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INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW  
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STUDY GROUP ON FRANCHISING

Report on the Third Session  
(Rome, 14 to 15 April 1997)

(prepared by the Secretariat)

Rome, July 1997

The third meeting of the *Unidroit Study Group on Franchising* was held on 14 and 15 April, 1997 at the seat of the Institute. A list of participants is annexed to this report.

Opening the meeting, **Mr Walter Rodinò**, Acting Secretary-General of the Institute, thanked the members of the Study Group for their contributions to the draft guide and for their continued commitment to the project. He transmitted to the Group the expressions of appreciation of the Governing Council of the Institute which had had the opportunity to review the draft text of the Guide at its session the previous week. The Council hoped to approve the publication of the guide at its 1998 session and had set up a sub-committee to examine the final draft for the purposes of recommending its publication to the Council in Plenary. The President of Unidroit, **Professor Luigi Ferrari Bravo**, endorsed these comments when he joined the Group in the course of the meeting and also expressed his own deep appreciation for the work of the Group.

**Mr Alan Rose**, member of the Unidroit Governing Council, chaired the meeting. He welcomed **Mr John Vernon** of Strasburger & Price, L.L.P., Dallas, who participated in the work of the Study Group for the first time.

#### **GENERAL POINTS**

The following general observations on the draft guide were made by the Study Group:

- (a) cross-referencing:** the Group found the cross-referencing between the chapters to be insufficient. Not all chapters had references to other chapters and to assist the reader an effort should be made to insert such references as necessary;
- (b) sub-titles:** these were also lacking in numerous chapters. Furthermore, the sub-titles that existed were frequently insufficient or were not sufficiently sub-divided. The authors of the chapters should therefore make an effort to introduce sub-headings when they revised their chapters;
- (c) emphasis:** several chapters dealt with unit franchise agreements instead of master franchise agreements. As the guide was a guide to master franchise arrangements, this should be corrected;
- (d) repetitions:** a certain number of repetitions had been left in the guide in the course of the editing so as to permit readers to consult each chapter as a self-contained unit. The Group however felt that too much repetition rendered the text heavy and boring, although in certain cases repetition was justified in consideration of the importance of the subject-matter dealt with, or with a view to adding emphasis. It was therefore decided that to the greatest extent possible repetitions should be substituted by cross-references, although a certain flexibility should be permitted in this regard;
- (e) purpose:** the approaches adopted by the authors differed, at times to a marked degree. In a number of chapters the author attempted to advise readers on what the author considered to be an acceptable practice, while other authors made no such attempt. It was reiterated that the purpose of the guide was not to take a position on any of the issues dealt with, but rather to illustrate the options open and the pros and cons of the different options. This was all the more necessary as international master franchise agreements were negotiated agreements and there

was no such thing as a right or wrong option. It was stressed that the reader should not be given the impression that the guide was an adequate substitute for legal counsel or that if the contract, for example, did not contain a clause or an obligation referred to in the guide, the contract would be wrong or unenforceable. Language such as the imperative "should" was therefore best avoided. This did not however preclude indications being given of commonly accepted practices or generally accepted views;

**(f) pros and cons:** in general, the document contained too few descriptions of the pros and cons of the different options available and this should be amended;

**(g) bias:** there were instances in which the drafting was heavily biased in favour of the franchisor. This bias had to be eliminated, as the guide was not principally addressed to franchisors but rather to prospective sub-franchisors and their lawyers. In several cases it was therefore necessary to deal with the issue or situation under consideration from the perspective also of the sub-franchisor and at times even of the sub-franchisees;

**(h) contradictions:** a certain number of contradictions existed between the chapters and these should be eliminated;

**(i) terminology:** a rather loose use of terminology was observed. As this tended to create confusion it was decided that efforts should be made to make the terminology more consistent;

**(j) length:** some members of the Group expressed concern at the length of the Guide. It was felt that in a number of instances whole sections could be either considerably shortened or even deleted. The elimination simply of the repetitions would in fact considerably reduce the size of the document. It was decided that a certain amount of material, above all from the first chapters, should be moved to an annex, which would also contribute to the shortening of the main body of the guide. It was however felt not to be appropriate to fix a maximum number of pages *a priori*. The amount of detail should be decided depending on the subject-matter. It was pointed out that users in developing countries might want more guidance as to what was common practice, as they might never have negotiated a franchise agreement;

**(k) glossary:** it was decided that the idea that had been aired at a previous session of the Group of creating a glossary of the terminology used in the guide should be accepted;

**(l) analytical index:** it was confirmed that in addition to the proposed glossary, the guide would be provided with an analytical index;

**(m) revision:** it was decided that the authors should submit the revised version of their draft chapters by 30 June, so as to permit the final editing to be completed by September. The edited revised version of the guide would thereafter be sent to the members of the group who would comment on the draft and submit their comments in writing. The draft would also be circulated to lawyers and others who had expressed an interest in commenting on the draft, such as the national franchise associations. In particular, the draft would be sent to those members of the *International Bar Association Committee on International Franchising* who had requested a copy following the publicity that was being made for the guide with a view to its presentation at the forthcoming IBA Conference in New Delhi (2-7 November 1997). A Drafting Committee would be convened before the end of the year to consider the draft and the comments received both in writing and during the IBA session. So as to speed up consideration of the drafts, it was decided

that the revised chapters would be sent out as they became ready, rather than all together. In particular the new Introduction, Chapter 1 and the annexes should be sent out as soon as possible. Detailed comments on the individual chapters should be sent directly to the author;

**(n) order of chapters:** the order of the chapters was rearranged to a certain extent. The following list gives the new order of the chapters, and who is responsible for each:

Preface (new) (Peters)	including the <i>History of the Unidroit Project</i> presently in the Introduction
Introduction (Peters)	
Chapter 1 (Peters)	Fundamental Concepts and Elements
Chapter 2 (ex 3 and 6) (Vernon)	Nature and Extent of Rights granted and Relationship of the Parties
Chapter 3 (ex 4) (Konigsberg)	Term of the Agreement and Conditions of Renewal
Chapter 4 (ex 5) (Mendelsohn)	Financial Matters
Chapter 5 (ex 7) (Schulz)	Obligations of Franchisor
Chapter 6 (ex 8) (Mendelsohn)	Obligations of Sub-Franchisor
Chapter 7 (ex 9) (Schulz)	The Unit Sub-Franchise Agreement
Chapter 8 (ex 10) (Zeidman)	Advertising and the Control of Advertising
Chapter 9 (ex 11) (Jesse)	Supply of Equipment and other Products
Chapter 10 (ex 12) (Konigsberg)	Intellectual Property
Chapter 11 (ex 13) (Frignani)	Know-How and Trade Secrets
Chapter 12 (ex 14 and 15) (Zeidman)	System Changes
Chapter 13 (ex 17) (Jesse)	Sale, Assignment and Transfer
Chapter 14 (ex 16) (Schulz)	Liabilities, Insurance and Indemnification
Chapter 15 (ex 18) (Mendelsohn)	Remedies for Non-Performance
Chapter 16 (ex 19) (Mendelsohn)	The End of the Relationship and its Consequences
Chapter 17 (ex 20 and 21) (Rose)	Applicable Law and Dispute Resolution
Chapter 18 (new) (Peters)	Generally used Clauses (formerly in Chapter 2)
Chapter 19 (ex 22) (Zeidman)	Ancillary Documents
Chapter 20 (ex 23) (Peters)	Regulatory Requirements
Annex 1 (new) (Peters)	Introduction to Franchising as such (formerly in Chapter 1)
Annex 2 (new) (Peters)	Franchising in the World Economy and What is Franchised (both formerly in the Introduction).
Annex 3 (Peters)	Laws and Regulations relevant for Franchising

So as to facilitate the reader, this report will refer to the old numbering of the Chapters.

## INTRODUCTION

The Group expressed concern at the length of the introductory chapters of the guide. It was suggested that rather than enter into details, the Introduction in particular should sign-post where in the guide a certain issue was dealt with at length.

As to the actual content of the Introduction, the Group felt that the history of the Unidroit project was more appropriately placed in the general Preface to the guide. Furthermore, the statistical information provided in the Introduction to illustrate the economic importance of franchising was better placed in an annex, as was the general description of franchising which in

effect dealt more with domestic unit franchising than international master franchising. The opportuneness of keeping the general description of domestic unit franchising was discussed and the Group in the end agreed that it should be maintained, even if not in the general body of the guide, in view of the educational value of the information provided therein. This included the section describing the advantages and disadvantages of franchising as compared to other more traditional forms of business. It was however pointed out that the analysis of the advantages and disadvantages would need to be considerably expanded, as there were several that had not been dealt with.

The section dealing with risk factors was felt to be misleading. While it was true that general statistics showed that a person buying a franchise had a better chance of success than one who started a traditional business, this was true in a mature franchise system but not necessarily in a not so mature system. Statistics in fact showed that buying a franchise in a not so mature system was as dangerous as, if not more dangerous than, starting a traditional business. Furthermore, available statistics and figures of franchised businesses failure rates referred to individual unit franchises within one country, and not to international master franchise arrangements. In unit franchising the individual basic risk that had been taken out of the equation was the development risk which was instead of considerable importance in international master franchising. The risk factors involved in international master franchising for the sub-franchisor were therefore far greater, because of the risk of going into a country with a system developed in a different country. The risk of failure in international master franchising was in fact astronomical. Furthermore, the risks in master franchising were different from the risks in domestic franchising. Very often, for example, the name of the franchisor was unheard of in the target country and this had an effect on the rate at which the business could grow and develop.

As to the different methods of franchising, it was pointed out that the term "direct franchising" was frequently misused or used to mean different things. It was sometimes used to mean single unit franchising and at others the issuance of an agreement, whatever the nature of the agreement, without the benefit of an intermediary. In fact, the method presently described as "Franchising through a Branch or Subsidiary" under "Direct Franchising" on page 32, could be used also in the case of master franchising. It was therefore suggested that the section dealing with franchising through a branch or subsidiary be removed from page 32 and placed instead on page 39 after "Franchising by Means of a Joint Venture", as in both cases franchising was conducted through a particular vehicle established for other purposes.

## **CHAPTER 1**

Also Chapter 1 was considered to be too long. It was felt that in particular the section on bare-bones licensing should be considerably shortened. The section on commercial agency should instead be re-written, including also a mention of the fact that there were countries in which the laws would lead the master franchise relationship to be equated with one of agency, even if in fact it was not.

It was suggested that the references to pre-contractual disclosure should be deleted from Chapter 7 and instead be included in the section that dealt with the due diligence that was to be exercised by the prospective sub-franchisor when evaluating the franchise it intended to buy. This section on due diligence was to be included in the section on negotiating and drafting

international agreements which was to be moved to Chapter 1 from its present location in Chapter 2.

It was observed that a general discussion of what made a good sub-franchisor should be included in one of the first chapters, possibly in Chapter 1. The present draft considered the fundamental functions of a sub-franchisor in connection with the end of the relationship and the selection of a substitute for the sub-franchisor (p. 196), rather than in connection with the initial setting up of the sub-franchise network. It was instead considered to be more appropriate to deal with such matters at the beginning of the guide.

## **CHAPTER 2**

Chapter 2, which contained two sections, one on “Negotiating International Agreements” and the other on “Clauses of Importance in Master Franchise Agreements”, was considered to be inappropriately placed. It was decided to incorporate the first part into one of the early chapters, the most appropriate being Chapter 1, and to transform the second part into a new chapter to be placed after the Chapters on Choice of Law and Choice of Forum. This new chapter would bear the title “Generally Used Clauses”.

