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NEW FRONTIERS IN INTERNATIONAL FRANCHISING

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SUPPLY CHAIN MANAGEMENT ISSUES IN INTERNATIONAL FRANCHISING

May 6, 2015

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1. Introduction

An efficient supply chain is critical to the financial success of most any franchise system. Top franchisors and sub-franchisors (in the context of a master franchise arrangement) often have an established supply chain, strong negotiating power and positive relationships with suppliers both domestically and abroad. Franchise systems that achieve supply chain excellence are able to realize cost savings for operating units, thereby creating a competitive advantage for the system and its franchisees, and generate new and substantial sources of revenue for the franchisor. However, developing an international supply chain strategy can be challenging and lead to various issues. Problems in the supply chain have the potential to cause a disruption in the system, which could lead to friction in the franchisor-franchisee relationship and damage to the reputation of the brand. Supply chain issues become even more complicated in an international setting.

In the first section of this paper we discuss key provisions in franchise agreements relating to supply chain management, providing U.S., Canadian and European perspectives. We next address the practical realities of international franchising and related supply chain issues that franchise systems encounter when expanding abroad. We then explore methods of dealing with local issues in a system’s target country using real world examples.

2. Common Practices Relating to Supply Chain

2.1 Products and Services

Franchising is a business method based on consistency and uniformity, allowing multiple units to operate under a common trademark, selling the same high quality products and/or services. A franchisor’s desire to meticulously control supply chain activities is often carried out in order to duplicate the business model with the hope of ensuring product quality and service levels. This is done to provide customers with a consistent experience at all franchise locations, thereby reinforcing the brand. It is also done for financial gain, often benefiting both the franchisor and the franchisee. As a result, the supply chain and its related standards must be strictly adhered to. As consistency is critical to success, many franchisors require franchisees to offer the same products and services.

(i) North America

In North America it is very common for a franchisor to mandate the particular products, services and items such as the menu or product assortment (if applicable) that each franchisee will offer at its outlet. Franchisors aim to ensure that core products and services, or even ancillary products and services, will be available to customers, thereby producing a consistent experience.

The following clause is a typical provision mandating products and services in a U.S. and Canadian franchise agreement:

Franchisee agrees to sell or offer for sale only such products and menu items that have been expressly approved for sale in writing by Franchisor; to meet Franchisor’s uniform standards of quality and quantity as have been prepared in accordance with Franchisor’s methods and techniques for product preparation; to sell or offer for sale the minimum menu items specified in the Manual or otherwise in writing; to refrain from any deviation from Franchisor’s standards and specifications for serving or selling the menu items.

1 The authors would like to thank Brittany Moloney, associate at Cassels Brock & Blackwell LLP for her invaluable contribution to this paper.
(ii) **Europe**

In Europe, both international and domestic franchises are on the rise. For practical purposes, many concepts now in Europe can be categorized as either “hard franchise” or “soft franchise” concepts. Hard franchise concepts are in particular popular and increasingly thought to be more successful than those which are soft franchising the franchisee has more freedom to exploit his business as he deems fit. Hard franchising provides for a clear common identity, maximum uniformity, and thus more certainty to the franchisee, as well as his capital investors. Finding capital and lenders has become a lot harder in Europe, in particular for small business entrepreneurs, because of the changed attitude of banks regarding risk. The food and retail markets suffered greatly from the economic downturn since 2009, which was severe and lasted at least a few years in most countries in Europe. As well, the brick & mortar retail markets for fashion and consumer products have suffered from the continuing rise of e-commerce.

Of the international franchise concepts operational in Europe, in particular regarding fast food, a large portion are from North America. Even though there are good reasons to localize the set up and contracts for the European market, most franchisors like to keep changes to a minimum, to preserve the international uniformity and consistency of the franchise system, in order to protect and grow the brand based on consistency and quality of the products and services offered throughout the world.

Therefore, the views on controlling the supply chain, and the clauses used in the contracts to achieve such control are largely the same as in North America, in particular for the franchise concepts that originate from North America. Most domestic franchise concepts also include either obligations to purchase products from the franchisor, or third party suppliers designated by the franchisor, or use some form of minimum percentage to be purchased from the franchisor or a rigorous set of quality requirements. It is safe to say that the domestic franchise concepts generally provide for shorter contracts that are less one-sided, and that these usually provide more choices and protection for the franchisee, but this is not always the case.

The country where the franchisee operates the business, can also be of relevance, since there is no general harmonization of franchise laws in the EU/EEA and many countries in Europe have some form of mandatory protection of the franchisee. For example some European countries have franchise “disclosure laws” and/or franchisee protections in case of disputes over profitability or termination under their general civil laws (on “distribution”) or otherwise.

But most important for supply chain restrictions in Europe is competition law. For the purposes of this paper therefore, we will distinguish between European countries in the EU/EEA, and European countries outside this region. In the EU/EEA, EU competition law is applicable, which sets forth a Block Exemption regulation on Vertical restraints (the “VBER”) and Guidelines. And in the EU/EEA, case law of the European Courts is applicable (superseding the Guidelines but not the Block Exemption) in all cross border cases in the EU/EEA. If a matter is solely domestic within the EU/EEA, these rules are still relevant because all national laws are shaped in compliance with EU laws, and for example in The Netherlands, the EU rules are declared directly applicable by a (“schakelbepaling”) in the Dutch Competition Act.

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2 Supermarkets and department stores tend to use this method.
Outside the EU/EEA an assessment per country will be necessary. It is noted, however, that several countries are in some stage of the process of accession to the EU and will have already adopted certain EU laws, or be bound by the accession obligations in place. In addition, other European countries outside the EU/EEA, have national competition laws with clauses on the topics relevant here (purchase obligations, non-competes, vertical price fixing and abuse of dominance by pricing behavior) that are largely the same as the EU/EEA laws.

Therefore, it is our assumption that in Europe, legal constraints will play a larger role in developing a sound commercial strategy by the franchisor for control over the supply chain of his franchise network. Hereafter in this paper, we will primarily focus on EU law when discussing Europe, to give an insight in how the legal constraints are an integral part of shaping commercial policy for franchisors regarding controlling the supply chain of their franchise network.

### 2.2 Sources of Products and Services

One of the most critical decisions in establishing a supply chain management strategy is deciding the degree of control a franchisor will have over its system. The level of control a franchisor exerts determines its involvement in the function of its supply chain. Although many franchisors mandate the products and services to be offered by their franchisees, not all systems require that such products and services come from a particular source. A restaurant chain, for example, may require franchisees to purchase pepperoni for their pizza, however, some, but not all franchisors require particular types of pepperoni to be purchased from a particular source. Levels of control vary from system to system; however, most franchisors identify specific goods or services that are critical to the system which will be subject to source restrictions.

The food service industry typically involves perishable products, whose price is highly volatile and dependent on uncontrollable factors, such as weather conditions. Restaurant chains must pay particular attention to their prices and the opportunity franchisees may have to purchase products from various sources at a lower price. Franchisees are particularly sensitive to the price at which the products and services are purchased. Thus, franchisor control over the sources of products and services may come under attack by franchisees and the franchisor-franchisee relationship may be strained. The ability to maintain a positive franchisor-franchisee relationship is critical in preventing tension in the system, and avoiding disputes. As a result, some franchisors may be more lenient on the sourcing of the products and services. However, it is often particularly the case in the food service industry that exact consistency of product offering can be ensured only when all ingredients are sourced from designated suppliers.

(i) **North America**

In North America, there is no one dominant approach taken by franchisors with respect to sourcing products. Typically there can be four differing degrees of control set out in franchise agreements (i) some franchise chains, such as McDonalds, exert a high degree of control with regards to the sourcing of their products, requiring franchisees to source their products exactly as directed (ii) some mandate the sourcing of only core products; (iii) others reserve the right to mandate the sourcing of products and services; and (iv) there are also systems that allow franchisees to have complete power and freedom over the sourcing of their products.

The following clause is a provision relating to the sourcing products and services that is illustrative of the level of control that one can find in a Canadian franchise agreement:

> Recognizing that the Products must conform to the Franchisor's standards and specifications, the Franchisee hereby agrees to purchase all Products, and any other goods or services used in the Franchised Business, including without limitation, all raw or prepared or proprietary food or beverage products, ingredients, inventory, restaurant
accessories, supplies, promotional materials, clothing, hats and kitchen equipment (including, without limitation, containers, dishes, glassware, take-out materials, cutlery, furniture, napkins, placemats and uniforms) only from the Franchisor or from sources, manufacturers or suppliers approved or designated in writing by the Franchisor (which sources or suppliers may include the Franchisor or affiliates of the Franchisor).

