International Franchise Association

54th Annual Legal Symposium

May 15-17, 2022

Emerging Approaches in International Franchising

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Emerging Approaches in International Franchising

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Traditionally, master franchising and the use of multi-unit (or area development) have been the preferred international expansion models for many brands. However, in recent times, other options, are becoming more prevalent. This paper will briefly summarize the traditional expansion models of master franchising and multi-unit, and provide a greater focus on the emerging approaches to international expansion of franchise systems.

Master Franchising

Master franchising is perhaps the most commonly used strategy in international franchising. By using this approach, the franchisor provides to the master franchisee a license to open locations, and to sub-franchise to others the right to open locations. Under this approach, the master franchisee is responsible to invest its own capital (money as well as talent/people) to develop the brand in the territory. The master franchisee has full responsibility for recruiting, training and supporting the sub-franchisees in the territory.

Master franchising is a three-party strategy issue wherein the franchisor contracts with a master franchisee, and the master franchisee contracts with unit/subfranchisees. The franchisor has no contract with the unit/subfranchisees.[1] After a master franchisee has opened the agreed number of pilot units, the franchisor usually trains the master franchisee in the skills needed to be a franchisor, using a formal classroom training at the franchisor's headquarters, as well as on-the-job assistance in the master franchisee's territory.

Fees paid by sub-franchisees to the master franchisee are shared between the master franchisee and the franchisor.

Multi-Unit/Area Development

Granting the rights to develop multiple locations in a country/territory is generally the second most frequently used approach in international franchising. This is often referred to as "area development" because the franchisor grants the rights to develop multiple locations within a defined area, which can be the entire country, a collection of countries, or a territory within a country. It is also a common expansion strategy for domestic franchising in the U.S. The franchisor and the area developer negotiate a development schedule for the number of locations the area developer is required to open in the territory, and the time frame to open the units.

The parties typically execute two agreements: a multi-unit/area development agreement that defines an initial fee, the size of the territory and a development schedule, and a unit franchise agreement that is

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[1] This section summarizing the various traditional international franchise expansion models has incorporated aspects of the paper "Avoiding Common Mistakes In International Franchising" from the IFA Legal Symposium May 2015 written by Carl E. Zwisler and Beata Krakus.

executed before each new franchised outlet is opened. Multi-unit/Area development franchising only involves two parties. Under this approach, the area developer is not granted by the franchisor the right to subfranchise to anyone else.

With distances greater and legal and cultural issues resulting in modified operating requirements in foreign markets, franchisors often assign duties to international area developers that resemble the duties assigned to international master franchisees. In order for it to make sense for the franchisor to enter into a multi-unit/area development agreement, the area developer must have substantial resources to be able to independently meet the obligations to open the required locations in the time frame required.

Strategic Alliances

Franchisors have recently adopted another approach towards international expansion: the "strategic alliance." Under this approach, a franchisor will partner with a party that has a particular expertise in a market or region and will look to leverage that particular expertise to either grow an existing franchised brand or develop an entirely new brand for that market or region. For example, over the past ten years the hospitality industry has seen a number of strategic alliances announced between franchisors (or other brand owners) and hotel management operators with specific expertise in managing and operating all-inclusive resorts located in the Caribbean, Latin America and Europe.[2] While the details vary from deal to deal, the most common thread among each of these alliances is the desire to separate branding and licensing (which remains the domain of the franchisor) from operations (undertaken by the local expert) to achieve shared business goals. In that regard, the strategic alliance is similar to the classic master franchise or area development approach. However, franchisors anticipate other distinct benefits from these strategic alliances each of which can present its own legal challenges that must be accounted for when the strategic alliance is formed.

First, and of immediate concern for most franchisors, strategic alliances typically come with the imminent conversion of a number of existing units to the brand contemplated by the strategic alliance and a commitment from the third-party operator for additional units within a defined period in the future.[3] As with the conversion of any existing branded unit, the franchisor must be careful to ensure

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[2] *See, e.g.*, "Playa Hotels & Resorts and Hilton Announce Strategic Alliance and Future Conversion of Two Initial All-inclusive Resorts" (available at: https://www.globenewswire.com/news-release/2018/09/17/1571693/0/en/Playa-Hotels-Resorts-and-Hilton-Announce-Strategic-Alliance-and-Future-Conversion-of-Two-Initial-All-inclusive-Resorts.html); "Sunwing Travel Group and Rex Resorts announce strategic alliance" (available at: https://www.globenewswire.com/news-release/2018/10/02/1600417/0/en/Sunwing-Travel-Group-and-Rex-Resorts-announce-strategic-alliance.html); "Wyndham Unveils an Upper Midscale All-Inclusive Resort Brand - Wyndham Alltra - through New Strategic Alliance with Playa Hotels & Resorts" (available at: https://www.prnewswire.com/news-releases/wyndham-unveils-an-upper-midscale-all-inclusive-resort-brand--wyndham-alltra--through-new-strategic-alliance-with-playa-hotels--resorts-301392897.html).

