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REAL ESTATE ISSUES IN FRANCHISING INTERNATIONALLY

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Table of Contents

1.	Introduction	1
2.	Threshold Real Estate Structuring Issues For Franchisors	1
3.	Key Legal and Market Factors	3
4.	Key Franchise Agreement Provisions and Issues	11
5.	Conclusion	15

1. Introduction

There is a famous line in a baseball movie: “If you build it, they will come.” If only it was that simple in the real world of franchising. While franchisors and franchisees are generally in the business of marketing and selling some type of products or services and much of the effort goes to building the brand and goodwill associated with the business as a whole, in many cases it is the physical real estate on which the franchised businesses are located (for a fixed premised business such as a hotel or restaurant) or the geographic area in which the franchised businesses perform services (for a mobile business) that really determines success for the individual business and sometimes the brand as a whole.

Making both macro and micro decisions regarding real estate norms for any franchise system can be a harrowing experience. Just as all franchisees tend to consider themselves experts in marketing and advertising, so too do many franchisees consider themselves experts in the real estate field, especially in their home market. Making these types of decisions in a franchisor’s home jurisdiction is difficult enough, but when it comes to international franchising, the laws, rules, regulations as well as the customs, practices and other norms vary widely and may seem unique, different or downright strange to foreign franchisors. This paper explores how real estate markets, leasing norms and strategies used to find and secure real estate can vary significantly from country to country around the world, and what is important for any franchisor considering expansion to an international market to take into consideration.

2. Threshold Real Estate Structuring Issues For Franchisors

In an ideal world, a franchise system will replicate their systems in place in their home jurisdiction when they go abroad. With respect to real estate, the structure used at home might be difficult or impossible to replicate. While Section III of this paper explores reasons why certain structures may not be legal or practical, this Section outlines generally some of the structures that franchisors may use at home and/or abroad. While this Section provides certain pros and cons for the different structures, there is of course no “one size fits all” structure and what might be ideal for one system may be completely inappropriate for another system.

2.1 Franchise Plus Lease Programs

Purchasing and developing a franchise is expensive, and the real estate for the franchised business (particularly a fixed premises business) is almost always one of the most expensive cost outlays for a franchisee, especially if purchasing the real estate for the business. Some of the more prosperous early franchisors (such as McDonald’s and IHOP as well as many gas station franchisors) sought to control not only the brand but also the real estate by offering franchises along with a lease for the property.

These so called “franchise plus lease” programs involve a franchisor that has the capital and real estate expertise to locate and then purchase or lease the real estate and package the franchise and real estate in a franchise offering to a franchisee. The franchisee signs a franchise agreement and a lease or sublease (that are almost always cross defaulted), and the franchisor has the added protection of controlling the real estate if the franchisee fails. Of course, many franchisors focus on franchising as a growth method to avoid the capital outlays, additional expertise and potential long term and contingent liabilities (loans, ground leases, guarantees, etc...) that come with owning a lot of real estate so these “franchise plus lease” programs are not for every franchisor.

While this model does not seem to be in vogue any longer in the United States (especially after various real estate crashes and the circa 2008 lending crisis), the authors are aware that this model is still used in Canada by several larger franchisors and might be ripe for use in other jurisdictions where real estate norms might favor the type of larger entities owning and controlling real estate.

2.2 Turnkey Programs

Another type of program akin to, and that sometimes morphs into, “franchise plus lease” programs are so called “turnkey” programs. Turnkey programs tend to start life similar to a “franchise plus lease” program in that the franchisor secures the real estate and will normally go ahead and build the franchise business with the idea of packaging the real estate and the franchise to a prospective franchisee, but then instead of retaining the real estate the franchisor sells the property or assigns the lease to the franchisee so that it becomes a more traditional franchise structure after the sale of the franchise and sale/assignment of the lease. In other words, the franchisee makes the required payments, signs the required documents and then just “turns the key” and walks into its completed franchised business ready to start operations (after training of course). Schlotzsky’s used a turnkey program as part of its growth model in the 1990s, but eventually ran into trouble after it was unable to extricate itself from a number of mortgages and leases when flipping the real estate to a franchisee.

2.3 Franchisees Owning Real Estate

This paper has repeatedly mentioned that real estate is expensive and is a significant cost outlay for a franchisee, but real estate is of course a significant asset and some franchisees might prefer to incur initial capital costs to purchase the real estate with the goal of building equity in the real estate for future gain vs. merely paying a continuing occupancy cost in the form of rent.

As will be detailed below in Section III of the Paper, purchasing and owning real estate can be legally or practically impossible in some jurisdictions, but may be very attractive in other growing economies where real estate prices are still low and expected to rise.

Instances of franchisees owning the real estate come in different shapes and sizes. For example, a mom and pop franchisee may already own a property that is otherwise “right” for a specific concept and so they seek out a franchisor that has a franchise that is a good fit for the raw real estate or even a finished building. On the other side of the spectrum, particularly in the Middle East, several large franchisees are owned by or otherwise associated with large real estate developers and mall owners, and their natural inclination is to populate their malls with hand-picked franchises that they purchase and locate in these malls. While perhaps outside the scope of this Paper, some of the typical real estate-related provisions in franchise agreement may not be workable in these franchisee-owned real estate scenarios because the franchisees have no interest in granting a franchisor purchase option rights on a transfer or termination/expiration of the franchise.