As to the content of the two sections, it was felt that a description of the “due diligence” required of prospective sub-franchisors should be added to the section on negotiation. This due diligence would cover properly checking out the franchisor and the franchisor’s history, both national and international, as well as speaking with other sub-franchisors about their experience with the franchisor.

It was also observed that there were numerous other clauses that should be mentioned in the section on generally used clauses. Hardship and *force majeure* clauses were important and the former should be considered also as an excuse for non-performance of the development schedule. There was furthermore usually an acknowledgement by the sub-franchisor that the success of the business would flow from, or depend upon, its own activities as opposed to those of the franchisor. Notice provisions, with an indication of what constitutes notice and what constitutes acceptance, should also be included. It was suggested that the clauses that needed to be stressed were those that had a particular impact on master franchise arrangements.

## **CHAPTER 3**

The Group decided to merge Chapters 3 and 6. The new title of the chapter would therefore be “Nature and Extent of Rights granted and Relationship of the Parties”. Mr Vernon, as the author of Chapter 6, was entrusted with the task of revising the new, merged chapter.

As regards the content of former Chapter 3, doubts were expressed as to the advisability of referring to the use of non-exclusive master franchise agreements in the same country, as in the experience of the members of the Group this was extremely rare or even unheard of. This appeared on pages 73, 94 and 95, and it was suggested that the sections dealing with this should be deleted. The discussion on exclusivity did however belong in the chapter that dealt with the rights that were granted and should therefore be treated extensively in this chapter.

Another issue of importance that should be dealt with at greater length was whether or not the franchisor should retain the right to distribute its products through different channels of distribution and the pros and cons of such a possibility. The methods adopted by the franchisor to retain this right may vary: it might retain the right to distribute the product bearing the trademark, or the same product not bearing the trademark, through different channels of distribution, or alternatively the same product through the same channel of distribution but with a different trademark.

It was furthermore suggested that the section in this chapter dealing with warranties should be deleted, as there was a certain amount of duplication with the chapter on intellectual property.

The Group considered whether or not the issue of exclusivity and non-exclusivity as regards the territories granted should be dealt with in Chapter 3. The conclusion was that it should be considered at some length in this chapter as it dealt with the rights granted, but that it should also be referred to in the chapter on the obligations of the sub-franchisor, even if the result was a certain duplication. For continuity purposes it was however important to examine the question in Chapter 3. In the discussion on exclusivity the question of the reservation of title should be discussed.

Reference was made to page 67 of the draft guide, where, under the heading "What is Granted" the second paragraph stated that there was only one licensed asset, namely the trademark. It was pointed out that if this was the case it would no longer be business format franchising but simply trademark licensing. The first paragraph on the same page was furthermore found to be confusing, and hesitations were expressed as concerns the fourth paragraph, which stated that "[w]hen a franchisee obtains a licence to use all the assets that comprise the business system, it is granted what is known as a combination know-how and trademark licence", as it was felt that what the franchisee was granted was a franchise that was made up of know-how and a trademark system. Similarly, the statement in the same paragraph which referred to the franchisee obtaining a license to use all the assets that comprise the business system, was considered to be misleading and inaccurate, as was the reference to the know-how being transferred, as it was not transferred but licensed.

The discussion on the know-how being proprietary or non-proprietary was furthermore confused where it stated that the know-how was considered to be proprietary if it was not available to unlicensed parties because it was patented, covered by copyright or secret, "[i]n other words, the know-how is proprietary because the intellectual property and other laws of the jurisdiction in which the franchise is to be operated gives the owner, the franchisor in this case, the right to bar others from using it". It was pointed out that most franchise systems did not involve patents and the know-how was contractual.

The nature of a licence was discussed. It was suggested that in reality a licence did not grant people rights, it authorised what would otherwise be an infringement.

The reference on page 67 to copyright as a method of protection of an idea was also misleading, in that copyright only protected that way in what was written was expressed, it did not protect the idea behind it. Similarly, the impression that know-how as such could be protected was felt to be incorrect, in that technical or commercial know-how was not protected. Parts of it might be, if it came under a specific law or if it was protected in the contract, but in general the know-how was free. The emphasis should therefore be reversed to indicate that know-how

generally was free whenever it was on the market, unless it was secret and someone got hold of it by illegitimate means, in which case it would be protected.

On page 69 reference was made to the good will of the system, whereas the good will would be attached to the name rather than to the system. As to warranties for the rights granted, that was dealt with also in Chapter 13, which was where it belonged and the duplication would therefore have to be eliminated. Furthermore, under the section "*How the Licensed Assets may be Used*", the statement that the franchisee would be granted "only the right to establish its own units as the franchisor will prefer to retain a direct relationship with the operator of all the units" was incompatible with a sub-franchise agreement which was what was dealt with. On page 71 the question of the options available to the sub-franchisor with regard to sub-franchisor-owned units needed to be dealt with in greater detail, so that it was clear that if the franchisor did not require another level, such as a subsidiary, to be created it would be the franchisor of the units owned by the sub-franchisor even if that was not the intention.

One issue which needed to be dealt with at some length, probably in the former Chapter 6, was that of control. Would, in other words, the sub-franchisee be subject to both the franchisor and the sub-franchisor? Would the franchisor try to create a direct relationship with the sub-franchisee and if so what would the implications of this be?

#### **CHAPTER 4**

The Group considered the possibility of placing Chapter 4 close to Chapters 18 and 19 and whether the three chapters should be placed towards the beginning of the guide or closer to the end. The philosophies of the members of the Group differed on this point, as for those from common law countries it was logical for prospective sub-franchisors or sub-franchisees to ask what they were getting and for how long they were getting it, which meant having the chapters at the beginning, whereas for those from civil law countries the duration of the agreement was not what was paid for, what was paid for was the introduction of the system, the reputation of the network and what the franchisor had done to build up the system. This meant that it was logical to place the chapters towards the end. The term of the agreement did not necessarily have anything to do with the quality of the franchise package, and this also had the consequence that the initial fees were not repaid in case of termination of the agreement. The concern was expressed that if the duration of the agreement came to be seen as part of what was being paid for, claims would be filed for the return of the part of the initial fee that was considered to be left in case of termination. For the common law representatives the suggestion that the length of the term was not a factor in determining what the franchisee was buying was astonishing. A franchisee was not going to pay for a franchise agreement lasting three years what they would be prepared to pay for one lasting twenty-five years. In the end, it was decided to leave the chapters in their present position and to take any final decision on their placing once they had been redrafted. It was however suggested that a cautionary note should be added regarding contracts for an indefinite term. These were not common in the case of international franchising, but in some countries, such as Germany, the effect of improper drafting might be that the agreement would be considered to be one of indefinite duration.

In relation to the term of the agreement, the question of whether or not it would be correct to take a position as regards the duration of the agreement was considered. While it was felt to be inappropriate to state that master franchise agreements should always be of long duration, it



was considered to be acceptable to state that they were commonly long-term. There was no universal standard as to length, as naturally the needs would vary from type of business to type of business. It was however generally accepted good practice for an adequately long term to be granted so as to enable the sub-franchisor to get a return on its investment and to stimulate the sub-franchisor to develop the territory properly.

It was further recalled that limits might be placed on the length of the agreement by law or by case law. There were for example provisions, which were usually born out of transfer of technology considerations, which laid down a maximum length for agreements because of fear that an unacceptable arrangement might bind people for too long. On the other hand there were statutory provisions in other countries which indicated that the agreements had to be no less than a certain period of time or that, if they were less than a certain period of time, there must be some form of compensation at the end of that period of time. In some cases statutory law or case law or principles of good faith demanded that a sub-franchisor who paid a certain amount of money be able to amortise it over a certain period of years. The agreement must therefore last for a reasonable minimum period of time to allow the sub-franchisor to do that.

An issue connected with the renewal of the agreement was a requirement that was often inserted in the agreements as a condition of renewal, namely that the franchisor's then current agreement be executed. This was extremely common in domestic arrangements and most franchisors attempted to apply similar requirements also internationally, although sub-franchisors in international arrangements were loathe to subject themselves to the uncertainties of what the market place would be dictating in the future. Furthermore, in an international situation the then current agreement would almost by definition not be the current agreement being offered in that territory, but would be what was offered somewhere else in the world. Lastly, rights had been granted to sub-franchisees on the basis of the first contract, which made it difficult to adopt another agreement in the case of renewal. It was suggested that rather than state that it was unrealistic in the international context to require the execution of the then current agreement, it should be pointed out that while there were tremendous advantages in requiring this in terms of maintaining uniformity of a system, nonetheless there were difficulties in an international context. There were situations in which certain provisions were sure to remain unchanged, such as those on the royalty, which it would not be possible to increase, or the territory, which it would not be possible to decrease. What was increasingly common internationally was the giving of guarantees that certain fundamental items would not be changed under any circumstances, and this was more important than whether or not there was another initial fee, as its economic impact was far greater over the term of the agreement.

With reference to the second paragraph on page 77, which considered the assignment of unit sub-franchise agreements, the validity of such assignments and the possibility or otherwise of financial compensation in the case of assignment, it was suggested that this was better placed in Chapter 18 which dealt with remedies for non-performance.

The issue of regional customs in contracting was considered in relation to the habit which existed in some Asian countries of inserting a provision in the contract to the effect that the term lasted to such and such a date, at which point the parties would sit down and reasonably negotiate the terms of the renewal. Such a provision, which was considered to be good practice in these countries, would be bad practice in, for example, North America. Customs varied considerably and a party used to this custom would be disadvantaged vis-à-vis a North American party if it tried to impose such a provision. It was in fact essential for the sub-franchisor to know

that it had a right to renew and on what conditions. This was particularly important in relation to the development schedule. It was nevertheless observed that in some countries it might not even be possible to get an agreement approved unless the agreement provided for the parties to sit down and re-negotiate the terms of renewal at the end of the term. It was therefore suggested that a warning should be inserted in the guide to the effect that parties should note that customs varied and that what in some countries was a good custom might be less appropriate in another countries.

Factors of considerable importance were the development schedule, how the development aspects of renewal were to be dealt with and whether they should be dealt with in the chapter dealing with the term of the agreement. It was suggested that wherever it was dealt with, it was important to recognise in the discussion of the renewal, and of the basis upon which the development schedule would be set for the future, that numerous nuances could be established. The development schedule could for example be based upon objective criteria, such as that under no circumstances could it be expanded or augmented by more than, for example, the growth rate in the national economy during the previous period of time. There were many different ways in which this could be done and it was felt that suggesting that these techniques are seen in agreements from time to time was useful, even if no definite statement of the "correct" way to do things was made. It was also suggested that the development schedule as such should be discussed in detail in Chapter 8.

## **CHAPTER 5**

Opening the discussion on Chapter 5, the author of the chapter objected to the last paragraph on page 80 which had been added in the course of the editing to reflect the comments and decisions made at the previous meeting of the Study Group, indicating that he found it to be inaccurate.

Furthermore, in the course of the editing the order of the sections had been changed, the section on the sources of revenue to the franchisor being placed after that on the sources of income available to the sub-franchisor. It was suggested that the original order should be reverted to.

On a number of issues the observation was made that the pros and cons of the different options had not been sufficiently illustrated. This was the case of the discussion on quantities: why the initial franchisee fee should be small or large, the pros and cons of cash payments or instalments. Furthermore the different ways of structuring royalty payments should be considered, as royalties might sometimes be based on purchases and sometimes on sales. It was also suggested that the discussion on the nature of the franchise that was being granted be divided up, as the fees might be included in the supply of products.

