# THE DARK SIDE OF MASTER FRANCHISING

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This article analyses some of the key elements, perceived benefits and potential disadvantages of master franchising, one of the principal structures franchisors use to expand their brands internationally. The focus is on the risks and challenges of master franchise structures, including costs, selection of master franchisees, fees, term and renewal of sub-franchisee agreements, multi-level disclosure requirements, and transfer and termination of master franchisee agreements. The authors conclude that these risks and challenges vary among jurisdictions, among franchise systems and among master franchisees, and that no structure should be the default option for all.

## 1. Introduction

For many years, master franchising has been one of the principal structures that franchise companies have employed when expanding their brands abroad. Unquestionably, there are benefits associated with the master franchise model. However, master franchising is the structure that franchisors (and their advisors) often use as a "default", sometimes without carefully considering the many challenges that franchisors will almost certainly encounter when expanding through master franchising (and in connection with ending the master franchise relationship) or without even fully understanding and assessing what master franchising involves.

This paper briefly describes some of the key elements and perceived benefits of master franchising, but it focuses on exposing and analyzing the potential disadvantages and pitfalls of master franchising. Does master franchising deserve its commercial reputation? Should it be the default model or in any event the favorite tool for international franchising? Are the promises of master franchising in line with reality? We explore these and other questions in an attempt to shed light on key challenges inherent in the master franchising

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model. This paper also discusses challenges that arise at the end of the master franchise relationship, both in connection with a transfer of the master franchise rights and upon termination of the relationship.

A comparison to other expansion methods (e.g., company-owned units, direct unit franchising and area development) is implicit in this discussion, but the purpose of this paper is not (and we have not undertaken) to compare and contrast master franchising with other structures. There are many thoughtful articles (some relatively recent) that undertake this exercise that the reader may reference.[1] We have included a high-level comparison of some of the key features of other structures in the attachment to this paper.

## 2. Master franchising as a model for international expansion

The hallmark of any master franchise arrangement is the grant by the brand owner (franchisor) of the right for another party (the master franchisee[2]) to offer and sell subfranchises to third parties for the underlying business which is the subject of the franchise within a specified geographic area. The franchisor effectively delegates all pre-sale and post-sale activities that the franchisor would normally conduct (except for certain approval rights noted below) within the agreed-upon area.

Many franchisors (at least during the early phase of the master franchise relationship) believe that it is critical that the master franchisees have hands-on experience operating the underlying business, so the master franchisee may also be granted the right (or required) to develop, operate and maintain one or more master franchisee-owned outlets[3]. In addition to ensuring that the master franchisee is engaged in the business from an operational standpoint, master franchisee-owned units can serve as outlets in which the master franchisee may conduct discovery days, subfranchisee training, product testing, etc.

The master franchisee enters into subfranchise agreements directly with subfranchisees, and, generally, the franchisor is not a party to the subfranchise agreement. The responsibilities of the master franchisee include those typically associated with a franchisor, including reviewing and approving proposed sites and providing initial and ongoing training and ongoing support and assistance to the subfranchisees. The franchisor's involvement with subfranchisees is generally limited to having final approval rights with respect to the subfranchisees and the forms of subfranchise agreements used by the master franchisee. The chart on the next page illustrates a typical master franchise structure.

Master franchisees are typically required to pay to the franchisor various fees including an initial master franchise fee, a percentage of the initial fee that each subfranchisee pays to the master franchisee, a royalty based on a percentage of the gross sales of the master franchisee's subfranchisees, and, sometimes, advertising fund contributions.

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[1] *See, e.g.* Will K. Woods and Sarah Yatchak, "The Art and Science of Drafting Multi-Unit Development Agreements", ABA Forum on Franchising (2012); Daniela Canale, Ned Lyerly, John Pratt, Philip Zeidman, and Will K. Woods, "Selecting the Appropriate Vehicle for International Expansion", IBA/IFA Joint Conference (2011); and Catherine Riesterer and Frank Zaid, "The Basics of International Franchising", ABA Forum on Franchising (1997).

[2] The master franchisee is sometimes referred to as a "master franchisor" or "subfranchisor". For consistency, throughout this paper, we will refer to the person or entity that is granted the master franchise as the "master franchisee".

[3] The master franchisee-owned outlets may be developed and operated pursuant to the master franchise agreement itself, under the terms of a franchise agreement to which the franchisor and master franchisee are parties or, alternatively, a subfranchise agreement under which the master franchisee grants to itself (or, often, a controlled affiliate) the right develop and operate the "pilot" outlet.


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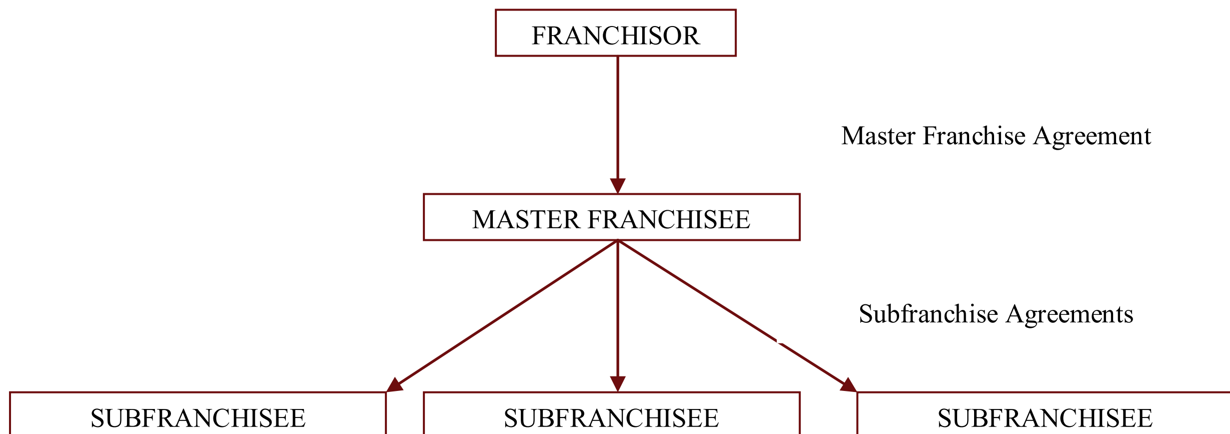


## 3. The case for master franchising: perceived benefits of expansion through master franchising vs. other approaches (e.g., multi-unit development)

### 3.1 Rapid system growth

Master franchising is often thought to be a structure that affords franchisors the ability to rapidly expand their franchise systems. It is one of (if not the) principal reason that franchisors often choose master franchising as an expansion method. Master franchisees in one or more jurisdictions can be deployed to sell and service franchises in markets in which the franchisor might not be ready or able to sell and support franchises. Unlike other structures used for international expansion, like direct franchising and area development, the pool of potential unit (sub) franchisees is greatly expanded since the master franchisee will have the right to grant subfranchises to qualified third parties.