2.4 Franchisees Leasing Real Estate

Franchisees locating and leasing real estate from a third party landlord is the preferred approach for most franchises in the United States, and remains the most likely structure outside the United States as well. While both the franchisor and franchisee give up long term control over the site and the potential for equity gains from increases in value in the local real estate market, the reduction in capital outlay, flexibility and (ideally) reduced direct and contingent liabilities can be well worth the limitations. Leased real estate is also the norm in most urban areas in both developed and developing countries where large real estate companies control downtown urban areas and the spaces as well in malls and other large suburban retail developments.

Of course, with the leasing of real estate comes one or perhaps several different players in a typical franchise relationship, including a third party landlord (and in many cases their third party property manager) and a lender who is lending money for buildout and FF&E. These additional

relationships add to the complexity of structuring (and of course enforcing) a franchisor's rights with respect to the real estate in the context of a transfer or termination. Section 4 of this Paper delves into some of those complexities, and how franchisors in the United States and abroad sometimes deal with them.

3. Key Legal and Market Factors

3.1 Availability of Real Estate Generally

Real estate is an important factor in any business, including franchised businesses. In many countries, most of the commercial premises are leasehold estates.

Availability of such real estate at a strategic location is usually a concern, and therefore, real estate planning becomes a crucial element of a business. Real estate planning should focus on availability of suitable premises at a strategic location, duration of lease, termination and lock-in restrictions, local customs, and cost of leasing and maintenance of property.

(i) *Urban vs. Suburban vs. Rural*

- ***Urban.*** In most countries, urban areas offer big business opportunities due to availability of a large population with high propensity to consume. Therefore, there is always a high demand for commercial real-estate compared to its supply. Thus, commercial properties are generally very expensive in urban areas.
- ***Suburban.*** The most important aspects of the suburbs are sub-divisions, shopping malls and a greater population density when compared to rural areas with the important determination being the specific footfall the franchise is looking at. Suburban areas tend to cost less than the urban areas, but in most cases, suburban areas also tend to have fewer footfalls than urban areas as well thereby lowering potential revenue.
- ***Rural.*** Rural areas are usually categorized by agrarian economy and isolated dwelling houses, which in itself make it a no-go area for business, unless the prime product of a franchise business is aimed at rural consumers. For example, setting up business in rural areas may be suitable for organizations that provide services or products to farmers. International franchising in rural areas may run the risk of being stuck in a desolate location with no demand for services or products being offered. Furthermore, the availability of commercial real estate in rural areas is generally scarce and may also vary from country-to-country. For example, in India, supply of developed commercial units is negligible due to lack of demand.

(ii) *Nature of Commercial Property - Sales and Leasing*

- ***Pricing.*** The most perplexing issue associated with leasing of real estate is that the asking price is missing for most commercial listings. The reason behind this is that it is hard to quantify the exact price for commercial properties. Different locations offer different business value to different types of franchises. A commercial property may be more valuable to some while being much less valuable to others. For example, a location ideal for a food and beverage industry franchise may not be ideal for some other businesses.

Along with the location, commercial property transactions are often scarce and usually occur over years at a time as lessors tend to prefer long term leases. This ensures the lessor is guaranteed income over a long period of time and reduces the risk of major fluctuations in market rent. The lessor is also able to secure a security deposit which could be up to 6 months monthly rent. The average commercial lease is usually for 3- 15 years with lock-in periods varying from 6 months to 5 years.

In some jurisdictions, sellers do not mention the prices on the listings as they do not want to eliminate potential buyers who might be willing to bid higher than the asking price based on the location. Sellers prefer to negotiate and hence, franchises must factor in all issues in this regard prior to finalizing any commercial property for potential franchises.

- **Capitalization Rate.** The capitalization rate represents the value of the property and the income that it produces. The net operating income of the property divided by the asking price provides the capitalization rate in most cases. The capitalization rate helps a company assess the prospective gains that could be attracted from any possible location, thereby making it one of the most important factors at the time of finalizing the real estate locations for potential franchises.
- **Sales and Leasing.** The sale or lease document governs the possible types of permissible uses for the commercial properties. Prior to commencing negotiations for buying or leasing real estate, it is important to carry out due diligence on the proposed premises in order to ensure that the person or entity leasing a property has a title in the property as well as the right to lease the same for the intended business purpose.

The local customs and regulations with respect to sales and leasing of real estate in foreign countries is paramount. There might be specific compliances required. For example, in South Korea, the Commercial Building Lease Protection Act governs the lease of business premises and leasehold rights between landlords and tenants. The payment of a “premium” is a unique real estate custom in Korea. A “premium” is an amount of money that the new tenant pays the outgoing tenant in consideration for any tangible (e.g., interior construction and equipment) and intangible (e.g., goodwill from operating a particular business at the business premises) benefits that might be realized by the new tenant.¹ Franchisees must take into consideration country specific customs and restrictions relating to sale and lease of real-estate.

During negotiation for the terms and conditions of the sale or lease documents, there are a number of areas which must be negotiated with the potential seller/ lessor of the potential commercial property such as assignability, lock in period, rights of first refusal, renewal, etc.

(iii) Limitations on Residential Properties used for Commercial Purposes

Local laws and customs may impose absolute or partial restrictions on use of residential properties for commercial purposes. The property could be affected by restrictive covenants that prohibit certain uses, and there could be an outright prohibition on business use. The title to the property (usually available for verification at public land registries) should have details of any such restrictions that would

¹ Terry Kim, Foreign Legal Counsel, Lee & Ko (South Korea)

apply and should be reviewed by local counsel engaged in certifying the title of real estate prior to taking any decision on the property.