On the subject of fees, the possibility of the initial fees being paid back if the franchise package was unsatisfactory was considered, as was the possibility of introducing a clause to change fixed franchise fees. It was pointed out that most franchisors would want to consider the money as non-repayable once it had been paid. If the franchisor did not deliver the services it was being paid for, it would be up to the sub-franchisor to sue the franchisor. As to the possibility of having a variable franchise fee, the author of the chapter indicated that he had never come across this possibility. Where there were products to be supplied over the whole period of the

agreement, a mechanism was always built into the agreement to permit the adjusting of the price of the products, but the franchise fee was usually a percentage of the revenues generated by the sub-franchisor's network. The agreement therefore had built into it a mechanism for overcoming problems that might arise through inflationary pressures. One question which presently was not dealt with in the chapter, but which the author proposed to add, related to visits by the franchisor. It was quite frequent to find that in return for the fee the franchisor would undertake to visit the territory a certain number of times per year, but that the franchisee would have to pay for additional visits. Similarly, it should be pointed out that the level of fees should reflect the cost of providing the on-going support services

With reference to the statements on page 85 that "[t]he sub-franchisor has to generate sufficient income to operate its business profitably after paying the continuing franchise fees to the franchisor" and that "[i]n many cases it is difficult to justify the payment of more than between ten and twenty percent of the sub-franchisor's income from the continuing franchise fees it receives from its sub-franchisees", it was observed that between ten and twenty percent was very low, considering that many franchisors insisted on 50%. It was therefore suggested that figures of 15 to 35% be given instead. The objection was however raised that that was very high, as it would be almost impossible for the sub-franchisor to make a living if a third of its gross revenue had to be given to the franchisor.

As regarded the discussion on the "Problems caused by Sales with Product Mark-Ups" on page 82, it was observed that the first paragraph really belonged under the general discussion on "Products Mark-Ups" on page 82, and that the second paragraph, which really had nothing to do with product sales with mark-ups as it was a general observation on the difficulty of deciding what a fee should be, should be moved to the very beginning of the chapter. There was need for a more thoughtful discussion of income, including an indication that there had to be sufficient income to cover people's costs, what the normal considerations for the setting of fees were, the consideration that the general observations were true in any setting, domestic and international, specifying any particular observations for the international setting. There should be a discussion of how most domestic franchisors in setting their international charges do so by using what they do domestically as a basis, and the question was how good a basis that was, whether or not it was a sensible basis and to what degree it was reflected in the charges set. It was felt that a general discussion of this nature at the beginning, before the individual analysis of particular breakdowns in fees, would be useful to the reader.

The question was raised whether franchisors who decided to expand abroad made their decisions on how much they would charge in fees on the basis of real budgets, on what the sub-franchisor and the sub-franchisees should produce as turnover. It was observed that the initial fee was often not calculated in this manner, whereas on-going fees were. The correctly operating international franchisor would start with the sub-franchisees, would consider the market of the sub-franchisee, what the sub-franchisee could charge, what the sub-franchisee could earn, what that would leave to be passed up to the sub-franchisor, how much the sub-franchisor had to receive to cover its costs, what the sub-franchisor would take to have a return on its investment and what would be left to be passed to the franchisor. The initial fee was to a large degree what the traffic would bear. In many cases the franchisor would ask the sub-franchisor to provide a market study to permit it to make the necessary evaluation.

It was pointed out that the chapter already stated that it was "necessary for the sub-franchisor carefully to prepare cash-flow and profit forecasts as part of its business plan so that it

is in the position to appreciate fully the impact of the payment of continuing franchise fees on its profitability". It was however observed that the question was not so much whether they prepared cash-flow and profit forecasts, but whether the assumptions underlying the preparation were based on realism. It was stressed that the guide should say to the franchisors and sub-franchisors reading the financial chapter and the obligations chapter, that for their success or failure it was fundamental that they had adequately costed business plans, that the specific percentage should be negotiated, but that the negotiation should start from a factual base that had clear assumptions that had been tested and costed.

There were clearly particular cases to be considered, such as that of countries in Asia and Latin America in which the bargain was struck on the basis of what would be allowed by the authorities as royalty or up-front payment. The authorities would often require a justification for the amount that was being charged. Their evaluation would frequently be based on how much that particular franchise would help the growth of the industry in the country, thus they might permit a higher up-front payment and royalty payments if, for example, there was a lack of technology or lack of expertise in the field concerned which would be provided by the franchise. It was however observed that the paragraph at the bottom of page 84 might cover that situation.

An issue of importance was furthermore that of the creation of a permanent establishment in the host country. Many franchisors would not want to create a permanent establishment as this would have fiscal and other consequences. Attention should therefore be drawn to the fact that there might be a risk that the franchisor would be deemed to have set up a permanent establishment even if that had not been the intention. In this connection the borderline between the franchisor simply obtaining the permits that would permit its staff to provide the sub-franchisor with assistance in setting up its network and the actual creation of a permanent establishment needed to be considered. It was suggested that a certain amount of attention should be devoted to the OECD treaty models concerning the setting up of a structure in another country and the repatriation of income via that structure.

As regards the taxation aspects, it was suggested that a paragraph or sentence should be added to page 87, to the effect that clearance with respect to foreign exchange and whatever else might be necessary to effect payments abroad in countries where currency restrictions were applicable was the responsibility of the sub-franchisor or franchisee. The wording of such a sentence might be "[p]ermission may be required under the laws of some countries for payment of franchise fees (lump sum) and royalty to the franchisor. The franchisee should normally be responsible for obtaining such permission". It was objected that the situation might vary from country to country and that it might therefore be more appropriate to draw attention to the issue but without stating clearly whose responsibility it was to obtain the necessary permissions.

In relation to currency a further issue that was brought up was that of the problems that might arise in view of the fact that the franchisor would want to be paid in its own currency whereas the payments made by the sub-franchisees to the sub-franchisor would be effected in the local currency, and in particular the problem of who stood the risk in such cases.

With reference to the section on Product Mark-Ups on page 82, it was suggested that the issue of fair pricing should be discussed not only in a good business sense, but also in a legal sense. Similarly, the fiscal and administrative aspects of advertising funds, which party's assets they were part of and under which fiscal regime they might fall, including questions of withholding tax, advertising allowances, rebates and so on, should be dealt with in the financial chapter as

opposed to the chapter on advertising which dealt with the non-financial aspects. It was therefore suggested that the last paragraph before the section "Advertising Alternatives" on page 123 should be moved to Chapter 5.

A question raised in connection with the chapter on advertising was which party should bear the responsibility of introducing a franchise into a target country. It was observed that there was no one single answer to this question, as it could not be said that this should always be the responsibility of either one of the parties. It was suggested that the guide should say that a prospective sub-franchisor should be prepared to accept the obligation of introducing the franchise unless the franchisor was willing to do so, and that the franchisor might not be willing to do so as the cost of doing so might far exceed any benefit the franchisor could get from a single country. It was pointed out that this fact had to be reflected in the financial issues as well, as the franchisor would be entitled to less money if it did nothing in terms of building the name, than if it were to make substantial investments in doing so.

A last editorial point concerned who should run the credit risk if the sub-franchisees did not pay the fees. This was touched upon on page 108, but it was suggested that it should be dealt with in terms of who assumed the risk.

## **CHAPTER 6**

As indicated in the report on the discussions on Chapter 3, it was decided to merge Chapters 3 and 6 under the title "Nature and Extent of Rights Granted and Relationship of the Parties". It was further decided that the contents of Chapter 6 should be inserted after the discussion on the grant of rights.

As to general terminology, it was agreed that rather than use "tripartite", which appeared to indicate that there were always three parties in the relationship, the term "three-tier" should be used, as this reflected reality. It was suggested that the guide should stick to the principle that the three-tier relationship was the usual structure which under certain circumstances it might be appropriate either to turn into a tripartite relationship or to consider a tripartite relationship.

The question of the relationship between the parties as regards questions of vicarious liability was examined. It was decided that the contractual aspects should be dealt with in Chapter 6, but that the actual examination of vicarious liability in the case of the three-tier relationship should be treated at greater length in Chapter 16, which would change title to "Liability, Indemnification and Insurance". It was decided that Mr Vernon would prepare the section on liability and send that to Mr Schulz for incorporation in Chapter 16. This should include a clear examination of the potential liability risk of the franchisor towards the sub-franchisees and the public, as well as the obligations of the parties vis-à-vis one another.

As regards the relationship between the parties in the three-tier master franchise relationship, it was suggested that the discussion on the question of whether the franchisor should have the right to intervene directly into the affairs of a sub-franchisee required considerably more detail and that the pros and cons should be dealt with more clearly.

In general the franchisor would not have direct contractual relationships with the sub-franchisees, although this was not universal. There were countries in which third party beneficiary contracts were not acceptable, but there were others in which they were. There were many

situations in which a franchisor would require a sub-franchisor to provide in the sub-franchise agreements that the franchisor is a third party beneficiary of the agreement between the sub-franchisor and its sub-franchisee specifically for the purpose of allowing the franchisor to step in and take action if the sub-franchisor dropped out of the picture. It was however observed that a distinction should be made between the situation where the sub-franchisor dropped out of the picture and that where the franchisor retained the right to intervene during the term of the agreement. The problem with the franchisor having a concurrent right was that it could enter the sub-franchisor's territory and create problems, even if in practice this was an option that almost never occurred internationally, considering the objective difficulties for a foreign franchisor to intervene. It was pointed out that the third party beneficiary issue was important also in the trademark section.

It was observed that the issue dealt with on pages 94 - 95 of "Several Sub-Franchisors in the Same Territory" was almost invisible in international franchising. The advisability of keeping a section dealing with it was therefore questioned. It was suggested that the treatment given to this issue should be modified to consider several sub-franchisors operating exclusive territories rather than non-exclusive territories within the same country.

It was felt that the issue of the different categories of wrongful advertising and of the liability for these categories (misleading, unethical, unfair, advertising by comparison, etc.) should also be considered in connection with questions of vicarious liability. The need for the franchisor to control the advertising to ensure that it was not false or misleading should be referred to.

On the larger question of liability, at national level franchisees often had the possibility to claim damages from a franchisor who did not sufficiently police defaulting franchisees harming the network. If the franchisor promised the franchisees to keep the network intact and working, and if it did not take the necessary steps against defaulting franchisees and the network as a consequence failed, the franchisees could claim damages. The question was whether a similar responsibility on the part of the franchisor existed also at international level. It was observed that in theory such a responsibility did exist, particularly in countries of close proximity. The fundamental question was to what degree a master licence in one country was affected by what the franchisor did in another country and this was not dealt with adequately. It was necessary to say that there were very few examples of such a cross-country responsibility, but that considering the increasing globalisation this would increasingly be the case.

## **CHAPTER 7**

It was agreed that the title of the chapter should be changed to "Obligations of the Franchisor". It was recalled that at the previous meeting consideration had been given to the possibility of either merging Chapters 7 and 8 or of merging Chapters 6, 7 and 8. A further proposal was made to merge Chapters 7, 8 and 9. The decision had now been taken to merge Chapters 3 and 6, but the proposal to merge Chapters 7 and 8 was still on the table. Consideration was given to the fact that to a certain extent the two chapters mirrored each other, a right of the franchisor mirroring an obligation of the sub-franchisor. In the end, the conclusion was reached that the chapters should stay separate, but that efforts should be made to ensure that the obligations that mirrored one another should be properly identified. A table of correspondences should therefore be prepared, in the first instance as a working document which would then be considered for inclusion in the guide. The proposal to merge Chapters 7, 8

and 9 was also discarded, in that it was felt desirable for each of the parties to a master franchise arrangement to be able to obtain the information from their own perspective.