From the above one can see that it is very common in a Canadian franchise agreement for the franchisor to require strict adherence to the standards mandated by the franchisor for virtually all of the products and services to be used in the franchised business. While it is not universally the case, the vast majority of business format franchise agreements in Canada follow this approach. The same is often true in the United States, especially in the larger chains. But more often there is recognition that a select group of products and/or services will be obtained from designated suppliers, leaving others to be sourced elsewhere. The following clause is a provision relating to the sourcing of products and services that can be found in a U.S. franchise agreement:

Franchisee shall purchase all ingredients, products, materials, supplies, and other items required in the operation of the Restaurant which are or incorporate trade-secrets of Franchisor, as designated by Franchisor (“Trade-Secret Products”) only from Franchisor or suppliers designated by Franchisor, and those Trade-Secret Products shall only be purchased for, used, or sold, directly or indirectly, at the Franchised Unit.

(ii) **Europe**

In the EU, the VBER provides for a safe haven for non competition clauses that prohibit the distributor in its sales of competing brands, where both supplier and distributor do not exceed the threshold of 30% market share in the relevant product- and geographic market. Also, the duration of such a clause may not exceed 5 years. Silent renewal clauses are best avoided, because these will be considered as if the agreement were continued since it can be expected that no real negotiations will take place. For purchase obligations, there is no such limit to duration. So, this is helpful for franchisors, but still, most franchisors want to restrict their franchisees from doing both. The VBER does not specifically deal with franchise purchase obligations, but the Guidelines specifically set out how the Commission views restrictions placed on the franchisee by the franchisor.

Most of these views already follow from the landmark case of the European Court of Justice in the Pronuptia case. In short, insofar as necessary to maintain the common identity and reputation of the franchised network, a non-compete may be as long as the franchise agreement lasts, even if it exceeds 5 years. Exclusive purchase obligations are recognized in Pronuptia as well as the Guidelines as useful tools to strengthen the quality, reputation and common identity of the franchised network. This is not limited to sourcing of the products sold in the store/restaurant but also products necessary to carry out a service (for

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6 Commission Guidelines on Vertical Restraints, Official Journal 2010 C 130/1, par. 189-191 (re franchising) and par. 129-150 (re single branding/purchase obligations).
7 Judgment of the Court of 28 January 1986, Pronuptia, 161/84, ECLI:EU:C:1986:41, par. 27: “In view of the foregoing, the answer to the first question must be that: (1) The compatibility of franchise agreements for the distribution of goods with Article 85 (1) depends on the provisions contained therein and on their economic context; (2) Provisions which are strictly necessary in order to ensure that the know-how and assistance provided by the franchisor do not benefit competitors do not constitute restrictions of competition for the purposes of Article 85 (1); (3) Provisions which establish the control strictly necessary for maintaining the identity and reputation of the network identified by the common name or symbol do not constitute restrictions of competition for the purposes of Article 85 (1); (4) Provisions which share markets between the franchisor and the franchisees or between franchisees constitute restrictions of competition for the purposes of Article 85 (1); (5) The fact that the franchisor makes price recommendations to the franchisees does not constitute a restriction of competition, so long as there is no concerted practice between the franchisor and the franchisees or between the franchisees themselves for the actual application of such prices; (6) Franchise agreements for the distribution of goods which contain provisions sharing markets between the franchisor and the franchisees or between franchisees are capable of affecting trade between Member States.”
example cleaning), furnishings, advertising materials, even up to designating the accountant for the bookkeeping of the franchisee’s financials. The non competition and exclusive purchasing restrictions are presumed to increase inter-brand competition (between franchisor’s brands) and the loss of intra-brand competition (between franchisees of the same brand) is then often (depending on the market structure and other factors such as whether there are any cumulative effects) acceptable because of the positive effects of the competition between brands. Still, the restrictions should be necessary for this purpose. It is important to assess whether the specific franchise concept and network justifies the restrictions inserted in the franchise agreement. This is where the strategy of the franchisor becomes relevant. A hard format franchise concept is rigid usually for the purposes of maintaining the common identity and will thus more quickly meet the test. A fast food restaurant chain may respect, as explained above, that the franchisee will be price sensitive, but the quality and reputation of the network may demand that the food products are sourced from the franchisor (or “designated” or “approved” suppliers, see below). This may be different for the cleaning detergent, which might be designated third party products. A monobrand fashion store chain, will clearly want no competing products sold in the store, because this would destroy the common identity of the store, and the same may apply for the furnishings and advertising materials shown in such store.

An exclusive purchase obligation is generally understood to be in place between the franchisor and the franchisee if the franchisee has to purchase 80% or more of its total demand from the franchisor (or designated/approved suppliers). For a supermarket or department store chain, it may be much harder to explain why all products sold have to be purchased from the franchisor or from “designated” or “approved” third party suppliers. The franchisor has the alternative of stating that the products must be “A-brand” or that the assortment must meet certain criteria, and should be displayed in a certain way in the store. In the Netherlands, for example most of the supermarket and department store chains allow the franchisees to purchase 20% (or a bit more or less) outside the franchise system, but still certain quality and service criteria will usually apply.

It is relevant to note that vertical price fixing continues to be restricted in Europe, and cannot be justified by arguments relating to the need for uniformity or reputation of the franchise networks. There are specific examples of where obliging the franchisee to apply certain prices towards its customers can be permissible, but these relate mostly to the temporary introduction of a new product, etc. these can be helpful also in a franchise situation, but do not resolve many franchisor’s wishes (and in certain countries, habits) of controlling end user pricing in their franchise network. In contrast it is noted that the former strict prohibitions on vertical price fixing or price maintenance have been relaxed in both the United States (by case law, at the Federal level) and Canada (by Federal statute), permitting franchisors more leeway than ever in controlling the retail prices charged by their franchisees. Horizontal price fixing between competitors (which can include franchisees operating under the same brand) continues to be prohibited, and can lead to civil and/or criminal liability.

2.3 Suppliers of Products and Services

Product uniformity allows franchisors to develop operational efficiencies for its system franchisees. These operational advantages are often realized through use of the strong buying power of the system, which

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8 This follows for example form a Dutch case citing Prompita: Judgment of the Court of Den Bosch of 20 December 2005, Multicopy Netherlands B.V., ECLI:NL:GHSHE:2005:AU8610.
9 Cumulative effects occur in the situation where the market is covered mainly refer to the effect of other. For example, foreclosure may occur for potential entrants when a number of major suppliers enter into single branding contracts with a significant number of buyers on the relevant market (this is a cumulative effect situation). See Commission Guidelines on Vertical Restraints, Official Journal 2010 C 130/1, par. 134.
11 Competition Act, RSC 1985, c C-34.
will often lead to economies of scale. Allowing franchisees to purchase supplies at a lower price than others will have a positive impact on the system’s bottom line without the need to increase sales. This is one of the greatest advantages of the franchise model.

Franchisors typically control the sources of its products by designating, or reserving the right to designate, the suppliers of certain goods and services. A “designated supplier” is a source from which a franchisee is required to purchase a particular product, whereas an “approved supplier” is one from which a franchisee is permitted to purchase a particular product from. Franchisors will often utilize both designated and approved suppliers in its system and will establish criteria for approving any proposed suppliers. Presumably, the franchisor has the negotiating power and has done the leg work, selecting appropriate suppliers so that the franchisees are not required to. If they have done their job correctly, franchisors should be able to negotiate costs that are lower than what the franchisees would be able to get on their own.

(i) **North America**

In Canada it is common for franchisors to require franchisees to purchase virtually all products and most services from specific designated suppliers. It is uncommon to allow franchisees to propose suppliers, and you will not often see any process for approving outside suppliers in a Canadian franchise agreement.

The following clause is a typical provision relating to the suppliers of products and services in a Canadian franchise agreement:

Recognizing that the Products must conform to the Franchisor's standards and specifications, the Franchisee hereby agrees to purchase all Products, and any other goods or services used in the Franchised Business, including without limitation, all raw or prepared or proprietary food or beverage products, ingredients, inventory, restaurant accessories, supplies, promotional materials, clothing, hats and kitchen equipment (including, without limitation, containers, dishes, glassware, take-out materials, cutlery, furniture, napkins, placemats and uniforms) only from the Franchisor or from sources, manufacturers or suppliers approved or designated in writing by the Franchisor (which sources or suppliers may include the Franchisor or affiliates of the Franchisor).

The Franchisee may purchase approved brands or types of fixtures, equipment and signs only from suppliers approved by the Franchisor, in its sole discretion, which may include the Franchisor or its affiliates.

On the other hand, in a U.S. franchise agreement, it is more common, although not universal, for franchisors to require the franchisees to use its suppliers but also allow franchisees to bring outside suppliers to them for approval.

