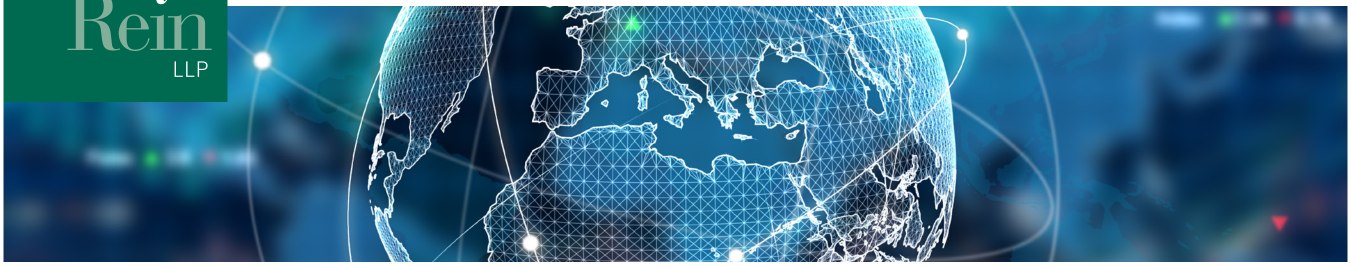

International Franchising: Structuring the Relationship

Approaches to Structuring International Franchise Relationships

Franchisors seeking to expand outside the United States can utilize several different approaches to system growth. Commonly used methods include (1) granting franchises directly to franchisees in the target country, (2) setting up a branch or subsidiary of the franchisor in the target country and having that entity grant franchises, (3) creating a separate legal entity with a "partner" in the target country and having that entity grant franchises, and (4) granting master franchise or development rights to franchisees in the target country. Before selecting an expansion method, the franchisor should confirm that the laws of the target country permit the structure that the franchisor intends to use. Franchisors can tailor their approaches based on the legal, cultural, and political landscape of the target country as well as the specifics of the potential franchisee; often, therefore, franchisors will use different approaches in different areas and/ or business partners. In short, there is no "one size fits all" approach to international franchising.

Direct Franchising

In this scenario, the franchisor directly grants a franchise to the franchisee in the target country. The direct franchising approach is frequently used by franchisors where the target country is geographically close to the United States; where the target country has customs, languages, and legal systems that are similar to those in the United States; and where training and ongoing supervision and assistance can be furnished on a cost-effective basis in the United States, in a country geographically close to the target country, or in the target country.

Potential Advantages

- Typically, the franchisor will not form a legal entity in the target country, thereby reducing costs.
- The revenues collected by the franchisor are higher because the initial and ongoing fees are not shared with a third party.
- The franchisor maintains greater control over the appearance and operation of outlets in the target country.
- A direct franchise can be a good way to expand internationally on a limited scale.

Potential Disadvantages

- The franchisor might experience problems providing timely and adequate service and support.
- Slower system growth in the target country.
- Difficulties in ensuring a supply of proprietary items to franchisees in the target country.
- The addition of outlets in a foreign market may strain the franchisor's resources.

- Government approval and/or registration may be required for each franchise agreement. This process can be time consuming and costly.

Branch or Subsidiary

If a franchisor establishes a branch or subsidiary in the target country, the branch or subsidiary acts as the franchisor in the target country and is responsible for granting franchise rights to franchisees in that country. A franchisor should use this technique only if it has adequate capital and management resources to dedicate to the branch or subsidiary in the target country. The franchisor should bear in mind that the branch or subsidiary will be responsible for franchise services in the target country, including recruiting, training, site selection and site development, marketing, and other administrative functions. Qualified management personnel must reside in the target country to manage the administrative offices and implement the franchise system.

Potential Advantages

- The franchisor will have greater control over franchising activity, including the use of trademarks, proprietary information, and other intellectual property.
- The franchisor will collect higher revenues because the initial and ongoing fees are not shared with a third party.
- The office and other facilities in the target country will create a stronger presence and allow the franchisor to offer more immediate services to the local franchisee(s).
- If the target country has limitations on currency conversion, the presence of franchisor-owned facilities in the target country can facilitate currency conversion.

Potential Disadvantages

- The franchisor must commit significant financial, management, and personnel resources to set up and maintain an office and other facilities in the target country.
- The franchisor must ensure compliance with laws, customs, and business practices of the target country.