In case there are no legal prohibitions for the use of residential property, human costs might arise such as nuisance which would lead to potential legal issues for the franchise. Hence, it is crucial to negotiate the lease or sale documents and to seek assistance from local counsel specializing in real estate laws.

3.2 Barriers to Purchasing and Owning Real Estate

A number of countries bar foreign individuals or entities from directly owning real estate. Russia, India, Australia, Thailand, and some other countries in the European Union require formation of joint ventures with local partners, or a local subsidiary for purchase of real estate.

(i) State-owned Regimes

In many jurisdictions, certain commercial estates are owned by the Government or its agencies. The Government may prescribe a certain additional set of rules to regulate the lease of such premises. Therefore, in addition to the existing local laws, regard should be had to such government specific regulations relating to leasing of property. For example, in the city of Noida in India, certain lands are provided on lease by a government agency named New Okhla Industrial Development Authority (“Noida”). The regulations of Noida require the lessee company to seek Noida’s approval prior to changing the shareholders of the company. Such stringent regulations are unusual but cannot be ruled out.

The importance of understanding the type of real estate regime in a country is directly related to negotiations with the country’s Government. It is common knowledge that Governments are typically hard to negotiate with and ideally, should be avoided wherever possible.

(ii) Local Ownership Requirements

In some countries, only citizens or residents are allowed to purchase real estate. In such cases, franchisees may have to explore options of joint venture with a local partner or setting up of a subsidiary. Joint venture arrangement may lead to a multiple number of issues, such as sharing of equity with local business partner leading to local control of business. This could also result in misuse of technology and know-how of franchisors.

In cases where franchisors wish to opt for joint venture arrangement with a local business partner, the terms and conditions of the franchise arrangements should be framed after taking into the consideration, legal enforceability of such terms and conditions in the jurisdiction of franchisee.

(iii) Permitting and Licensing Requirements

Different countries may have different registration and licensing requirements for carrying out day-to-day business. Such registrations and licenses may have to be obtained from tax, environment, labour and various other authorities. These license and permit requirements may also differ based on the nature of business that a franchise may be undertaking. For example, a prospective franchise in food and beverage industry, would require permissions from local health departments regarding the products and the physical locations.

Under employment related regulations, the franchise may be required to comply with requirements under labor law to register a premises where a franchised business operates from, and to register the details of the employees in that location.

Foreign franchises should ensure that franchise agreements make it obligatory for the local franchisees to obtain all such licenses and approvals, prior to commencement of franchise business. In some jurisdictions, securing appropriate licenses and approvals may take some time, and hence, this should be factored in while deciding on time-lines for commencement of business.

(iv) Foreign Direct Investment Requirements/Limitations

The foreign exchange control regulations of each country provide a detailed prescription on the types of business entities that may be established by a foreign investors, entry routes for foreign investments, conditions relating to nature of business that can be undertaken by a company with foreign shareholders, cap on foreign investments, and certain other sector-specific conditions that may have to be followed by a foreign investor.

In most countries, companies with foreign shareholders are permitted to acquire real-estate required for carrying out business operations, such as for setting-up offices, stores, service centre, etc. However, there could be restrictions on such companies from undertaking business of real-estate trading. For example, in India a company with foreign shareholders may acquire real-estate for operating a restaurant business or for setting up of office, stores, etc. However, companies with foreign investments are not allowed to acquire real-estate for trading purposes.

3.3 Real Estate Leasing Norms

As noted above, most franchisees lease their real estate from a third party. Internationally, there are certain differences in leasing norms from the United States and Canada that we have noted and discussed below.

(i) Key Money

In the United States, most leases are tied to continuing rent. Tenants do not normally pay a premium or initial fee for the right or honor of leasing a particular property. If anything, they pay a rental deposit that they will receive back at the end of the lease term so long as they properly comply with the lease's post-termination obligations. That is not always the case internationally, where it can be commonplace in a number of countries for certain types of so called "key money" to be required as a condition to entering into the lease, especially for prime properties that might have multiple potential tenants vying for the right to lease the real estate.

Key money can be loosely defined as a payment made to a landlord or existing tenant at the outset of a new lease, but depending on where you are in the world, in reality key money is a form of bribe or graft to win the rights to a specific location. As detailed above in this Section, United States franchisors and other franchisors in developed countries like Canada, the UK and Australia that have implemented anti-corruption law must be very careful when it comes to key money. The authors are aware of one instance where a United States franchisor was embroiled in a key money-centric "scandal" and investigation involving its "fastest growing" international franchisee that seemed to always obtain the best sites and was making things quickly in a jurisdiction that was known for being able to secure sites and cut through red tape with such consistency and effectiveness.

(ii) Lease Term Duration and Renewals

Historically, lease terms in the United States were 10, 15 or even 20 years, with similar renewal periods. In certain cities or countries, lease terms can be significantly shorter. For instance, it is not uncommon for lease terms in crowded cities such as Hong Kong or Seoul to be for 2 to 3 years, and it is not uncommon for some fast food or smaller footprint franchisors to see their restaurants located in a large international city open and close (whether or not through an approved relocation process) as lease terms come up and other lease options come open. The authors are aware of several franchisors who routinely face frustration with master franchisees in certain countries whose master-affiliate and subfranchisee restaurant location lists always seem to be a moving target, and the response is always a vague reference to a lease expiration or great opportunity for a new location. While there can of course be opportunities for quicker expansion when lease terms are so short and leases come open so often, there are also negatives related to the likelihood of corners cut on the site buildout itself and brand and customer consistency.

