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INTERNATIONAL FRANCHISING COMMITTEE

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STRUCTURING JOINT VENTURES IN FRANCHISING

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1. Reasons for Structuring a JV for Expansion

With the internet anything is possible. For a franchise system wishing to expand beyond its domestic boarders, the internet can provide it with opportunistic inquiries from potential foreign partners about the possibility of franchising or otherwise opening units in a different country. Often times the franchisor’s immediate thought is that since its system plays well domestically so it should easily translate to other countries. But the franchise landscape is littered with franchisors making snap judgments about the adaptability of its concept outside its native jurisdiction. For a franchisor that wishes to act prudently pure franchise expansion may not be the key to successful expansion beyond one’s own boarders. In fact, there are certain jurisdictions that will require a franchisor to open and operate company owned units before it can set up a purely franchise vehicle in a foreign country. Accordingly, it is often a good business practice for a franchisor to first enter into a joint venture relationship with a potential partner to develop a concept abroad.

1.1. The Concept of a Joint Venture.

In the discussion of international joint ventures in the franchise context there can be no single definition of a “joint venture”. The term is best defined by the existence of certain characteristics, understandings and arrangements. An international joint venture is often described as the joining together of two or more business partners from separate jurisdictions to exchange resources, share risks, and divide rewards from a joint enterprise. Usually, but not always, one of the partners is physically located in the jurisdiction of the joint venture.

A joint venture is most likely an agreement of limited duration that can be either renewed or replaced by another partnership vehicle. In the franchise concept this successor vehicle may result in a partnership, master franchise relationship, or a direct franchise relationship with a franchisor’s foreign partner, or a combination of all three.

1.2. The Most Common Reasons that Parties Begin their Expansion Relationship as a Joint Venture.

From a franchisor’s viewpoint it is a great temptation to convince a potential international franchise partner that the franchisor’s domestic concept is immediately transferable to another country without the necessity of setting up a pilot or group of pilot locations in the target jurisdiction. Often the potential partner, after its immediate euphoric view of the franchise concept will have many concerns regarding the barriers of entry that will likely occur in the transfer of the concept into the local country. Some of these concerns will center around the following: how well-known is the franchisor’s trademark outside its domestic locations; will the franchise concept appeal to the same or different customer base; will there be difficulty in sourcing the necessary supplies in developing the concept, and can it be done to provide the foreign partner with adequate profit margins; and, what will be the operational hurdles that a franchisee can look forward to in establishing a brand in another country. These are questions...
that both a franchisor and franchisee should be asking if they truly seek a successful expansion into a new market.

So one of the principal reasons to set up a joint venture is for both the franchisor and the potential local franchisee / partner to provide each other with a certain expertise that translates into a joint relationship. The potential franchisee / partner will have a better understanding of the local market conditions such as customer tastes, sources of supplies, labor and other regulatory issues, as well as other barriers of adaptation of the brand concept into a new country. Conversely, the franchisor will have a better understanding of the franchise system, how to set up individual franchises as well as how to develop various markets. This complimentary expertise should work to the advantage to both parties.

1.3. What Are the Values of Company Owned or Joint Ventured Units?

Another reason to establish a joint venture is to test the concept in a new market before employing a pure franchise model. With a joint venture there are a limited number of parties that can tinker with or fine tune a foreign concept before further developing it on a grand scale. Moreover, some countries like China may require the operations of company owned units before permitting franchising in its country. Depending upon the jurisdiction a company owned location must be in operation for at least one year before a foreign franchisor can begin expansion through franchising.

But beyond the immediate legal reasons, it makes good business sense to test the concept before franchising it. Joint ventured locations between a franchisor and its future master franchise partner can test such things as customer tastes, location development, staffing, and sources of supply through the “test kitchen” of a jointly owned and operated unit. While the franchisor may give up an immediate development fee and royalty stream it will gain a valuable understanding on the best business practices for transferring a business concept to a new country.

2. Advantages of Using a Joint Venture for Franchise Expansion

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1. One of the most controversial and debated franchise issues in the China franchise regulations is the so-called ‘2+1 rule’ – the requirement that a franchisor cannot offer franchises until it can establish that it has owned and operated two franchise units for at least one year.

Although the franchise regulations do not state specifically whether the units must be located in China or whether these units may be located outside of China, most franchise experts are taking the position that a foreign franchisor can satisfy the legal requirement by operating two directly owned units located anywhere in the world. This position is supported by oral statements made by officials within the ministry of commerce franchise department and the China Chain store and Franchise Association.

One of the ongoing uncertainties in relation to the 2+1 rule is that the 2007 franchise regulations do not indicate how the Ministry of Commerce will determine ownership and what types of ‘directly operated outlets’ will satisfy the requirements of the 2+1 rule. This situation has been clarified to some extent by draft franchise regulations (Draft Regulations) the Ministry of Commerce released in April 2011 for public comment. Such draft regulations provide that:

- a franchisor can rely upon the units of a company that is under the same corporate ownership as the franchisor
- franchisors that engage in non-store activities, such as online education companies, do not need to satisfy the 2+1 rule requirements
- a hotel directly managed by a hotel management franchisor would be considered as a directly owned and operated unit by the franchisor.
How can a Joint Venture structure be positive for franchisor?

Among some of the reasons already indicated above, such as providing each other, franchisor and franchisee, a certain expertise, a complementary expertise, to set up a joint venture with a local partner as a formula for franchise expansion involves several advantages for franchisor.

On the basis of the assumption that franchisor has chosen a partner with the following profile:

- Owner or operator of similar business in the franchisor's industry;
- Developer and operator of company-owned units and desirable of franchise units of its own brands or third party's brands;
- Consolidated support structure;
- Credibility in the local market: first class partner is the best business card for a franchisor who lands in a new market.