Joint Venture

In a joint venture arrangement, the franchisor and a "partner," which is generally an individual or business entity located in the target country, will enter into a joint venture agreement and form a separate legal entity that will operate as the joint venture company. The joint venture company can either grant franchises to franchisees in the target country or will itself directly open and operate franchises in the country. Franchisors might opt for a joint venture if the business is relatively unknown or if the market for the products or services is uncertain. In terms of the contributions of each party to the joint venture, generally, the franchisor contributes the franchise system, the proprietary information, and intellectual property; the partner contributes money, expertise in operating a business in the target market, and knowledge of the laws and customs of the target country.

Potential Advantages

- Because costs are shared between the franchisor and the partner, the parties share the risk of loss.
- The partner has local market expertise, including knowledge of local customs and tastes and valuable business and political contacts.
- By having an ownership interest, even though shared, the franchisor has greater control over the development of the franchise system in the target country and the use of its system and trademarks.

Potential Disadvantages

- The franchisor and the partner share the initial and ongoing fees, profits, and other benefits.
- There is a risk of ineffective management by the partner, disagreements with the partner, and diffusion of authority.
- The creation of a joint venture requires a large investment that may be vulnerable to currency conversion limitations and political instability.

Master Franchise/Development Rights or Area Representative

Franchisors utilize master franchise agreements and development agreements to establish a number of franchise outlets, simultaneously or successively, within a substantial geographic area during a defined period of time. When the parties enter a development agreement, the franchisor grants to the developer in the target country the right to establish and operate multiple franchised outlets. The developer will directly operate the franchised outlets that are established. If the parties enter a master franchise agreement, in addition to granting the master franchisee the right to establish and open franchised outlets, the franchisor also grants to the master franchisee the right to grant subfranchises to third parties to establish and operate franchised outlets within the designated geographic area.

A master franchise agreement enables the franchisee to expand more rapidly than a development agreement. In a master franchise relationship, however, the franchisor's control over its franchise system, including its trademark, may be diminished. In addition, the franchisor may experience practical difficulties dealing with subfranchisees upon termination of the master franchise agreement. Because a developer will generally receive exclusivity to develop a specific area itself, a franchisor choosing this approach must find a franchisee with adequate capital and management resources to satisfy the development obligations.

In lieu of a master franchisee, a franchisor could use an area representative to recruit franchisees within a specific area. The primary difference between the area representative and master franchise model is that the franchisor, and not the master franchisee, is the party that enters into franchise agreements with individual franchisees (that are recruited by the area representative). Another difference is that an area representative will not necessarily have the right to sign a franchise agreement with the franchisor for its own franchise. An area representative arrangement can provide a franchisor useful recruiting assistance, while still providing the franchisor significant control over its international development, as the franchisor ultimately contracts directly with franchisees.

Potential Advantages

- The franchisor commits fewer financial and management resources.
- The technique permits rapid market penetration and system growth.
- Generally, more sophisticated investors will be attracted by these arrangements.
- The costs to enter the market are significantly less even if the language, culture, customs, and laws are different because, among other things, the franchisor can rely on the master franchisee's experience in such areas.

Potential Disadvantages

- A master franchisee's focus on meeting its development obligations may result in its providing less attention and devoting fewer resources to supporting subfranchisees, to the detriment of the success of such subfranchisees.
- If a master franchise relationship is used, the franchisor will receive less revenue because most fees will be split between the master franchisee and the franchisor.
- The franchisor's control over the franchised system in the target country will be diminished, and a "bad" master franchisee can tarnish the brand in the entire area.
- There is a risk of "breakaway" franchisees in the target country.

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While international expansion is appealing, it should not be undertaken lightly and without a careful assessment of a multitude of factors. The franchise attorneys at Wiley Rein have closed franchise deals for a variety of franchisors in more than 80 countries and have the experience to provide quality, cost-effective legal guidance each step of the way.

FRANCHISE *Services*

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration disclosure requirements, we can help you to modify the business concept to avoid coverage by the franchise laws, if possible, or take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and provide assistance in maintaining and protecting those marks.
- Prepare the Franchise Disclosure Document (FDD) and provide FDD compliance training to your franchise sales and franchise administration teams.
- Prepare and file all franchise registrations, exemptions, amendments, and renewals in all applicable states.
- If you are a U.S. franchisor, assist you in developing your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the U.S.
- Help you understand your contractual rights and obligations and the statutory restrictions that apply to the franchise relationship, including transfers and contract renewals.
- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.

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