*"This method of expansion can be particularly attractive to franchise systems that are (or wish to be) in a growth phase but that do not have the infrastructure to support significant expansion."*

For some of the reasons discussed below, the structure is used most commonly by franchisors wishing to expand outside of their home jurisdictions, often in far-flung locales or in markets about which the franchisor has very limited knowledge. In theory, the local master franchisee should have a well-developed knowledge of the market and the nuances of doing business in the area in a way that the franchisor would never be able to develop, and, therefore, be in a position to recruit subfranchisees and develop the market for the franchise system quickly and in an efficient manner. Often, prospective master franchisees will have grand plans for development and/or propose expansive territories that include multiple jurisdictions (this seems to be particularly true in master franchise deals involving the Middle East). These plans can be alluring to franchisors eager to expand, but, as discussed below, come with significant risk and potential up-front and ongoing cost to the franchisor.

This method of expansion can be particularly attractive to franchise systems that are (or wish to be) in a growth phase but that do not have the infrastructure to support significant expansion. However, even though the franchisor's involvement with day-to-day operational matters should be limited, the franchisor must, nevertheless, be prepared, and have adequate resources, to support the master franchisee and to monitor the activities of what it hopes will be a fast-growing market.


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### 3.2 Lower franchisor investment (time and resources)

The franchisor will have some potentially significant initial expenditures to get a master franchise deal done and the master franchisee up and running (e.g., trademark registration costs; transactional costs (including negotiating and documenting the deal and, in some jurisdictions, complying with franchise disclosure laws); and training and related travel costs). However, master franchise arrangements generally require significantly lower capital expenditures by the franchisor than other structures over the life of the master franchise relationship.

The master franchisee will bear the costs of establishing the on-the-ground infrastructure, recruiting subfranchisees, and providing on-going support for the master franchise system locally. Franchise systems with more limited resources, including smaller and younger systems, and some larger, more established franchisors that wish to utilize capital in different markets or for other purposes are often drawn to master franchising for this reason. However, the trade-off from the franchisor's perspective for shifting responsibility and financial risk to the master franchisee is that the franchisor will receive less revenue from subfranchised units than units developed by way of other expansion methods.

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### 3.3 Local market knowledge

One of the other key benefits of master franchising is that it permits the franchisor to enter markets in which it does not have the in-depth knowledge of the market that is a critical ingredient to the success of the brand on various levels locally. The right master franchisee should be in a far better position that the foreign franchisor not only to market the subfranchise offer to prospects but also to navigate market-specific issues that are sure to arise in the day-to-day operation of the business.

This knowledge and the ability to communicate without language or cultural barriers can also be a practical necessity when negotiating with prospective subfranchisees and training and supporting subfranchisees and can contribute positively in the franchisor's efforts to enforce system standards and in ensuring that the system is generally in compliance with local laws, regulations, and business norms. Additionally, to the extent that idiosyncrasies in the local market make changes to the franchise system or the products or services offered necessary or desirable, the master franchisee can be a valuable resource in working with the franchisor to determine what modifications should be made and how to implement them.

### 3.4 Significant initial master franchise fee

Historically, many franchisors expanding into new markets through master franchising have expected (and often obtained) significant initial master franchise fees in consideration for granting master franchise rights. The initial master franchise fees are typically not directly tied to the number of units to be developed and are not creditable to initial franchise fees paid under unit agreements (like in the area development context) and are in addition to the franchisor's share of initial franchise fees and royalties paid by subfranchisees to the master franchisee. Depending, of course, on the size and desirability of the territory, the length of the term, the development schedule, and other factors, initial master franchise fees can be in the six figures or higher.


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Large initial fees like this can be enticing, particularly to franchise systems that may be cash-strapped or that are being offered for markets that are not a priority for development by the franchisor. However, over the past few years, perhaps due to the economic malaise that has settled in over many parts of the world, there appears to be a shift away from astronomical initial master franchise fees towards "performance-based" fees that are realized by the franchisor when the master franchisee is successful in selling subfranchises. For example, franchisors may be more willing to accept a relatively modest initial master franchise fee upon execution of the master franchise agreement but take a larger percentage of the initial fees paid by subfranchisee or require an additional "opening fee" that is payable upon the opening of each unit. In effect, this type of structure can act to defer a portion of what might have in the past been part of the initial master franchise fee until the master franchisee has more cash flow from the business.

### 3.5 Ability to shift unit disclosure obligations to master franchisee (but does franchisor remain exposed for master franchisee's disclosure mistakes?)

In countries that have franchise disclosure requirements, the franchisor will generally have an obligation to provide disclosure contemplating the master franchise offer to the prospective master franchisee. However, with some exceptions,[4] unlike in direct franchising or area development arrangements, the obligation to provide disclosure at the unit (subfranchise) level in a master franchise system is that of the master franchisee.[5]

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The ability to shift unit disclosure obligations to the master franchisee reduces the franchisor's administrative burdens and can result in significant resource savings since the franchisor will not be required to prepare and maintain a unit disclosure document or be responsible for providing disclosure to prospective operators. The franchisor does, however, have an interest in ensuring the master franchisee is providing accurate and complete unit franchise disclosure in accordance with applicable law. This can be accomplished through a variety of mechanisms, including requiring that the master franchisee use competent counsel to prepare and update the disclosure document and requiring periodic certification by the master franchisee that it is in compliance with all applicable franchise laws. The franchisor may also wish to reserve the right to review the master franchisee's disclosure document, but in some countries it may not want approval rights in order to avoid potential imputed liability in the event that the disclosure document is found to be deficient.

[4] One notable exception is in Australia, where, somewhat, illogically, the franchisor is required to provide to master franchise disclosure to subfranchisees, either as part of a disclosure document that is jointly prepared with the master franchisee or as a standalone disclosure document.