The following clause is a typical provision relating to the suppliers of products and services in a U.S. franchise agreement:

Franchisor will establish uniform criteria for approving suppliers; will make every reasonable effort to disseminate its standards and specifications to Franchisee’s prospective suppliers upon the written request of Franchisee, provided that Franchisor may elect not to make available to prospective suppliers the standards and specifications for such food formulae or equipment designs deemed by Franchisor in its sole discretion to be confidential; and may conduct periodic inspections of the premises and evaluations of the products used and sold at the Franchised Unit and in all other restaurants.

(ii) **Europe**

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In Europe, we see both types of clauses but it all very much depends on the franchise concept and the strategy of the franchisor. Usually in larger hard format franchise networks, there is not a lot of room for the franchisee to suggest alternative suppliers. Any suggestions of the franchisees would typically be dealt with via any Franchise Association that negotiates with the franchisor on all matters relevant for the franchisees. So if an individual franchisee has an idea for an alternative supplier, or a suggested change to the retail concept, or whatever he wants that is a deviation from the franchise system as it is in place, he would bring it to the Franchise Association, who would decide (usually after checking if other franchisees are supportive of the idea) and then would put it on the agenda for the meeting with the franchisor. There are smaller franchise networks, and also “soft” franchise concepts, where there is more room for the franchisee to run his business including certain parts of his sourcing “as he deems fit” as long as the quality of products and customer service meet the criteria and do not suffer. As indicated above for certain types of franchise networks, large as well as “hard format” such as supermarkets and department stores, still a certain portion of the total assortment (demand) may be purchased outside the franchise system. The commercial idea here is that the franchisee will be more successful if he operates as an entrepreneur, and it helps his success if he can try new products, or local products from local suppliers to make more profit, or to adapt the customer experience more to local flavor.

Fast food chains and fashion retail networks in Europe tend to do quite some adjustment to the local flavor and situation, but usually driven by the franchisor, in close consultation with a Master franchisee, or by using “options” in the franchise concept, or by a differentiated strategy (for example, different concepts for a small versus a large store, or for a “city” rather than a “provincial” location of the franchised restaurant or store).

2.4 Use of Third Party Suppliers and the Franchisor (or an Affiliate) as Supplier

As explained above, under the terms of the franchise agreement, franchisees are customarily required to purchase only from designated or approved suppliers. The level of control a franchisor desires will determine a system’s supply chain management strategy and the involvement of the franchisor and its affiliates. Depending on the franchisor’s strategy, the sourcing and distribution of a system’s products and services may be accomplished through use of an outsourced third party supplier. On the other hand, if a franchisor chooses to exert a greater degree of control over its supply chain, it may require certain products and services to only be purchased from the franchisor entity or an affiliate and no other source. Some of the largest restaurant chains choose diametrically opposed strategies regarding this subject. Some aim for almost complete vertical integration, by becoming the supplier to franchisees of almost every single product required in the operation of the business. Others adopt a “hands off” approach and turn over the supply chain management function to unrelated entities, sometimes so called “broadline” suppliers, or in other cases ones owned in whole or in part by the franchisor and the franchisees. And, of course, many choose a path that is somewhere in the middle.

If authorizing or mandating that franchisees buy directly from third party suppliers, franchisors must establish an approval process to qualify its suppliers. As discussed above, a franchise agreement may allow franchisees to submit proposed suppliers for approval. In such cases, franchisors may charge franchisees a fee for managing the evaluation process, and set other stringent conditions on giving their approval. In examining a third party supplier, franchisors must first consider their own local, national and international growth and development expectations, warehousing capabilities, and existing supply relationships. Once the franchisor has completed a self-assessment, they should evaluate third party suppliers by considering a number of factors, such as, its ability to provide consistent quality, national and/or international reach, capability to fill orders in a timely and cost effective manner, consistent processes, warranties offered, customer service, and financial viability. Quality control is critical and will often be monitored on an ongoing basis to ensure quality of the products does not fall below a certain standard. Once quality is compromised, the integrity of the product and brand may be put into question. Franchisors may in fact change approved suppliers if a supplier’s quality falls below its standards.
Another important consideration is confidentiality. A franchise system’s success depends on its proprietary information and thus franchisors need to manage the risk to ensure confidential information doesn’t fall into the wrong hands. As such, franchisors need to evaluate the professionalism of its suppliers and any confidentiality risks.

(i) North America

In North America it is common for franchisors to designate the third party suppliers. Less common is for the franchisees to have any right to choose or suggest an alternate third party supplier. The following clause is a fairly comprehensive supply provision which may be found in a U.S. franchise agreement, and which contemplates a franchisee proposing an alternate supplier for approval:

Franchisee shall purchase all food items, ingredients, supplies, materials, and other products used or offered for sale at the Restaurant solely from suppliers (including manufacturers, distributors, and other sources) who demonstrate, to the continuing reasonable satisfaction of the Franchisor, the ability to meet the Franchisor’s then-current standards and specifications for such items; who possess adequate quality controls and capacity to supply Franchisee’s needs promptly and reliably; and who have been approved in writing by the Franchisor prior to any purchases by Franchisee from any such supplier, and have not thereafter been disapproved. If Franchisee desires to purchase any products from an unapproved supplier, Franchisee shall submit to the Franchisor a written request for such approval. Franchisee shall not purchase from any supplier until, and unless, such supplier has been approved in writing by the Franchisor. The Franchisor shall have the right to require that the Franchisor or its agents be permitted to inspect the supplier’s facilities, and that samples from the supplier be delivered, either to the Franchisor or to an independent laboratory designated by the Franchisor for testing. A charge not to exceed the reasonable cost of the inspection and the actual cost of the test shall be paid by Franchisee or the supplier. The Franchisor may also require that the supplier comply with such other requirements as the Franchisor may deem appropriate, including payment of reasonable continuing inspection fees and administrative costs. The Franchisor reserves the right, at its option, to re-inspect from time to time the facilities and products of any such approved supplier and to revoke its approval upon the supplier’s failure to continue to meet any of the Franchisor’s then-current criteria. Nothing in the foregoing shall be construed to require the Franchisor to approve any particular supplier, nor to require the Franchisor to make available to prospective suppliers, standards and specifications for formulas that the Franchisor, in its sole discretion, deems confidential.

Note that while some North American agreements do contemplate the franchisee seeking approval for alternate suppliers, even less frequent than the right to ask is the times any one or more franchisees actually seek to make use of these rights.

(ii) Europe

In Europe the practices do differ somewhat, and many variations are seen, as the franchisor may choose to only set certain quality criteria for the products or services to be acquired, rather than approving the suppliers themselves. Indeed there is a downside to approving the suppliers, if there is a liability issue, responsibility is then shifted to the franchisor (in addition to the franchisee that made the bad purchase). While the risk of damage to the reputation of the brand is for many franchisors so serious that they want the maximum control, nevertheless one often sees franchisors opting for a different solution than is
common in North America. As well, the added cost of going through a full approval process with all suppliers suggested by franchisees is one rarely employed, in part due to the reluctance of franchisees to pay fees for such approval processes in Europe.

In Europe, there is also a perceived correlation between the higher the burden of franchise fees on the franchisee and the services provided, as the more likely it is that the franchisor is expected to provide advice to the franchisee, and to take over certain tasks and roles, in order for the franchisor to meet his duty of care. The civil laws applicable on this point are different per country in Europe (since there is no harmonization within the EU on franchise nor distribution) but the overall approach is that the franchisee deserves some kind of protection (against disappointing sales figures, termination, etc.) because he is the weaker party, and because the agreement leaves him, even though he is an independent entrepreneur, little room to run his business exactly as he deems fit. Many franchisees complain quickly and fiercely when the cooperation is not running smooth. Thus, regarding control over sourcing, keeping it simple and cost efficient (and such that the franchisor can easily monitor compliance with the agreement) is an important consideration.

**2.5 Franchisors and Affiliates as a Supplier**

Franchisors and affiliates may act as the sole supplier of certain goods and services, or simply one of many approved suppliers. Systems that require franchisees to purchase goods and services from the franchisor entity, an affiliate or a third party supplier who gives the franchisor some form of consideration, should pay special attention to the authorizing language in their franchise agreements, and where applicable, what is being disclosed in their franchise disclosure document. They must also be careful not to strain the fragile franchisor-franchisee relationship. Franchisees may view its requirement to purchase goods directly from the franchisor or its affiliates as a revenue center for franchisors, and may question whether the prices charged and profit made by franchisors is excessive (also, in relation to the franchise fees being paid). As such, franchisors must give careful consideration to its supply chain arrangements. These practices have been challenged by franchisees in the U.S. even on anti-trust grounds, but with little success.12

It is very common for franchisors to receive compensation from its supply chain, through payments from third party suppliers (commonly referred to as volume rebates) or selling products at a mark-up. Such payments may cause franchisees to feel that the franchisor is receiving “kickbacks” in order to increase its profits, specifically if such income is not viewed to benefit the system as a whole. Regardless of the way a franchisor earns income from its supply chain, the most important factor in managing tension in the franchisee-franchisor relationship is keeping franchisees informed and being transparent, where appropriate, and ensuring that franchisees at least receive their products and/or services for a price that is an improvement over what they could achieve if they operated independently. If that is the result, it should be seen as a “win-win”. Franchisors should involve franchisees in supply chain decisions as needed and try to help franchisees understand the need for a franchisor to cover its cost of sourcing and managing the supply chain.