(iii) Guarantors

Many franchisors in the United States require personal or corporate parent guarantees from some or all of the direct or indirect owners of the franchisee, particular in lower investment franchises where the typical franchisee is a “mom and pop” enterprise operated through a newly created and lightly capitalized special purpose business entity. Real estate landlords outside the United States are no different, but the form of guaranty can take different forms and require different formalities. For instance, notary, witness or other similar requirements may apply, or there may be some additional security or underlying consideration for a guaranty.

When it comes to personal guarantees, it is fairly common in the United States for spouses to be required to sign personal guarantees even if not a direct owner or otherwise involved in the business. This is in part because many states have so called “community property” laws that provide that most property acquired during the marriage (except for gifts or inheritances) is owned jointly by both spouses and is divided upon divorce, annulment, or death. However, in some jurisdictions such as Latin America and the Middle East, it is both highly unusual and borderline offensive to expect a spouse to co-sign a personal guaranty. A number of United States franchisors have run into this road block when attempting to impart their United States-based policies and procedures into their international franchise programs.

(iv) Assignment

Similar to franchise agreements, lease assignment and transfer provisions comes in all shapes and sizes, including in some cases being silent. In the United States, states still differ as to whether a contract that is silent regarding transfer or assignment can be transferred without the other parties’ consent. In many cases, it depends on whether the contract is deemed a “personal services” contract in which the specific knowledge, expertise or ability of the particular party is crucial to the performance. Franchisors have been largely successful in claiming that franchise agreements are “personal services” contracts, but this is a harder position in real estate leases where concepts such as marks, systems, brand and goodwill are not so easily envisioned in the landlord/tenant relationship.

(v) Local Lease Registration Requirements/Norms

It is fairly typical for leases and subleases to require some form of national or local governmental registration. Section 3.5 below includes a number of statements regarding international filing regimes.

3.4 Impact of Anti-Corruption and Bribery Laws

Over the past few years, several governments in various countries have taken an interest in establishing anti-corruption regimes to curb multinational companies from conducting unethical business practices. It is very important for a franchisor to understand that their home country's anti-corruption regulations might also be attracted on local franchisee in foreign countries.

The United States of America introduced the Foreign Corrupt Practices Act (FCPA) in order to combat bribery by United States based companies working in other developing countries. The United Kingdom introduced the UK Bribery Act, 2010 in order to make a UK based company liable for corrupt acts committed by persons on behalf of that UK based company. Spain recently introduced the Sapin II, which criminalizes influence peddling, i.e. inducing a foreign public official to abuse his/her position or influence to obtain an undue advantage.

Some other examples of the anti-corruption laws around the world include the Africa Union Convention on Preventing and Combating Corruption (adopted in 2003), Germany's Law on Fighting Corruption which is aided by the Criminal Code and the Administrative Offences Act, Canada's Corruption of Foreign Public Officials Act and Brazil's Clean Company Act, 2014, and India's Prevention of Corruption Act.

Many countries around the world require real estate owners or lessees to obtain building occupancy permissions along with host of other clearances, such as fire clearances, and electrical and safety clearances in respect of a building. In many countries, these local licenses and registrations are usually the touch points and very hard to obtain without offering bribes to government officials, thereby making the proper acquisition of such licenses crucial for complying with various anti-bribery regulations.

Typically, a Franchisor-Franchisee relationship is on an arm's length basis, and this should reduce the liability of the franchisor. However, the liability cannot be extinguished completely. Regardless of liability, as franchising includes licensing the name of the company to a local entity, there is always a risk of bad reputation where the local franchisee engages in bribery.

Although there have not been any cases with respect to a franchisor being held accountable for the improper dealings of its franchisee, it is important to mention that in essence, most anti-corruption regulations do seem to envisage such vicarious liability. There are no reported enforcement cases under the United States FCPA, where the franchisor was held liable for the acts of the franchisee. However, from a bare reading of the FCPA, it does appear that a franchisor could be held liable for its overseas franchisee's actions.

Mostly, companies tend to view franchisees as different from other types of third party vendors, such as company sales representatives, agents, resellers or even joint venture (JV) partners, for the purposes of establishing FCPA liability. At the moment, a United States incorporated company's FCPA liability is curbed to third parties such as company sales representatives, agents, consultants, resellers or even joint venture (JV) partners. However, there is no guarantee such liability cannot be extended to the franchise relationship as well.

In the case of the United States FCPA, the determining factors for the relevant authorities to establish FCPA liability are primarily the franchisor's intent and the degree of control it exercises over the overseas franchisees' operations.

Hence, this makes the requirements of anti-corruption and bribery related regulations to be included in the franchise agreements even more crucial with specific language to be inserted which clarifies completely the relationship between the parties and the onus of abiding by your own countries anti-corruption or bribery related legislation.

3.5 Brief Survey of Key or Unique Real Estate Issues in Selected Jurisdictions

The authors asked a number of franchise attorneys from around the world the same question and asked them to weigh in with a couple sentence or paragraph response. Below are the original question and the responses we received in alphabetical order along with each attorney's name and firm:

If you are advising a United States or other foreign franchisor entering your country for the first time, what would you tell them is the most unique or important law, rule or custom for them to consider when it comes to real estate issues in your country?