5 If the franchisor wishes to enter into direct unit franchise agreements with the master franchisee or its affiliate for master franchisee-owned units, the franchisor would likely have an obligation to provide unit disclosure to the master franchisee or its affiliate contemplating the unit franchise. If, however, master franchisee-owned units are treated as subfranchised units such that the franchisor is not a party to the unit agreement, such unit disclosure obligation may be avoided. This comes at the cost, of course, of not having privity of contract vis-à-vis the master franchisee-owned units and the ability to directly enforce the obligations of the master franchisee or its affiliate under the unit agreement.


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## 4. Challenging assumptions related to master franchising

While there are many advantages to master franchising, thoughtful practitioners will conclude that there is no one-size-fits-all approach to international franchising, whether considered from the perspective of one franchise system to the next or, in many cases, even within the same system when considering franchise expansion in one international market compared with another. For example, a Boston-based U.S. franchisor may want to seize upon opportunities in eastern Canada (which may be an easier market due to proximity to the north eastern United States).[6] Comparing two markets, the franchisor might see cultural and legal similarities in Toronto, but when looking at expansion in Montréal, which is even closer, the franchisor may have concerns as to the sufficiently different cultural, legal, and language considerations. Although that franchisor may choose to pursue direct franchising in the Greater Toronto Area, when considering Québec, the same franchisor may conclude that a master franchise arrangement makes more practical sense.

### 4.1 The high cost of master franchising (hidden upfront and ongoing costs, time to manage relationship, loss of control)

Among the benefits of master franchise arrangements, as noted above, is that the master franchisee brings a wealth of understanding as to the local market, so that the master franchisee can recruit, train, and deal directly with subfranchisees. That is, to some degree, introducing a two-edged sword into the franchise relationship. For as close as the master franchisee is to the subfranchisees, frequently that closeness can attenuate the franchisor from a relationship to the subfranchisees. The practical impact of having the master franchisee as an intermediary is not at all negative to the franchisor, so long as things are going well. However, if there is a problem, by virtue of the subfranchisees being closer to the master franchisee, that may make it far easier in some systems for the master franchisee and the subfranchisees to de-identify, rebrand, break-away, and reopen, especially in countries where it may be difficult to enforce covenants against competition.

Moreover, master franchisees sometimes need to adapt the franchisor's system to operation in a distant market. While ideally these adaptations are made with close cooperation and coordination between the franchisor and master franchisee, in practice, the master franchisee (and sometimes its subfranchisees) may make these adaptions and changes "on the fly," without consulting the franchisor. In some systems, this degree of dynamic change is neither a challenge nor a concern, but for the most part, franchisors have concerns when system changes are made without their approval. Not only can these circumstances lead to a loss of uniformity (possibly with another master franchisee operating in another nearby market, with its own unapproved variation on the system), but these situations can also lead to disputes as to which party owns the rights to an unapproved innovation, whether the changes are part of the system (e.g., for the purpose of intellectual property ownership, confidentiality, and non-competition considerations), and whether compensation might be due to the master franchisee if the franchisor were to adopt the innovation elsewhere.

An increasingly familiar phenomenon is franchise arrangements that are negotiated on a multinational or regional basis, rather than with a focus upon development in only one country. While this is certainly the case in the "Gulf Countries,"[7] the same also can be found in transactions under which rights are granted for some or all of the "MENA" countries

[6] Another example of this dynamic could be Eastern Australia and New Zealand.

[7] This reference is typically to the GCC countries, or those that comprise the Gulf Cooperation Council: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.


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(the Middle East and North Africa), the Caribbean, and Russia and Ukraine together with the Baltic States of Estonia, Latvia, and Lithuania. While it is not the lawyer's role to deny clients who wish to enter into a multinational entrepreneurial arrangement, it certainly is the lawyer's responsibility to make certain that her or his client's transaction is properly structured and that the laws of the various nations are properly addressed. Where multinational or regional arrangements are considered, the costs can be quite substantial, given the likely need to review the transaction details with respect to the laws of all the countries in which the rights will be exploited.

### 4.2 Problems in selecting the right master franchisee; securing commitment to resources (human and financial)

Master franchising in some respects can be likened to an Olympic 4 x 100 meter relay, where the first runner sprints for 100 meters and then passes a baton to the second runner, who, in turn, sprints 100 meters to a third runner and passes along the baton, only to have the third runner do the same until reaching the fourth runner, who runs the "anchor" leg of the race. The success of the overall enterprise in a relay depends on each runner capably completing his or her leg of the race, as well as executing a successful interchange with the others.

In master franchising as well, each party holds some of the keys to success. The franchisor has to have the right disposition and ability to select and train its master franchisees (akin to running the first leg and making a successful hand-off of the baton). The master franchisee must accept the training, guidance, and support, get set up, and then hit the ground running (akin to accepting the baton and then sprinting).

Among the biggest challenges in master franchise arrangements is choosing the right "partner" (we use that term advisedly, as most lawyers cringe when the "P" word is used, even colloquially). In master franchise arrangements, it goes without saying that the master franchisee's approach, resources, and disposition will be critical to the health, viability, and success of the franchise system in that market. While not universally the case, most franchisors entering upon international franchising have spent substantial time considering and structuring their offerings, and have a well-developed and evolved system, but not every master franchisee is a company (or collection of individuals operating as an entity) with the requisite experience, appreciation for the *gestalt* of franchising, or resources to devote to the task of becoming a franchisor in the local market.

The franchise systems that have enjoyed substantial success in master franchise settings frequently are those with a strong and capable franchisor and master franchisee – akin to the first and second runners in a relay race. One of the hallmarks of success in this arena is a master franchisee that sees sufficient long-term potential in the system to justify investing the resources (both human resources and capital) needed to plan for and achieve long-term success. These factors reinforce the notion that it is critical to select a capable party with which to negotiate the master franchise agreement, no matter where the market is located.

In drafting terms, many sophisticated master franchise agreements require certain specific capitalization levels for the master franchisee at various times of its development and operation.

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However, a large master franchisee's balance sheet may reflect not only its native capitalization but also the financing arrangements that it must enter into with third parties such as banks, private sources of equity, and in some instances, the public markets as well. These settings all call for careful coordination and close cooperation – among the franchisor, the master franchisee, and its financiers.