(i) **North America**

In Canada, if a franchisor plans to profit as a supplier, or wishes to reserve the right to profit as a supplier in the future, it must be explicitly stated in a provision of the franchise agreement and in any province

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with a franchise law, disclosed to the franchisees in a franchise disclosure document. Section 5(1) of the Ontario Arthur Wishart Act\textsuperscript{13} requires that every disclosure document include:

A description of the franchisor’s policy, if any, regarding volume rebates, and whether or not the franchisor or the franchisor’s associate receives a rebate, commission, payment or other benefit as a result of purchases of goods and services by a franchisee and, if so, whether rebates, commissions, payments or other benefits are shared with franchisees, either directly or indirectly.\textsuperscript{14}

In the relatively recent decision \textit{Fairview Donut Inc v TDL Group Corp}\textsuperscript{15} the Ontario Superior Court noted that:

The plaintiffs were unable to point to any evidence that it is customary in the franchise business in general, or in the QSR business in particular, that the franchisor supplies all ingredients or other inputs to franchisees at prices that are lower than can be generally obtained in the marketplace....The evidence does not establish that it is the practice of franchisors generally, or of franchisors in the QSR business in particular, or of Tim Hortons, to pass on to their franchisees the benefit of their purchasing power in the case of every input they supply to franchisees.\textsuperscript{16}

In this case, the court reaffirmed that franchisors are authorized to make a profit on the price of goods sold to franchisees so long as it is provided for in the franchise agreement and franchise disclosure document.

The following clause is a typical provision relating to franchisor or affiliate profits in a Canadian franchise agreement:

\begin{quote}
The Franchisee acknowledges and agrees that the Franchisor and/or its affiliates have the right to realize a profit on any items that the Franchisor or its affiliates supply to the Franchisee.
\end{quote}

In the U.S. franchisors are required to provide more detailed disclosure in its franchise disclosure document. If franchisors in the U.S. receive income from their supply chain, the actual amount of any consideration received must be disclosed in a franchise disclosure document.\textsuperscript{17} In addition, it is recommended that the right to earn a profit on the sale of products and/or services be expressly permitted by the terms of the franchise agreement.\textsuperscript{18}

The following clause is a typical provision relating to franchisor or affiliate profits in a U.S. franchise agreement:

\begin{quote}
Franchisor and its affiliates shall be entitled to mark up and earn profit, either directly or indirectly, on the sale of goods and services to Franchisee, and other franchisees in the System.
\end{quote}

(ii) \textit{Europe}

\textsuperscript{13} \textit{Arthur Wishart Act (Franchise Disclosure),} 2000, SO 2000, c 3 s 5(1). Similar provisions also exist in the Alberta, Manitoba, New Brunswick, and Prince Edward Island franchise law statutes.

\textsuperscript{14} O Reg 582/00, s 6(8).

\textsuperscript{15} \textit{Fairview Donut Inc v TDL Group Corp.}, 2012 ONSC 1252.

\textsuperscript{16} \textit{Ibid} at par. 472.

\textsuperscript{17} 16 CFR § 436.5(h).

\textsuperscript{18} For an excellent discussion of American practices, and legal issues arising from them, see Gino Romo, James Straus & Suzanne Trigg, \textit{Building an Effective Supply Chain and Distribution System} (ABA Forum on Franchising 2012).
Under EU competition law, there are no obligations to disclose whether a franchisor will now or in the future profit from the supply chain arrangements in the franchise system. Since there are no harmonized (civil) franchise law, it all depends on the national civil laws applicable to franchising. Five countries in Europe have mandatory disclosure laws, and of those five, only Sweden positively, and Belgium arguably, even require disclosure of these amounts, while the franchise laws of France, Italy and Spain do not require it. Other countries rely on general civil law such as on distribution, termination of agreements, pre-contractual liability and the like. While not binding, there also exists in Europe various materials expressing widely accepted best practices, such as the European principles of contract law (which have to be declared applicable in order to apply and which are not commonly used by franchisors), as well as the European Franchising Code. Otherwise in Europe, the fine balance of interests of the franchisor and the franchisee is in our experience the same. It is important to achieve economies of scale and to ensure a healthy profit for the franchisor also to finance further developments of the franchise system, improvements, services and advice to the franchisees. On the other hand, the franchisee should see the benefits of being part of the franchise system, and preferably see that he pays less for the products purchased from or via the franchisor, not more than when purchases for these products are made outside the franchise system.

A different example would be where it is a given that the products are purchased from the franchisor for example a monobrand fashion retail store network licensed by the manufacturer of the branded products. No franchisee will raise its eyebrows when he learns that the franchisor makes a profit margin on the sale of those products. He may, however, expect that he will receive higher discounts than customers of the franchisor in other retail channels, such as customers that operate multi-brand stores, or concept stores (store within a store, a smaller space usually and less risk attached.

When developing a supply chain strategy for a franchise system in Europe, it is also important to realize that it follows from the Pronuptia case, that while if necessary for the uniformity and quality of the network, purchase obligations are generally permissible, but sales between franchisees (and thus also purchasing from another franchisee) may not be restricted. This could lead to market partitioning which is severely restricted, and impermissible. It would be very difficult to prove economic advantages, and an individual exemption is thus very unlikely.

While not likely an issue in restaurant chains, as franchisees would have little commercial interest in purchasing ingredients from each other, it is different in retail business franchises such as those featuring fashion, consumer electronics, etc. In such case, once the franchisor has sold the branded products to the franchisee, he can in principle not restrict the franchisee from selling such products to other franchisees in the network. This means in reality that also purchases from another franchisee by a franchisee (instead of purchasing all of his demand from the franchisor) cannot be restricted. This legal impediment to restricting sales as between franchisees is certainly an unwelcome carve out in the control franchisors can exercise over the supply chain of their franchise system, in particular if it is their own manufactured products that are the principal items being offered for sale.

These restrictions arise under European competition law. The explanation is that, within the EU, once a product is brought to market with consent of the trademark owner, the owner’s exclusive rights under the trademark are exhausted. The trademark owner cannot prevent further resale of the product under applicable intellectual property rights. Contractual obligations to prevent sale and purchase between authorized distributors in a selective distribution system, are prohibited (while other restrictions are permitted in a selective system, such as the prohibition to sell (both actively and passively) to non-members of the system, to restrict a wholesaler from selling to end users, etc.). The rationale is that within

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20 See for example: Guidelines at par. 188.
the EU there needs to be a free flow of goods, because otherwise the borders that have been removed for the purposes of customs, will again be erected, due to behavior of suppliers in the market. The EU should be one market, one level playing field.

2.6 Volume Rebates and Other Consideration

As discussed above, depending on the franchisor’s supply chain management strategy and desired level of control and responsibility, franchisors may engage the services of third party suppliers. It is common for such suppliers to provide franchisors with volume rebates, advertising allowances, direct payments, and/or other benefits or consideration\textsuperscript{21} for directing franchisees to purchase their products and services from them. Such rebates are often negotiated and are typically tied to the system’s number of franchisees, buying performance and/or overall volume. Rebates can amount to a significant profit for franchisors and what a franchisor chooses to do with the proceeds of such rebates varies from system to system. Some systems pass the rebates, or portions of the rebates, to franchisees, some contribute them to an advertising or marketing fund for the benefit of the system as a whole, while others keep the proceeds as a way to offset costs of managing the supply chain.

Franchisors willing to give up a bit of control over its supply chain to focus on its core competencies may choose to outsource its supply and distribution tasks entirely. Where a franchisor chooses this “hands off” approach, a system’s supply chain may offer a chance for franchisors and franchisees to collaborate. Franchisees in large systems are increasingly becoming involved in supply chain management through purchasing cooperatives and establishing advisory councils. Purchasing cooperatives are often owned by the franchisees, allowing them to act as purchasing agent, participating in negotiating agreements with suppliers on behalf of system franchisees, handling product distribution, and returning any benefits generated by the cooperative back to its members. The purchasing cooperative allows the franchisor and its franchisees to work together, lessening but not entirely eliminating the control and influence of the franchisor entity.