Franchisor's advantages could be summarized in four words, as somebody said: "Think globally, act locally". Let's guess what could be behind:

a) Market: Setting up the Development Strategy with a Well Established Partner.

The local partner may provide Franchisor consolidated expertise and a deep knowledge of the local market on several issues as the holding market capacity, competition, the first and best areas of the territory where the development of the foreign franchise should be launched, the selection of the major target cities, and the best locations for the "flag ship" unit.

To agree upon terms such as the exclusivity should address the question which channels of distribution should be tackled at first (or which channels should remain outside the scope of the future agreement).

The definition of an investment business plan, together with the definition of a development growth plan strategy (setting up a minimum development schedule to be accomplished by the partnership) and the estimated returned unit profit, and its method of calculation, leads to the advantages of the credibility of the master franchisee partner in the local market, with strong and reliable position in its market.

(i) Financial Resources: In terms of financial resources it may render easier the access to banks and other local entities, in order to make available funds by means of loans and credits for a faster development investment.

(ii) Favorable Tax Treatment: From a fiscal point of view, setting up a joint venture company with a local partner belonging to a country with a tax treaty avoiding double taxation may provide a favorable treatment for both parties, transparency for the local tax authorities (instead of a franchisor's branch with the legal profile of a permanent establishment). In this regard, it may be noted that equalization clauses would be requested in the main agreements with respect to payments to be made to franchisor.

(iii) Franchisor’s Role: From a legal standpoint of view, franchisor may play two roles: as franchisor (which may be located in its origin country or anywhere in the franchisee region) and as partner of the joint venture company. This dual role may also allow the parties to limit and allocate risks and liabilities within the franchisor's group. Franchisor may benefit from the legal knowledge and expertise of the local partner which will incorporate the project into its
corporate day-to-day life without additional costs of outside lawyers (setting up a new company, corporate issues, handling of the joint venture, etc.).

b) Let's go into action. "What else positive for me as franchisor?"

Let's think about the assets obtained by the franchisor to launch its concept in a country with a partner who shares its business structure with franchisor in terms of:

(i) **Construction**: Franchisee real estate team with access already in place to the local real estate companies and agents and to the landlords network (as desirable, if the local partner already operates units) may allow a smoother and more successful landing and launching of the brand in the new country. Matters as the negotiation of the occupancy contracts, the handling and maintenance of any kind of permits and license, including condominium issues, are on the scope of the franchisee partner.

(ii) **Procurement and Supply Chain**: Partner, as a company in the local market, will have access to a variety of services and goods suppliers, from engineers and construction contractors to logistics and supply chain providers (going through IT, insurance providers, etc.).

The access to the sources of supply, already put in place by the local partner for its own business with good knowledge of the local players and with contract terms and conditions already existing in most of the cases, allows the franchisor to rely on its partner for all the logistic structure.

Different matters may be the scope and split of products that franchisor may desire to provide and moreover impose to its partner, which may be subject to a thorough study of the competition laws (i.e.: EU countries with legislation at the level of the European Community and at the level of each country, even when most of them are transpositions of the European directives).

(iii) **Learning and Operations**: The labor task force and the labor laws, rules and practice (including trade unions activities) are usually a complex issue for a foreign industrial investor. The existing framework of the franchisee partner will make easier to face the launching and operation of the units from a human resources point of view.

An excellent training program a planned in advance, a learning process provided by franchisor together with well translated and "transferred" (adjusting to local market) operations manuals to the local market (and to the language of the local market in its broadest sense) may contribute to the success of the project.

(iv) **IT**: Franchisor may benefit from the same IT framework as the franchisee may have access (and more if this local partner has already its own company-owned units) to:

- **Hardware and Software** (possible interfaces with franchisor's software, intranet with better understanding and professional conversations at the same level);
- **Proactive Management of the Communications Network**;
- **Maintenance**.
v) Customer Service: Talking the same language and, more important, understanding the local idiosyncrasy and the local laws and practices applicable at each case.

vi) Better Control of the Franchise Partner: Those above indicated advantages by themselves will bring another one to franchisor, which will be its ability to focus on the core issues of its international franchise business and in particular on the new market as protection of its industrial and intellectual property rights, as trademarks, know-how, design and image of the units (tradecress), marketing, quality assurance and inspections, improvement of the products and manuals in the local market (again "Think global, act locally"), surveillance of the fulfillment of standards, etc.

Nevertheless, with the existence of the joint venture, the key questions will remain subject to franchisor's approval: the selection of the sites, the layout process, communication and marketing plans, quality assurance, products category (definition of the essential products and services linked to the brand, when products can be manufactured locally according to franchisor's technical specifications, etc).

The joint venture franchisee company will allow franchisor to be very involved from capital contribution decisions to the daily local business, participating at a strategic and tactical level by means of quarterly business review, being a member of management committees or board - member and consequently being part of the decision making process.

vii) Possible Synergies: Synergies may exist in other domains in addition to those indicated above (procurement, real estate, human resources, etc.) more linked to the support of the business: finance, legal, human resource management, internal audit, etc. and, as consequence, a cost sharing.

As result of the above, franchisor likely will gain knowledge, thus leading to a faster and more solid growth trajectory.

3. Disadvantages

But that is not to say that we are satisfied for saying "let's go" and that everything in the garden is rosy.

Even in the best scenario and with the best partner, a franchisor may face some disadvantages or obstacles to be taken into account that could adversely impact its growth initiative:

(a) Mandatory Corporate Structure

It may seem that a Franchisor's branch as permanent establishment would be discarded due to its lack of plausibility the long-term perspective.