Frequently, when a master franchisee requires capital for administrative or infrastructure needs as well as unit expansion, various challenges arise. In these transactions, the issues involved may include many factors, some of which are:

- *underwriting* (e.g., how much information about the franchisor and the master franchisee will the underwriters want, and to what extent will the franchisor have concerns about releasing that information to a party such as a private equity fund);
- *contractual arrangements* (e.g., among the bank/financier, the master franchisee, and the franchisor, addressing matters such as default, the exercise of foreclosure rights, the franchisor's right to cure the master franchisee's defaults, and dispute resolution considerations as among a local bank, local master franchisee, and an international franchisor);
- *the offering documents and statements made therein* (e.g., the points raised in the text below);
- *collateralization or securitization by the master franchisee* (e.g., what rights would the franchisor or its designee have in a secured financing, would the bank insist upon the ability to break-away from the franchisor if that might provide the most value, for example, by selling the system to a competitor, etc.);
- *dispute resolution with the bank or financier* (e.g., consideration must be given to the fact that while the bank or financier is likely from the same nation as the master franchisee, the terms of the master franchise agreement are likely controlled by offshore law (e.g., US law), and in an international transaction, the franchisor may prefer international arbitration under the aegis of the New York Convention rather than being subject to jurisdiction in local courts).

While these endeavors are not unique to master franchising, large master franchisees typically do require financing and hence, banking and financial arrangements become factors to address not just for the master franchisee but also for the franchisor.

In some instances, a large, well-financed, multi-brand master franchisee will have sufficient capitalization to start with, and while additional capital or credit facilities may be needed, the master franchisee will stand on its own experience in backing up those efforts. In other cases, however, as capable and large as a master franchisee may be, its appeal to the financial markets will be, to a large degree, a reflection of the master franchisee's relationship to the franchisor and to the brand. In those instances, experience shows that the master franchisee and its backers may overstate or embellish the relationship with the franchisor, with the effect (whether intended or not) that the franchisor may wonder whether targets of the securities offering will think they are buying stock of the master franchisee or of the franchisor.[8] In all of these facts, the franchisor must carefully review and, if appropriate in the circumstances (and after consultation with local counsel), require revision to the offering prospectus to correct any misperception

[8] As an example, we have seen an offering prospectus prepared by a master franchisee in Australia with only one thing on the front cover: the U.S. franchisor's colorful logo.


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as to which party is offering the securities: the franchisor or the master franchisee. The misunderstanding can not only lead to legal exposure, but disappointed investors' suits and the attendant publicity could tarnish the brand. As blurry as that distinction may appear on paper; franchisor personnel need to carefully consider requests to participate (and if so, how) in presentations to prospective investors in the master franchisee. Participation in securities offers (especially without close consultation with local counsel) could subject not just the franchisor but also its personnel to exposure for securities law violations and claims arising from the offering itself.

The U.S. Supreme Court recently declined to find a party other than the actual issuer liable for statements made in an offering prospectus under the SEC's Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934[9], in *Janus Capital Group, Inc. v. First Derivative Traders*.[10] One can speculate as to whether the *Janus* decision would be extended to a franchisor whose information appeared prominently in a master franchisee's offering statement.

However, conjecture as to exposure under U.S. law may be of no consequence in an international master franchise arrangement, because a claim regarding the master franchisee's prospectus would be made under the securities law of the jurisdiction in which the offer is made or the investors are located and thus, would likely be heard in the courts where the investors are located; that is, the courts of the country in which the master franchisee operates. A court outside the U.S., interpreting its own laws, may consider a claim of misrepresentation in a securities prospectus from the eye of the beholder – that is, the investor. Where the prospectus is unclear as to who is actually making the offer, there may be the temptation to find the *apparent* offeror (e.g., the franchisor) responsible for the statements made (especially if the master franchisee is not capable of paying a claim, or if the franchisor's personnel participated in oral presentations to prospective investors). Because of those factors, it makes sense for a franchisor to proactively address an unclear prospectus by requiring the inclusion of proper disclaimers, eliminating any embellishment as to the role that the franchisor plays in the master franchisee's business, and clarifying (if necessary) which party is actually issuing the securities.

*"In some circumstances, the parties may try to strike a balance between initial fees and ongoing fees, for example, where the master franchisee raises concerns that a significant initial fee may deprive it of working capital needed to start business operations."*

### 4.3 Setting and collecting the initial master franchise fee: it's not so easy

Setting the initial franchise fee in a master franchise agreement can take various forms, depending on various factors. Franchisors have considered numerous factors in setting the initial fee in a master franchise arrangement, including the strength of the brand, whether there is competition for the rights to be granted to the master franchisee, whether the franchisor is competing with other franchisors for the same master franchisee, whether the franchisor may encounter difficulty collecting royalties on an ongoing basis, whether the franchisor controls inputs (e.g., proprietary products) such that the master franchisee will be more likely to pay on an ongoing basis, whether there is offshore security for the ongoing royalty fees, whether the initial fee is subject to different taxation than royalties, and

[9] 15 U.S.C. § 78j(b)

[10] 131 S.Ct. 2996, 2302 (2011)


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whether the franchisor will incur substantial start-up costs that it wishes to defray by collection of an initial fee. In some circumstances, the parties may try to strike a balance between initial fees and ongoing fees, for example, where the master franchisee raises concerns that a significant initial fee may deprive it of working capital needed to start business operations. Another critical consideration to bear in mind is whether the fees will be sufficient to remunerate both the master franchisee and the franchisor, each of whom are required to support the franchise system in the target country.

Finally, as a practical matter, the initial fee in some countries may only be payable in "hard currency" after the agreement is signed and registered with a government agency.[11]

## 4.4 Multi-level disclosure requirements

For the most part, disclosure issues in international franchising arise in connection with the target country, with a few exceptions.