Argentina - David Gurfinkel of Allende & Brea: Two particularly relevant real estate regulations in Argentina for foreign investors to consider are the Rural Lands Law 26,737, which limits the amount of rural land that can be owned by foreign individuals or companies, and Resolution 166/2009 from the Ministry of Domestic Affairs, which requires a special authorization (which is generally granted) for foreign individuals or companies to own, occupy or use in any way, land near the border.

Brazil - Cândida Ribeiro Caffé of Dannemann Siemsen Advogados: In Brazil, Lease Agreements are regulated by Federal Law nº 8,245/1991. In general terms, it is difficult to highlight the most important aspect, but if I had to select one I would say it is that, in Brazil, the amount paid for the sublease cannot exceed the amount paid for the lease, in principle. This is particularly important if a local master franchisor decides to enter into leases and subleases for the franchises outlets. Further, it is possible to include certain provisions in the lease agreement, as follows: (i) mandatory business activity: a clause prohibiting any change of the business activity to be conducted in the property by the tenant, which is very common for premises located inside malls, where the tenant mix is usually strong, and (ii) the right to assign the lease agreement: it is usually possible to include in the lease agreement the landlord's authorization to assign the lease to the franchisor or to another franchisee. However, this has to be negotiated on a case by case basis.

France (and Monaco) – Remi Delforge of DL Corporate & Regulatory: Franchisors entering or operating in France [and Monaco] should have in mind certain specific features of French tenancy laws. French tenancy laws offer protection to lessees under a commercial lease ("*bail commercial*"). Lessees of commercial property have an automatic right to the renewal of the lease in order to continue operating their business. In the event a landlord does not renew the lease upon its expiry, the landlord has to pay damages to the lessee/Franchisee. However, this automatic right of renewal is conditional upon the Franchisee owning the goodwill ("*fonds de commerce*"). If the Franchise Agreement states that the goodwill is owned by the Franchisor, there is a risk of loss of such automatic lease renewal right. For newly entered leases, this risk can be dealt with adequately in the lease through a waiver by the landlord, irrespective of the provisions on ownership of goodwill in the Franchise Agreement. If the Franchisor is purchasing a franchised system with existing leases, an assessment should be made of both leases and Franchise Agreements especially for flagship locations. This helps to assess lease terms and valuation of networks in a due diligence exercise and prevent undesired terminations of franchised locations in France (including French overseas territories as well as the Principality of Monaco).

Korea – Terry Kim of Lee & Ko: In Korea, the Commercial Building Lease Protection Act governs the lease of business premises and leasehold rights between landlords and tenants. Meanwhile, the payment of a "premium" is a unique real estate custom in Korea. A "premium" is an amount of money

that the new tenant pays the outgoing tenant in consideration for any tangible (e.g., interior construction and equipment) and intangible (e.g., goodwill from operating a particular business at the business premises) benefits that might be realized by the new tenant. Most franchisees take the “premium” – the “premium” that they must pay to secure the lease and the “premium” that they can recover later as outgoing tenants – into account when considering a lease of the desired business premises.

Malaysia - Adhuna Kamarul Ariffin of Messrs Bustaman: In Malaysia, real estate tenancy includes a lease (long term tenancy) and tenancy (short term tenancy). Under the National Land Code 1965 (“NLC”), every lease granted shall be for a term exceeding 3 years, where the maximum term for which the property can be leased is for a period of 99 years (if it relates to the whole of the property) or 30 years (if the party leases out only part of the property). Unlike a lease, a tenancy normally is created for a term not exceeding 3 years. To have a valid lease, it must be registered with the Land Authority using an instrument specified by the NLC whereas for a tenancy, there is no prescribed instrument specified by the NLC. Tenancy therefore is subject to mutual agreement (either in written or orally) between the landlord and tenant.

Panama – Jose Agustin Preciado M. of Fabrega Molino: Panamá has a unique centralized and reliable Public Registry System. The first thing you should advise your client when it comes to Real Estate issues is to conduct a search in the Public Registry to ascertain the standing of the property they are planning on buying or leasing. This search will reveal basic critical information such as ownership, liens, use restrictions, easements, measurements, etc...

Russia - Sergey Medvedev, PhD, LLM of Gorodissky & Partners: In the context of commercial real estate, no restrictions apply to foreign business entities holding a real estate interest or being the sub-lessors in real estate transactions. However, the following general restrictions may apply to foreign companies, including franchisors: (a) they may not own land or plots located alongside the national borders; however, they may lease land or plots located alongside the national borders; (b) they may not own agricultural land plots (this restriction applies to Russian companies in which over 50% of the equity capital belongs to foreigners); however, they may lease agricultural land plots; and (c) they may not enter into transactions which establish control over businesses of strategic importance (eg, aerospace, military and nuclear) without the prior permission or license from the government. Transfers of real estate ownership are subject to registration in the Unified State Register of Real Estate. Long-term leases (ie, one year or more) also require registration and are effective and enforceable against third parties as of the registration date.

Saudi Arabia – Chris Johnson of Al-Sharif Law Firm: One special issue is the reluctance of Saudi courts to issue injunctive relief, which in the case of real estate can make it difficult to obtain an order for an overstaying tenant to vacate the premises. If the tenant leaves while leaving his fixtures and personal property behind, the owner acts at its peril in removing these; some tenants have in such cases accused the owner of conversion of valuable property, hence the custom of seeking a court order for the police to remove and inventory personal property removed in such cases. Another issue involves sensitivities over posting names in prominent places that arguably refer to forbidden topics, hence the trademark name change from Church's Chicken to Texas Chicken. In the event of a franchise termination/transfer, it is unusual to see much cooperation between terminated and new franchisees, such as willingness to assign or transfer leases; terminations can be acrimonious and litigious, and local culture does not always accept the indignity of involuntary termination gracefully.

