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BASIC ASPECTS OF NEGOTIATING INTERNATIONAL AGREEMENTS

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PRELIMINARY OBSERVATIONS

The purpose of this paper, and the accompanying presentation, is to outline **some** of the major considerations involved in negotiating international franchising agreements. Note that there is no discussion of the underlying factors that, from a business standpoint, enter into the decision to franchise in a foreign country. This paper assumes that (1) a viable business decision to franchise in a foreign market has already been made and (2) that either a process for selection of a foreign associate has been developed or a valid foreign associate has already been identified. Many considerations not touched on in this paper (some of which have been discussed by other panel members) control those decisions.

This paper also is directed to the situation of a U.S.-based franchisor interested in setting up operating units in areas outside the U.S. No examination is made of the reverse or other situations, although many of the principles explained probably apply to other scenarios as well.

In addition, this paper, even though presented by a lawyer, is business-oriented rather than legalistic and is intended to be a general guide to businessmen and businesswomen in thinking about and preparing for international negotiations. It is not a substitute for competent, informed and experienced legal advice in the international arena.

Finally, no one, whether businessperson or attorney, should assume that the points discussed include all possible issues involved in negotiating international franchise agreements. Entire texts (some of which are cited in the bibliography), consisting of hundreds of pages, deal with the issues we'll discuss and any international negotiation deserves extensive and detailed preparation. This discussion can only touch on the high points and alert businesspersons and attorneys to some of the issues involved.

1. FACTORS TO CONSIDER IN SELECTING THE STRUCTURE FOR THE FRANCHISE RELATIONSHIP

Prior to beginning any negotiations, the Franchisor should have a clear picture of the basic structure it will use in franchising operations in a foreign location. Alternative structures are discussed below (in Section 2), but a preliminary business evaluation must be made by the Franchisor of its history, traditional methods of doing business, resources and the prospective foreign environment before the alternative structures can be evaluated.

1.1. <u>How Has the Franchisor Been Doing Business in the US?</u>

Some Franchisors will prefer to structure their foreign franchising operations on the same lines as their domestic operations. For example, if a U.S.-based Franchisor has been comfortable doing business in a Master Franchisor-Subfranchisor-Local Franchisee format, and has organized their entire system of administration, financial control, support and service on that model, some very convincing reasons would have to be advanced to adopt a different structure abroad. On the other hand, some traditional domestic franchising structures (e.g. direct unit-by-unit franchising) may be inappropriate for foreign operations and the Franchisor will have to consider whether it is equipped to work effectively with an alternative structure.

1.2. <u>Availability of Financial and Human Resources</u>

The Franchisor needs to realistically evaluate two factors: (1) What will be necessary to effectively market franchises in the foreign country and thereafter <u>properly support and service the local units</u>? (2) Does the Franchisor have the necessary financial and human resources to perform these functions?

There is no substitute for "doing the numbers." By that we mean that it's vital to realistically consider exactly what support is necessary, based on the Franchisor's U.S. experience, to give the local Franchisee the best possible chances of success and to evaluate the costs of providing those services. Obviously, this varies from industry to industry and system to system, but any experienced Franchisor should already know what is legitimately required in initial training, on-going training, store visits, co-operative advertising, supplier relationships, site location assistance, etc. Significant factors in foreign success include first-hand observation of the Franchisee's business, the ability of the Franchisor to assist the local Franchisee in adapting to the local market, providing "feed-back" from other units operating in the same market and adequate advertising, promotional and marketing programs.

In addition to financial considerations, human resources are critical. Limitations on the availability of quality management personnel may preclude certain methods of entry into a foreign market, such as direct franchising. Often, existing management personnel must be assigned to the foreign market on a full-time basis for a significant period of time and will generally need to be supported with foreign personnel familiar with local laws, business culture, market conditions, etc.

If a structure is selected that fails to provide for these services and their associated costs, the chances of success for the foreign units decline radically and the probability of "break-away" situations developing increases proportionately. Alternatively, the Franchisor may have to evaluate its system to determine if a simple licensing arrangement, rather than traditional franchising with the ongoing support that implies, will be a viable method of entering the foreign market.

