

## ROUNDTABLE

Who's Who Legal brings together four of the leading practitioners in the world to discuss key issues facing franchise lawyers today.

**WWL:** Have you observed the adoption of international franchises in emerging markets? If so, what are the major legal barriers to expanding major brands into these countries?

**Bethany Appleby:** Absolutely. The set of international locations has expanded dramatically. Areas that wouldn't have got a second thought are now gaining buzz (and units), including a real interest in exploring Africa and the opportunities there. No one wants to be left out or behind, but, of course, there will be many challenges, and many failures. At least some of the challenges in these less-developed nations and markets are obvious and include lack of infrastructure, unreliable supply chain issues, dietary preferences and restrictions, political instability, public health problems, and lack of confidence in the legal system, to name just a few. Franchisors have to realise that they are in this for the long haul and should be prepared for a rocky start if they do decide to jump in. Established US franchisors would also do well to think back on some of the now well-developed European and other international markets and recall what they learned from some of the early failures there. Franchisors expanding into emerging markets are also concerned about effective, and enforceable, dispute resolution provisions in their franchise agreements and adequate protections from the theft and infringement of intellectual property.

**Peter Buberis:** The acceptance and importance of franchising internationally is now so obvious that jurisdictions that previously paid little attention to it are now either looking at specific legislation or, as part of the terms of participating in global trade, creating economic and legal conditions more conducive to its operation and hence are more enticing to foreign brands. These steps, encouraging as they may appear, don't, however, remove the need to be aware of the usual grab bag of risks endemic in many emerging economies. Corruption may be rife and, of course, political risk a continual concern. On a more practical note, particular attention needs to be given to certain "frustrations" that often accompany an expansion into new markets. Chief among these include delays and costs associated with any pre-required registrations of franchise documents or trademarks, an actual or perceived practical absence, or lack of development of intellectual property rights, differences between the way the law (or its translation) reads and the way it is applied by the authorities, dispute resolution and enforcement and, of course, the taxation treatment of income and the movement of money in or out of a country. These markets are being mined for opportunities, but must be approached with caution and often the preferred path is to do so with a joint venture local partner.

**Richard L Rosen:** With the saturation of domestic markets in the US, the globalisation of business in general and the relaxation of trade barriers, there has been a surge in the number of franchisors (and not just the "majors") looking beyond the US borders for untapped markets where they can promote and expand their brand. However, franchisors looking to develop their brand internationally cannot jump into these markets haphazardly. Besides the economic, cultural and political risks inherent in developing international franchising opportunities, there are myriad legal barriers that a franchisor must carefully consider and overcome to thrive in its target market. Some of those legal barriers include: the franchisor's ability to implement and enforce an international franchise agreement; the level of international intellectual property protection, if any, the country affords and that country's commitment to enforcing



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those rights; trade restrictions between the franchisor's country of origin and the target country; language barriers; and compliance with registration and disclosure laws. To overcome these and other legal barriers, it is imperative for a franchisor to immediately identify and retain knowledgeable local counsel once it has targeted a foreign market.

**Michael Malloy:** Expanding into international markets is a necessity for the growth and even survival of franchised brands, and emerging markets offer some of the most dynamic opportunities.

In addition to increasing business and revenue, expansion into emerging markets provides a ground floor opportunity to establish brands in new markets. As an "emerging" market is one where a consumer society is developing, entering such a market at an early stage is an opportunity to establish primacy as an iconic brand.

The primary barrier to entering the Russian market is the complication in enforcement of rights across borders. Many contractual mechanisms customarily used for brand protection and enforcement of agreement terms are difficult, if not impossible, to implement in Russia. This creates a frustrating situation for franchisors seeking to take action where a franchisee is not performing. Because of this, special consideration and protective measures should be taken to really know the franchisee and to provide additional leverage for enforcement. Due diligence on a franchisee is critical and is skipped only at one's peril. Personal guarantees, bank guarantees, letters of credit and other mechanisms should be considered as essential aspects of any international franchise relationship coming into the Russian market.