As far as franchisor and franchisee incorporate a special purpose company, the joint venture company, becoming both parties' shareholders, a primary question to be agreed would be which stake each party should hold: 50/50 or more, a majority stake with a dominant shareholder? In such case, who?
It seems that 50/50 structure is not the best for a healthy and quick growing: who takes the critical decisions? And the liability? How can Franchisor can be shareholder and franchisor 50/50?

Who will be ready to invest its own money in a business which is not growing as expected, irrespectively of franchisee’s timely fulfillment of the royalties’ payments?

Deadlock becomes a high real risk when the development and the openings are not bringing the budgeted results in the business plan, let alone the lack of dividends distribution.

As an additional issue, would the legal company hurdles be increased by the presence of the foreign shareholder/board-directors, some times and in some jurisdictions subject to some monitoring tax requirements (i.e.: Portugal to designate a tax representative; Spain, to have a tax number; France, to receive official communications, and Brazil to designate a representative and a tax number etc.).

Usually this type of special purpose company chooses a board of directors as a management body, which involves nominated board-members. The bylaws are usually as simple as the local law allows managing the company without contradictions or inconsistencies with the covenants of the joint venture agreement (quorum rules, reinforced majority for certain reserved matters, transfer of control at the second level, exit clauses, etc.).

(b) Political Risks

The high political risk is added to the commercial risk of the business in some jurisdictions targeted by franchisor:

- Political instability or changes of government (i.e.: Greece, Portugal, Spain, Poland, Perú, etc.);
- Naturalization or nationalization of the joint venture company or the assets with the subsequent loss of investment;
- Changes of laws applicable to the business and, therefore, to the company resulting in a less legal certainty: stronger and more controlled permits issuance, royalties, taxation benefits disappearance (i.e.: investment in know-how by means of research and development activities).

(c) Excess Sovereign Control of the Joint Venture

The main control of the joint venture structure would be in the hands of the local partner. This point may not be a problem as far as the joint venture is healthy and both parties have benefits and comply with its undertakings.

However in the event that the franchisee partner fails to comply with its obligations, mainly and among others:

- Development schedule: growth is not going as expected, the unit profit and the return of the investment is not reached: probably no further investments are approved at corporate level in the joint venture company;
- Standards;
- Procurement and strategic products;
- Marketing.
It will become more difficult for franchisor to change those hats, franchisor and part of the franchisee company, and to make enforceable its rights under the master franchise agreement.

(d) Dilution of Profits

Depending on the local laws, the high taxation on the corporate incomes may discourage some franchisors to become partners with a local master franchisee. The dividends are the gain of the investment for the franchisor-shareholder who has invested in the company; royalties do not cover such effort and royalties do not have such purpose. Meanwhile, franchisee partner may receive other types of gains by way of transfer prices for goods and/or services, provided to the special purpose company or by way of mark-ups to certain services provided (management and handling of local procurement, support services, etc.) provided to the special purpose company.

The business model conceived at the beginning might have been foreseen the different "expected profit". Among others, we could think of:

i) an investment model adapted to the economics of the country;

ii) such scenarios where the distribution of dividends could not be feasible for several years (i.e.: exit clauses, termination of the joint venture in consistency with the appropriate provisions with regard to the existing franchises);

iii) those benefits for one or the other party in terms of extra-costs of the products and services by way of mark-ups or indirect support costs to be considered in the estimated P&L and Business Plan, and

iv) the incorporation of the appropriate clauses and safeguards in the joint venture agreement or the master franchise agreement: a maximum mark up or mark up for bracket prices, minimum conditions of gains for the distribution of benefits, break options, loss of exclusivity, etc.

(e) Capitalization and Guarantees

In general, the joint venture company is conceived as an operating company at a first stage: investment for growing and returning the investment to shareholders, besides the payment of royalties and other amounts to each party as consideration for services provided.

When the business is not running as expected and the company needs to be capitalized in order to prevent an asset imbalance, further needs of equity are required, finance entities or banks require further guarantees from the shareholders, almost always requesting further joint and severely guarantees from the shareholders of the joint venture company. This situation may lead franchisor to require franchisee (or its principal(s)) counter guarantees.

(f) Local Employees

The nature and profile of the local employees with regard to the purpose of the company to be incorporated is very relevant as far as according to the local regulations (and European regulations for sure), it may be required to hire a certain number of local employees in order to make evidence to the real substance of the company (from a tax point of view this matter becomes more relevant in the EU).
When the special purpose company will develop its own company-owned units, it should be necessary to clearly hire local employees, at least at operational level. The question may become blurry when the special purpose company franchises / sub-franchises, then a rational task force at support and operational level would be required to provide real substance to the company (from a tax point of view this matter becomes more relevant in the EU).

(g) Liabilities

Franchisor as investor and as member of the board becomes bound to comply with local regulations including local compliance issues (even criminal liability compliance for the legal entity) and to control that the company complies with.

Its directors and officers acting on behalf and for the account of the company may also result personally liable according to some jurisdictions (D&O liability).

Again a disadvantage to carve-out in the joint venture agreement by way of indemnifications to be provided i) by franchisee to franchisor as result of liabilities arising from the operation of the business in the market, and ii) by franchisor to franchisee as result of liabilities arising from: the license of the trademarks and other intellectual property rights, know-how; image and design; standards; manuals; products provided by franchisor, etc.

(h) Exit Strategies

What happen in the event of a deadlock?

What happen if the development schedule is not fulfilled?

What happen in the event of occurance of an scenario of dilution of profits?