South Africa – Era Gunning ENSafrica: Franchisors should be aware of the fact that franchisees in South Africa are given special protection under the Consumer Protection Act, 2008 (even if the franchisee is a corporate). The franchise agreement must include prescribed information and address prescribed categories of information, including a description of the site or premises and location from

which the franchisee is to conduct the franchise and the nature and extent of the franchisor's involvement or approval in the process of site selection.

Spain – Bárbara Sainz de Vicuña of Gómez-Acebo & Pombo Abogados, S. L. P.: There are no legal restrictions on foreign ownership of Spanish property. However, and only for statistics purposes, the General Office for Trade and Investments (Dirección General de Comercio e Inversiones) must be notified of all foreign investments in real estate for a value exceeding €3,005,060.52 or those originated from a tax haven irrespective of its value. Transfer of a property typically takes place by means of a notarised deed (*escritura pública*). Once executed, the deed is filed for registration at the relevant Property Registry. Registration is not a requirement for the valid transfer of the property, but it is of paramount importance for the purchaser to be protected against third party rights not recorded at the Property Registry.

In 2013 Spain enacted a law offering non-EU residents the possibility to obtain a residence permit in Spain through investment in real estate with a value of at least €500,000. This scheme is commonly known as the Spanish “Golden Visa”.

4. Key Franchise Agreement Provisions and Issues

Garnering substantial familiarity with structuring issues and the key legal and market forces in a targeted foreign jurisdiction are the underpinning of the terms and conditions upon which a franchisee/franchisor relationship will be contractually bound, particularly in the context of real estate. Generally speaking, it is sensible to conclude that a franchisor will desire to have a significant amount of latitude when it comes to the providence of the real estate brandishing its flag. The extent to which the terms and conditions of the franchise agreement are able to accomplish generous latitude will be dictated by the enforceability of certain provisions under local law, as well as the commonality and acceptance of the franchisor's desired level of control. A sampling of countries with largely mature economic climates proves that, while customary baselines exist, such as the routine use of leasehold interests, there are many local nuances that preclude a franchisor from remaining in compliance with the local laws while exercising its reservation of rights in connection with transfers, purchase and assignment rights, subordination, collateral assignment, and self-help.

4.1 Transfers/Rights of First Refusal

Ideally, a franchisor will want to reserve the right to approve a proposed transferee and, if rejected, have the option to exercise a Right of First Refusal (“ROFR”) that would allow the franchisor to substitute itself as the transferee in a transaction. These are commonplace provisions that should never be excluded if incorporation is legally possible due to the amount of control the franchisor gains.

Fortunately, in most countries, the right of a franchisor to approve a transfer is widely recognized as an enforceable provision of a franchise agreement and/or by way of ancillary documents such as deeds, powers of attorney, organizational documents or a pledge of shares, each of which incorporate the substantive terms and conditions of any applicable transfer restrictions. The vast majority of countries require that the transfer restrictions imposed be reasonable. Generally speaking, restrictions recognized as “reasonable” are failure to meet selection criteria, non-payment by current franchisee or other outstanding breach, and the creditworthiness and/or financial wherewithal of transferee. In some countries, such as China, any proposed transfer of ownership must, by law² have the consent of the franchisor. Despite being codified however, Chinese law does not deem a transfer of ownership an assignment of the franchise agreement, therefore making it important that transfer restrictions always be expressly

² Commercial Franchise Administration Reb. Ord. 485 (2007)

memorialized in the franchise agreement. When memorializing transfer restrictions in any country, special attention should be given to regulations in that regard. There are several countries that confine a franchisor's determination with regard to a transfer to a prescribed list of factors and/or have very protective competition laws with broad definitions of "trade restraint" that could interpret certain transfer restrictions as an interference with a franchisee's freedom to market and profit from the sale of its business.

Similar to transfer restrictions, ROFRs are also generally accepted, but with considerable complexity. Unlike transfer restrictions, which are for the most part "boilerplate," ROFRs require the drafter to take into careful consideration the reality of how local law dictates the right be exercised and, perhaps more important, the consequences of exercising that right. For instance, in master franchise or sub-franchisor models, subordination of ROFR rights may be best and the ROFR should embody protective provisions in that regard. In countries where Wholly Foreign Owned Entities ("WFOE") are used to control premises, laws requiring that a resident director or agent be identified to regulators will require the ROFR to be inclusive of additional restrictions and governing terms applicable to the involvement of such third-parties. In other instances, franchisors are rightfully urged to form other types of resident entities wherein a substantial part of that entity is comprised of resident investors; again requiring additional language addressing such a relationship. In Australia and the UK, the traditional ROFR is commonplace with little complexity and tripartite agreements between the franchisor, franchisee and landlord are not unusual. In contrast, due to the challenging hurdles presented by Indian law³ and the necessity to obtain approval from the Reserve Bank of India for long-term real estate interests, ROFRs in India are typically reserved for only the most desirous of locations that can be quickly resold. Unique drafting is required in that regard, as well as the requirement that a power of attorney granting authorization to manage the various formalities involved in selling the premises, which is required pursuant to the Stamp Act¹. In China, while a ROFR is generally enforceable, particularly by a WFOE, rampant urban redevelopment makes it sensible for the franchise agreement to also take into consideration a scenario in which the property used by the franchised business will be forcibly redeveloped, thus making provisions governing relocation of primary importance. Lastly, in some countries, especially those in East Asia as a result of Anti-Dominant Party legislation, acknowledgment and agreement that provisions of the ROFR are not anti-competitive or an abuse of power may be appropriate, although disclaimers in this regard are generally frowned upon.