1.3. The Foreign Environment

Factors related to the foreign location may also affect the structure chosen. Generally, as obstacles to the ease of franchising in a foreign location increase, direct franchising may become less viable and use of an alternative structure may be required. Factors increasing the difficulty of franchising in a foreign country include:

- Cultural and Language Differences
- Physical Distance
- Communications Systems
- Ability to Train Franchisees and Their Employees
- Differences in Legal Systems
- Stability
- Nature of Products and Services
- Level of Economic Activity

In summary, as the Franchisor's (or its foreign partners') resources (human and financial) increase and the economic and cultural differences between the U.S. and the target market decrease (e.g. Canada compared to Brazil), the Franchisor will have a greater range of choice of alternative structures and the opportunities for a successful entry into the foreign market increase. Limited resources and significant differences between the U.S. and the target market will often require selection of a structure to accommodate such factors.

2. ALTERNATIVE STRUCTURES (See attached charts.)

2.1. Direct Franchising - By the Franchisor or through a U.S.-based wholly-owned subsidiary

This structure involves a direct contractual relationship between the Franchisor (or a wholly-owned subsidiary) and one or more local Franchisees in the foreign country on a unit-by-unit basis without the involvement of any third party. In essence, the individual Franchisee in Paris is dealt with under the same structure as used for the individual Franchisee in Dallas.

This approach may be indicated when:

1. The number of units to be placed in the country is small.

2. The nature of the business does not require extensive support of, or co-ordination of activities between, units.

3. Training, supplies and other functions can be effectively rendered from the U.S.

4. Distances and cultural differences between the countries are small and communication is relatively easy (U.S./Canada).

Advantages:

- Direct relationship with the Franchisee facilitates operational control and regulation of advertising, marketing, etc.
- Revenue received by the Franchisor (initial franchise fees, royalties, equipment sales, etc.) is maximized and is not shared with any third party.

Disadvantages:

- It may be costly to train and service Franchisees in remote locations.
- Greater difficulty in initial franchise sales (lack of a local representative, perceived lack of "commitment," cultural barriers, etc.).
- May require establishment of an office in the foreign country to sell and service franchises and this may generate adverse tax and other consequences.
- Lack of familiarity with local customs, commercial practices, etc.
- Franchisor assumes all risks if the franchising venture fails.

2.2 **Direct Franchising** - Using a Subsidiary or Branch Office Resident in the Foreign Country

This approach is substantially identical to that outlined above except that the U.S.-based Franchisor organizes a subsidiary in the foreign country to sell and service franchises. That subsidiary will execute the franchise agreements with the local Franchisees and is technically their "franchisor." The choice between a branch office and a subsidiary is generally driven by tax, trademark, public relations and legal considerations.

Advantages:

- Establishment of a local office (in whatever format) makes franchise sales and service and support easier.
- Use of local personnel increases familiarity with the market, suppliers, sites, etc.
- Allows establishment of a "pilot" or demonstration facility with spin-off benefits for franchise sales, training, market research and contribution to bottom line.

Disadvantages:

- Additional up-front financial and human resource investment.
- Establishment of a "pilot" or demonstration facility may divert management attention from franchising and into operational details.
- Senior management of Franchisor is still unfamiliar with local customs, etc.
- Establishing local branch or subsidiary may incur additional taxes.
- Some countries may require local ownership or control of a subsidiary.

2.3. Area Development Agreements

This format is nearly identical to direct franchising, involving a direct contractual relationship between the Franchisor and the Franchisee/Area Developer and no third party being involved, with the added feature that the Area Developer is granted an "exclusive" territory (which may include a portion of a country, all of a country or a number of countries) for the placement of a number of retail units and with a required development schedule (X number of units must be opened in Y period of time.)

This approach may be indicated when:

1. A prospective Area Developer has adequate sophistication and resources to properly develop the area and would be unlikely to make the necessary investment without assurance of "exclusive" rights.

2. More rapid expansion is required than may be achieved by selling units one-by-one.

3. The Franchisor wishes to limit the number of Franchisees in a country or market area, while retaining direct control over the franchising process.

Advantages:

- Increased marketability of the franchise to large investors.
- Area Developer may be well funded and a businessperson of proven ability.
- Reduced marketing, training, assistance in start-up, etc. costs since the franchise has to be "sold" only once and the Franchisee rapidly becomes knowledgeable in the business.
- Reduced ongoing cost since the Franchisor will have to deal with only one Franchisee per "area."
- A substantial development fee (generally 1/2 of the individual franchise fee for each unit covered by the Agreement) is paid on the signing of the Development Agreement and the balance of additional fees may be paid on the signing of the Franchise Agreements covering each unit.
- Fees generated by the operating units are not split with any other party.