It was observed that on page 102 this chapter had a section dealing with the supply of products and that this section was best placed in Chapter 11, which was entirely devoted to the supply of products or services. It was therefore decided that this section should be integrated in Chapter 11.

It was suggested that reference should be made in this chapter to the fees due to be paid to the franchisor, as it was not possible to consider, for example, initial training or follow-up training independently from fees. Furthermore, the level of the fees would to a certain extent depend on other obligations as well, such as who was responsible for the registration of the trademark.

As regarded the terminology used, objections were raised as to the excessive use of the verb "should" with reference to the contents of the contracts, as this seemed to indicate that if a contract did not specifically refer to that obligation, there was clearly something wrong with the contract or it was unenforceable in some way. The best example of this was the beginning of Chapter 7, which spoke of pre-contractual disclosure. A reader of this section would assume that there was a legal obligation of disclosure and that this obligation was pre-contractual. It was suggested that pre-contractual disclosure could instead be dealt with in Chapter 1, in connection with the discussion of the due diligence that should be exercised by the prospective sub-franchisors. Prefatory language might also be added to that chapter, describing pre-contractual disclosure and other obligations referred to as good practices, so as to avoid giving the impression that a legal obligation was involved. This applied also to statements such as the one according to which training programmes to keep the sub-franchisor up-to-date "should [...] be held at least once a year", which could cause serious problems: the needs of the different franchises varied and fundamentally there was no one correct answer as to the appropriate frequency of such matters as training programmes. Either one gave standards of good practices and indicated what the minimum and optimum standards were and that anything in between could be negotiated, or one merely addressed the issues that should be dealt with and then indicated that it was up to the parties to arrive at a contract. It was decided that the issues should be listed and discussed, but without a position being taken on any of them. The options available and the ramifications of these options should be given to the reader who should then be free to decide.

Statements to the effect that the franchisor should provide the sub-franchisor with all information that will allow it to adapt the foreign franchise system and that "[t]he franchisor should provide this information independently of whether it is an express requirement of the agreement", or references to "[o]ther information [...] which the agreement could expressly indicate as being a franchisor's duty to provide", were also considered to be dangerous and should therefore be scaled down. Similarly, statements to the effect that something was in the "best interest" of the franchisor should be modified to read that it was generally recognised that it was "in the best interest of the system".

Permanent techniques of communication between the franchisor and the sub-franchisor should also be considered, together with the possibility of setting up advisory councils of sub-franchisors at national or regional level. It was observed that although such councils were not often set up, there were a number of industries in which they were, such as the hotel industry.

As to the adaptation of the system, it was first and foremost necessary to decide who had primary responsibility to do market research and to adapt the franchise system to the requirements of the foreign country. It was observed that this responsibility lay primarily with the sub-franchisor, who however very often was limited in its possibility and ability to make the necessary adaptations as the franchisor frequently wanted there to be as little adaptation as possible and only as much as necessary.

There were in fact two closely related but distinct issues, the first being how much adaptation was to be made, the other, once a decision had been taken, who had the responsibility (and at whose expense) to make proposals for adaptation, who had to provide information on the local market and who had to make an estimate of how many units could be placed. In a domestic context the franchisor would know that these points came under its responsibility, whereas in an international context many of them would fall to the sub-franchisor. This also required discussion on who was to bear the burden once a decision had been taken in relation to the adaptations that were going to be made. It was felt that both of these issues required more extended treatment than they had been accorded in the present draft.

The question of the different types of manuals was also considered, in that only very rarely did the franchisor provide the sub-franchisor with a manual illustrating what was required of it in its capacity as franchisor. This was considered to be a gap, in that it was felt that at least a guidance manual should be provided.

It was further suggested that the section on page 104 entitled "Remedies for Non-Performance by Franchisor" should be taken out of this chapter and its substance dealt with instead in the chapter on remedies for non-performance.

In summary, the more personal recommendations made by the author should be eliminated and more neutral language adopted; in the stressing of the different interests involved and of the tension that existed between these interests, what should not be forgotten was that the sub-franchisor bought a franchise system, that the natural interest of the franchisor was to keep the system as identical as possible throughout the world, whereas the natural interest of the sub-franchisor was to obtain as many possibilities as possible to earn in its own country. This tension should be discussed slightly more at length at the beginning of the chapter and then the other points should be discussed with pros and cons and less recommendations. It was suggested that for the benefit of users from developing countries and economies in transition, as many issues as possible should be raised so as to provide the negotiators from those countries with an indication of what needed to be taken up in the negotiations.

## **CHAPTER 8**

The title of Chapter 8 was modified to read "Obligations of the Sub-Franchisor".

As was the case with the section on the supply of products to be found in Chapter 7, it was decided that the sections dealing with this in Chapter 8 should also be moved to Chapter 11. Similarly the discussion on territory should be located in Chapter 3 and not Chapter 8.



Although the treatment of the development schedule in this chapter was more extensive than the placing of the sub-titles indicated, a fuller treatment of the development schedule was still considered to be desirable, even if devoting a separate chapter to it was not considered to be justified. In this connection the consequences of the failure of the sub-franchisor to meet the development schedule, presently dealt with in Chapter 18, was also considered.

It was decided that a reference to the three-tier relationship of master franchise arrangements, with a reference to Chapter 6 (now part of the new Chapter 2), should also be made.

The chapter on manuals was to be divided into two separate parts, the one dealing with manuals as a vehicle to transmit know-how being absorbed into Chapter 8 and the part dealing with manuals as a vehicle for system changes being absorbed into Chapter 14 on system changes.

As indicated in the report on the discussion on Chapter 7, Chapters 7 and 8 should to a large extent be mirror images of each other and efforts should be made to ensure this.

The obligation of the sub-franchisor to administer the advertising fund in a certain manner should also be dealt with in this chapter rather than the chapter on advertising.

Lastly, it was observed that there was a large chapter on the obligations of the franchisor and that these obligations were to a considerable extent obligations vis-à-vis the sub-franchisor, but that the consequences of the franchisor not fulfilling its obligations and the remedies available to the sub-franchisor were not stated. It was suggested that it might be stressed that both parties should have similar rights, and that this might be done also in the chapters dealing with remedies for non-performance and the end of the relationship and its consequences.

## **CHAPTER 9**

It was suggested that the chapter on the unit agreement should mention the three-tier structure of the master franchise arrangement, and refer also to the new Chapter 2.

It was observed that the introductory part was misleading, in that the sub-franchise agreement was the tool by which the franchisor controlled the ultimate way in which the system was used, and it was only in the last paragraph of the first page of the chapter that that problem was dealt with.

It was objected that an introduction to the subject was necessary and that the fundamental question facing a franchisor when entering into the arrangement was the degree to which it was going to vest the sub-franchisor with discretion as to how it handled the marketing of the system with the sub-franchisees. It was felt that a basic discussion on this point should be left in the chapter. It was observed that it was not possible to say that the sub-franchisor must run a system that was identical with the system developed in the country of origin of the franchisor, as adaptations might be necessary and this possibility had to be covered. The phrasing should therefore be adapted accordingly.

Criteria for the selection of the sub-franchisees by the sub-franchisor appeared at page 113 and it was observed that this was the only place in the guide in which such criteria were

mentioned. If the franchisor imposed certain criteria for the selection of the sub-franchisees, then perhaps it was justified to include the criteria under the obligations of the sub-franchisor. There was a range of possible interference on the part of the franchisor, as some franchisors would not establish any criteria and would leave the selection of the sub-franchisees totally to the sub-franchisor, whereas others would be very precise in the criteria they laid down and this should perhaps be reflected. In fact it did not happen very often that precise criteria were laid down, in most cases the required personal qualities of the prospective sub-franchisees were given in very general terms. In this connection it was observed that, as mentioned on page 105, many agreements might provide that the franchisor had a right to approve sub-franchisees, or a right to approve leased locations, and it was disputable whether these were legitimate rights.

The issue of the communication between the sub-franchisor and its sub-franchisees, and the techniques adopted for this permanent communication, should also be dealt with in a short paragraph of this chapter.

A lengthy discussion was held on the question of whether the section in Chapter 9 dealing with choice of law and choice of forum should be deleted, considering the presence of chapters which specifically dealt with these issues, and considering also the fact that the unit agreement was a domestic agreement and that therefore no choice of law problems should be involved. It was however observed that this was not necessarily the case, as there might be multi-country master franchise arrangements in which a master franchise covered more than one country, and conflicts situations might furthermore exist in federal states. Although the legal problems involved were the same, the economic situation was different, for which reason it might be better to keep the section in this chapter. On the other hand, as the legal principles involved in regulating the conflicts situation were the same, it might be more appropriate to deal with these questions only in the chapters specifically on choice of law and choice of forum. In the end, it was decided that the section should stay in the chapter and that a decision as to its placing should be taken once the final draft had been prepared.

## **CHAPTER 10**

A first point raised in connection with the chapter on advertising was which party should bear the responsibility of introducing a franchise in a target country, who should advertise a company that intended to enter the country. It was observed that there was no one single answer to this question, as it could not be said that this should always be the responsibility of either one of the parties. It was suggested that the guide should say that a prospective sub-franchisor should be prepared to accept the obligation of introducing the franchise unless the franchisor was willing to do so, and that the franchisor might not be willing to do so as the cost of doing so might far exceed any benefit the franchisor could get from a single country. It was pointed out that this fact had to be reflected in the financial issues as well, as the franchisor would be entitled to less money if it did nothing in terms of building the name, than if it were to make substantial investments in doing so.

A criticism levied against Chapter 10 was that the last paragraph spoke of the case where there was more than one sub-franchisor in the same territory, which was extremely rare. While it was recognised that the section should be kept, also in view of the fact that where there was more than one sub-franchisor in the same country each of them had a far greater responsibility for the advertising, it was suggested that it needed more careful treatment. The situation

considered was not where there were non-exclusive territories, but where there were exclusive territories and there were some issues where notwithstanding the fact that there were exclusive territories there was seepage between the two and advertising was an example of this. Much more detail was required if this issue was to be dealt with here, such as how adjoining sub-franchisors, even when located in different countries, might affect each other.

A dimension which was not treated adequately in this chapter was furthermore what could be termed the cultural dimension. The language dimension was dealt with, but not the cultural dimension which was equally important.

The title of the chapter referred also to the control of advertising and it was felt that this issue had to be further developed. There were essentially two reasons for a franchisor to want to keep control. In the first place the franchisor would want to keep its system as uniform as possible so that all the outlets reflected the same system; secondly the franchisor would want to avoid any misleading advertising on the part of either the sub-franchisor or the sub-franchisees, as it might be held liable for that misleading advertising. Clearly, misleading advertising should also be avoided when the system was first introduced into the country. These two reasons were not spelled out with sufficient clarity.

It was pointed out that the issue of advertising allowances as a source of revenue should be examined in the chapter on financial matters, whereas the chapter on advertising should be an operational chapter dealing with why the franchisor would want control over the advertising, the methods of control used, how unfair advertising may be avoided, what kind of approval processes were used, what sort of material would be provided by the franchisor to the franchisee and so on.

It was decided that the last section before "Advertising Alternatives" on page 123 should be moved to the financial chapter. Furthermore, the subject of international advertising funds that are managed exclusively by the franchisor should be discussed. Regional funds were mentioned, but in terms of a domestic region, rather than in terms of an international region and this should be remedied.