What happen in the event of a breach of main obligations by the special purpose company? Should the assets be sold? Should franchisor designate a third party as developer and franchisee? Should the units be closed and then each unit franchise terminated? Should franchisor be assigned to franchisee's position? What happens with the services provided by the partner?

Those may be some of the questions to be answered at the time of setting the business with the franchisee partner as the exit strategies can change depending on the nature of each scenario.

A possible dormant controversy would be related to an alleged confusion of know-how of franchisor and master franchisee (improvements of franchisor know-how owned or at least alleged by franchisee).

4. Business Cooperation / JV Agreement and Due Diligence
It goes without saying that the franchisor, normally the owner of IP rights, should know the local partner it will be bound to, especially if the structure chosen for expansion is a JV.

However, the local partner / franchisee should also verify and conduct at least a brief search in connection with such franchisor and franchise system it/he/she will jointly explore, in order to ascertain related opportunities and risks.

In this sense, even before executing any kind of preliminary agreement whatsoever, it is highly advisable to conduct a search in connection with the following aspects for this venture:

(i) **Due Diligence**

It is material that the franchisor conducts a financial due diligence proceedings regarding the solvency and good standing of the local partner, due to the guarantees required by commercial banks for loans and capitalization needed to start the business in a new market. Obviously, choosing a local partner with high financial capacity could bring results sooner, especially due to the fact that a JV has normally a limited duration of time.

On the other hand, the local partner – mainly experienced business partners – should consider not only verifying the financial situation of the franchisor, but also any recurring complaints from franchisees and its committees, of all kinds, and how long franchisees have been in such particular system, as an indicator of a healthy and possibly profitable business.

(ii) **Background Checks and Lists**

It is almost mandatory for the franchisor to conduct at least a background check – a light legal due diligence – in connection with the local partner and its ongoing business and verify with local counsel how possible existing debts and legal problems could adversely affect the new corporate vehicle that will be used to conduct the JV activities. For that purpose, clerk and good standing certificates should be obtained and carefully verified, in order to preserve the future business and the reputation of the brands and franchise system. For instance, a criminal background would certainly jeopardize the business and its reputation before it even starts. In some jurisdiction, even a full legal due diligence may be required.

The local partner, in its turn, must consider and analyze the legal situation of the brands and intangible assets that make up the franchise system, especially locally, and how this will affect the agreements to be executed between the parties. If possible, it is also recommendable to proceed with a commercial due diligence in connection with the franchised trademarks to check if there is a potential to develop the market in that particular segment.

Also, certain countries, companies, groups or individuals could be included in national lists of economic and trade sanctions, based on security goals against targeted countries and regimes, terrorists, international narcotics traffickers, weapons of mass destruction and other threats to national security. As an example, the Office of Foreign Assets Control (“OFAC”) of the US department of the Treasury publishes the so-called the “OFAC Sanctions Lists”. Therefore, it is also necessary to verify if a partner is listed, before the negotiations are even started.

4.1 **Business Cooperation or Exploratory Agreements**

After this initial phase, the parties normally execute a Memorandum of Understanding, Letter of Intent, Term-Sheet, etc., called herein Business Cooperation or Exploratory
Agreements. Despite its name, such initial document is often a non-binding instrument outlining the basic terms of the agreements to be executed between the parties.

(i) Goals of the Participants

A very important section of this initial document would be the definition of the Territory to be jointly explored and also the growth targets, which corresponds to the parties’ immediate plans to develop the market. In other words, the commitment to the opening of a specific number of stores or units that would constitute a critical mass within a specific market, in order to maintain such JV existing; the exclusivity of the IP agreements to be executed or even as a just cause to terminate them, if not accomplished. In this sense, the parties may establish a required minimum number of stores or units to be opened during a given year or years and the possibility or not of carrying over and adding the number of unopened stores or units to a subsequent year, during a certain limited period of time.

Other basic terms should also be stipulated in such initial document as (a) the duration of the JV and the IP Agreements and if they are renewable for equal periods, provided certain conditions are met, as established by the parties; if there are, depending upon the structure adopted and applicable legislation, (b) opening franchise fee for corporate stores different from opening franchise fee for sub-franchisee stores, if allowed by applicable legislation; (c) progressive royalties for a corporate store, due to the initial investment made by the JV, subject to transfer pricing and/or arm’s length applicable rules or other possible local limitations; (d) development fee; (e) advertising fee or fund and which party will be responsible to manage it, among others, as applicable to the specific activity.

(ii) Contribution of Each Party

Even though in such initial document the obligations of the parties are not described in detail, it is advisable that the basic pillars of the contribution of each party are already defined. For instance, which party will manage the corporate stores, train personnel or sub-franchisees, if applicable, manage the advertising fee or fund, and customize the system for a particular culture or legislation. Customization by local partner could entail clientele and goodwill discussions. Better sooner than never, in order to avoid disputes upon expiration or termination of the definitive agreements.

(iii) Good Market to Develop

Besides all legal working and documents, a previous commercial analysis is needed to foresee possible challenges and opportunities. Therefore, an important task for the parties is verifying the specific functions that need to be performed to determine if it is effectively a good market to expand and develop a particular franchise system.

(a) Potential Customers

A marketing team should identify potential customers by identifying target groups and needs, amongst individuals and organizations, which would lead to market segmentation. In this sense, grouping consumers allow the parties to identify which group is the most appropriate target for your franchise products or services in a given country.

In addition, another way to get insights into potential customers is to identify possible local competitors, if any, in the same franchise industry. One way or another, the initial document should establish which party (or if either party) will be
responsible and pay for such research, which is as important as all legal paper to be executed.