In the U.S., the Federal Trade Commission drew a helpful bright-line and clear distinction between domestic and international transactions, and concluded that the Franchise Rule applied only to domestic transactions. When the Commission formally amended the Franchise Rule in 2007, it made clear that the disclosure obligations under the Rule only apply to the "offer or sale of a franchise to be located in the United States of America or its territories."[12]

However, the FTC is not completely out of the picture when it comes to international transactions, as parties still must consider the possible impact of the FTC's broad authority under Section 5 of the Federal Trade Commission Act, which declares unlawful unfair and deceptive practices. Various courts have upheld application of the Federal Trade Commission Act to deceptive acts committed in international transactions, even though there is a split in the circuits on that point.[13] At present, only one state's law – that of New York – is generally perceived to apply to international franchise transactions that are the results of offers made from, or accepted in, that state.[14]

Focusing upon the laws of the target country,[15] parties are faced with laws that have different requirements. In some countries, the franchisor is required to provide disclosure to the master franchisee, even where the master franchisee is experienced, possibly more heavily capitalized than

[11] For example, in Russia, registration of a master franchise agreement with ROSPATENT is often a prerequisite to a bank being willing to transfer funds outside the country (e.g., to the franchisor). However, that is not universally the case, as some banks do not impose this requirement.

[12] 16 C.F.R. § 436.2.

[13] *See F.T.C. v. Skybiz.com, Inc.,* 57 F. App'x 374, 377 (10th Cir. 2003), as well as *Branch v. F.T.C.*, 141 F.2d 31, 36 (7th Cir. 1944). However, application of the FTC Act, and the FTC Franchise Rule in particular, was rejected in *Nieman v. Dryclean U.S.A. Franchise Co., Inc.,* 178 F.3d 1126 (11th Cir.1999), cert. denied, 528 U.S. 1118 (2000). Notably, the 10th Circuit's 2003 decision in *Skybiz* distinguished the earlier *Neiman* decision on its facts. The conclusion in *Branch* that U.S. law can be applied to protect international consumers (as well as the reputation of the U.S. with respect to the probity of businesses ) is consistent with Judge Brieant's holding as to application of the New York franchise law in *Mon-Shor*, discussed *infra*, and the D.C. Circuit's decision in *Doe v. Exxon-Mobil Corp.,* 654 F.3d 11 (D.C. Cir. 2011), in which the court noted that "[t]he Supreme Court has not found an extraterritorial bar when a federal statute provided for criminal or civil liability for a scheme devised and executed in the United States intended to inflict harm abroad, e.g., to a Frenchman in London." *Id.* at 28. While *Nieman* and the 2007 FTC Rule amendments are strong indicators with respect to the Franchise Rule itself, parties cannot ignore the adage that "bad facts make bad law," and that application of the Federal Trade Commission Act to conduct originating from within the U.S. remains possible.

[14] In 1984 decision, a highly-respected U.S. District Judge, Charles L. Brieant, concluded that the New York franchise law applied to transactions that took place outside the state because New York had a legitimate interest in the integrity of franchise transactions emanating from within the state (or accepted by the offeree in the state). *Mon-Shore Mgmt., Inc. v. Family Media, Inc.*, 584 F. Supp. 186, 192-93 (S.D.N.Y. 1984). However, in a later case, a federal district court in New Jersey observed that the New York law does not apply to "a transaction wholly unrelated to the state, involving entirely non-New York parties." *Instructional Systems, Inc. v. Computer Curriculum Corp.*, 826 F. Supp. 831, 851 (D.N.J. 1993). *Cf. Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal.4th 1036, 1059 (Cal. 1999) (California law could be invoked by out-of-state purchaser of securities where conduct that gives rise to liability arises in California); *Norwest Mortgage, Inc. v. Superior Court*, 72 Cal.App.4th 214, 224-25 (Cal.App.4.Dist 1999) ("state statutory remedies may be invoked by out-of-state parties when they are harmed by wrongful conduct occurring in California").

[15] *See generally* "International Franchise Sales Laws," ABA Forum on Franchising (2006-11) (Andrew Loewinger and Michael Lindsey, eds.).


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the franchisor.[16] The franchisor's registration to offer and sell a master franchise typically does not confer immunity upon the master franchisee when, in turn, the master franchisee wishes to offer and sell subfranchises. Instead, the master franchisee must itself develop a disclosure document and comply with all pre-offer and pre-sale requirements, such as registration (where those laws apply) and proper furnishing of a disclosure document. In some countries, the franchisor remains liable for the master franchisee's failure to provide proper disclosure to prospective subfranchisees; however, that is not the case in every country. This is another area as to which it is necessary to consult with a qualified and experienced practitioner who understands the law, as written, and how it has been interpreted administratively and in the courts.

### 4.5 Term and renewal – that is, term in relation to the term of the underlying subfranchisees; renewal of development rights? subfranchise rights?

The discussion concerning term of a master franchise agreement can pit competing interests against one another. For example, in a conventional single-unit franchise agreement, the franchisor and franchisee typically agree upon a fixed term of years for operating the business, plus a defined number of fixed-year renewal terms. The reason for granting term of any particular length varies from business to business, but to a franchisee, a key element is to have sufficient and certain time within which to obtain the benefits of its investment in the franchise. That incentive is not only important to the franchisee, but also to the franchisor – which needs its franchisees motivated to perform at a high level for the long-term. Indeed, some franchisors ask how much investment in the business they can expect from a "lame duck," term-limited franchisee.

In a master franchise arrangement, there are several layers to consider. Working back from the units, there is the subfranchise agreement – which when it

[16] For example, China, under the Franchise Regulation that took effect as of May 1, 2007.

*"In some countries, the franchisor remains liable for the master franchisee's failure to provide proper disclosure to prospective subfranchisees …"*

comes to the length of the agreement term and renewal options will, by and large, have the characteristics described above. Moving up one level, the master franchisee that grants the subfranchise rights has two considerations:

- First, for what period of time will the master franchisee be able to grant new subfranchises? Typically, the master franchisee is permitted to grant subfranchises for a limited period of time.
- Second, for what period of time will the master franchisee be able to service the subfranchisees?[17]

Here, as with the unit franchise example noted above, the franchisor wants to align its master franchisee's incentive with that of the franchisor. The franchisor does, of course, have the right to expect that its master franchisee will properly build-out the territory, meet a development schedule, and continue to serve at the highest levels of quality and performance.

While there is not universal acceptance of any single approach to setting the term of a master franchise agreement, the most prevalent approach is to limit the period of time within which the master franchisee may offer and enter into new subfranchise agreements (each of which in turn is limited to a finite number of years and a finite number of renewal terms), and to afford the master franchisee the right (as well as to undertake the obligation) to service the subfranchisees for the duration of the terms of the underlying subfranchise agreements.