(i) \textit{North America}

In North America, franchisors commonly receive volume rebates and other consideration. However, supply and volume amounts are very contentious issues in the franchise system. In the U.S. and Canada, several large franchise chains, such as Dunkin Brands, Burger King and Dairy Queen, have given up the responsibility for managing their supply chain and have opted to institute purchasing cooperatives. By giving up this responsibility, these chains are also giving up the potential to realize large revenues and profits off of supply. However the trade off is peace within the franchise system.

The following clause is a fairly typical provision allowing a franchisor to benefit from volume discounts and other consideration, which may be found in a Canadian franchise agreement:

\begin{quote}
In the event that any cash rebates, mark ups, volume discounts, concessions, advertising allowances, or discount bonuses (collectively “Discounts”), whether by way of cash, kind or credit, are available to or received by the Franchisor or its affiliates from any manufacturer or supplier designated by the Franchisor, whether or not on account of purchases made (i) by the Franchisor for its own account or for the account of the Franchisee, franchisees generally or the Other Brands, or (ii) by the Franchisee directly for its own account, the Franchisor and/or its affiliates shall be entitled to retain the whole of the amount or any part of such Discounts.
\end{quote}

\textsuperscript{21} For the sake of consistency, we will refer to all such consideration as “rebates”, although the consideration can take many forms. Disgruntled franchisees might often refer to them as “kickbacks”.

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Note that most franchise agreements in Canada will provide the franchisor with an absolute right to retain any rebates entirely for franchisor’s benefit. So long as the contract provides for this, and it is properly disclosed in the disclosure document that is provided in any of the regulated provinces, this is perfectly acceptable. If the franchisor then chooses to share some or all of the amounts received with franchisees or the advertising fund is a matter of policy, which the franchisor can then choose to change in its discretion.

The following clause is a fairly typical provision allowing a franchisor to benefit from volume discounts and other consideration, which may be found in a U.S. franchise agreement:

The Franchisor or its affiliates may receive rebates, bonuses, discounts, or other allowances from some or all of the sources or suppliers associated with the franchise, and the Franchisee acknowledges that the Franchisor or such affiliate shall be entitled to retain or distribute same in their sole discretion.

While choosing to use language that suggests distribution of the rebates to someone other than the franchisor, the clause amounts to much the same in that the franchisor can choose to retain the rebates. Once again what is disclosed in the franchisor’s disclosure document will be important, and if the then current policy is subject to change, that would be important to be explicit about.

(ii) **Europe**

In Europe these trends are initiated more by the North American franchisors operating internationally than the domestic ones, but the trend is certainly visible. Under EU competition law, there are no considerations, other than the notes already made above. It is worth noting that under civil law, the level of independent entrepreneurship may affect liability issues between franchisee and franchisor, and such cooperatives may shift the balance more towards the franchisee (even if he is still restricted by the arrangements with the cooperative and thus still not entirely free to make the business decisions he deems fit), since the supply chain is further outside the control of the franchisor. For franchise systems that are centered around the sales of products manufactured by the franchisor, this system of placing the supply chain outside the franchisor’s direct responsibility, is of course not a solution.

One consideration under EU competition law is that if a party is dominant on the relevant market, he may not display abusive behavior. Example of such behavior can be, predatory pricing, loyalty discounts (exclusive purchasing), tying, refusal to deal, etc. An undertaking is dominant when he can behave unilaterally from its suppliers, customers etc. (more than 50% market share is an indication thereof, but more factors such as market structure are relevant).22

Volume rebates, even if the supplier, or the buyer would be dominant, are in any case permissible if the rebate is proportional to the volume. This can be different if top slice, loyalty or other forms of pricing are applied that lead to exclusive purchasing under considerable pricing pressure in such way that alternative sourcing really no longer is a viable commercial option.23 Buying power that amounts to dominance, is in general rare, but it is something to assess in particular if there is suspicion that the supplier may be dominant and it is becoming difficult to get fair pricing for products sourced even in larger volumes for the franchise network. The arguments under competition law may then be used to leverage a better position in the negotiations. When a dominant supplier requests the buyer to show counteroffers of

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competing suppliers, this may also be a sign of a dominant party securing his position in an unacceptable way.24

3. Practical Issues Upon Entering a New Country

3.1 Practical Issues Relating to Importation

Once a franchisor decides to cross borders and operate as an international franchise system, a number of potential supply chain issues arise. Franchisors often want to be able to send the franchise system standard equipment, software, manuals and employees across the border without any large impediment. Importation of goods may lead to tariffs, duties, customs issues, taxation concerns and other product specific restrictions and thus, some franchisors may opt to source products locally. After choosing a target country, conducting due diligence and market research, the use of local counsel and/or consultants can be critical in implementing a seamless international expansion. Franchisors will not know the nuances of the import laws in each country it operates; however, legal or other local advisors should be aware of various issues that may arise. As such, franchisors will need to seek advice on areas such as local laws and regulations, tax implications, intellectual property rights, and importation issues and restrictions.

(i) Importation of Inventory

Moving goods across international borders can be challenging, as most countries have restrictions on what and to whom goods can be imported and exported. This is especially critical for franchisors operating in the food sector. It is common for countries to require governmental permits and authorizations in order to bring certain items into their country. These requirements often act as a quota system to limit certain goods from entering a country and are commonly seen with the importation of drugs, poultry and meat, dairy, plants, petroleum, liquor, and fruits and vegetables. There is also a concern with food safety which may come into play.

In the U.S., importations of food and beverages are governed under the Federal Food, Drugs and Cosmetic Act,25 and administered by the Food and Drug Administration.

In Canada, there are marketing boards for certain items, such as dairy and poultry, whereby the importation of such goods is restricted in an attempt to protect the Canadian farming industry. Federal regulators have instituted a very small import quota, for example eight per cent of the domestic market for cheese, or one per cent in the case of yogurt.26 Beyond that quota, tariffs skyrocket. In 2011, such tariffs ranged from 168% for eggs, to 238% for chicken, 246% for cheese, and 299% for butter.27 Franchisors must be aware that such import restrictions exist before developing a sourcing strategy for its target country. These types of trade impediments are not uncommon, and if menu items consist of such ingredients, franchisors need to consider these as barriers of entry and consider ways of getting around them in order to create a realistic and achievable pricing model.

Moving alcohol across national and international borders can also be complicated. In the U.S., the Alcohol and Tobacco Tax and Trade Bureau requires importers of alcoholic beverages to obtain a permit. In Canada, alcohol is regulated at the provincial level, and each province has its own restrictions and

24 In combination with a right for the dominant undertaking to match the counteroffers is sometimes referred to as an “English clause. Such a clause is assumed to have the same effect as a non-compete obligation. See Bellamy & Child, European Union Law of Competition, 7th Edition, Oxford University Press 2013, par. 7.147 and Commission Guidelines on Vertical Restraints, Official Journal 2010 C 130/1, par. 129.
27 Ibid.
duties applied to the importation of such. Some provinces restrict a franchisor’s ability to collect royalties based on the sale of liquor. For such reasons, franchisors would be wise to engage local legal counsel in managing its supply chain abroad.

If the franchisor does not have established practices in other countries already, and/or a potential master franchisee is experienced or well advised, the issue of supply chain can be subject to significant negotiation in the finalization of a master agreement. The franchisor may wish to control supply chain, to have the highest level of possible control over the quality of supplies, benefit from profits on the sale, and/or receive volume rebates. On the contrary the local master franchisee may similarly wish to be the one to benefit from the supply chain in this way, by sourcing locally wherever possible. Often if there are significant duties involved in importing goods into the target country, local sourcing will be a practical necessity, and the franchisor will need to recognize that if the concept is to succeed in the target market.

Examples of clauses that were the result of such a negotiation are as follows:

Example #1: Master Franchisee agrees that all Outlets in the Territory will offer for sale only such products and services as the Franchisor authorizes from time to time. Master Franchisee further agrees that Outlets in the Territory will only offer for sale products and services that conform to the Franchisor’s specifications and quality standards. Certain proprietary products, such as [redacted] must be purchased through designated suppliers of the Franchisor. There may be certain minimum order quantities (MOQ) required for these products to be shipped cost effectively to Master Franchisee or to a third party food storage warehouse facility in Master Franchisee’s Territory. It is the sole responsibility of the Master Franchisee to establish a line of credit with the supplier or food warehousing facility, or to cover the pre-payment of goods if required. Master Franchisee shall secure suppliers for all other approved products and supplies to be used, offered and sold in Outlets in the Territory. Master Franchisee shall provide the Franchisor with the identities and other information about manufacturers and suppliers procured by Master Franchisee as the Franchisor may request from time to time. The Franchisor may modify its approved specifications and standards, and Master Franchisee shall not, after notice of such modification, reorder, or permit any Franchisee to reorder, any product or supplies which do not meet such specifications and standards.