(b) **Source of product**

The parties should also address in this initial document how the products will be sourced, considering franchised products. Taking into consideration the high tax burden to import specific products in certain countries, they will need to identify a local source of products and/or supplies and goods to ascertain if their characteristics are compatible with the system standards and, for obvious reasons, the related costs.

In some cases, such initial document could establish the general intention of the parties, for instance, they may outline that the industrialization and distribution of supplies and goods for the franchise units within the Territory will be carried out by local partner or another legal entity directly or indirectly controlled by such Partner, due to its expertise.

(c) **Business Entrance Hurdles**

Besides opportunities and synergies, it is very important to identify the obstacles and hurdles when expanding a franchise system to another country or territory. When entering foreign markets, franchisor may face obstacles or increase costs due to legal and business environment, monopolies, poor legal protection related to IP rights, lack of effective dispute resolution mechanisms, cultural sensitivities, an undeveloped bank and financial system or even bribery and corruption, in the worst case scenario.

Having a local partner may help the franchisor to foresee such obstacles and the possible ways and alternatives to mitigate or avoid the arising risks, in order to determine in an initial phase, if it is effectively a good market to develop.

(d) **Best Structure to Operate**

In this initial document – certainly not construed as a preliminary agreement if non-binding – the parties generally establish that they are beginning to discuss the best structure, including the terms and conditions to jointly incorporate, either direct or indirectly through other related or affiliated legal entities, a JV entity in the Territory to explore and maybe disseminate the franchise business system. Also, at this stage, at least basic terms in connection with equity interest of each party in the capital stock and the management structure and nomination should also be addressed.

Regarding the IP structure, the instrument may also address that the JV corporate vehicle will act as an area developer to open corporate or owned stores, or a master franchisee duly authorized to franchise others to open franchise units within the Territory, normally due to tax advantages or in a later stage, due to franchise regulations. In some situations and depending upon the local law, other IP agreements and/or arrangements could be negotiated and executed.

5. **Intellectual Property Issues**

(i) **Ownership of the Marks**
From the beginning of negotiations, from the franchisor’s point of view, the initial instrument must contain a provision through which the local partner recognizes the ownership of the trademarks and undertakes that it will not (a) challenge, contest or object to, nor will it assist any third party in challenging, contesting or objecting to the validity or enforceability of franchisor’s rights in or related to the franchised marks; (b) file any application to register or obtain, on its behalf or that of any third parties, any registration for any confusingly similar variation of, or for any other trademark or name that makes reference to, or for a trademark that might cause any confusion with the franchised marks; and that the execution of the MOU or the definitive agreements (c) shall not be construed as granting to local partner any rights or interests related to the franchised marks. Along with the confidentiality provision, such undertakings normally survive the termination or expiration of this initial agreement.

(ii) **Ownership vs. License Intellectual Property.**

The JV corporate vehicle is often authorized solely to use the IP rights in connection with the franchise system and such aspect must be clear from the beginning of negotiations. In other words, it is highly uncommon that franchisor or the owner of the related IP rights would assign those rights to the local JV. However, the local partner might have better leverage when it comes to the local domain name, which could be managed by it. Even though, if the agreements are terminated, the domain name should either be assigned to franchisor (or any other legal entity it will indicate) or even cancelled, as the case may be.

(iii) **Know-how vs Technical Assistance and other Services (free charge or remunerated)**

A franchise agreement is a complex agreement that comprises several obligations and rights between the contractual parties. From the franchisor’s point of view, the license to the franchisee to use the marks and other IP rights, the right to use the know-how related to the establishment and management of a business or operating system developed or used by the franchisor, along with the right to distribute products or services on an exclusive or semi-exclusive basis and, possibly, training services or technical assistance related to the franchise business.

Depending upon the characteristic of each specific franchise business, franchise legislation and tax treatment in the local country, the contractual parties may decide to adopt a royalty-free license and payment may be remitted to franchisor by the JV as a know-how compensation, technical assistance services or other services. The parties may also decide that such payment be allocated between different kinds of obligations established in the franchise agreement. However, in certain countries, payment of royalties incurring from both know-how and trademark licensing are not allowed. In addition, it is also important to have legal and economic grounds and substance for the transaction, in order to avoid any different interpretation from tax authorities and observe transfer pricing and/or arm’s length applicable rules or other possible local limitations, as mentioned.

(iv) **License Agreements vs Franchise Agreements**

Also depending upon local franchise legislation and regulation and the characteristics of the specific franchise business, a license agreement could be executed between franchisor and the JV, instead of a franchise agreement. In this initial stage, it is advisable that the parties verify possible advantages and disadvantages, which may vary from country to country, as mentioned below. However, some disadvantages of the
license agreement may be mitigated by the corporate documents executed between the parties, for instance, as per veto rights in connection with operational aspects and IP rights favorable to franchisor.

<table>
<thead>
<tr>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
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<tbody>
<tr>
<td>Franchise</td>
<td>- Risk of labor claims brought by franchisee employees due to the imposed controls, as applicable. As corporate owned stores, such risk already exists; - Compliance with Franchise Law; - Risk of lawsuits by franchisees for lack of support, services or promised results, as the case may be. As corporate owned stores, such risk is mitigated; - Greater responsibility with regard to operating the business.</td>
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<td></td>
<td>- Control of retail sites; - Justification for demanding and enforcing operating standards; - Better legal grounds for imposing noncompetition and confidentiality restrictions; - Requirement of exclusive supply and product mixes.</td>
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<tr>
<td>Trademark Licensing</td>
<td>- Difficulty to impose any standards; - Difficulty to impose confidentiality and noncompetition restrictions. As corporate owned stores, the corporate documents will also address this aspect and thus mitigate this risk. - Difficulty to impose exclusive supply and compliance with product mix and display standards. This aspect could also be mitigated by corporate documents.</td>
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<td></td>
<td>- Smaller degree of control over the retail site; - No need to offer services or retail-site supervision; - No training or recycling of licensee employees; - Not responsible for the standardization of the business operations.</td>
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6. **Structure of the Joint Venture Agreement**