[17] This presumes that the franchisor does not grant contracts without a limitation in time, which could be found to be contracts of indefinite duration in the franchisor's home country or that of the master franchisee, and thus subject to termination earlier than the franchisor or master franchisee may prefer.


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That approach keeps the master franchise agreement in effect for a period long enough so that each of the subfranchise agreements can have a full term and a full number of renewal periods.

The alternative approach would be to limit the number of years that the master franchisee can exercise its rights in its capacity as master franchisee. Doing so means that at some point, the number of years of term that the master franchisee can offer to new subfranchisees will diminish, and the value of entering into new businesses will be diminished as well. While this approach may work in some lines of commerce and with some investments, it is not well-suited to all and can act as inadvertent but undeniable cap on growth potential of the system.

*"the most prevalent approach is to limit the period of time within which the master franchisee may offer and enter into new subfranchise agreements [...] and to afford the master franchisee the right (as well as to undertake the obligation) to service the subfranchisees for the duration of the terms of the underlying subfranchise agreements."*

## 5. Other challenges arising during (and following) the master franchise relationship

### 5.1 Master franchise transfer issues

#### (i) The role of individuals

Master franchising, perhaps most of all the structures used in international franchising, is highly dependent on the identity and skills of the master franchisee. The success of the franchise system in a particular country will almost always depend upon the individual or group of individuals who are the driving force behind the master franchisee entity. That will be the case for the initially chosen master franchisee, and will remain the case for any subsequent master.

The franchisor may be unfamiliar with the chosen jurisdiction, but should have developed sufficient comfort with the leadership of the prospective master franchisee, that it is prepared to place its local reputation in their hands. They may have assumed that the key leaders will remain actively and substantially engaged in the master franchisee's business on a day-to-day basis. They may assume that individuals whose talents lie in locating and opening sites will remain in that role, or that others skilled in locating and managing franchisees will remain responsible for that area of the master franchisee's business. If it is intended that such individuals will retain active management roles, the master franchise agreement should require this. On the other hand, the franchisor may be perfectly comfortable for a master franchisee's ownership structure to change, so long as the individuals who commenced the business retain a majority stake, the franchisor can satisfactorily complete due diligence on any new owners, and they are not related to competitors. Just as the choice of a master franchisee for a country is a high-stakes game, as is the choice of any successor master franchisee.


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*"The success of the franchise system in a particular country will almost always depend upon the individual or group of individuals who are the driving force behind the master franchisee entity."*

A change in the ownership, control or personnel in the master franchisee may be even more critical to the franchisees. If the system is doing well and the franchisees are content, a change may upset this equilibrium. On the other hand, if a master franchisee is not developing the territory as it should, or has a poor relationship with its franchisees, a change in the master franchisee may be welcome. In the absence of a full transfer, the introduction of a new business partner into the master franchisee vehicle may be an opportunity to address skill, gap issues within the master franchisee's organisation.

**(ii) Structural issues with transfers**

Once the possibility of a transfer arises, it needs to be clarified whether the proposed transfer will impact all of the interests held by the master franchisee and its owners in the jurisdiction or only some of these. It may be that there is only one agreement entered into in the jurisdiction, giving the master franchisee both master franchise rights and the right to itself open and operate its own units. Alternatively, the master franchisee could have a series of agreements with the franchisor, one for the master franchise rights and a separate franchise agreement for each and every "corporate" unit held by the master franchisee. Another possibility is that interests associated with the master franchisee have entered into franchise agreements with the master franchisee entity.

It is common for a master franchisee to open some outlets itself and to sell these to franchisees over time. It is far less frequent for a master franchisee to sell its master rights but to retain an ownership interest in one or more individual franchise units.

Franchisors typically like to retain the flexibility to consider each restructure on its own merits. However, to be sure that a former master franchisee may not retain an interest in any part of the local franchise system if it is no longer welcome, consideration could be given to specifying in the master franchise agreement that the franchisor reserves the right to withhold consent to a transfer unless the master franchisee (and interests associated with them) exit from all of their interests in the franchise system in the territory.

**(iii) Events triggering a transfer clause**

The transfer provision in a master franchise agreement is typically triggered if the master franchisee wishes to transfer the master franchise agreement, any interest in the master franchise agreement, a substantial position of the assets used in the master franchisee's business, or if there is a change in more than a specified percentage over time of the legal or beneficial interests in the master franchisee. It is less often the case that a master franchise agreement will contain a "key person" provision triggering transfer provisions if the principal individual is no longer actively engaged in the business. Such a clause could be considered.

As it is important for a franchisor to understand the individuals behind its franchised businesses and to do due diligence on them, it needs early warning of any proposed change. While a contractual obligation to notify the franchisor of such proposals is essential, it may not always suffice. A change may occur without the franchisor's knowledge. Publicly available searches are usually available to evidence if a change has occurred. The master franchisee may be required to make annual filings to a corporate regulator, which could be required to be copied to the franchisor. Prospective transferees could be made aware of the franchisor's interests and the obligations in the master franchise agreement by notations on share or other certificates evidencing ownership interests in the master franchisee or by a provision in the master franchisee entity's constitution or by-laws noting the need for the franchisor's approval before a transfer can occur.


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*"It is commonly the case that a franchisor has a right of first (or last) refusal to buy a master franchisee's business at the same price and otherwise on the same terms as the proposed transfer."*

While these techniques are common in the United States, they are less common in other jurisdictions.[18]

The ultimate control over a transfer would be for a franchisor to have a security interest over the assets of the master franchisee or the shares held by its owners. While such security interests may prevent a transfer occurring without the franchisor's knowledge and consent, in many jurisdictions such security interests need to be first registered to be enforceable. Importantly, such restrictions, while theoretically available can be impractical where the master franchisee needs to rely on bank financing for the operating of its business. This issue is discussed further in section 4.1 above.

**(iv) Approving a transfer**

A prospective master franchisee will always wish to ensure it has an exit route, so master franchise agreements typically provide them with a right to transfer with the franchisor's consent.