Disadvantages:

- Failure of the Area Developer may be catastrophic for the Franchisor's reputation in the country (lots of eggs in one basket.)
- If the Area Developer succeeds in its development plans, it may grow to the point where it has significant negotiating leverage *vis a vis* the Franchisor, possibly even allowing a "breakaway" situation to develop.

- Unit franchise fees are generally fixed at the time of signing the Development Agreement and cannot increase if the Area Developer meets the schedule.
- Finding a suitable Area Developer is more difficult than finding individual Franchisees.
- Individual unit managers will be employees, not Franchisees, and may lack entrepreneurial spirit.

2.4. Regional Subfranchising

In this approach the U.S.-based Franchisor (sometimes called the Master Franchisor) grants a Master Franchise, for a territory covering a country or group of countries, to a Subfranchisor (sometimes called the Region.) The Subfranchisor sells and services individual franchises for Local Franchisees throughout the Regional (subfranchised) territory, generally on an individual (but conceivably on an area development) basis. The U.S.-based Franchisor does not have any direct contractual relationship with the Local Franchisees and has no direct legal obligations to them. As a practical matter, the Subfranchisor ("Region") acts as the franchisor in the foreign country.

This approach may be indicated when:

1. The Franchisor already uses subfranchising in the U.S.

2. The Franchisor lacks the resources (human and financial) to directly engage in the sale and servicing of franchises in the foreign country.

3. Rapid expansion into the foreign country is necessitated by competitive circumstances.

4. Significant cultural differences, great distances or other factors make it difficult to do business without a local management team.

[Note: Surveys indicate that over 50% of U.S. Franchisors franchising outside the U.S. and Canada utilize the subfranchising method of internationalization, probably primarily for reason no. 2 above.]

Advantages:

- Initial Regional Franchise Fee paid by the Subfranchisor may be a significant sum.
- Subfranchising may be one of the few ways that a Franchisor with limited capital can enter a foreign market, since investment of capital and human resources is minimized.
- Subfranchising can offer at least the potential of rapid expansion in a foreign market.
- Direct financial exposure of the Franchisor to potential losses is minimized.
- The foreign Subfranchisor is intimately familiar with local customs, business methods, suppliers, sites, etc.

- The foreign Subfranchisor has made a substantial investment and is less likely to “walk away” from its commitment to success of the franchising venture.

Disadvantages:

- Fees (initial franchise fees, royalties, etc.) generated by the operating units are shared with the Regional Subfranchisor, who will generally retain between 70% and 85% of this income.
- The Franchisor has largely given up control of the franchise system in the foreign country. Selection of Franchisees, sites and even operating methods may be largely outside the control of the U.S.-based Franchisor. While legal steps can be taken to enforce system standards, they are extremely expensive and time-consuming.
- If the Subfranchisor is ineffective, failing to sell franchises and/or properly service them, expansion into the foreign market may be crippled.
- It is generally difficult to terminate the Franchisor—Subfranchisor relationship.
- Finding a competent Subfranchisor may be difficult.
- Failure of the Subfranchisor may require the Franchisor to take over the system in the foreign country. Significant difficulties may arise where the Subfranchisor controls leases, non-competition agreements may be unenforceable, etc.

2.5. Area Representative Agreements

This approach involves the appointment of a representative to sell and service franchises in a foreign country for a limited period if time. The Local Franchisee has a contract directly with the U.S.-based Franchisor, but most of the services normally provided by the Franchisor (site selection assistance, initial and on-going training, managing local advertising co-ops, handling relations with suppliers, etc.) are provided by the Area Representative. The Area Representative is paid a sales commission and a portion of the ongoing royalty stream (up to 50%) so long as it provides such services. The Area Representative does not pay anything to the Franchisor for the relationship.

This approach may be indicated when:

1. A Franchisor wishes to obtain the services of a local associate to sell and service franchises but does not wish to give up as much control as in subfranchising.

2. The Franchisor has decided to forego any upfront payment for area rights in exchange for retaining a greater percentage of ongoing royalties, etc.

Advantages:

- Access to a local management team for franchise sales and service.