(i) **What are the initial considerations?**

As discussed earlier, there are a host of issues that must be considered with cross-border joint ventures. What will be the actual purpose of the joint venture? Will the joint venture be superseded by a formal franchise relationship such as a master franchise agreement, or will the joint venture remain in existence to govern jointly owned units. It is not uncommon to have multiple agreements that are part of the joint venture relationship. These agreements likely will include, a master franchise agreement, a trademark license agreement, and quite possibly a shareholders’ agreement.
The actual structure of the joint venture also will be determined by taxation issues and competition issues. Taxation issues also will be driven by the form that the joint venture takes, such as whether it is a corporation, partnership, or limited liability company. The structure will be determined, in part, by the country in which the joint venture will be conducting its business.

Another issue that should be given consideration is the legal systems governing both the franchisor’s jurisdiction and the target country’s jurisdiction. Under the Anglo-American common law tradition an agreement between the parties will be given significant weight. The parties will expect that the agreement will be fully enforceable. Parties entering a joint venture in a civil law jurisdiction may not have that same luxury, because the general legal background of the civil law may give less weight to the contractual agreement of the parties. In fact, in some civil law jurisdictions joint ventures have only recently been recognized as a viable business vehicle. In addition, in negotiating the terms of a joint venture one must take into consideration the differences between the common law negotiations employing the concept of caveat emptor and civil law jurisdictions employing the concept of culpa in contrahendo.

(ii) Business of the Joint Venture.

Once the parties to the joint venture have been established then the parties should determine the actual business of the joint venture. Most likely the joint venture will be the immediate vehicle to set up jointly owned company units. One issue that should be resolved is whether the joint venture will carry out a specific project or will it be a continuing business. If the ultimate goal of the parties is to franchise the concept in the target county then a master franchise agreement likely will be a collateral document to the joint venture agreement, and may take over the ownership of the initial joint ventured units. It also should be determined where will the business be based. In order to satisfy different franchise regulations it is likely that the joint venture will be located in the country where the business will be operated.

A companion issue to where the joint venture will be based will be the geographic reach of the business of the joint venture. Since the ultimate goal of the business will be to develop the franchisor’s concept within the target country, the definition of the territory to be developed by the joint ventured units needs to be established. It is likely that the further definition of the exclusive territory will be set forth in the master franchise agreement, which will contain the development schedule of the units to be developed in the designated territory.

The joint venture agreement also should identify the various licenses and consents that will be required to be obtained incident to the formation of the joint venture. As will be discussed later, the joint venture will need to take into consideration the specific country’s competition laws if the joint venture speaks to combining different assets.

(iii) Structure.

In the context of the exportation of a franchise system the joint venture may take on a variety of structures including the specific structure of the joint venture, whether it be an informal contract or an entity that maintains a specific capital structure. To satisfy many of the international franchise regulations that require company owned units before franchising can be accomplished, the joint venture structure likely will need to be a corporation, partnership, or limited liability company. The structure of the joint venture also will be driven by tax considerations.

2 Joint Ventures and Undivided Co-ownership Arrangements: A Quebec Perspective, Michal Garonce
4 See for example the requirements under the Hart Scott and Rodino Act for combinations set up in the United States.
If the joint venture is going to be set up as a corporation will there be any capitalization requirements and can shares be issued in exchange for the contribution of property. Will the corporation provide for equal ownership or will there be minority ownership, and if so will there be minority rights provided for either in the documents or by the law of the jurisdiction where the joint venture will be located.

Since for one of the parties the organization of the joint venture company will cause foreign ownership what are the ownership controls or other restrictions on foreign ownership or investment. Does the target country have any controls that restrict the conversion of local currencies?

(iv) Capitalization and Financing of the Joint Venture

A major component of the business operations of the joint venture will be how its operations are financed. It must be remembered that the immediate purpose of the joint venture will be the operation of company or co-owned units for the franchise concept. Depending upon the justation period of the concept in the target country, which may be dictated by the franchise laws of the target or host country, the majority of the costs associated with the development of the franchise concept in the host country will likely be the expense of the master franchisee through the master franchise agreement. As the franchisor may maintain a majority ownership of the actual joint venture it may take on much of the financing of the initial units.

As part of the financing considerations it must be decided what portion of the financing will be in the form of capital contributions and what amount will be in the form of debt. If there is there will be third party financing how will it be undertaken and what will serve as security. Will the creditor be satisfied with the balance sheet of the legal entity of the joint venture or will it require guarantees from the actual owners of the joint venture vehicle.

Beyond initial financing requirements there likely will be a need for continued working capital. How will those amounts be financed? In addition, to the extent that the joint venture will incur losses how will those losses be funded or distributed?

(v) Regulatory Issues

a) Competition Law.

Virtually every country in which a franchise system will operate will have some version of competition law that could affect the manner in which the joint venture operates. In essence these laws may require that approvals will be necessary as part of the initial formation and operation of the joint venture. Will the joint venture have certain protections against the owners of the joint venture such as soliciting customers or employees of the joint venture. Moreover, will the parties to a joint venture have obligations to refer business to the joint venture.