Lastly, the discussion on the different kinds of advertising that are prohibited by law (misleading, unethical, unfair, advertising by comparison, etc.) should also be referred to here, even if the in-depth discussion should be placed in the chapter dealing with liability.

In summary, the fact that the guide dealt with master franchise relationships and not with unit franchise relationship should be reflected throughout; a discussion should be included at the beginning of the chapter of the fact that the parties should consider who should bear the responsibility for building up consumer recognition for a system which was not well-known in the target country even though it was well-known in the host country; the discussion of translations should be broadened to make clear that in addition to purely linguistic translation there was a need for what could be called "cultural translation"; an explanation should be inserted to the effect that one of the reasons for the franchisor to control advertising was to avoid misleading advertising; and as regards the last paragraph on page 125, it was to be made clear that it did not refer to non-exclusive territories, but rather to sub-franchisors in separate exclusive territories, that these could have an impact upon one another and that advertising structures must be produced to deal with situations in which advertising in one area had an impact in another area.

## CHAPTER 11

It was observed that this chapter, as several others, dealt essentially with the relations between the franchisor and the franchisee in a domestic situation and not with relations between the franchisor and sub-franchisor in an international situation. This should therefore be corrected.

The question of whether this chapter dealt with the supply of the equipment necessary to use the franchise as well as the supply of products and services was raised. As this was considered to be the case, it was decided to change the title to "Supply of Equipment and other Products", also in view of the fact that services offered by the franchisor or sub-franchisor were considered to be part of the obligations of the party concerned and should therefore be dealt with in the appropriate chapters.

A general observation was that the supply of products was dealt with in numerous places in the guide and should perhaps be consolidated in one place only, typically the chapter specifically devoted to the supply of products. The sections in the Introduction and in Chapters 7 and 8 in particular should therefore be moved thereto.

An issue that was dealt with, but perhaps not in sufficient detail, was that of commissions, of advertising allowances. Furthermore, they were dealt with from a domestic perspective rather than from an international perspective. The pros and cons of advertising allowances, of volume rebates, of volume discounts should be illustrated, and an indication of who would get the benefit provided. It was agreed that this issue should be dealt with in detail in Chapter 5, whereas this chapter should raise the issue, contain a limited discussion and refer back to Chapter 5. Advertising allowances should also be considered in this connection, even if they should also be referred to in the chapter on financial matters.

It was suggested that a distinction should be drawn between different types of franchise systems. There were franchise systems that were based on the supply of products, such as Pro Nuptia, while in the case of others the supply of products was incidental. This fact caused certain doubts to be expressed with reference to the sentence "[...] if the franchisor supplies the products, this may ensure not only that the products are available, but also that the price that is charged for them is reasonable." It was further suggested that a discussion should be included to the effect that although the supply of products was typical domestically, it might not be so internationally, and an explanation of how it might differ provided. The discussion that the chapter already contained, which indicated that there were franchise arrangements in which the supply of products was important and in which the products were delivered cross-border, should remain, even if placed in perspective.

A discrepancy between the content of Chapters 11 and 5 was noted as regards product mark-ups, in that Chapter 11 stated that "[...] if the franchisor supplies the products, this may ensure not only that the products that are available, but also that the price that is charged for them is reasonable and one that the franchisees can afford to pay" whereas Chapter 5 stated that "[i]t is necessary to ensure the sub-franchisee is protected against unreasonable price increases which would affect its ability to operate with sufficient profitability".

It was observed that a more comprehensive treatment of the legal aspects of supplying products, equipment, supplies and services in cross-border transactions was necessary. There was for example no reference to pricing, whereas that was important for prospective sub-franchisors.

It was recalled that when the contents of the guide had first been discussed, the Group had considered the possibility of having a chapter on anti-trust. At the time, those against having such a chapter had objected on the grounds that in many countries anti-trust was a foreign notion and these countries consequently had no anti-trust legislation. It had further been suggested that if anti-trust were dealt to be with, then a discussion of exclusivity (territorial exclusivity, exclusivity in pricing, etc.) would also have to be included and these were already dealt with in other chapters of the guide. The decision that had been taken was not to group all these issues together in a single chapter, but rather to deal with the issues as and when they were relevant to the subject-matters of the individual chapters. In line with this decision, it was felt that a more comprehensive treatment of antitrust law needed to be offered in Chapter 11. A general discussion should however be inserted in the Annex dealing with legislation relevant for franchising.

As regards other legislation relevant for this chapter, it was suggested that the *United Nations Convention on Contracts for the International Sale of Goods* should be dealt with in greater detail. At present it was mentioned in only one sentence and considering the state of knowledge of the convention among lawyers generally, more details were felt to be required.

## CHAPTER 12

The title of the chapter, which at the previous session of the Group had been agreed should read "Rights created by Statute", was considered to be unsatisfactory in that it did not adequately reflect the content of the chapter. It was therefore decided to change the title to "Intellectual Property".

The relationship between Chapter 12 and Chapter 13, which dealt with know-how, was discussed. In essence, Chapter 12 dealt with what in some jurisdictions were called "proprietary rights", such as patents and trademarks, which were protected by statute, whereas Chapter 13 dealt with rights that were not protected by statute. It was observed that presently copyright was not dealt with in Chapter 12, and that this omission should be remedied. Similarly, other rights that played a role in franchising, such as design rights, should also be considered.

In this connection the different registration possibilities might usefully be mentioned. Thus, in addition to national registration, international registration under for example the WIPO system or, in the case of copyright, under the European Community system, ought to be referred to. Clearly, the importance of having the trademark registered, and the possible consequences if it were not, should be stressed, a simple reference to infringement proceedings not being considered sufficient. The question here was who assumed the risks that flowed from the lack of a registered trademark.

It was felt that in this connection the issue of changes to the trademark or trade name should be considered, both for the case in which it was the franchisor that introduced the changes and for the case in which the sub-franchisor wished to introduce changes as, for example, it was not possible for the trade name to be used in that particular country. In this case a question of compensation might also arise. Thus, for example, if it was not possible for the system to use the name because the franchisor failed to register, then the sub-franchisor and the members of the system might ask the franchisor for compensation for the cost of changing the name, of re-badging and so on. For cases in which it was the franchisor who wished to introduce changes, the possibility of limitations in the right of the franchisor to do so should be considered. There were situations in which a sub-franchisor or franchisee would not have bought the franchise if it had known that it would not be able to use the name and in which it would feel that it was not adequate for it to receive compensation for having to change trade name. Clauses under which the franchisor was able to force franchisees to introduce changes were drafted constantly, although the problem with such clauses might be one of enforcement. Whether or not such a right was enforceable would depend on the law in the country in which one tried to enforce it. It was therefore not possible to take a position on this issue, even if the issue had to be aired. In the end it was decided that the issue should be raised, so as to tell both parties that in the case of a rejection of a registration, or if the franchisor later wished to change some of the fundamentals, the sub-franchisor might have to go along with those changes. To a certain extent this latter point was touched upon in the chapter on system changes, but the chapter on intellectual property should deal with it.

Connected with this case was that in which it was discovered after the trademark had been in use for some time, that someone else had prior rights. How situations like this were dealt with in the agreement should also be discussed in the chapter.

In essence, three points needed to be specified. First, that the agreement had to contain indications on how the consequences of an infringement, when it was not possible to use the mark, should be handled. Secondly, the contract had to deal with the consequences of an unsuccessful attempt to have the trademark registered. Thirdly, the agreement should contain a provision dealing with the consequences of the franchisor seeking to make changes in the franchise because of the changing conditions of the market place.

It was suggested that the issue of the third party beneficiary, which was and should be considered also in relation to trademarks, might furthermore be discussed in the chapter on ancillary documents, as if there was a separate trademark licence agreement the responsibility for the trademark, and for its safeguarding for the benefit of the network, would lie directly with the trademark owner, namely the franchisor.

Lastly, the need or opportuneness of dealing more extensively with the international regulation of intellectual property was considered. This did pose certain problems in view of the complexity of the systems, but the group felt that even if the international conventions were not dealt with in depth, they should be afforded a certain amount of treatment.

In summary, it was decided that in addition to what it presently covered, Chapter 12 should cover also warranty provisions, copyright, passing off and registration procedures generally, and should refer to the relevant international conventions.

## CHAPTER 13

As had been the case with Chapter 12, Chapter 13 had been given a title that the Group now felt did not reflect its content (“Rights Protected by Contract”). It was therefore decided to change the title to “Know-How and Trade Secrets”.

A general observation was that the chapter was too long and at times academic in style. There were several sections which could be considerably shortened, in particular the opening discussion on the theoretical differences between know-how and trade secrets and confidential information. There was, for example, a lengthy discussion of the *Trade-Related Aspects of Intellectual Property Rights Agreement (TRIPS)* signed in Marrakesh in 1994, which might be shortened. It was objected that the TRIPS Agreement was probably the most important piece of international legislation dealing with know-how and trademarks and was destined to be the future legal foundation of the protection of know-how. It was therefore accepted that a consideration of the TRIPS Agreement might remain, but that it should be shortened.

As regards confidential information, it was observed that the chapter touched upon different matters that were normally excised from confidential information and that this should be elaborated upon. This was the case, for example, with information that was commonly in the public domain. Restrictive covenants and non-competition clauses should furthermore be discussed at greater length. These were areas of the agreement that were usually made applicable to other parties. Thus, in the case of a corporate sub-franchisor, these obligations might be extended to officers, directors and key employees. In many instances this might call for a separate agreement directly between with these officials and employees and the franchisor. It was pointed out that the separate agreement situation was dealt with on pages 223 and 224 in the chapter on ancillary documents. It was therefore concluded that what was necessary in Chapter 13 was a reference to that chapter.

The question of the length of time such a confidentiality obligation lasted was raised. Confidentiality obligations normally did not end with the end of the agreement. If confidential information had been received it would therefore not be possible for that confidential information to be disclosed when the contract had expired. An issue which had to be considered was what the situation would be if the information that was covered by the confidentiality obligation became public knowledge, as a rather contradictory situation might arise in which outsiders were free to use and spread the information as they pleased because it was common knowledge, whereas those connected with the franchise were not, as they were bound by the confidentiality agreement. This would be the case even if the information had become public knowledge through no fault of the sub-franchisor/franchisee or their dependants.

The discussion on covenants not to compete was considered to be very important, both as regards in-term and post-term covenants. The difference between the domestic situation, in which the typical person issued with a franchise was someone who was entering the business for the first time and might not know much about it, and the international situation, in which the person likely to be granted a franchise was one who already had franchises in the same or a similar business, was noted. The situations were quite different and this should be reflected in the guide. It was suggested that a paragraph might be added to the effect that it should be noted that in international franchising practices might differ significantly for the reasons stated and that this might lead the parties themselves to restrict the scope of covenants against competition, or might in some cases cast some doubts on their enforceability.

The relationship between Chapters 13 and 22 and the way these two chapters should deal with confidentiality agreements and non-competition clauses was considered. In substance, Chapter 13 should deal with the legal substance of the issues that arose, such as legal enforceability, whereas Chapter 22 should inform its readers of the issues they had to keep in mind. Thus, for example, Chapter 22 would discuss the desirability of having the non-competition agreement signed by key officials considering that there was no purpose binding an entity with a non-competition agreement unless the officers were also bound. Chapter 13 on the other hand would consider what made the agreement enforceable.

It was furthermore observed that the chapter referred to the “transfer of know-how”, whereas in actual fact the know-how was not transferred but licensed. It was therefore suggested that the terminology should be changed, as there was considerable difference between communicating the information that someone was licensed to use, and transferring it. The fact that the know-how was recorded in the manuals should also be mentioned.