Example #2: Master Franchisee shall purchase all ingredients, products, materials, supplies, and other items required in the operation of the Restaurant which are or incorporate trade-secrets of Franchisor, as designated by Franchisor ("Trade-Secret Products") only from Franchisor or suppliers designated by Franchisor. The parties expressly acknowledge that the ability of Master Franchisee to receive shipments of Franchisor's Trade Secret Products is an essential element of and condition to the grant made herein. If Franchisor is prevented by a governmental authority from delivering such Trade Secret Products to Master Franchisee, or if Master Franchisee is so prevented from receiving such Products, the prohibited party shall immediately notify the other and, at which time, Franchisor may, at its sole option, do one or more of the following: A. Franchisor may, at its option, arrange for other suppliers of such Trade Secret Products in the country in which the Franchised Unit is located during such period of prohibition; or B. Franchisor may, at its option, terminate this Agreement.

In the first example, there is a division of the responsibility to procure, and obligation to buy. In the first example the franchisor designates proprietary products that the franchisor or its designated suppliers supply. Otherwise the master franchisee is responsible to secure products. The second example deals only with the franchisor’s right to designate suppliers for trade-secret products.
Whether implementing a North American franchise system in Europe or a European franchise system abroad, much of these considerations and possible hurdles and costs to overcome them will be the same, but treating the EU for customs and several other topics as one country. This follows from the (very beneficial) impact of the EU Treaty for EU cross-border franchising. The EU is a customs union, and there is free movement of goods, services and capital, as well as freedom of establishment and very large harmonization of national product laws and regulations (and to a large extent in VAT), and also for overseas franchising towards the EU: one-stop at the EU border. Regarding its outside borders, the EU has customs duties, and restrictions, as well as a range of product safety and compliance laws (CE mark). In addition there are strict privacy laws if the franchisor would like to store and or process data relating to individuals (such as the franchisee’s customer or employee information).

(ii) Importation of Equipment

Franchisors who wish to move system equipment into a target country must be aware of unique restrictions that exist on certain types of equipment.

A franchisor must jump through certain regulatory hoops to import electrical equipment into U.S. or Canada. In the U.S., electrical equipment must receive certification evidenced by an Underwriters Laboratories Listing Mark, ETL Listed Mark or FCC Mark, in order to be deemed safe for use. In order to be authorized to use electrical equipment in Canada, a franchisor or any importer would need to receive Canadian Standards Association or Underwriters Laboratories Canada approval, confirming that such electrical devices meet the Canadian Electrical Code relating to the installation and maintenance standards in Canada. All electrical equipment must be certified as such before it can be used or sold.

Wireless equipment to be imported into Canada must comply with the Radiocommunication Act, and must not interfere with domestic wireless networks. Anyone who violates the legislation and import unregistered equipment may be fined up to $5,000 or may be sent to jail for a term not to exceed one year, or both. Each authorized wireless device will have an Industry Canada approval label on the back or bottom of the device. In the U.S. there is a similar certification process which is administrated by the Federal Communications Commission.

In Europe there are restrictions regarding the importation of certain electrical equipment and there are regulatory issues and standards regarding telecommunications equipment, computers, (wireless) networks and the like.

(iii) Employees

Where a franchise system requires certain key employees to cross borders and work in a target country, franchisors must be aware of any existing regulatory requirements. In Canada, for example, employees commencing pre-operational activities may be allowed to enter the country as temporary business visitors; however, when the business is up and running, such employees must obtain work permits, a process that can take several weeks. Franchisors should develop a timeline to plan for the application of such work permits. The franchise agreement should contain specific language specifying who bears the cost of obtaining visas and work permits for certain specified personnel for training or working abroad.

If a system’s target country is the U.S., they may be in luck when it comes to obtaining a U.S. visa for a foreign franchisee. The EB-5 visa was created in 1990 allowing foreign nationals the opportunity to enter the U.S., eventually obtaining permanent residency if they (a) invest $500,000 or more in a U.S. business;

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28 RSC 1985, c R-2.
and (b) create 10 or more full-time jobs for U.S. workers within two years. The country also has what’s called an E-2 visa which is temporary and must be renewed every two years. An E-2 visa has a shorter processing time and requires only a $100,000 investment. These programs have helped to attract foreign nationals entering into the U.S. by becoming franchisees in a U.S. franchise system.

Training in an international franchise system also presents cross-border issues. As part of its planning, franchisors need to decide the location of training, and again, should state in the franchise agreement whether the franchisor or franchisee is responsible for such training related travel. In addition to training, the expense of key employees travelling internationally to assist the franchisee in setting up the business in the target country is often a large expense and should be addressed in the franchise agreement. These expenses can include air travel and other transportation, lodging, dining, and entertainment and business development costs. Amounts spent on such items may vary depending on factors such as the distance between the home and target countries, and thus should be factored into the franchisor’s financial planning.

In Europe, many of the same considerations, costs and risks apply. Visa’s will be necessary for short term and long term work (except when it concerns travel of workers within the EU), also depending on the country where the employee resides. In addition, and more importantly, under certain circumstances there is a risk that the employee will be viewed as in employment of the franchisor, which triggers a range of liabilities, such as regarding the obligation to pay social premiums and taxes, employer’s liability, dismissals laws including the obligation to pay a severance compensation in case of termination. In particular this could be the case if the franchisee is not operational yet (pre-operational activities) and/or not yet operates as a fully incorporated legal entity (a limited liability company would be mostly used and recommendable as the most suitable, or a joint venture, which carries a range of other considerations and risks to deal with) and the franchisee has a direct relationship of authority with the employees and pays the salaries of the employees. It may also be at hand in a post termination situation where the employees are employed by the franchisee, but the contract provides for the opportunity for the franchisor to step in and take over the (management of the) franchisee’s business. That situation could lead to a transfer of undertaking based on the European Directive of Transfers of Undertaking (“TUPE”). If there is a transfer of undertaking that would imply that the employees who were employed by the franchisor will transfer to the franchisee by operation of law as per the transfer date. As TUPE is mandatory European law, these rules are applicable regardless the intention and any (deviating) contractual agreements made between parties.

3.2 Impediments to Importation

In addition to the above, there are many technical barriers when shipping goods over international borders. Depending on the target country and existing free trade agreements between the exporting and importing countries, franchisors may encounter regulatory barriers such as tariffs, duties, customs issues, exchange rates, labeling requirements and tax implications. The franchisor should specify in its franchise agreement which party is required to bear the burden of any such cost implications.

(i) Tariffs and Duties

It is common for countries to classify goods into separate categories with corresponding rates of import duties. For example, the U.S. Harmonized Tariff Schedule sets out whether certain goods entering into the U.S. are duty-free or subject to a duty and, if so, at what rate. Duties apply to tangible goods but not

certain intangibles, for example franchise rights. As the schedule shows, the country of origin is a factor in determining such duties. Certain trade agreements, such as the North American Free Trade Agreement and the Canadian Comprehensive Economic and Trade Agreement, made between countries may ease the process of importing goods depending on the countries involved. In the U.S., countries that have been granted “permanent normal trade relations” status will also receive trade advantages such as lower duties and tariffs. Franchisors must be proactive in their approach to moving goods across borders. Goods must be appropriately classified and the appropriate rate of import duties should be factored into any financial model in order to properly evaluate the viability of the expansion and budget accordingly. If import duties and other impediments are too restrictive, costly and/or time consuming, the franchisor may want to consider sourcing its products and inventory locally. Local counsel can be helpful in providing advice to franchisees looking to expand abroad.

(ii) **Language Barriers**

If the target country speaks a foreign language, the franchisor may be required by law or necessity to translate any one or more of its franchise agreement, disclosure document, operations manual, website and any marketing or promotional materials into that language, depending on the legal and regulatory scheme. In some instances, the franchisor and franchisee may be able to contract out of such requirements; however, a franchisor would be wise to factor these possible translation costs into its financial model. Again, the franchisor should also make it clear in its franchise agreement which party will bear such translation costs.

In Europe, the considerations, costs and risks regarding taxes, duties and tariffs are largely the same. Whether there will be a need to translate the agreement into the local language is not harmonized and will depend on local laws per country. In some countries in Europe, such as the Netherlands it is not necessary. In other countries it may be not necessary under the laws, but recommended because the franchisees would otherwise perhaps not understand the contract and, just as important, the operations manual. In other countries in Europe, there are obligations to translate the contracts and other relevant documents that are binding on the franchisee.

(iii) **Tax Implications and Currency Exchange**

Currency exchange and tax issues may arise through the cross-border nature of an international franchise transaction. In drafting the franchise agreement, franchisors must establish payment procedures to which national and international franchisees must abide. The contract must stipulate what currency payments are to be made in, and how the currency will be converted. Franchisors may be exposed to currency exchange risk, and volatile economic conditions may have a significant impact on bottom line profit.