- Less loss of control since there is a direct contract between the U. S.-based Franchisor and the Local Franchisee.
- The Franchisor retains a greater percentage of royalty income generated by the Local Franchisee.

Disadvantages:

- The Area Representative, having not made an up-front investment in any area rights and only being entitled to a lower percentage of royalty income for services, may not be as committed as the Subfranchisor, may provide fewer quality services and may more easily "walk away."
- Area representative arrangements are relatively uncommon in international franchising. Lack of familiarity with the structure in foreign countries may make it less likely to find a willing and competent participant, particularly where no "ownership" has been granted.

2.6. Joint Ventures

In this scenario, the U.S.-based Franchisor enters into a Joint Venture Agreement with a foreign individual or company to establish a joint venture company (generally a corporation). The joint venture company is then licensed by the U.S.-based Franchisor to do one or more of the following: open company-owned units, engage in direct franchising or act as a subfranchisor. The Franchisor retains equity in the joint venture company.

This approach may be indicated when:

1. Local legal restrictions make it impractical to do business in any other way.

2. The U.S.-based Franchisor wishes to retain equity, but limit its exposure and investment.

Advantages:

- Involvement with a local company familiar with the market, etc.
- Local partner has made a significant investment.
- Sharing of risks.
- Access to local government grants, subsidies, etc.
- Possible favorable tax treatment.
- Possibly greater control by the Franchisor over the franchise system in the foreign country.

Disadvantages:

- Sharing of profits.
- Issues of control, potential buy-outs, etc. must be resolved.
- Possible deadlocks.
- The U.S.-based Franchisor may be required to make a capital investment.

- In the event of a dispute, the U.S.-based Franchisor, as a foreign national, will always be at a disadvantage in local courts.
- Possible difficulties in the repatriation of profits to the U.S.-based Franchisor if unanimous consent is not obtained.

2.7. Test Period Agreements

Before leaving the topic of Alternative Structures, you should be made aware of the uses of Test Period Agreements.

In typical subfranchising situations, the prospective Subfranchisor may be reluctant to commit to the payment of a significant Regional Franchise Fee or a specific Development Schedule until he has some assurance that the proposed franchise is commercially viable in the target market. In addition, the U.S.-based Franchisor may have some questions regarding the suitability of the prospective Subfranchisor. Test Period Agreements allow the parties to enter into a limited relationship without the necessity of a major financial or legal commitment.

A Test Period Agreement would generally provide for the following, along with other terms:

1. Permission to open one franchised unit in a specified area.
2. Payment of a unit Franchise Fee.
3. Execution of a Unit Franchise Agreement.
4. Provisions for training, assistance, possible modification of operations to suit local market, etc.
5. Discussion of mechanism for conversion to a Master Franchise Agreement covering the entire country.
6. Undertaking by the U.S.-based Franchisor not to open other units or franchise in the country for a period of time (this may require payment of a separate fee.)
7. Discussion of what happens if no Master Franchise Agreement is executed (continued status as franchised unit, mandatory or optional repurchase, etc.)

3. RELATIONS WITH LOCAL COUNSEL

3.1. Selection

Local counsel will be an invaluable guide to (1) the practicality of franchising in a particular country, at least from a legal standpoint, and the analysis of the structural means you choose and (2) handling the necessary details involved in your entry into a foreign market. Therefore, selection of local legal counsel may have a significant effect on your success in international franchising.

Local counsel can be identified through the following means (listed in approximate decreasing order of usefulness and reliability):

1. Referrals from the International Franchise Association and IFA members, particularly those who may have recently franchised into the country you are targeting.

2. Referrals from your U.S. franchise counsel, trademark counsel, etc. if your U.S counsel has had international franchising experience.

3. Referrals from counsel you have used in neighboring or other countries.

4. Referrals from the Franchise Association (if one exists) of the target market.

5. Referrals from Commercial Attache of U.S. Embassy in the target market.

However you identify prospective local counsel, the following points are vital:

Interview more than one counsel. Just as you would want to interview more than one new Vice President of Operations or Marketing, you should have more than one choice of local counsel. This is your decision and you should not simply hire the first lawyer you're referred to.

Hire only experienced counsel. You should not be paying for someone else's learning curve, particularly in an area such as international franchising where your own experience may be limited. Your foreign counsel should already have experience in bringing U.S.-based Franchisors to his/her country. Counsel experienced only in general commercial or corporate matters are not adequate.