4.2 Purchase and Assignment Rights on Termination/Expiration

Most of the manners and methods of premise control exercised or reserved by franchisors in pursuit of transfer restrictions and ROFRs can be readily applied toward purchase and assignment rights on termination or expiration of a franchise agreement. As the franchisor and franchisee navigate the conclusion of their relationship, the franchisor's ability to either continue operating the franchised location under its own umbrella or assign the location to a new franchisee pivots on, not only the existence of a well drafted ROFR and other ancillary documents, such as a tripartite agreement, a collateral assignment of lease, and/or a deed restriction (an "Option Deed" in the UK), but also the rights granted to franchisees by local law in the context of a termination or expiration.

Presuming the termination or non-renewal of a franchise is allowed by law, which in many countries it is not unless good cause exists, post-termination provisions that govern a broad range of possible scenarios are essential. For instance, in Australia the franchisor's ROFR upon termination should take into account the method by which goodwill is valued. In Australia, if a franchisee is not offered compensation for the value of goodwill, or the compensation offered is nominal or not genuine, the

³ Foreign Exchange Management Act (1999); Foreign Direct Investment Act (1999); Indian Stamp Act (1899); Competition Act, Sect 3 (2002); Indian Contract Act (1872); Transfer of Property Act (1882)

franchisor may not terminate the relationship if the franchisee is otherwise compliant and wants to remain in the system. Similarly, in the UK and India, as well as many other countries, the likelihood of a legal challenge for compensation relating to the shortened return-on-investment period may necessarily put the chill on any anticipated purchase or assignment. Agreeing upon valuation in advance can mitigate this. In China, the franchisor's right to purchase and/or assign a location upon termination should take into account the amount of time it will require the franchisor to form a WFOE. Without a WFOE, foreign franchisors do not have purchase rights in China, which makes the ability to extend the time period within which the franchisor must exercise its rights essential to accommodate the organization of a WFOE if one does not already exist.

In addition to an ROFR and/or right of assignment, it is advisable that the franchisor take into consideration what happens to the real estate, and the operation of the business, if the franchisee contests the termination. A preliminary injunction pending trial on the merits could significantly delay the eventual conclusion of the relationship and atrophy of goodwill and potential future performance is likely. In that regard, a Collateral Assignment of Lease (discussed in more detail below), whereby the landlord is obligated to assign the lease upon the termination of the franchise agreement, is an excellent avenue by which the franchisor can gain control of the premises. Adequate fallback provisions in the franchise agreement should also exist to accommodate for a scenario in which the Collateral Assignment of Lease is either non-existent or inadequate. These provisions include a requirement that the franchisor be allowed to manage or appoint management for the premises pending adjudication and/or taking a first priority security interest in the franchisee's assets. The more options a franchisor has that allow for control over aspects of the business, the better chance the franchisor has of protecting its goodwill and the ongoing performance of the franchised location.

4.3. Lender Subordination Requirements

Bearing many resemblances to a Collateral Assignment (discussed below), and called by a variety of names including Subordination Non-Disturbance Agreement ("SNDA"), "tri-party" agreements or, more common in the hotel industry, "comfort" letters, these each provide that the lender may cause the franchise agreement to be retained after loan default, including through foreclosure or bankruptcy. Some will be recorded as interests in real property; others will be unsecured letter agreements. While a franchisor has little, if any, ability to negotiate a lender's demand for first priority, there are certain rights the franchisor should retain to protect its interest in a franchise location. Namely:

- Default notification requirements by the franchisor and the lender;
- The lender's rights should be contingent upon triggering events such as, loan default or loss of possession;
- The lender should acknowledge and agree to the franchisor's right to "step-in" and manage or assign the franchised location;
- Step-in rights should be contingent only on payments moving forward; not bringing the loan current;
- Lender "step-in" rights should require that the lender (i) agree to keep payments due to the franchisor current, (ii) cure any outstanding default; and (iii) obtain the franchisor's approval of management;
- The conditions upon which the lender may assign the franchise agreement should be clearly spelled out and closely mirror the transfer restrictions in the franchise agreement;
- Each of franchisor's rights should expressly apply to any trustee or receiver in the event of insolvency or foreclosure;
- Franchisor should expressly require the lender to acknowledge that franchisor (i) does not endorse, approve, recommend or otherwise concur with the financing arrangement, (ii) is not guaranteeing or providing any assurance that the franchisee is of good character or

- reputation, or in a financial position to repay the debt, (iii) has not provided any financial projections to the lender, and (iv) has not made any representation or warranty or intervened or supported franchisee in any manner that caused lender to make a financing determination; and
- Automatic termination of the SNDA upon satisfaction of debt.

In addition, special attention should be given to local laws governing the validity of a disposition. For instance, in some countries, an additional provision providing for consideration in connection with the exchange between the franchisor and lender may be necessary. By way of example, in South Africa, the law provides that a subordination agreement could constitute a “voidable disposition” due to the lack of value exchanged between the parties⁴. Spain has a similar law⁵. To protect the franchisor’s interest in the real property, knowing what local laws may void a disposition based upon any factors and adjusting the terms of the SNDA accordingly is imperative.

