisees if the master franchise arrangements have to be terminated, may outweigh any other concerns on the part of the franchisor.