For example the competition law in China is the Anti-Monopoly Law (“AML”). Effective as of 2008 the AML governs mergers as well as anti-competitive conduct. Under certain circumstances joint ventures must undergo a notification process through the Ministry of Commerce (MOFCOM). The MOFCOM issued “Notification Guidelines in what circumstances the establishment of a joint venture notification that is predicated on the concentration of undertakings. Under the AML if a joint venture is under the joint control of at least two undertakings the transaction constitutes a concentration of undertakings that requires approval from the MOFCOM.
In the European Union the European Merger Regulation allows the European Commission to examine concentrations with "EU dimension" for their compatibility with the internal market. Concentrations can be prohibited if they significantly impede effective competition in the internal market or in a substantial part of it in particular as a result of the creation or strengthening of a dominant position. For a joint venture to constitute a concentration under the EU Merger Regulation it must be jointly controlled.\(^5\)

For joint ventures that will take place in the United States, competition will be viewed without regard to particular triggering events or jurisdictional thresholds. The test is whether the joint venture affects US commerce. A joint venture may be subject to pre-merger notification and waiting period requirements of the Hart-Scott-Rodino Antitrust Improvement Acts of 1976\(^6\)

b) **Sourcing of Products.**

Depending upon the country that the target units will be located the parties will need to understand that country’s laws regarding the sourcing of products and equipment. In some countries, such as Indonesia, there are requirements that a certain portion of the product and equipment purchases must be made from local sources of supply in that country.\(^7\) Depending upon the concept this may radically affect the administration of the particular business concept. Moreover, one will need to check the customs requirements and the cost of importing products and equipment into the host company.

c) **Franchise Disclosure and Registration.**

It goes without saying that the parties will need to research and understand the franchise disclosure and registration laws of the host country as well as the franchisor’s country depending upon what the disclosure requirements are with that country. Certain requirements must be reviewed. For example, at what point does the host country require disclosure to the

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5 See EC 139/2004; [2004]OJ l24/1
6 Hart Scott Rodino Act, 15 U.S.C. §18a, as amended
7 For example in Indonesia the franchise concept may be required to source its products locally. See Regulation No. 16/1997 on Franchising (“Regulation 16”). D. Operation of the Franchise and Procedures

Both Regulation 16 and Regulation 12 have important provisions relating to operational aspects of the franchise. These include, among others, the following:

- **Local Content:** it is a requirement that all parties give priority to the maximum use of domestic products or services provided that quality standards are met. It is unclear to what extent or how this may be imposed on a franchise arrangement other than by the authorities reviewing the franchise agreement.
- **SME Priority:** it is required that priority be given by the franchisor to small and medium-scale enterprises as franchisees/sub-franchisees and in certain cases as suppliers.
- **Business Areas:** except for provincial capitals, a franchise business may not be conducted unless the city or area has been "opened" specifically for franchise activities by the Ministry. Again, this is to protect smaller enterprises. The precise location of franchise activities (i.e. whether in a traditional market or in a modern shopping mall) is also regulated as is the ability to appoint franchisees for the same products or services on adjacent sites at a particular location.
- **Franchised Products:** it appears that uniquely Indonesian products or services, including traditional food and drinks, may only be franchised in Indonesia by or with the participation of small or medium-scale enterprises.
joint venture partner. If the joint venture partner is a minority owner in the joint venture will that ownership interest trigger disclosure. The franchise laws may also affect whether the joint venture can contain a non-compete or non-disclosure requirement. The franchise laws also may address winding up of a joint venture relationship that appears to satisfy the requirements of a franchise. The franchise laws of a country must be reviewed both from a disclosure and relationship basis, as some countries also will govern the actual franchise relationship.

(vi) **Intellectual Property.**

The backbone of the franchise relationship is the trademark belonging to the franchisor. While the franchisee/joint venture partner will maintain a right to use the franchisor’s trademarks those marks will not be conveyed to the joint venture partner. The terms of the use of the trademarks likely will be set forth in a trademark license agreement that likely will be an exhibit to the joint venture agreement or documents. The trademark license agreement will be signed by the joint venture and by the master franchisee as part of its master franchise agreement.

The trademark license agreement will cover the joint ventures right to use the marks during the duration of the agreement and will set forth what happens to the marks after the expiration or termination of the joint venture agreement and the master franchise agreement.

In addition to trademark rights there will be other intellectual property issues. The most pronounced issue will be the sharing of confidential information. Much of this information may emanate from the operations manual, but additional confidential information may result from the joint undertakings of both partners in the development of the initial units to be located in the host country. It would seem logical that by right, since the underlying concept originates with the franchisor/joint venturer it should remain the property of the franchisor. However, the retention of this information should be spelled out in the supporting documentation of the joint venture documents. The disposition of the intellectual property rights also should be addressed in any exit provisions for the administration of the joint venture.

(vii) **Administration.**

Since it is likely that the joint venture vehicle will be a corporation or other legal entity the administration of the joint venture will be left to other collateral documents, that likely will include bylaws, a management or operations agreement, and/or a shareholders agreement. Each of these documents will address very specific issues regarding the operation and administration of the joint venture.

Among the issues that will need to be addressed in these documents will be, what will be the composition of the board of directors or board of managers of the joint venture. Who will be the officers and what will be their various authorities and responsibilities? It will be critical to determine what responsibilities will be reserved to the board and what authorities will be granted to the officers.

Another issue to be resolved will focus on the distribution of money in the form of distributions or dividends. These distributions will be tempered by the tax implications. One will need to determine the various tax treaties between the host country and the franchisor’s country to determine whether distributions are subject to withholdings and what are the tax consequences of a foreign national, which could be the United States holding majority ownership rights in a joint venture company.