The franchisor may have the right in the agreement to approve the transfer in its absolute discretion, or it may only be able to do so on certain enumerated grounds. In some jurisdictions,[19] a franchisor has a statutory obligation not to unreasonably withhold consent to a transfer. In others,[20] refusal can only be based on one of the grounds listed in the local franchise law. In some of the jurisdictions which regulate transfer, a procedure or required timing for obtaining approval may be mandated.[21]

If the transfer proceeds without the franchisor's consent, the enforcement options available to the franchisor will vary with the jurisdiction. The governing law of a contract will usually play no part in a decision by a local court whether or not to grant an injunction to restrain a transfer. This will be an issue for the law of the forum and the powers of the particular court, and not all courts have the power to order injunctive relief.

**(v) Other options?**

It is often useful to provide a franchisor with a fall-back option if it does not wish a transfer to proceed. It is commonly the case that a franchisor has a right of first (or last) refusal to buy a master franchisee's business at the same price and otherwise on the same terms as the proposed transfer. However, this is not always practical or achievable. It may not be of interest to the franchisor if only part of the ownership interests in the master franchisee are to be transferred. A right of first refusal may need to be registered as a security interest in some jurisdictions for it to be enforceable, and registration at point of exercise may be too late.

Even where a transferee is acceptable to the franchisor, local law or other practical restrictions may affect its implementation. For example, in some jurisdictions local foreign investment restrictions will limit the identity of an equity owner.[22] In others, an obligation to operate a business for a minimum period before franchising can have the effect of severely limiting the prospect of a transfer.[23] At a practical level, if the system is highly dependent on site leases, if site owners have the absolute right to

[18] This is not the practice in Australia. It is the practice in Malaysia.

[19] Such as Australia.

[20] Such as Vietnam.

[21] For example, in Australia, a franchisor is deemed to have given its consent to a transfer unless it gives the franchisee written notice that they are withholding consent and provides the reasons consent is withheld, within 42 days after the transfer was requested. A similar deemed approval applies in Vietnam, but the period is only 15 days.

[22] In the UAE for instance, all foreign investors should have a "national partner" holding not less than 51% of the share capital of a limited liability company.

[23] For example Vietnam, where a master franchisee must operate for at least 1 year before franchising.


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consent to a change in control or a transfer, the feasibility of the transfer may be outside of the franchisor's and master franchisee's hands.

Finally, it may be important for the franchisor to have the right to approve the transfer terms to be entered into by an outgoing master franchisee and its replacement. It is in the franchisor's best interests to ensure that the outgoing master franchisee enters into an enforceable non-compete arrangement with its successor, to the extent permitted by law. It will also be in the best interests of the franchisor and of the system in the territory that the master franchisee does not over-pay for the business, so that it retains sufficient capital to develop the business.

## 5.2 Difficulties in terminating a master franchisee

### (i) Consider all options

Terminating an international master franchisee is a "nuclear option." As termination may lead to the cessation of the franchise system in the territory, it is usually only considered as a last resort. The exit of the franchise system from a country (or the means of exit) can cause lasting damage to the brand.

In some cases (such as insolvency) termination may be unavoidable. In others, there are a range of steps a franchisor could consider to "encourage" compliance and retain the franchise system in the territory. These include:

– the franchisor may elect to suspend some of the master franchisee's rights to "encourage" performance, such as its right to open new units. This may have some short term impact, but is not a solution, as it would restrict the growth of the franchise system in the territory;

– the franchisor could consider converting the master franchisee's rights from exclusive to non-exclusive if it has the power to do so in the master franchise agreement, but the prospect of two master franchisees in the same area is likely to be unworkable;

– the franchisor could reduce the master franchisee's territory, while keeping it exclusive. This may leave the master franchisee better focused on developing the franchise system in a more limited geographical area and opens the possibility of appointing others;

– the franchisor could consider removing the master franchisee's rights to act as a master franchisee, but allowing it to retain any "corporate" units;

– the franchisor could consider exercising any right it has in the master franchise agreement to purchase the master franchisee's business. As noted above this may be impractical or impossible due to local regulatory reasons and is unlikely to be attractive to a franchisor who had previously decided not to operate in the territory; or

– if the master franchisee remains solvent, to ensure a smooth handover and avoid the prospect of litigation, the most practical option may be to allow the master franchisee to sell its business to another local master franchisee candidate.

### (ii) Ability to terminate

It is critical for a franchisor to obtain local law advice regarding its power to terminate, even if the agreement gives a clear termination right and the local law is not the governing law of the agreement. This is because local legislation, public policy or rules of equity may impose additional requirements or prohibit a termination. For example, some jurisdictions regulate how much notice is required before a termination can occur in certain circumstances[24] or require a particular process to be followed before such a notice may be effective.

> *"... local legislation, public policy or rules of equity may impose additional requirements or prohibit a termination."*

[24] For example, Korea and Vietnam require notice and an opportunity to cure. Australia requires reasonable notice in most cases, but not more than 30 days. Malaysia requires "good cause" to terminate.


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*"When the franchise agreement is silent on the issue, the impact of the termination of the master franchise agreement on the franchise agreement appears to differ from jurisdiction to jurisdiction."*

### (iii) What rights are terminated?

If the master franchisee has multiple agreements, the franchisor needs to decide whether some or all should be terminated. To enable a franchisor to fully exit a relationship with a master franchisee, it is useful to include a cross-default provision in each agreement. However, before exercising any cross default termination right, it will be important to obtain local advice to ensure the franchisor may lawfully terminate an agreement in respect of which there is no breach, if they need to establish a breach or "good cause."

Terminating a master's unit franchise while keeping the master franchise agreement in place may be problematic in jurisdictions which require the master franchisee to operate its own outlets.[25]

### (iv) Impact on franchisees?

The future of the franchisees after the master franchise agreement has terminated or expired will depend on the terms of the master franchise agreement and the franchise agreements, although the franchise agreements are most likely the key. More often than not the agreements between the master franchisees and in-country franchisees will be governed by the laws of the master franchisee's jurisdiction, so the contract law of that jurisdiction is likely to determine the impact.

Franchise agreements do not often state what will happen to the franchise agreement if the master franchise agreement terminates or expires. If it does deal with the issue at all, it is usually to clarify to the franchisee that the franchise agreement will terminate once the master franchise agreement is at an end. As this is not good news, franchisors can be reluctant to share it.