Many countries charge additional taxes which must be paid on any revenue earned in that country. For example, excise taxes, withholding taxes and value added taxes may be required to be withheld by the franchisee and paid to the target country’s taxing authority. The system must forfeit use of the funds that are withheld and franchisors must be sure to budget items such as withholding taxes into their cash flow models. Franchisors may qualify for certain tax credits in their home country, but that will depend on whether the franchisor’s home country and target country have a tax treaty that covers this issue. It is critical for franchisors to get tax advice and/or advice from local counsel to properly plan for expansion into a new country.

In Europe, the considerations are the same. It is important to check the currency and tax implications well in advance of implementing a franchise system there. In particular VAT rules in Europe can be complicated and sometimes even a driver for certain business decisions (such as where to open a store or restaurant as a “pilot” first). Regarding currency, it is noted that the contract must above all, provide clarity on the applicable currency and consequences of exchange rate fluctuations. It is also important to think about the consequences of certain changes in the market. Will the franchisor or the franchisee have
to carry the burden? For example food ingredient pricing has fluctuated tremendously in Europe in the last decade. This can have a major impact on the prices paid for sourcing ingredients purchased locally, and it may affect profitability of the franchisees to the point where they have trouble breaking even. The question is, whether the franchisor may then have to lower its franchise fees, or otherwise assist and advise (such as regarding sourcing strategy, or by changing the franchise system requirements to a different menu that is more profitable using lower cost ingredients) to resolve the problem.

3.3 Local Sourcing

As has been clear to this point, while conducting research and developing a supply chain strategy, the franchisor should consider whether it is more advantageous to export its products to the target country, or whether sourcing its products locally is a more viable and cost-effective option. Although the process of finding and vetting suppliers in the target country will likely be time consuming, such processes may allow the franchisor to avoid the cross-border complications caused by the importation of products, inventory, equipment and the like, and avoid related costs. Provisions must be made in the franchise agreement stipulating who is responsible for sourcing suppliers. On one hand, the franchisor may be happy to delegate this task to the franchisee; however franchisors must be wary of giving up control over the quality of its products, risking potential damage to the overall reputation of the brand.

When franchisors enter into a new country, there may be certain conditions requiring the company to source a portion of their production locally. Sourcing local products that meet a brand’s international quality standards can be challenging and many franchisors experience initial setbacks. For example, when McDonald’s expanded its operations to India, the company made a commitment to source a certain percent of its goods locally. In order to maintain its high quality standards and need for product consistency, while upholding its commitments to India, McDonald’s searched for a specific variety of potato that had low moisture content, acceptable length and high solids content. Lamb Weston, one of McDonald’s Indian suppliers, set up production lines to create fries using such potatoes; however, when it was found that acceptable potatoes could not be sourced, the production was halted and McDonald’s was forced to explore alternative options. Working with its supplier partner, McCain Foods, and local farmers, McDonalds was able to develop acceptable potatoes and implement a successful supply chain strategy in India overcoming a number of initial obstacles.

3.4 Logistics

Once the products and inventory have made it into the target country, whether by importing or sourcing locally, such goods will need to be transported to the franchisee locations and ultimately the end consumer in an efficient and cost effective manner. Franchisors must develop a logistics strategy in the target country. If a franchisor chooses to forego local sourcing and decides to import its inventory and supplies, then the storage and shipping of such materials to each of the franchised locations must be arranged. In order to assist with such logistical arrangements, outside professionals should be retained to ensure a smooth transition. Many unanticipated costs may come up throughout the process and planning ahead of time is the key to success.

In Europe, the considerations are no different. The advantage of sourcing locally can be lower cost and less organization, logistics and transportation. Considering the strict product safety rules in Europe, this might in terms of quality be a sound choice. Compared to the examples provided above, we note that Europe is importer of many food products and sourcing locally may not mean the products are actually produced locally but rather somewhere closer than where the franchisor resides and sources the products.
for franchisees in his home market (so the cost advantages will always have to be investigated on a case by case basis).

4. Local Legal Issues Arising from Common Practices

Practices that are routinely followed in a franchisor’s home country may not be acceptable, either legal or culturally, in the target country. Neither outside counsel in the franchisor’s home country nor in-house lawyers can be expected to advise on legal issues in a foreign country. In order to properly develop a plan for international expansion and lessen the risk of running into barriers down the road, franchisors should engage local counsel and other necessary advisors in the early planning stages. Conducting an international deal involves higher stakes, foreign laws with possibly complex regulatory requirements, cross-border issues, and a number of other moving pieces.

An international franchise agreement should be drafted with the input of both home country lawyers and local counsel located in the target country. The franchisor should seek out proper advice on matters such as intellectual property rights and protection, payment issues, tax and corporate structure, franchise agreement drafting and the target country’s franchise disclosure regime (if any). In addition, there may very well be a host of issues that cannot be listed here, as the laws and regulations of any one target country may be vastly different from that of any others. The scope of such advice from local counsel can vary. In some instances local counsel is retained and used during each step of the transaction, providing comprehensive advice along the way. In other instances franchisors carefully draft specific questions addressing their primary concerns they would like advice on and allow their home country outside or in-house lawyers to take care of the rest. Regardless of the approach, the key is to engage local counsel early in the planning stages, preferably before any letter of intent has been signed or agreement has been negotiated.

4.1 Legality of Common Practices in Target Country

Laws and business practices are far from consistent across the world. Although franchisors typically choose to first expand into an international market that is similar to their own, it is likely that both legal and cultural variances exist. In some cases they are substantial and can determine the success of such expansion.

In the U.S., events such as the 9/11 terrorist attacks have impacted franchise agreements. It is common for franchisors in the U.S. to include such events as part of its force majeure clause. If the franchisor is a U.S. corporation, they are now required to conduct extensive due diligence on their business partners to ensure the individuals they are working with are not terrorists or criminals. It is common for franchisors to require their franchisees to make the following representation (or similar), in their franchise agreement, ensuring that they have not violated any anti-terrorism laws:35

You represent and warrant that neither you nor any of your direct or indirect Owners, employees or agents is a person subject to trade restrictions under United States law, including (without limitation) the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701 et seq., The Trading with the Enemy Act, 50 U.S.C. App. 1 et seq., or any Executive Orders or regulations promulgated thereunder (including Executive Order 13224 of September 24, 2001 Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism, and the Specially Designated Nationals and Blocked Persons List) (“Anti-Terrorism Laws”). You and your Owners may not engage in any activity that would expose us to a risk of criminal or civil

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penalties under applicable United States law. Any violation of the Anti-Terrorism Laws by you or your Owners, or any blocking of your or your Owners’ assets under the Anti-Terrorism Laws, shall constitute good cause for immediate termination of this Agreement.

Many Middle Eastern and other countries have enacted strict religious laws and follow religious customs which in effect regulate standard business practices in the countries. Cultural differences cannot be understated. Franchisors must be sensitive to religious customs in foreign countries and must do their homework before entering into other areas of the world. Restaurant chains in particular must pay special attention to certain food preparation methods involving meats.

In Europe, we recommend to not only have proper checks carried out by local counsel of local laws and practices, and in particular the enforceability (and desirability) of the franchise agreement clauses in the target country. Apart from European wide competition laws, each country needs to be considered separately for legal purposes, as civil laws are different per country. It will also be necessary to repeat the checks of local systems and enforceability of the contract to ensure local laws are complied with at all times. In addition, it should be clear in the contract for which obligations franchisor is required to ensure compliance with the laws and for which compliance the franchisee is responsible for. For example, if the franchise system is centered around the resale of a product manufactured by the supplier, the franchisee may be responsible for notifying the franchisor of changes in local laws that affect the compliance of the product with local product safety laws, but the actual changes in the product or labeling, or the decision to take the product in question out of the directed assortment in all franchise stores in such country because they cannot be made compliant at a reasonable cost, ultimately is, and in our view should be, on the franchisor.

Reflecting on cultural differences, it may sometimes be helpful to work with a strong master franchisee that has a lot of background and experience in the target region, and to delegate some responsibilities such as the assessment of local flavors, culture and methods of doing business, adaptation of the franchise concept to local needs and compliance with laws and customs.

4.2 Real World Examples

In this part of our paper we discuss some real world examples of issues arising when various brands have made attempts at dealing with supply chain issues in a market that was foreign to them. There is a noted lesson in each one of these case studies:

(i) Case Study #1- Foreign Country Localizing Supply Chain (Indonesia)

Issue: On occasion, foreign countries have tried to protect their local supply chain by imposing restrictions on the amount or percentage of ingredients that can be imported for use at local units. Unfortunately, this has had unintended negative consequences when not thought through.

Example: While Indonesian people are typically pro-US brands, their government, during a nationalist uprising, decided to protect local suppliers by passing a regulation requiring that 80% of all ingredients used at restaurants must be local. Unfortunately, the existing local supply chain did not exist at the quality levels required by the US brands looking to expand through franchising in the country.