The difference between assignment and licensing should be highlighted, as in many cases the people who would be taking on a franchise would be people who came from other disciplines and would not be familiar with the significant difference between assignment and licensing.

Similarly, the formulation of the sentence at the top of page 147 regarding copyright should be changed, as copyright did not protect the ideas, but only the way in which they were expressed. It was therefore not correct to say that copyright became an important means to protect the franchisor’s know-how.

As regards legal remedies, it was noted that whereas Chapter 13 had a section dealing specifically with legal remedies, Chapter 12 did not. It was suggested that the two chapters should have a similar structure, and that therefore a legal remedies section should be added to Chapter 12. It was however observed that the different characteristics of intellectual property, which was protected by statute, and know-how which was not, justified a certain difference in treatment. Know-how was not a patent that could be defended against all and sundry, it was not a trademark, it was not a registered design. Contractual protection was therefore still of great importance for know-how. It was consequently not necessary to expand upon the protection of trademarks, as what was necessary was specified in the statutes concerned. More explanations were instead required for know-how. It was pointed out that a remedy that had not been dealt with, and which should be dealt with, was passing off, which in continental legal systems was covered by the concept of unfair competition.

The possibility of including in Chapter 13 a reference to penalty and liquidated damages clauses and the circumstances in which their use might be justified was considered. It was however concluded that Chapter 13 was not the appropriate place, but that such a reference should instead be included in Chapter 16.

## **CHAPTER 14**

A general observation on this chapter was that it related more to the unit agreement than to the international master agreement and that this should be remedied.



Considering the important role of manuals in the introduction of changes to the system, it was decided that the part of Chapter 15 that dealt with manuals as a vehicle for change should be merged with Chapter 14, whereas the remaining general consideration of manuals as a vehicle for the transmission of information should be inserted in Chapter 7. The focus of Chapter 14 was the consideration of how change took place in a system, why it was important, why the reader should be aware of it and the ways in which franchisors sought to introduce changes into a system, independently of whether these changes originated externally to the system or from within the system.

A discussion of the contents, and consequently of the purpose, of the chapter brought forth the observation that it dealt with everything imaginable, whereas according to one member of the Group the chapter should be limited to a discussion of the extent to which changes had to be made, independently of whether they were initiated by the franchisor or by the sub-franchisor. Opinions were divided on the type of clause that might be inserted in franchise agreements, on whether or not those described belonged in a chapter that dealt with system changes. This was the case with escape clauses, with clauses by which the franchisor reserved a right to scale-down a non-competition covenant, or by which the franchisor was permitted to cease selling products to the franchisees if and when alternative sources of supply had become available to them at competitive prices, for example buy-back provisions. It was observed that while these were changes, they were not actually system changes: system changes regarded the operational aspect of the arrangement, not the contractual aspect. In the end it was decided that the content of the chapter should be limited more to true system changes.

Section 4 on pages 154 to 155, which referred to the changes that might have to be made to internationalise the system, was furthermore considered not to belong in Chapter 14, as this chapter referred to the changes that might be made in the course of the agreement, whereas Section 4 referred to the changes that were necessary at the beginning, when the system was first adapted to a particular international situation, and this was already to some extent dealt with in the opening chapter. Section 4 should therefore be deleted in Chapter 14 and its contents be integrated in Chapter 1. Another section that might be moved from Chapter 14 to Chapter 1 was that on "Changes of Particular Significance in the International Context" on pages 168 to 170. Again, this section had nothing to do with changes made during the lifetime of the agreement, it referred to adaptations made at the beginning.

In this connection it was observed that as parts of the present Chapter 2, which dealt with the negotiation and drafting of international master franchise agreements, were going to be placed in a new chapter on "Generally used Clauses" towards the end of the guide, some of the issues dealt with in Chapter 14 might be moved to this new chapter. It was therefore decided that Section 6 ("Other Drafting Techniques") on pages 166 and 167 should be moved to the new chapter on "Generally used Clauses".

A topic of importance which it was observed was not dealt with sufficiently, was that of sub-franchisor driven changes. While it was recognised that in many cases the changes proposed by the sub-franchisor in actual fact originated with the sub-franchisees, it was the sub-franchisor who made the proposals for change to the franchisor and who would be entrusted with the implementation of any changes. The section on page 118 entitled "System Improvements by Sub-Franchisees" was referred to, although it was pointed out that it should be re-phrased to take into account the fact that the sub-franchisees did not actually make any system improvements themselves, but proposed such changes to the sub-franchisor who in turn approached the

franchisor. It was considered appropriate for the chapter to include such a section, as a sub-franchisee who read the guide would need to understand how the master franchise system was structured and how any contribution it made could impact on the system. It was further agreed that a full section on sub-franchisor driven changes should be added. A considerable elaboration of what was now a two-sentence paragraph on page 154 was needed.

In this connection it was suggested that a distinction might be made between changes that were caused by cultural differences, market conditions and the like, which usually required the consent of the franchisor, and those that were caused by changes in legislation, which might not require the consent of the franchisor although some franchisors would include a clause in their agreement a clause to the effect that they wanted to approve also any such change. In relation to changes initiated by the sub-franchisor the crux was in fact whether or not the franchisor could unilaterally withhold its consent or whether it had to act reasonably.

In summary, it was decided that the portion of Chapter 15 on Manuals that related to the use of manuals as an instrument to effectuate change would be incorporated in Chapter 14; that throughout the chapter an effort would be made to tailor it more to international master licensing; that the discussion on pages 154 and 155 called "Internationalising the Franchise System" would be removed, its content being covered by Chapter 1; that the discussion on pages 168 - 170 called "Changes of Particular Significance in the International Context" would be moved to Chapter 1; that the discussion on pages 166 and 167 called "Other Drafting Techniques" should be moved to the new chapter on "Generally used Clauses" and that at the end of the second paragraph on page 154 a reference should be made to the discussion on page 118 on sub-franchisee initiated changes. There would further be an expansion of the discussion in the next paragraph, the last sentence before the heading number 4, so as to consider the possible role of sub-franchisors in initiating or proposing to initiate changes in more detail.

## CHAPTER 15

As indicated in the report on the discussions on Chapter 14, it was decided that the part of Chapter 15 that dealt with manuals as a vehicle for change should be merged with Chapter 14, whereas the remaining general consideration of manuals as a vehicle for the transmission of information should be inserted in Chapter 7, as it would be appropriate to indicate in that chapter the manner in which franchisors communicate information to sub-franchisors or sub-franchisees. A reference should furthermore be made in the chapter on know-how to the fact that the know-how is recorded in manuals.

## CHAPTER 16

A general observation on this chapter was that it was necessary to introduce sub-headings throughout. It was also decided that the chapter should be placed after the chapter on "Sale, Assignment or Transfer of Rights".

It was suggested that the three-tier structure of master franchise arrangements should be recognised also for insurance and indemnification purposes: different people had to be indemnified and there might be different people for the named insurance.

The issue of vicarious liability was discussed also in connection with Chapter 16. It was suggested that although it should be considered in the context of the three-tier relationship of master franchise arrangements, it was perhaps best fully discussed in the chapter which dealt with insurance and indemnification. There was general agreement that the issue of vicarious liability should be discussed at considerably greater length than it was at present. A fundamental question for the readers of the guide was what the situation was in franchising as regards liability or the rights of a third party. In the end it was decided that Chapter 3 should contain a reference to the question of liability to increase the understanding of the extent of the rights granted, with a cross-reference to the full discussion of liability issues in Chapter 16. A first section specifically on liability should therefore be added to this chapter. It was decided that Mr Vernon should take on the drafting of this particular section and then pass it to Mr Schulz for inclusion in Chapter 16. The title of the chapter would consequently change to "Liability, Insurance and Indemnification".

As regarded insurance, it was observed that although the issues of the kind of insurance that was going to be required, who would pay for it and who would indemnify whom for doing what, were felt to be important to prospective sub-franchisors and should therefore be dealt with adequately in the chapter, their present treatment might usefully be condensed. An introduction explaining why insurance was an issue could also usefully be added. It was however observed that one point which should be elaborated upon was the fact that in certain countries it was not usual to take out insurance cover for third party liability risks, which could cause problems as there was the risk that third parties, such as the clients of the sub-franchisees, might bring an action directly against the franchisor. In certain countries there was tremendous opposition to taking out insurance, but the franchisor might be sued in the United States or Canada where vicarious liability was more established. It was felt to be necessary to explain why these matters were so important.

It was also suggested that certain issues should be removed from the section on indemnification, including the possible liability of the sub-franchisor vis-à-vis the franchisor for

accidents which happened as a consequence of a legitimate use of the franchise. An example of such an event would be if a recipe of the franchisor used poison, the recipe was used correctly and a client died. The sub-franchisor should in other words not be asked to indemnify the franchisor if the franchisor was sued as a consequence of the legitimate use of the trademarks, or of the franchise system, by the sub-franchisor. The situation where on the other hand it was the sub-franchisor who was required to indemnify the franchisor was not usually left as broad as was indicated in the present chapter. It should furthermore be stressed that it was very important for the franchisor and sub-franchisor to examine their own insurance policies in detail to make sure that the indemnification provisions in their contracts did not go beyond what the insurance policy covered. There was further normally a provision asking the sub-franchisor not to make any representations and warranties with regard to any product that he sold going beyond those given by the franchisor.

An important omission in this chapter was a consideration of the legal remedies available to the sub-franchisor. The only consideration of this question was in two paragraphs on pages 190 - 191. The message that came across was that the sub-franchisor had no rights, which was clearly the wrong message and was also inaccurate. While there were differences between a franchisor/franchisee relationship and a franchisor/sub-franchisor relationship, many of the issues involved applied to both relationships. This was the case when, for example, the franchisor entered the sub-franchisor's territory and granted rights to other people, or if the franchisor entered, started to sell products or services through a different channel of distribution and injured the rights of the sub-franchisor, or if the franchisor placed an obligation on the sub-franchisor to purchase products which was inconsistent with the non-competition laws. It was therefore suggested that the section on the remedies available to the sub-franchisor should be enlarged upon considerably.

Lastly, it was decided that Chapter 16 should contain a reference to penalty and liquidated damages clauses and to the circumstances in which their use might be justified.

## **CHAPTER 17**

The name of the chapter was changed to "Sale, Assignment and Transfer", so as to ensure that it did not merely deal with rights. It was decided that sub-headings should be introduced wherever possible. The location of the chapter was furthermore changed, with the consequence that Chapter 17 would be followed by Chapter 16 which in turn would be followed by what presently was Chapter 18.

A general observation on Chapter 17 was that it dealt extensively with sale, assignment or transfer of the rights of franchisees as opposed to those of sub-franchisors. Again, as the emphasis of the guide was on master franchise agreements, this should be remedied.

It was suggested that this chapter did not adequately reflect the realities of life in the international market place. It did not recognise the much greater sophistication of the parties that was likely to characterise an international master franchise or sub-franchise arrangement as compared with a domestic sub-franchise arrangement. Furthermore the care taken with an international transfer clause was far greater, not the least because in an international master franchise arrangement a totally different level of investment and resource was involved. It was observed that in an international arrangement it might be more appropriate not to go into all the

details of different conditions of consent that might commonly be specified in the case of domestic arrangements, but instead merely state that a transfer was not possible without the consent of the franchisor, who however should not withhold its consent unreasonably. It was further pointed out that there was far less likelihood that a franchisor would in fact exercise, or be willing to exercise, the right of first refusal, because it was not likely to want to step into the shoes of someone thousands of miles away.