Don't feel it is necessary to hire only the largest law firms. Unless you are involved in a deal that is particularly large or complex, you may be paying for a name on the door rather than actual legal expertise. If a firm is experienced in international franchising and can also handle the related tax, immigration, trademark, real estate and commercial matters, you are probably well represented.

3.2. Relationship and Management

From the viewpoint of the U.S.-based Franchisor, the relationship with the local counsel you have selected involves a judicious exercise of management judgment. On the one hand, local counsel has been hired for (among other things) his/her expertise in local legal matters and (hopefully) his/her experience in successfully introducing U.S.-based Franchisors to the foreign country. Since the U.S.-based Franchisor is paying for that advice, it's generally a good idea to follow it.

On the other hand, the U.S.-based Franchisor must be watchful to insist that the business relationship and the related documentation meet their standards and ways of doing business. By definition, the franchise system and the Franchisor's methods of doing business have been successful in the U.S.; changes should be made only where they are legally mandated or are required for valid business reasons. Drafting contracts simply to suit local style, for example, should never be permitted.

The bottom line is that local counsel is an expert you have hired. Respect his/her advice when it is in their area of expertise. Draw on their practical business experiences (and those of their clients) for possible relevance to your situation. But you, as the Franchisor, are the one managing the relationship and should never surrender decision making to any local "authority."

As with any legal counsel, cost control is vital. Never authorize counsel to undertake a project without having an estimate of the costs involved. Do not be intimidated by "legal mystique." Counsel with adequate international experience in the franchising area to handle your project should also be able to closely estimate the costs involved in trademark registration, setting up a foreign subsidiary, modifying your documents to meet local legal requirements, etc. If cost control is an important factor and legal work must be kept to a budget, let local counsel be aware of that fact.

3.4. Preliminary Considerations

At a minimum, advice from local legal counsel should be obtained in the following areas prior to entering into any substantive negotiations, making any significant expenditures or taking any steps to enter the target market:

Trademark Protection. Trademark piracy is not uncommon in many areas and obtaining preliminary protection of your name and marks, by filing or otherwise, is vital to avoid the experience of negotiating with someone who already controls your trademark in his/her country! Be guided by advice of counsel and take these steps before doing anything else.

General Structural Considerations. Local counsel can give you guidance as to various factors affecting your choice of structure for franchising into the foreign country. Remember, however, that (as outlined above) this is a business, not a legal, decision and must be made by you, not your attorney.

Exchange Controls. Limitations on your ability to remove earnings, franchise fees, royalties, etc. from the country in question, in a hard currency form useable to you, may affect the entire internationalization decision. Advice on this factor at an early stage is vital.

Taxation/Withholding. Taxation of payments to Franchisors located abroad may affect the profitability of the proposed venture or its form and should be "penciled out" at an early stage.

Import and Immigration Restrictions. If your franchise system depends on the use of special equipment by the Franchisee or you need to have your staff resident in the foreign country for extended periods, these areas must be reviewed for possible impact.

General Discussions re Cultural Factors, Impact of Local Law, etc. Local counsel can also be useful in general guidance as to how business is done in the country, relationships with government officials, practicality of the franchise concept, potential legal hurdles (e.g. restrictions on foreign ownership of real property), etc.

Compliance with Local Franchise Laws. As more and more countries begin to regulate franchise sales and the franchise relationship, local counsel's advice regarding compliance with these laws may be critical even before you begin your franchise marketing program.

4. PRACTICALITIES OF NEGOTIATIONS AND DRAFTING

4.1. Maintaining Control of the Drafting Process

Notwithstanding pressures from the foreign Franchisee (and sometimes from the attorney you've retained in the foreign country), it's vital that you maintain control of the drafting process. Remember that you have a developed and successful system and that that system has significant value. That value will be protected and enhanced when you use a standardized approach to negotiating agreements. While there are obvious areas where concessions to local law or practice must be made (local legal requirements, tax and exchange considerations, etc.) and any resulting agreement must be fair for both sides to be workable, part of your approach should be consistent use of one basic form of agreement for all of your international expansion.