A second important legal barrier is the very dynamism of emerging markets. The hallmark of an emerging market is change and development and this applies to legal/regulatory rules and practices as well as to economics. The legal and regulatory rules and practices in emerging markets are subject to frequent and deeper changes than one might expect in more mature markets. This is certainly true in Russia where the rules and practices have changes dramatically even over the past year.

Franchisors working with emerging markets need to stay on top of changes and adapt as these changes come along. This creates a greater burden and cost to operations than might be expected.

**WWL:** There seems to be major legal uncertainties in the responsibilities franchisors and franchisees have to one another in a number of markets. To this end, how has the relationship between the two developed in your jurisdiction?

**Bethany Appleby:** Some of the most concerning open issues involve government ignorance or disregard of the basic nature of the franchise relationship. This ignorance or disregard can undermine or destroy that fundamental relationship. For example, there have been well-publicised efforts to treat

franchisees' employees as the franchisor's employees for various purposes. This is an unsettled and hot topic in the US franchise community right now and could give rise to any number of new franchisor expenses and obligations, including vicarious liability, wage and hour and other liability, and could also have wide-ranging impacts on the possibility of unionisation. There are also increased efforts in some US jurisdictions to impose potentially onerous restrictions on franchise termination, non-renewal and transfer, which could have broad quality control and other effects on franchisors. States are also increasing their attempts to tax out-of-state franchisors. Not quite as high profile, but also increasing, are claims raised against franchisors, and statutory protections asserted, by third parties to the franchise relationship, such as spouses and investors. So far these third parties have not seen much success in court, but franchisors are keeping their eyes on this issue and looking for ways to minimise risk in the franchise negotiation and contracting process.

**Peter Buberis:** As a federally regulated environment Australia has enjoyed ongoing review of its mandatory Franchise Code. Of course, such review has been influenced by vested interests within either the franchisor or franchisee sector; however, general consensus has been achieved that franchisees need to understand the practical implications of franchise agreements. Under disclosure, therefore, the focus is shifting to not so much what is in an agreement but what outcomes could flow from those provisions and what impact this would have on the franchisee. This may be viewed as beneficial to the franchisor, as through clear and certified understanding of the franchise agreement terms the ability of a franchisee to attempt repudiation is constrained. The generally accepted benefits of a compulsory mediation process have also added a practical gloss to circumstances of dispute, with readily available, timely and cost-effective dispute resolution often offering a way out of the issue satisfactory to both parties. The absence of a statutory good faith obligation on each party is being considered for change; however, there has been a tendency of courts in recent years to imply such a duty and apply it to particular facts in a matter – a scenario that may need to remain a fact-based analysis even should the notion of good faith assume statutory status. Fortunately, the Franchise Code specifies that certain relationships do not constitute a franchise and in the absence of very particular facts that might be caught by individual state laws the risk of an employer/employee relationship existing is less concerning than would appear to be the case in the debate currently occurring in the USA.

**Richard L. Rosen:** One of the most pressing topics for both franchisors and franchisees in the US has been the degree to which a franchisor can be held liable for the actions of its franchisees, which has required franchisors to evaluate how closely a franchisor should control its franchisees. This, of course, is troubling in the franchise context, as the franchisor-franchisee relationship by definition involves a uniform system, and franchisors must police and protect that system, creating a benefit

for both franchisors and franchisees. Previously, one of the main concerns for franchisors was that by exerting such control they might be found inadvertently liable under the theory of “vicarious liability”. Fortunately, the trend for the past decade has been a slow but pronounced shift in the US courts towards an issue-specific “instrumentality” test, instead of simply looking at the degree of control exercised by a franchisor. Also, a new trend has emerged for finding franchisors liable for the actions of their franchisees under a “joint employer” theory. Recently, certain courts (and, notably, the National Labor Relations Board (NLRB) in a recent decision against McDonald’s), have utilised the “joint employer” doctrine to hold a franchisor accountable, under fact-specific circumstances, as a joint employer for violating the rights of its franchisees’ employees. As the NLRB’s recent finding warns, a franchisor that becomes too involved in union or labour-related activities, even if being pressed by its franchisees to lend assistance, may find itself so enmeshed in its franchisee’s employment activities, that it is considered to be a “joint employer”.