Outcome: Unintended consequence was that this regulation stopped foreign food and beverage (“F&B”) brands from entering the market, thus negatively affecting job creation. This led the Ministry of Trade (MOT) to provide variances allowing increased levels of imports until the region had adequate supply chain to match quality requirements, but this took nearly 5 years. The issue was made more difficult because 95% of Indonesians are Muslim, but the large US licensees (for McDonald’s and Yum, for
example) were controlled by Catholic and ethnic Chinese who represented a small minority of population (but who controlled most of the commerce).

**Lesson:** Need local presence to track proposed legislation.

(ii)  **Case Study #2- Foreign Country Imposing More Stringent Control on Imported Goods than on Local Providers (China)**

**Issues:** 
(a) Some franchisors were stopped from importing key ingredients, even though similar ingredients were widely used locally, and 
(b) less stringent local control led to quality control issues, negatively affecting franchise system.

**Situation 1:** US franchisor was importing frozen dessert product. Due to new regulation, Chinese government required a detailed analysis of all imported food products and found one artificial coloring in the product mix that did not meet new regulations.

**Outcome:** Franchisor was forced to create another product that was not as popular, led to decreased ROI, and eventually forced the franchisor to shut down their entire Chinese expansion.

**Situation 2:** Major QSR chain was using a meat supplier that was a US company with a Chinese operator. The Chinese operator performed ongoing quality control checks on the US company. However, at the Chinese plant, when meat came back unused from the Chinese location (past its due date), the less stringent local regulations allowed them to repackage the meat and send it back out for sale.

**Outcome:** Ended up causing scandal for US franchise system(s) and negatively impacted their earnings, even though it was a local factory of a US-owned company that had passed quality control standards.

**Lesson:** Never deviate from US standards or you will see it on Facebook the next day.

(iii)  **Case Study #3- Foreign Country (ies) Fixing Shelf Life for Products (Middle East)**

**Issues:** Some territories require special certification for particular food items, and also create rules for how that product can be served.

**Issue:** In UAE, there is a rule that when food products land in customs, there must be greater than 90 days shelf life left or the product is thrown out.

**Outcome:** In Middle East, need to serve Halal beef in most venues. The US is a huge producer of Halal meat, usually sent frozen to the Middle East. However, because of shelf life rule, many F&B brands needed to air-ship Halal product to the UAE instead of relying on shipping the product another way. This resulted in higher prices to the consumer to offset the increased expense.

**Lesson:** Need to pay attention to sell by dates and related regulations, because this may affect how the product is produced to increase shelf-life (i.e., adding preservatives).

(iv)  **Case Study #4- Countries Imposing Minimum Order Requirements (India)**

**Issue:** Several countries (India, Australia, Canada) want local restaurants to primarily use local dairy producers, so makes it very hard to import dairy. However, the local dairy suppliers also have a minimum order requirement before they will sell you dairy products.
Situation 1: In India, if you do not have enough operating units to satisfy the minimum order requirements, then you can’t buy from local suppliers. At the same time, the tariffs on inbound food products are too high to produce an acceptable ROI. Finally, you don’t want to sacrifice quality.

Situation 2: In Canada, area developer of major US restaurant chain that relied on cheese in many recipes only learned of prohibitive duties on importation of cheese products from US to Canada after contract signed. By the time the US franchisor was prepared to waive its requirements for US sourced cheese products, the developer’s initial 2 restaurant locations were losing so much money that they closed. Lawsuit resulted.

Lesson: Need to do due diligence in advance of signing contract, and find both the right licensee (who understands the issues) and the right supplier (who can help find solutions), or you may not be able to operate profitably.

(v) Case Study #5- Specialty Product that Cannot be Locally Produced (Asia)

Issue: Large US F&B franchise company exports specialized product (specially cut and seasoned french fries) to restaurants in Asia in large, refrigerated containers.

Situation: Massive west coast US port strike/stoppage threatens Asian store supplies of the franchisor’s top food item.

Lesson: Some shipments had to go by air at great expense, and this increased cost of supply and led to increased cost to customers.

(vi) Case Study #6- Emerging Market Issues to Police

Issue: As US franchise companies expand into new territories, it is important to retain local counsel who can identify laws that may impact the ability to successfully conduct business.

Situation: In Mongolia:

a) Paperwork at Customs: general lack of consistency; different documents may be required by different agents.

b) Dual labeling: this is where labels are required on both the outside and the inside of boxes

c) Translated documents: challenging and expensive to both the franchisor and the freight forwarder.

Lesson: Particularly in emerging markets, it is important to see if there are any franchised systems currently operating in the territory, and if so, to reach out to them for input before even retaining local counsel. If laws/regulations are subject to rapid change, it is important to know that ahead of time, and factor that into your decision whether to move forward.

5. Conclusion

Developing and maintaining an efficient and effective international franchise supply chain requires a multifaceted approach, often requiring participation of local counsel, other consultants, franchisee representatives, and third party suppliers. There is often no "one size fits all" approach that can be employed, especially for franchisors new to international franchising. What is perfectly acceptable as a practice at home may not be practical or legal in the target market. Rather, franchisors need to examine their options, choosing a supply chain management strategy that provides the best benefit to the franchise
system as a whole. Managing franchisor-franchisee relationships while implementing cost-effective processes will align all parties’ interests and provide longevity for the business.
Martine de Koning – Partner, Head of Practice Group Commercial, Attorney, Kennedy Van der Laan

Martine de Koning is specialized in EU and Dutch competition law and commercial contracts and disputes in an international landscape. Martine de Koning has a highly regarded expertise in the field of franchising and agency/distribution, and related (complex) contract drafting and dispute resolution in an international environment. She has extensive experience with cross border franchising, and selective distribution and competition law advice in this context. Martine handles commercial and compliance aspects of supply chain management, procurement, manufacturing, sourcing, sales, logistics, warehousing, transportation and horizontal alliances such as (technology) licensing and joint ventures. She regularly publishes articles and lectures on these subjects. Martine advises many parties with a dominant position on their commercial strategy, in particular regarding pricing and product offerings. She handles litigation before supervising bodies and in civil courts. Martine studied law at the University of Utrecht graduating in 1995. She studied and lectured in the U.S.A. and Australia. In 1997 Martine joined Kennedy Van der Laan, where she has developed a practice in EU and Dutch competition law, commercial contracts, litigation and technology law. Martine graduated cum laude at the Grotius Academie, EU and Competition law, in 2004.

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Mr. Kolton is highly regarded as one of the leaders and innovators in the franchising community, with over 30 years’ experience at the highest levels within the legal, research, marketing and finance sectors. Mr. Kolton began his professional career as an attorney with the law firm now known as DLA. In 1989, he founded FRANData Corporation and sold it to National Cooperative Bank in 2001. From 2001-2004, he was a partner at Kaufmann Gildin & Robbins, specializing in transactional legal work in the international and M&A areas, before founding Franchise Market Ventures in 2004 to provide outsourced strategic development services to market leaders. Mr. Kolton has been a member of the IFA Board of Directors and Chairman of the Supplier Forum, is an honors graduate of Cornell University and the London School of Economics, and received his law degree from Georgetown.

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Larry is a partner at the Toronto law firm of Cassels Brock & Blackwell LLP. Since 1989 he has had a practice that specializes in franchise law and providing all necessary legal services to franchisors. He is currently Vice Chair of the International Bar Association’s International Franchising Committee and the Immediate Past-Chair of the Ontario Bar Association’s Franchise Law Section. Larry was the founder of, and to date has organised and chaired four Ontario Bar Association annual franchise law conferences. He is a member of the American Bar Association’s Forum on Franchising, and in 2006, he was the first Canadian lawyer to be appointed Director of the ABA Forum’s International Division and to a leadership role on its Governing Committee. In 2009 he had the honor of being Co-chair of the ABA’s 32nd Annual Forum on Franchising conference. He is also a member of the International Franchise Association, and the Canadian Franchise Association, where he serves as Chair of the CFA’s Legal and Legislative Committee. In 2004 he acted as co-editor of the ABA Forum on Franchising’s book entitled Fundamentals of Franchising-Canada. He is a co-author of the chapter on Canada for the ABA Forum’s book entitled International Franchise Sales Laws. In 2004, 2005, and each year from 2009 to 2015 Larry was named by Franchise Times to their “Legal Eagles” list of the top franchise lawyers in the United States and Canada. He and Cassels Brock are each listed in the Lexpert® Canadian legal directory as being among the leaders in Canada in franchise law. In 2014 and 2015 Larry received Who’s Who Legal’s worldwide Lawyer of the Year award for Franchise law, and in 2014, the Lexpert® Zenith Award. Larry was called to the Bar of the Province of Ontario in 1989.