When the franchise agreement is silent on the issue, the impact of the termination of the master franchise agreement on the franchise agreement appears to differ from jurisdiction to jurisdiction. In some common law jurisdictions, there is reason to believe that the termination of a head franchise agreement will be treated in the same way as the termination of a head license or a head lease: that all sub-franchises, sub-licenses and sub-leases will terminate automatically.[26]

If the franchise agreement permits the master franchisee to "transfer" the franchise agreement to a third party, this can be used to move the franchise agreement from under the master franchise agreement before it terminates. In jurisdictions where the franchise agreements will automatically terminate if the master franchise agreement terminates or expires, it will be critical to ensure that this occurs before the termination or expiration takes place, not "on" or after that event.

The franchisor may have rights as a third party beneficiary to step in and "save" the franchise agreement if it wishes to do so, although the availability (and enforceability) of third party beneficiary rights will depend upon the governing law of the franchise agreement as well as the prevailing law in the jurisdiction where the subfranchisees are operating. In jurisdictions where third party beneficiary rights do not arise,[27] the franchisor would need to be a party to the franchise agreement or the rights under that agreement need to be held by the master franchisee as agent or trustee of the franchisor, in order for the franchisor to have its own rights to enforce under the franchise agreement. It is often best to put the matter beyond

[25] Examples of countries requiring this are China, Indonesia, Malaysia and Vietnam.

[26] This would be the position in the UK, Australia, Singapore, and New Zealand.

[27] Such rights arise in the US, the UK and New Zealand, but do not exist in Australia.


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doubt by specifying in the master franchise agreement that the franchisor may give notices of assignment or novation of a franchise agreement to a franchisee in the master franchisee's name and on its behalf.

In some jurisdictions, due to the operation of insolvency laws, termination provisions in the master franchise agreement will state that the agreement automatically terminates on a particular event, without the need for any notice. If this is the case, and there is no warning of the impending insolvency event, the franchisor may not be in a position to first provide notice to the franchisees before their agreements terminate.

In common law jurisdictions it is important to distinguish between an "assignment", which will be construed to be of a party's rights but not its obligations, and a "novation", which is of both rights and obligations and essentially constitutes a new agreement. An assignment often requires that only a notice is given to the other party, but consent is usually required for a novation. This means that it will be important for the "assignment" provision in the franchise agreement to be clear that the master franchisee may transfer both its rights and obligations to a third party of its choice and that the franchisee provides its consent to this in the franchise agreement. Local law may require formalities for an assignment, so this should be verified.

#### (v) Other issues

The franchisor may need time to locate a new master franchisee or determine the future of its franchise system once a master franchise agreement has terminated. It may be tempting for it to act as the master franchisee while this occurs. While this may be commercially necessary, a franchisor doing this needs to be careful to avoid a number of legal pitfalls. For example, if it starts acting as the master franchisee, including by receiving royalty payments, it may be considered to have assumed the rights and obligations under the master franchise agreement. Even if that is not the case, it is likely that an agreement of some kind will have been formed with the franchisee, such as an agreement on the terms of the previous agreement terminable on reasonable notice. To avoid these conclusions, the franchisor could put in place a short term license with each of the franchisees permitting them to continue to use the system for a short period of time or terminable on an agreed period of notice. The urgent need to do this may make it next to impossible for the franchisor to comply with local laws requiring a period of franchise disclosure. This also becomes problematic in countries which require each franchise agreement to have a minimum term.[28]

If the franchisor's level of activity in the jurisdiction is prolonged or substantial, it may reach the stage that it is required to register with corporate regulators as doing business in the jurisdiction or become liable to taxation in respect of its activities in the jurisdiction, so early tax and local law advice is advisable.

On a practical level, even if the franchise agreements terminate it is usually the case that the franchisor wishes the franchisees to remain with the franchise system and is able to persuade them that they should sign new franchise agreements with an incoming master franchisee. However, even in this situation, it will be important for a franchisor to manage the transition extremely carefully, to avoid the consequences described above.

## 6. Alternatives to master franchising: pros and cons

The inherent challenges associated with master franchising are described in some detail in our paper. Although these challenges are not unique to master franchising, each of the structures most commonly chosen as the vehicle for international franchising has its advantages and disadvantages. These are briefly summarized in the table attached to this paper.

*"… no structure should be the default option for all."*

[28] Such as Malaysia and Italy.




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## 7. Conclusion

In this paper we have examined some of the core assumptions around the use of the master franchise model in international franchising and noted the risks and challenges it often involves. We have seen that the risks and the challenges will vary among jurisdictions, among franchise systems and among master franchisees. What will uniformly be the case is that no structure should be the default option for all.

In order to maximize its chances of success in international franchising, a franchisor should, as a matter of best practice:

- set a strategic plan around priority countries;
- conduct due diligence on the suitability of the country, of master franchisee candidates and on the possible structures that could be used;
- obtain advice from local counsel before a decision is made on the structure or the agreement to be used; and
- not assume that the same structure will be the best for each jurisdiction.

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## Key features of alternative structures

| Type | Maximises financial return to franchisor | Assists fast roll-out | Requires continuing on-the ground support | Candidate profile | Provides access to in-country expertise to adapt the franchise system | Enables franchisor to directly control the units |
|---|---|---|---|---|---|---|
| **Direct** (franchisor contracts with individual unit franchisees) | X (not for up-front fees)<br><br>✓ (for ongoing fees) | X | ✓ (may require on-ground assistance from franchisors) | Suits larger scale franchisees and where few are required. | X | ✓ |
| **Area Development** (one or more franchisee given the right and obligation to open multiple stores without the right to sub-franchise. Typically exclusive) | ✓ | X | X | Suits larger sophisticated franchises with substantial operational and industry experience and with access to significant capital | ✓ | ✓ |
| **Master Franchising** (one or more franchisee given the right and obligation to open multiple stores, with the right and likely obligation to sub-franchise. Typically exclusive) | ✓ (for upfront fees)<br><br>X (for ongoing fees, as will share fees from sub-franchisees) | ✓ | X | Suits experienced managers with local expertise. Suits large territories. | ✓ | X |
| **Joint venture** (franchisor may be minority, equal or majority owner) | X (depends, but likely to require more investment by franchisor) | X | ✓ (depends, may require some on-ground assistance from franchisor) | May be required due to local regulatory requirements or cultural sensitivities. Suitable where franchisor permitted to take over or replace local partner. | ✓ (depends, as a franchisor JV partner may retain more responsibilities) | X (depends, but often not possible for regulatory reasons.) |


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