[3] *E.g.,* "As part of the alliance, by the end of 2018, two Playa resorts, the Royal Playa del Carmen, and the Dreams La Romana, will be converted to Hilton all-inclusive resorts, with the potential for the conversion and management of eight additional resorts by 2025." (https://www.globenewswire.com/news-release/2018/09/17/1571693/0/en/Playa-Hotels-Resorts-and-Hilton-Announce-Strategic-Alliance-and-Future-Conversion-of-Two-Initial-All-inclusive-Resorts.html). Where the alliance is premised on the creation of an entirely new brand, the franchisor must take all steps required of any franchisor starting out in a new territory (including proper registration of all marks and compliance with any franchise registration or business opportunity laws) before the conversion of any units may occur. Where the alliance is premised on the growth of an existing brand,

that those conversions are properly timed to coincide with an existing termination right or expiration date to minimize any risk of a tortious interference claim. Likewise, the third-party operator will be similarly motivated to ensure that the conversion can be undertaken without incurring any liability to the existing licensor. Conversion to the new brand will, inevitably, result in costs to the third-party operator; minimize additional, avoidable cost, therefore, is imperative. As with any master franchise or area development agreement, the strategic alliance agreement must also clearly spell out the timeline for any future development targets, the ability of the franchisor to approve or reject future units proposed by the third-party operator, and any reward / repercussions if those targets are exceeded or missed.

Second, by leveraging the third-party operator's expertise, franchisors can defray some of the risks and costs associated with the research and development required to launch a new or alternative business model in a less familiar market. Franchisors may lean on their chosen expert to provide meaningful input into the creation of the operating manual for the brand or into marketing material that will resonate with the new brand's customer base. In each instance, the strategic alliance agreement should clearly address both the process for soliciting and providing such input and, crucially, which party has final decision-making authority if and when disagreement arises.

Third, where the alliance is premised on the creation of a new brand, franchisors hope to leverage the reputation and skill of the third-party operator to quickly establish the goodwill of that brand both within the market contemplated by the strategic alliance agreement and outside of that market. Within the market, the alliance may provide that the operator is the exclusive franchisee of the new brand or the exclusive operator of all units granted to franchisees of the new brand. In either case, the franchisor can have a degree of confidence that, based on the operator's experience with the operating model for the new brand, those initial units will be well run. This is in contrast to a master franchise model where, even if the franchisor is confident in the master franchisee that it has selected, the brand's reputation is reliant on the operational abilities of the third-party franchisees selected by the master franchisee.

In addition to the above, parties to alliance agreements should also contemplate and allocate the obligations of the parties with respect to: financial commitments, indemnification, brand governance, marketing spend, technology integration, and the scope of permitted competition while the alliance is in place. This last point is deserving of particularly special attention. Typically, both the third-party operator and the franchisor will have operating units and brands that compete directly, or indirectly, with the brand and units developed pursuant to the new alliance. Defining the extent to which each party may (or may not) expand those existing competing interests or the extent to which each may develop any new competing interests should be explicitly addressed as part of any alliance.

The strategic alliance requires an intricate intertwining of two businesses that makes it unique from the traditional expansion models employed by franchisors. Therefore, as one commentator on this trend has neatly summarized, maximizing the chances of success for both parties requires:

1. "Affinity: having strategic, cultural, operational and organizational fit between the parties;
2. Alignment: sharing a common vision and approach between teams and cultures;
3. Accountability: possessing the appropriate shared metrics for tactical execution; and

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however, that compliance structure is presumably in place and may expedite the conversion of existing and future units to the brand.

4. Agility: recognizing that change is constant and adaptability is the key to longevity."[4]

Even where each of those factors is in place, the value of drafting a robust and detailed strategic alliance agreement cannot be understated.

Cloud Kitchens & Licensing

Over the past 5 years, the proliferation of cloud kitchens and outsourced services for restaurants has grown exponentially. For the food service/restaurant sector, there are many different types of outsourced/cloud kitchen type "models" leading to different contractual terms. Some examples of these models are:

1. Original Dark Kitchen model:

    - no physical store, kitchen only but the kitchen only servicing one brand;
    - usually set up by brand owner or a franchisee directly to service online orders – aggregators and/or brand's direct orders collected from these locations;
    - can prepare "ready to eat meals" for various dine-in locations.

2. Cloud kitchen model:

    - multiple brands from a single kitchen;
    - no storefront (although might have branding of the cloud kitchen operator at the front whereby delivery drivers can collect food from a front of house pickup point);
    - orders might come from the brands direct or online food aggregators.

3. Co-working kitchens:

    - usually kitchen space only where an established or new restaurant business can rent the kitchen space;
    - restaurant/brand supplies the chefs and recipes (and sometimes some of their own equipment).
    - kitchen "owner" usually handles the online ordering, delivery services and bulk ordering of food across all brands utilising the kitchen to save on food costs.