It was observed that one point which required more elaboration was that which presently was rendered by the sentence “[a] transfer caused by the insolvency or bankruptcy of the franchisee may be subject to different rules or procedures than a transfer that is completely voluntary” (page 184).

A last question to be raised concerned what happened when the franchisor or sub-franchisor changed legal personality. In recent times it had happened in particular in East European countries that a franchisor, who was not a company, incorporated, or that it changed from being one type of company to another. It was pointed out that in these cases there was also a problem of succession of rights. There could also be a problem where there was a privatisation and there was a statute that effected the privatisation, that actually transferred the rights and vested them, as the contract might not be able to over-ride this. It was suggested that this question might be dealt with by a sentence such as “special circumstances, given changes in the political world, may dictate special treatment. For example, emerging societies may have situations in which wholly or partially State-owned enterprises, which originally received franchises, are privatised and this may require special treatment in the contract”.

## **CHAPTER 18**

A general discussion was held on the relationship between Chapters 18 and 19, on the possibility of either merging the chapters or dividing their content differently. One suggestion was to limit Chapter 18 to remedies short of termination and to deal with both termination and the consequences of termination in Chapter 19. It was objected that the logic of the present division was to discuss in one chapter all the remedies, both those short of termination and termination, that are available in the case of non-performance of the other party, and to consider the end of the relationship and its consequences, independently of whether the end was due to the expiration of the agreement or to termination, in the other. In the end, it was decided to keep the present division of the content of these two chapters.

It was pointed out that the chapter contained no discussion on the legal limitations on the right to terminate. The chapter thus appeared to imply that whatever was laid down in the contract by the parties was all right, which was not true. There was legislation which caused certain consequences to flow from termination, including the payment of compensation, and this ought to be considered in the chapter. As the payment of compensation was a consequence of termination, it was observed that that should be dealt with in Chapter 19.

It was stressed that the development schedule and the inability of the sub-franchisor to meet the development schedule needed to be elaborated upon. As it stood, although the chapter listed the consequences, it did not actually deal with how one arrived at the development schedule, the factors that should be taken into account when establishing it, what was involved in a development schedule, whether it was a minimum development schedule or a goal, and the

consequences of a failure to comply with the development schedule. It was felt that this needed to be elaborated upon.

In this connection it was observed that the heading of the section dealing with the development schedule had been moved, that the chapter actually contained more on the development schedule than appeared to be the case. Despite this the contents of the chapter was felt to be insufficient. While it was agreed that more detail on the development schedule was required, it was however not considered to require a chapter of its own. It was suggested that the chapter on the obligations of the sub-franchisor should contain a section dealing with the development schedule, as compliance with the development schedule was one of the most important obligations of the sub-franchisor.

The imbalance between the grounds upon which franchisors could terminate and those upon which the sub-franchisor could terminate was noted. It was observed that there were fewer grounds for termination by the sub-franchisor because there were fewer obligations to be met. Reporting and payment obligations flowed from the sub-franchisor to the franchisor and therefore a breach of these obligations caused termination. There were no payment obligations that flowed the other way, so the list was inevitably going to be shorter. It was observed that it would not be desirable to have a long list weighted to one of the parties only, a certain balance should be striven for. As it was not possible to have a proper balance between the grounds for termination available to the two parties, it was suggested that at least graphically the imbalance be eliminated by putting what presently was in the form of bullet points into the text itself. It was however observed that what could be done was to explain why there was no parallel between the grounds for termination available to the franchisor and the sub-franchisor.

It was observed that it was also necessary to deal with the consequences of termination when it was the sub-franchisor who terminated, especially in the event of bankruptcy. Similarly the consequences that flowed from the normal expiration of the term should be covered. There were thus three sets of consequences that should be dealt with, which differed to a certain extent. As regards the consequences of termination, there had to be a much more in-depth analysis and discussion of what happened to sub-franchisees. The chapter spoke of assignment, but did not deal with the consequences of assignment, with whether there was mandatory assignment, with whether the franchisor could select the unit franchises it wanted to have assigned to it, or with whether the franchisor picked up the liabilities of the sub-franchisor. A distinction had to be made between the rights the sub-franchisor had short of termination, damages or specific performance. A further distinction needed to be made between bankruptcy and other grounds for termination, including also a discussion on whether in a bankruptcy situation the sub-franchisor should have the right to acquire the franchisor's trademarks and system for that particular country.

As regards the rights of renewal and the terms of the master-franchise and sub-franchise agreements, it was observed that there were three possibilities: either the sub-franchisor or sub-franchisee had not renewed because it did not want to, or the renewal had been denied because the it was in default, or there was no renewal provision at all. The consequences in these three cases differed. It was suggested that the master agreement should continue in effect until the expiration of the term of the last individual unit agreement but for the unit agreements only, that as long as the sub-franchisor continued to fulfil its obligations it should have the benefit of the royalties. A problem would arise in the case where the sub-franchisees had a right to renew their contract, as the sub-franchisor should have the corresponding right to renew those sub-franchise

agreements even if its own master franchise agreement had expired and was not renewable. The terms of the unit franchise agreement had to be phrased very carefully to avoid that any perpetual rights were granted the sub-franchisor. The risk was that a twenty-year agreement in fact turned into an agreement of twenty years plus the number of years for which the last sub-franchise agreement had been granted and for which it could be renewed, but as the sub-franchisor would not be as interested in the development of the area as would be desirable in view of the fact that its own agreement had expired, the result might be a stagnation of the territory. This problem led to the drafting of mini-agreements which were written not for a fixed term, but rather for a term of x years following the granting of the last sub-franchise within a particular period of time. The term of the sub-franchisor would then last long enough for it to be able to fulfil its commitments to every sub-franchisee it has signed up. It was also possible to prevent the sub-franchisor from executing sub-franchise agreements within a certain period of time prior to that, so that it did not extend its term beyond the end of its own master franchise agreement.

It was pointed out that termination was also a means to end a relationship of indefinite duration. Contracts in which the duration was not specified were more frequent in Europe than elsewhere, but were not frequent in international franchising. In some countries however, a badly drafted contract might be construed as a contract of indefinite duration. It was suggested that this particular case also be considered in the chapter, even if briefly, possibly in the form of a cautionary note in the section dealing with termination.

This being the case, the definition of termination would also change, as in the present draft "termination" was used exclusively for the ending of the contract by either party as a result of non-performance on the part of the other. Termination would more generally be the voluntary ending of the agreement by either party by virtue of a power it had been given under the agreement.

It was observed that a discussion of trademark violation needed to be included, as it was a particular kind of default that was treated differently from other defaults.

It was suggested that the present chapter should also draw attention to the legal impediments which prevailed in many countries in respect of termination. In some countries it was not possible to close an outlet without prior permission of the authorities dealing with labour and only upon payment of compensation in accordance with the law. This was of importance also because that could affect the relations of the sub-franchisor with the sub-franchisees.

## **CHAPTER 19**

A suggestion was made to include a paragraph on damages in Chapter 19. There was a brief mention of this in Chapter 2 and penalty and liquidated damages clauses were referred to on page 188, but one of the most important consequences in the case of liquidation was compensation for damages. It was true that the way to assess damages varied greatly from country to country, but it was suggested that it might be important to deal with them in this chapter.

The discussion on damages was enlarged to include not only damages to be paid by the defaulting party, but also damages to be paid to the party who had been terminated by the other

party when the termination was not justified. To be included under the first of these categories were also the damages due for the profits lost as a result of the early termination of the contract. While it was considered to be opportune to deal with damages as a consequence of the end of the relationship, it was not considered appropriate to go into great detail.

A question that should furthermore be discussed was the effects of a decision of the franchisor not to take over the sub-franchise agreements of the sub-franchisor in the case of assignment. It was suggested that a few alternative scenarios for cases of take-over might usefully be discussed, with possible alternative solutions given.

The discussion on page 193 on renewal as a possible consequence of the relationship coming to an end was generally felt to be odd, as it was remarked that that did not happen unless the renewal provision did not work. It was therefore suggested that the order of the discussion might be reversed, with the consequence that the first statement would be that consideration should be given to whether or not there was a right to renew, and that if there was no right to renew there were good business reasons why a renewal should be considered.

It was suggested that a number of points that were dealt with in the chapter really did not belong there. Thus, the paragraphs at the bottom of page 195 and the top of page 196, which in reality dealt with non-competition clauses, were immediately followed by a discussion of the selection of a new sub-franchisor, of who was appropriate as a sub-franchisor and of what a sub-franchisor was supposed to do, which was a discussion that belonged at the beginning of the guide. It was suggested that an appropriate place for this discussion might be the section on advantages and disadvantages of master franchising and problematic areas in Chapter 1.

An important discussion concerned the assets of the sub-franchisor who owned its own units. There was a brief discussion of this in the second paragraph on page 198, but other points relevant to the discussion seemed to be ignored. On page 197 there was a discussion in the second full paragraph of the acquisition of the assets of the sub-franchisor. These assets typically fell into three categories: a minimal asset, such as a training facility, the intangible assets which were the most important ones and which were the rights of the sub-franchisor under the franchise agreement, and lastly the rights of the sub-franchisor when it actually owned its own units. In addition, the sub-franchisor might own the premises that it let, or might lease the premises that it sub-let to its sub-franchisees, and it might be the supplier of the goods used or sold by the sub-franchisees. These were all points that should be discussed, as attention should be drawn to the fact that situations in which the sub-franchisor, for example, continued to be the supplier even if the master franchise agreement had expired might not be desirable. Similarly, pages 198-199 spoke of the de-identification of the premises, whereas typically the sub-franchisor would not have outlets in its capacity as franchisor. A distinction had therefore to be made between the sub-franchisor in its capacity as franchisor and the sub-franchisor in its capacity as franchisee.

## **CHAPTER 20**

It was agreed that Chapters 20 and 21 should be merged, even if they should be kept as distinct sub-sections of the new chapter. The section on Choice of Law should furthermore deal more in general with applicable law and should be entitled accordingly. The section on Choice of Forum should also change its title to "Settlement of Disputes".



As regards the content of this chapter, it was observed that it contained no reference to the *1980 Rome Convention on the Law applicable to Contractual Obligations*. While it was true that a decision had been taken to be sparing in the inclusion of references to regional instruments, the importance of this particular convention was that it represented the modern trend in national legislation, as the “most closely connected” factor it adopted, and which was related to the notion that the performance was characteristic of the contract, had been adopted in the recent laws of Italy and Switzerland. The Convention should therefore be mentioned, even if details were not entered into. A further feature of interest of the Convention was the fact that it permitted different parts of the contract to be governed by different laws, as it indicated that a severable part of the contract that had a closer connection with another country might by way of exception be governed by the law of that other country (Article 4(1)). It was also suggested that it might be opportune to state that if the parties did not select the law applicable to their contract, this would be determined by the private international law of the country in question, or by international conventions such as the Rome Convention or the *1994 Inter-American Convention on the Law Applicable to International Contracts*.

## CHAPTER 21

As indicated in the report on the discussion of Chapter 20, it was agreed that Chapters 20 and 21 should be merged, even if they should be kept as distinct sub-sections of the new chapter. While the section on Choice of Law should deal more in general with applicable law and should be entitled accordingly, the section on Choice of Forum should change its title to “Settlement of Disputes” which offered more possibilities to deal with alternative means of dispute resolution.