**Michael Malloy:** The most important consideration regarding the franchisor/franchisee relationship in Russia involves what I call the “flip of leverage”. Whereas a franchisor (especially coming from the US) will often presume that, through various contractual provisions, it holds an advantageous position in the ability to monitor and enforce compliance in a franchise relationship, this is an erroneous assumption in Russia. While it may seem that during negotiation of the initial agreement the franchisor has powerful leverage, once that agreement is in place, the leverage essentially flips to a situation where the franchisor depends upon its relationship with the franchisee, so that the franchisee can depend upon coercive enforcement of contractual provisions.

This is because many protective measures sewn into a franchise agreement are either unenforceable under law or difficult (if not impossible) to effect in practice. Because of this, it is all the more important to undertake exhaustive due diligence to choose the right franchisee, to keep a close watch on the relationship and performance, and to have additional leverage mechanisms such as guarantees or letters of credit in place.

**WWL:** Respondents have observed the increased access to financing for franchises. How has this changed the market in your jurisdiction? Have you seen many new franchise brands coming through?

**Bethany Appleby:** As a litigator, I am not generally involved in financing issues for my franchise clients. Anecdotally, however, financing is somewhat easier to come by. As in all economic times, it is of course always easier to obtain financing for an established, proven brand with a low unit failure rate. The hope and expectation is that continued growth of the US economy in the immediate future will mean that consumers may have

more money to spend on products and services, and this bodes well for the franchising sector. In addition, a trend that is likely to continue is the participation of private equity in providing needed capital to franchisors, particularly when private equity purchasers acquire a concept from the original entrepreneur. This trend continues to create both challenges and opportunities.

**Peter Buberis:** Some franchise systems negotiate with bankers to get “whole of system” finance terms for their franchisees. The franchisor is not a party to the finance arrangement but negotiates the terms the bank will offer. This assists in the expansion of franchise systems, as banks are more willing to offer finance where they have familiarity with the system. There may in such circumstances be a tendency on the part of banks to seek supporting projections of future franchisee turnover from the franchisor and the close nature of the relationships engendered by such financing facilities may result in the franchisor doing so. The pitfalls of such behaviour in subsequent disputes (especially if based on alleged misrepresentations or failure to achieve mandated performance standards) are clear for all to see and this practice has been largely discouraged by franchise lawyers who have been made aware of it. Occasionally the franchisor itself is the source of franchisee financing, which raises the need for security protection. The recent passage of the Personal Property Security Act (PPSA) has introduced a new system of registration to ensure preferential treatment in the event of insolvency. A failure to implement the procedures under the PPSA may be fatal to a franchisor recovery of a funding advance.

**Richard L Rosen:** With the recession on the wane and the availability of increased financing supported by the Small Business Administration (SBA), the franchise landscape may expect to experience a steady increase in the opening of new franchised brands and more franchised businesses. With renewed support by the SBA, traditional banking institutions seeking to expand have moved towards providing more financing opportunities for franchises, although we still detect a note of caution in the air, probably as a result of past excesses. While this trend may bring more prospective business owners to the table who otherwise lack the necessary upfront investment capital, the increased availability of financing for franchises should be viewed with some caution. Franchisors’ desire to open more units has traditionally been the driving force behind financial expansion as many franchisors have been actively engaged in encouraging lenders to open their doors to prospective franchisees. Unfortunately, many individual franchisees have faced negative consequences as a result of aggressive expansion. Most franchisees both collateralise and personally guarantee the loans they receive and if their businesses are unsuccessful, they are at risk of losing not only their franchised business(es) but their homes and other personal assets as well. This, of course, can negatively affect a franchise system and even the franchise marketplace, generally. We like to see franchisors cautiously examine the financial backgrounds of prospective franchisees and call for sufficient “back-up equity” in a deal so that a business failure does not

necessarily equate to a complete personal disaster.