4. Online aggregator owned kitchens:

    - kitchens may be owned or rented by the aggregator;
    - here the aggregator is using their know-how regarding order demand management to manage the kitchens and bulk ordering of food across all brands;
    - sometimes these kitchens may have a storefront where customers can walk-in to order food from multiple brands (similar to takeaway only restaurants);
    - no dine-in seating – no "front of house" staff (except maybe one person to assist with ordering).

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[4] Jonathan Kracer, Hotel News Now, *Strategic Alliances Proliferate in All-inclusive Space* (November 7, 2018), https://www.costar.com/article/1053143404/strategic-alliances-proliferate-in-all-inclusive-space).

5. Fully outsourced model or "brand asset light model":

    - in the Middle East this is the Kitopi model[5] - brand usually outsources everything to the operator;
    - operator handles the brands' call centre operations;
    - operator may take the brands existing kitchens (for both delivery and dine-in operations);
    - dine-in operations potentially also outsourced to the operator (so note here – this is where standard "franchise agreement" like clauses on operation of "front of house" can come into play);
    - all orders come into the operators call centre (i.e. brand's online platforms and delivery aggregators);
    - all raw materials purchased by the operator;
    - all staff/chefs/brand delivery drivers employed by the operator;
    - for dine-in locations food may also be pre-prepared in central kitchens but "final touches" may be done by the dine-in locations' kitchen;

Some of the agreements for the above models are called "license agreements" some are "services agreements", some are "partnership agreements" but regardless of the title of the agreement there are a number of considerations for a brand when either it, or its franchisee, utilises this model – many of which overlap with the considerations dealt with in traditional franchise agreements.

Using the "Fully outsourced model" as a live example in the Middle East and arising out of necessity due to COVID, we saw the situation whereby cloud kitchens could not find space fast enough to service online ordering demands, but brands with dine-in locations were suffering from lack of footfall. The cloud kitchens' needed the kitchen space that the brands had within the dine-in locations, but the brands' still needed some of their dine-in locations to stay open to ensure" brand awareness" and so that once the COVID restrictions eased, their dine-in customers were still serviced. This led to some interesting and creative deals being struck which, which while at first looked similar to an "outsourcing" arrangement, ended up being a blend of a traditional franchise model with elements of service/outsourced arrangements for the delivery only side of the business.

As an example of one of the deals struck:

- the cloud kitchen operator purchased the "assets" of the brand's business – under asset agreement type clauses the leases for the business including kitchen equipment, fitout, staff, vehicles, drivers, etc);
- a "service" agreement was entered into where the "brand" effectively outsourced the "front-of house" operations of their dine-in locations to the cloud kitchen;
- the kitchens of the dine-in locations were upgraded to become "central" kitchens servicing multiple brands.

Clauses similar to what you would find in a franchise agreement around operating the dine-in part of the physical locations were included in the agreements and although there were references to brand standards, no operations manual was part of the deal. Detailed intellectual property ("IP") clauses were

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[5] Cooking food to over 100 restaurants: How a 'ghost kitchen' is adjusting to life in a pandemic, Stephanie Bailey, CNN 14 December 2021 (available at: [Dubai 'ghost kitchen' Kitopi is adjusting to life in a pandemic | CNN Travel])

contained in the agreements making it clear that all IP related to the cloud kitchens' technology on things like the point of sale system, operation of the kitchens, online/central ordering, delivery, etc were kept with the cloud kitchen operator but that any IP related to physical operation of the dine-in services, menus, signage, uniforms and the trademarks were owned by the Brand. In some jurisdictions which have specific franchise legislation, such a deal may have fallen foul of the franchise laws. We have also seen situation of cloud kitchen operators agreeing to open and operate full dine-in, single branded outlets (similar to a franchisee) but deliberately structuring their deals in such a way as to benefit from any franchise law exemptions – such as that the sales of the outlet would not exceed 20% of the entire sales of the cloud kitchen operator to benefit from an exemption.

There are also often deals drafted as a "licence" agreement which could, in some jurisdictions, fall within the definition of a "franchise" for countries with specific franchise legislation. For example, jewellery and single product line brands (such as mattresses and other home furniture items) where:

- the brand is permitted to be prominent in the front window of the outlet
- the brand name is not be used as the name of the outlet or on the main signage but might be on the main signage together with one or two other brands.

These concepts are commonly dealt with as a "licence" agreement rather than a "franchise" agreement. In such arrangements there are still the same strict brand standards and "franchise" type clauses such as reporting sales, obligations on customer service, mystery shopper, etc are within the agreement. As the brand is however just one of a few being sold at the physical outlet some common "franchise agreement" clauses such as point of sale systems, are not included. Again whether or not such agreements fall within the franchise legislation of a particular jurisdiction needs to be assessed on a case by case basis.

<u>Conclusions</u>

While there is no expectation that these emerging approaches to international franchise expansion will replace the master franchise and area development models, it is worth considering all potential alternatives when developing an international expansion strategy. One of the keys to any successful international expansion is proper planning and strategic analysis of the market, and the best ways to approach the new market.