4.4 Collateral Assignments of Lease/Lease Riders

Given the global popularity of leasing, Collateral Assignments of Lease or “Lease Riders” are of paramount importance to franchisors, lenders and landlords. Each of these parties has a vested interest in knowing the existence of defaults, retaining “step-in” rights, exercising secured interests and, while mutually distinctive in relevance to each party, preventing the often irreparable damage caused by a vacated space. From the franchisor’s perspective, a Collateral Assignment or Rider should, at a minimum, modify the lease to accommodate:

- a term that is coterminous with the franchise agreement;
- exclusivity as to the franchised location and surrounding tenants (i.e. during the term, the location shall only be operated as an ABC branded location and no other competitive business may be located in the shopping center);
- an acknowledgement and agreement by the landlord that the lease may be assigned to the franchisor or its designee, provided that the franchisor or its designee execute such documents evidencing its agreement to keep and perform, or cause to be kept or performed, all of the obligations of the tenant (franchisee) arising under the lease from and after the time of such assignment;
- an acknowledgement and agreement by the landlord that the franchisor (or its designee) shall not be responsible for any of the tenant’s (franchisee’s) debts or obligations to the landlord incurred before the date of the assumption;
- a waiver by the landlord of any administrative, assignment, or transfer fee that the lease may otherwise require following an assignment or assumption;
- a provision requiring the landlord and the franchisor to provide one another with copies of all notices of default given to the franchisee;
- a requirement that the landlord sign and deliver to the franchisee or the franchisor, within a reasonable number of days after a request from the franchisee or the franchisor an estoppel certificate certifying that the lease is in full force and effect, is unmodified, or if modified, describing the modification and that there are no defaults under the lease, or if there are defaults claimed, describing the claimed defaults, the dates to which all rentals have been paid; and any other matters reasonably requested by the franchisee or the franchisor;
- the landlord’s consent to the franchisee’s use of the required colors, dimensions, signage and design for the franchised business;

⁴ Section 26 of the Insolvency Act 24 of 1936

⁵ Spanish Insolvency Act of 2003

- a provision prohibiting the franchisee from subletting or assigning (except to the franchisor or its designee) all or any part of the franchisee’s occupancy rights under the lease;
- a provision prohibiting the franchisee from extending the term of the lease, or renewing the lease without the franchisor’s prior written consent;
- an acknowledgement and agreement by the landlord that the franchisor or its appointed representatives have the right to enter the leased premises to make any modification necessary to protect the franchisor’s trademarks or to cure any default under the franchise agreement or the lease; and
- an acknowledgement and agreement by the landlord that the franchisor shall have, at its option, an additional amount of time to cure any default under the lease by the franchisee after the cure period expires under the lease.

4.5 Self-Help Provisions

“Self-help” remedies are those that a franchisor may be entitled to exercise without initiating legal action. The most common self-help remedies include termination of the franchise agreement and a subsequent exercise of the rights discussed above, those being the franchisor’s ROFR and/or assignment rights. Exercising self-help remedies, while inexpensive and expeditious, is not without risk. Many countries have competition laws that prohibit abuse of a superior bargaining power that causes harm to another contracting party⁶ and courts generally do not regard unilateral action by a party with greater bargaining power well. By exercising a self-help remedy, the franchisor runs the risk of being the target of a variety of claims such as (depending on the jurisdiction) breach of good faith and fair dealing, breach of fiduciary duty, breach of competition laws and allegations of discrimination and constructive termination, each of which may be accompanied by a demand for punitive and exemplary damages⁷. Before utilizing self-help in any dispute, a thorough analysis of local law and the popular temperature of the tribunal in that regard is fundamental.

4.6 Compliance with All Laws

Provisions requiring compliance with all laws are generally “boilerplate” and commonplace, but should not be overlooked. While it may seem counterintuitive to presume that a ROFR may be disadvantageous to a franchisor, exercising a ROFR can be a gamble if the franchisee has not obtained and kept current business permits and licenses and operated the location in compliance with all laws related to such matters as health, safety, employment, consumer protection, etc... A franchisee’s lack of compliance with laws can result in the deduction that taking control of the franchised location involves too much risk or is simply no longer an economically viable option. For that reason, special attention should be given to this clause that can often be a victim of presupposition as to adequacy. Taking into consideration not only a blanket provision requiring “compliance with all laws,” but specifically listing matters such as, data protection, privacy, data security, actual or alleged fraud, Foreign Corrupt Practices, Anti-Bribery, sanitation and health, permits and licenses, and any acts, omissions, events or circumstances specific to the franchised business that would reasonably be expected to give rise to a violation of law, will help the franchisor enforce any violations of the franchisee that have the potential of making the exercise of an ROFR or assignment right undesirable.

5. Conclusion

This paper has hopefully provided a brief insight into how real estate markets, leasing norms and strategies used to find and secure real estate can vary significantly from country to country around the

⁶ American Bar Association Fundamentals of International Franchising - Richard M. Asbill and Steven M. Goldman (2001)

⁷ Franchise Dispute Remedies – Steven H. Goldman (2005)

world. There is of course no substitute to obtaining (and following) expert assistance in the country in which you are pursuing a transaction. In franchising, especially for foreign franchisors, real estate is not usually the main focus of legal review per se, but depending on the type of franchise concept and the nature of the interplay between real estate and the concept, the real estate can be almost as important from the legal point of view as it is for the business side of the franchise relationship.

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