**Michael Malloy:** Russian franchisees for international brands are usually successful business owners or companies in other business lines seeking to diversify their business portfolio. These franchisees generally bring their own resources or attract investors or credit outside of the franchise transaction, so, attracting finance is usually less of a factor in the franchise transaction than is the general health of the economy and the franchisee's other businesses.

Russian banks and investment groups have become much more receptive to investing or lending into franchise operations, so obtaining financing is likely to become a more important factor in international franchise transactions and the market of potential franchisees may expand.

**WWL:** What main developments to franchise agreements, either in your jurisdiction or worldwide, have affected your practice?

**Bethany Appleby:** I have seen an increased focus, both from franchisees and franchisors, on transfer standards and restrictions and succession planning, particularly when the franchisees are individuals or closely held businesses. I have also seen an increased franchisor interest in transparency of franchisee investors and behind-the-scenes ownership interests in an effort to prevent future claims or assertions of rights in the franchise by third parties. I also anticipate that we will see increased attempts to "draft around", to the extent possible, efforts to hold franchisors liable as joint or co-employers of franchisee employees. Introducing new and more versatile technologies can also sometimes be difficult in the face of franchise agreement language written before the technology existed. I anticipate additional challenges to the adoption of new technology, or the participation in new computerised systems and procedures, particularly when franchisees perceive participation to be expensive or otherwise decrease franchise revenue. However, I expect franchisees to embrace new franchisor-introduced technology that reduces the need for employee involvement or risk of employee error and saves franchisee labour costs.

**Peter Buberis:** There would seem to be an emerging trend of micro-franchising, such as selling the rights for a discrete task, for example the reading of electricity meters. These arrangements carry particular contractual considerations and, where applicable, have changed the face of what may be termed "the standard franchise template". That observation aside, there has been ongoing legal reform in Australia as well as different marketing and communication advances to justify frequent revision of franchise agreements. It hardly needs to be said that the increased relevance of online marketing and online sales has resulted in significant amendments to agreements where those documents

touch on exclusivity, intellectual property ownership, approaches to market and termination issues. But broader structural moves seem afoot. Systems now seem more willing to adopt flexible models in their expansion utilising combinations of direct licencing, master franchising, area development agreements and the appointment of development agents. The integration of these concepts in matters such as contributions to marketing may pose an intellectual challenge, however the benefits of flexibility outweigh the very acceptable burden put on lawyers to draft appropriately.

**Richard L. Rosen:** We have observed the increased utilisation of "contractual limitations periods" in franchise agreements. These provisions limit the time (frequently as little as "one year") within which a franchisee must assert claims that it may have against the franchisor, even where the statutory time period is substantially longer. This sometimes leads to avoidable litigation, since the time within which matters might "work themselves out" is no longer available. Further, while I have been pleased to see a significant increase in the number of franchise agreements that contain a requirement that the parties engage in mediation as a prerequisite to engaging in litigation (or arbitration), I have noticed that such mediation provisions rarely provide that the "contractual limitations period" and any statute of limitations period, generally, are "tolled" during the mediation period (and slightly beyond). The lack of a tolling period combined with a "short (contractual) statute of limitations" can act as an impediment to the mediation of disputes. I have also observed a "cutting away," or even an elimination, of "exclusive territories" in franchise agreements. We have seen an increasing trend for franchisors to expressly reserve for themselves their right to market, advertise, distribute and sell to consumers through "alternative" distribution channels (eg, over the internet, in supermarkets, etc), the same branded products and services which the franchisee is selling. There has also been increasing reservations by franchisors of the right to market, advertise, distribute and sell products and services through "non-traditional" venues (eg, airports, hospitals or sports stadiums). This approach has significantly eroded the concept of a franchisee's "exclusive territory". While this frequently leads to the negotiation of these issues, in the worst cases, litigation may result.

**Michael Malloy:** Probably the most notable development we have seen over the past five years has been the expansion of retail store franchising as an enhanced distribution sales model. In addition to being a way to strengthen the retail image of certain brands, the retail franchise distribution model presents some important advantages in the ability to control how distributors present and sell lines of products and can create an attractive revenue stream from royalties.