The manner in which arbitration was best dealt with in the guide was discussed by the Group. On the one hand it was felt that a certain amount of detail was justified by the importance of the arbitration clause in international franchise agreements, on the other too much detail was not justified as the guide was not intended to be a treatise on arbitration. The *1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards* should be dealt with, but doubts were expressed as regards the opportuneness of dealing with all the national legislation adopted in recent years, a majority of which had been adopted on the model of the *UNCITRAL Model Law on Arbitration*. It was suggested that to avoid this problem a strong statement on the desirability of professional counsel should be inserted in the chapter.

It was felt that the importance of alternative means to solve disputes, such as mediation, should be stressed in the chapter. This was particularly true in the case of master franchising where litigation was very damaging for all parties concerned.

General drafting points were raised and adopted as regards the formulations used. Thus, on page 211, the last sentence of the third paragraph was deleted (“Thus, for example, in Asian societies the contract commonly does not have the authority or importance that it enjoys in European and Anglo-American jurisdictions”). In the following paragraph “many” was changed to “some” in the sentence “[p]ersons from many Asian backgrounds [...]”. On page 218 the second last paragraph stated that “arbitrators are not in general required to state reasons for their decisions [...]” whereas in actual fact the current tendency was to provide for an obligation on the

part of the arbitrators to state reasons in the arbitration agreements, particularly when international disputes were concerned. The statement should therefore be changed.

The utility of including in the chapter discussions of a number of general questions, which were not particular to franchising, was considered. These included whether or not an action should be taken, whether or not the national judicial system should be resorted to, and questions of the enforcement of a judgment rendered pursuant to arbitration. It was however objected that the necessity of resolving disputes without resorting to litigation was paramount in franchising and that it therefore was important to encourage people to mediate. Furthermore, very few practitioners in the franchising field knew anything about arbitration and considering the educational value of the guide, it was important to provide some information, even if details were not entered into.

There were in fact some parts of this chapter that might be shortened, such as the section on the "Recognition of Choice of Forum Clauses", and the parts dealing with the enforcement of a judgment rendered by a court, with the choice of arbitration, with denial of a fair hearing, with excess of authority, and with procedural irregularities.

As regards arbitration, the question of the competence of the arbitrators when dealing with franchising and the possibility to choose arbitrators with sufficient knowledge of franchising were discussed. The existence of the National Franchise Mediation Program in the United States was pointed out, although doubts were expressed on the advisability of making reference to it, or to any other similar initiatives, in the guide.

## **CHAPTER 22**

As indicated in the report on the discussions on Chapter 2, the proposal to merge Chapters 2 and 22 was rejected.

The question whether the documents dealt with in this chapter could be considered to be real ancillary documents was discussed. Many were in fact clauses that might be included in the main franchise agreement itself and could therefore be considered not to be ancillary documents. Others instead were documents that essentially were of a different nature, such as letters of credit.

The author of the chapter indicated that his understanding had been that the chapter should flag to prospective sub-franchisors all the relationships that it might end up having with the franchisor that did not of absolute necessity fit within the framework of a franchise agreement. The sub-franchisor could for example also be a borrower, a lessee, a guaranteed party, a purchaser of goods, the beneficiary of a supply agreement, and the beneficiary of a finance agreement. None of these relationships came necessarily within the framework of the pure franchisor/franchisee relationship and attention should be drawn to these other types of relationship. There was agreement on this point, considering also that the expected readers of the guide were in most cases people from developing countries and economies in transition and the intention was to ensure that the prospective sub-franchisor, particularly in an emerging economy, realised that there could be other relationships in addition to the basic agreement. That was the reason it had been thought useful to have all the documents listed and briefly discussed.

The question was asked whether ancillary documents were only those relevant for the beginning of the franchise relationship, such as lease agreements or supply agreements, or also those concluded later on during the life of the agreement, such as the transfer agreement. It was generally agreed that all documents, independently of whether they were concluded at the beginning of the relationship or later on during its lifetime, should be included under the term “ancillary document”.

The relationship between Chapters 13 and 22 as concerns confidentiality agreements and non-competition clauses was also considered. It was concluded that Chapter 13 should deal with the legal substance of the issues that arose, such as legal enforceability, whereas Chapter 22 should inform its readers of the issues they had to keep in mind. Thus, for example, Chapter 22 would discuss the desirability of having the non-competition agreement signed by key officers because there was no purpose binding an entity with a non-competition agreement unless the officers were also bound. Chapter 13 on the other hand would consider what made the agreement enforceable.

In the end, the Group decided to keep the chapter as it was, but to add an introductory paragraph to put it in context, explaining that there could be other relationships between the franchisor and the sub-franchisor that went beyond the pure minimal issues of the franchise relationship and that those relationships entailed both benefits and burdens and were typically documented either within the context of the main agreement or in ancillary documents.

## **CHAPTER 23**

The title of Chapter 23 was changed to “Regulatory Requirements”, which it was felt better to reflect the contents of the chapter. A general observation was that the chapter throughout spoke of franchisees rather than sub-franchisors and that this should be remedied. A suggestion to merge Chapter 23 with the Annex was rejected.

The concern was expressed that readers might receive the mistaken impression that what the chapter listed was exhaustive, so that if something was not listed it was not important. It should therefore be stressed that a certain amount of due diligence on the part of the sub-franchisor was appropriate, as the sub-franchisor would know far more than the franchisor about any requirements that should be taken into consideration in its country. It was pointed out that in the United States there was a particular situation, in that there was a requirement in the US franchise disclosure laws to the effect that franchisors should alert franchisees to laws and regulations of general applicability. What should be considered in this chapter were the burdens and not just the benefits, it was not just a question of the franchisor telling a prospective sub-franchisor what to do, it was a responsibility that the sub-franchisor had to take upon itself. It was a question of shifting responsibility to the person who was closest to the requirement in question.

It was suggested that the chapter should begin with a paragraph stating that there was a small but growing number of countries in which there was specific legislation dealing with franchising and that this legislation was dealt with in the Annex. It should be pointed out that in most cases this legislation did not require registration, but nonetheless required that a specific procedure be followed. It should be stressed that these laws needed to be reviewed regularly as they changed frequently. It should also be pointed out that the remainder of the chapter dealt with matters that were not unique to franchising.

A certain discrepancy between the headings of the different points dealt with and their contents was noted. Thus, the section on the registration of trademarks, trade names and transfer of technology agreements did not really deal with that. There was a mention of registration under the competition acts, but competition law as such was not really dealt with anywhere and, considering its importance, if it was to be mentioned it required a heading of its own. It was necessary to explain that there were some systems which required, or which had the facility of obtaining, an administrative decision and others which did not. It was observed that in general the franchisor would do everything possible to keep the trademark registration in its own name and to avoid that the sub-franchisor had any rights in the trademark. When trademark registration was considered, it was therefore appropriate to indicate that the sub-franchisees would not be involved with the registration of the trademark and that the franchisor would usually try to avoid anyone else obtaining any rights in its trademark.

It was furthermore suggested that a reference to the registration requirements of franchise-specific legislation should be included. Admittedly the Annex dealt with legislation specific to franchising and the registration requirements of those laws would be dealt with there, but a reference to the Annex was felt to be appropriate.

Of the requirements dealt with in the chapter, it was decided to delete numbers 6 (Permits required for the Obtaining of Domestic Credit) and 10 (Real Estate) as well as the section on Warranties. It was suggested that the listing of the points that would be dealt with in the chapter at its beginning was superfluous and could therefore be deleted.

An issue of importance regarded the setting up of permanent establishments of the franchisor in the host country. While there were franchisors who would be wanting to set up permanent establishments, the majority would not. It was important to warn franchisors against the risk of their being considered to have set up a permanent establishment by the authorities of the country concerned, even though they had had no intention to do so. This might be the case if employees of the franchisor actually immigrated into the country, as opposed to their merely obtaining a work permit for the time-period required.

There were furthermore countries, such as India, in which franchising was considered to be a form of investment and in which the legislation that applied to investments would be applied also to franchising. Furthermore, again in India, if income accrued the foreign party was required to appoint an agent for tax purposes even it did not have a permanent establishment. Considering peculiarities of this nature, it was suggested that a note be added to the effect that regulatory requirements varied from country to country, that they were liable to change from time to time and that parties were well advised to make the needed enquiries.

A question of importance concerned who was responsible for the obtaining of the permits required and who was required to make the necessary registrations. In some countries, such as India, the primary obligation to obtain approval of the agreement lay with the resident party. It was therefore suggested that a statement should be added to the effect that franchisors should ensure that the formalities had been complied with, failing which the contract itself might be void in case of non-compliance with the requirements. It was however observed that the situation would be different in different countries, that the responsibility might not always rest with the franchisor. A more general statement might therefore be more appropriate, to the effect that if the

requirements had not been complied with there was a risk that the contract might be considered void and that the requirements would vary from country to country.

The reference to guilds on page 236, which had been inserted following the previous meeting of the Study Group, was felt to be somewhat misleading, as it was not the guilds as such, but the whole artisanal business that was protected. The guilds were merely the bodies that administered the business and that handed out the permits. These might of course not be allowed foreigners or people who did not fulfil certain qualifications, but it was not the guilds that laid down the rules.

## **ANNEX**

The title of the Annex was modified to read "Laws and Regulations Relevant for Franchising".

The Annex dealt with legislation that was specific to, or relevant for, franchising. What the second part of the chapter did, was to try to identify those laws that were deemed to be the most important and relevant out of the non-franchise specific laws. In some ways the guidance that was offered was guidance to the sub-franchisor, but it was also more general guidance as to the relationship of the sub-franchisor with its sub-franchisees. This was the case, for example, with some of the industry-specific legislation and care had to be taken not to go so far as to advise the franchisor on what were purely domestic matters.

There was furthermore legislation which fell between the two categories, such as for example the United Kingdom Trading Schemes Act. Although this Act was not a franchise-specific law, it was a law which in its application could have direct effect upon certain types of franchising. Presently it was not covered in the guide although its importance was such that it should be. In the case of pyramid schemes, which were covered by the Trading Schemes Act, the question was whether the statutes covered also the internal relationship between the franchisor and the franchisee, and not only that between the franchisee and the consumer. Other legislation which might be relevant was that which had been adopted with particular consumer protection objectives in mind. This legislation was not dealt with in the guide but should be. The consumer protection laws were in fact to be considered on two levels: first of all on the level of liability towards the consumer in the common sense, secondly on the level of whether or not the franchisee or sub-franchisor would itself be viewed as a consumer and therefore be covered by the protection of the consumer protection statutes. The question was whether the reach of those statutes to protect people would be viewed as broad enough to protect franchisees who were not purchasing items for consumption, but were making an investment and were therefore traditionally and historically not thought of as consumers, although they might in the end be treated as consumers for the purpose of the statutes.

Other additions to be made included references to the United States Business Opportunity Laws, to the disclosure regulations applicable in Japan and to the voluntary code adopted by the Franchise Association of Southern Africa. It was suggested that the section on Mexico needed to be re-written, as did that on Australia. A reference should furthermore be inserted in the section on France, to the effect that the relevant law was known as the "Loi Doubin". Deletions which should be made included the reference to the Quebec securities legislation and the adjective "ordinary" before "property law" in the list of general areas of law relevant for franchising.

The nature of the annex on legislation was discussed, in that it was pointed out that it would require constant up-dating. So as to avoid having to publish new editions of the guide every time legislation was adopted by a country, it was suggested that this particular annex might be published as a pocket part to the guide.

## UNIDROIT STUDY GROUP ON FRANCHISING

Third Session, Rome, 14 - 15 April 1997

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