As discussed in more detail later, it will be critical for the joint venture to address exit and termination rights of the various parties upon the expiration or termination of the joint venture.
One area that could be fraught with difficulty is the control of the affairs of the joint venture. As mentioned earlier, one of the collateral documents to a joint venture arrangement should be a management or shareholders’ agreement that addresses which decisions can be made by the officers, which decisions are subject to board or shareholder approval, and which decisions require a super majority to be implemented.

(viii) Conflict Resolution.

It is more than likely that the joint venture will require a conflict resolution procedure, especially if there is a 50-50 ownership structure. Conflict resolution should be gradual, meaning that it is better to start on an informal basis instead of relying solely on arbitration or the local court system. The use of an ombudsman or informal non-binding mediator may be able to help the parties solve difficult issues without unilaterally forcing a party into a certain position. If the parties still cannot reach consensus then they can rely on more formal mediation of if they still are unable to reach consensus then a formal arbitration proceeding. Most countries recognize the New York Convention to enforce global arbitration decisions.⁸

(ix) Language of the Agreement.

One provision that is often overlooked is the language of the agreement. However, the particular language to be used will be significant. Since there will be many occasions where the interpretation of the agreement will be at issue, understanding the language in the agreement will be paramount. In addition, to the extent that the language used by one of the parties to the agreement is not their mother tongue then thought should be given to require certified translations made of the governing documents. A companion issue to language of the documents is the language of any proceedings to enforce the terms of the agreements.

(x) Non-Competition, Non-Disclosure, and Non-Solicitation Provisions.

It will be critical that the agreement contain provisions addressing the rights of the parties after termination or expiration of the agreement. Since there will be a likely temporary transfer of confidential information the parties should designate what constitutes confidential information and under what circumstances, if any, a party can continue to use such information after the termination of the agreement. Likewise, to the extent enforceable, the franchisor will likely require the franchisee/joint venture partner to agree to a post termination covenant against competition that must be reasonable as to geographic and temporal scope in order to be enforceable.

(xi) Jurisdiction and Venue.

The joint venture agreement should contain a choice of law provision. If it is the franchisor’s intent to enforce a provision of the agreement in the host country then it likely will be more successful if the law of the host jurisdiction controls, whether or not the parties rely upon arbitration to enforce the provisions of the agreement. Even with arbitration the host jurisdiction will still be the place where the arbitration award must be enforced. To the extent that the provision being enforced violates a fundamental rule in the host country then this may be reason enough for the courts in that country to not enforce such provision.

(xii) Ancillary Agreements

The parties to the joint venture relationship will be limited to their imagination as to what will be the ancillary agreements that should be part of the joint venture relationship. At a

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⁸ New York Convention; Convention of the Recognition and Enforcement of Foreign Arbital Awards; United Nations 1958
minimum the agreements listed below should be part of the joint venture relationship in the franchise context.

a) Master Franchise Agreement
b) Trademark License Agreement
c) Shareholder or management agreement

(xiii) Change of Control.

While there will be defined instances where a party wishes to exit from the joint venture relationship, there will be other instances, where a change of control will accomplish the same result. Accordingly, the parties will need first to define what constitutes a change of control, whether it is pursuant to a change of ownership interests or a change in management. Then it must be determined what happens upon a change of control. In other words, under what circumstances can there be a transfer of the interests of the party upon a change of control. The provisions relative to a change of control may be similar to the exit provisions also found in a joint venture agreement. Will the change of control result in drag-along or tag-along rights, and what approval mechanisms will be put into play? Moreover, will the remaining joint venture partners have rights of first refusal or other pre-emptive rights when there is a change of control?

(xiv) Exit Strategy.

Since the joint venture by its very nature is likely to be an agreement of limited duration, the joint venture agreement must contain exit or winding up provisions. These provisions will center around who, if any, will maintain ownership interests in the joint venture upon one party exiting the venture. One of the key issues will be how to establish an exit price or valuation of the joint venture. There are many ways to establish this valuation, from using mandatory buy-out provisions to requiring the venture be appraised by a third party appraiser. In addition, the exit provisions must address the confidentiality, non-competition and non-solicitation provisions discussed earlier in this paper.

7. Conclusion: JV as the Best Course of Action

Given the host of considerations set forth in this paper, a franchisor should consider the joint venture model as its preliminary vehicle to establishing a franchise model outside of its domestic jurisdiction.

As discussed above, the pure franchise model may not be the best vehicle to establishing a cross boarder franchise. In fact it may not be the initially permitted model. Over and above the legal reasons that have been discussed, there are significant business reasons to consider the joint venture model. One of the key advantages of using a joint venture is to leverage the target market franchisee’s superior understanding of the local market place. In addition, a joint venture partner likely will possess a better understanding of the legal environment and regulatory issues, as well as other barriers of adaptation of the brand concept into the target market.

Another key advantage of the joint venutre is the ability to test the concept in the target market before franchising it. Each country will have its unique customer tastes, location peculiarities, development, staffing needs, and local sources of supply requirements.
For obvious reasons, choosing a local partner with high financial capacity could bring results sooner in that such a partner will have greater access to necessary capital. This access to capital will translate into the ability to develop a strong relationship with local financial institutions that will be necessary to assist in further expansion of the concept in the target market.

The joint venture should give both parties the ability to explore the cross borderer tax treaties to determine whether it is possible to avoid double taxation or otherwise provide both parties with more favorable tax treatment.

By using a joint venture as the initial cross borderer expansion it will permit both parties to the transaction a better opportunity to engage in joint collaboration to test and develop the concept in the target market before making a full scale commitment to expand the concept through the pure franchise model.

From a franchisor’s point of view it is important to keep the following phrase as part of its development lexicon: "Think globally, act locally".

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