4.2. Using Your Form

Difficulties are bound to erupt (as well as legal fees escalate) if a different form of basic agreement between the (U.S.-based) Master Franchisor and foreign Subfranchisor (or other entity) is used in each country. Not only will local forms of agreements make it difficult for you to understand exactly what your commitments and rights are, administration of a franchise system with 15 different forms of agreement is an almost impossible process.

The international attorney representing the (U.S.-based) Master Franchisor should prepare a standardized form of international agreement, reflecting the chosen structure for international expansion, prior to initiating negotiations with the foreign Subfranchisor, so that it will be clear as to the basic form of the deal and the "draft" from which all parties will be working. It should be made clear that this basic form will be subject to minor modification to take into account local legal requirements, but that the basic structure of the deal will not be departed from. Obviously, if the Master Franchisor is already utilizing an area development, area representative or regional subfranchising system of expansion in North America and plans to use the same vehicle abroad, existing documents can probably be modified at a relatively modest investment.

Aside from generating negotiating and administrative advantages from using a standardized form, there's an integrity - level playing field issue here. It's not unfair to say that foreign Subfranchisors have a right to expect that their deal (for, say, Spain) will not be radically different in its basic business elements from those for other countries (Holland, Mexico and Hong Kong, for example.) Just as one would use the same Franchise Agreement in Illinois and Nebraska, the same forms should probably be used in Sweden and Germany. If basic business differences exist (valuation method for the territory, development schedules, etc.), the Master Franchisor can be assured that it will, at some time, be asked to explain and defend such differences with a response more fair-minded than "We asked for and got whatever the market could bear."

4.3 Local Legal Compliance

Obviously, relatively minor changes may need to be made in your standardized documents to account for the fact that a different legal system (the Civil Code) will apply in most countries into which you may be expanding. Certain standardized provisions may or may not be enforceable in other countries (e.g. non-competition), regulations (such as the EEC Block Exemption) may need to be taken into account and tax and exchange controls may modify portions of your Agreement (e.g. treatment of payments as trademark royalties rather than transfer of technology payments may have significant adverse effects.) In these areas, local foreign counsel will be your best guide.

4.4 Pricing

Pricing the rights for a country or area involves business considerations more than legal or structural ones and pricing approaches can vary significantly from one Franchisor to another. However, some general guidelines are appropriate:

1. Uniformity of Approach and Use of Formulas

The pricing for area rights is probably most defensible when (a) a uniform approach is used with regard to all countries and (b) a formula has been developed that provides a rational basis for the price selected. This method of setting price makes negotiations easier and creates fewer "integrity" problems later in the relationship.

2. Relationship Between Initial Franchise Fee, Royalties and Financing

A number of Master Franchisors have found it advantageous to stick to the original price proposed for a country or area but to be willing to make concessions in the areas of royalties or financing the purchase price. An initial down payment followed by later payments tied to the development schedule for the territory may represent a workable compromise.

3. Special Considerations for Developing Countries

In some areas, where legal enforcement of your rights to receive the balance of the initial fee for rights to the area may be difficult to enforce in the local legal system, the (U.S.-based) Master Franchisor may find it prudent to require a significant "up-front" fee designed to cover all costs and provide a reasonable return in the event that no further funds are forthcoming from the area sold.

4. Setting the Price

No "magic formula" or universally accepted method exists for determining appropriate prices for area or country rights, but some general suggestions can be made.

First of all, the (U.S.-based) Master Franchisor should carefully calculate all costs involved in the internationalization effort, including U.S. and foreign legal costs, trademark registration, U.S.-based training, foreign training, translation (although this cost may often be best borne by the foreign Subfranchisor), support of the foreign Subfranchisor until royalties generated are significant, the possible "loan" of an executive to assist the foreign operation in start-up, etc. Obviously, the initial fee for the area rights should be significantly more than anticipated costs to do the deal!

Second, the (U.S.-based) Master Franchisor should be able to calculate the value of the area rights to the foreign Subfranchisor by estimating the number of franchises reasonably to be placed in the area (this obviously ties into the development schedule), the expected income stream to the foreign subfranchisor from these operating franchises and an appropriate ratio for an adequate return on investment to the foreign Subfranchisor. At the same time, remember that you are not selling an existing income stream and that the foreign Subfranchisor will have to make additional investments of cash and effort to realize an area's potential.

Third, ask other Franchisors. Those not directly competitive with you may be willing to share their experiences and methodology in determining/negotiating price, royalties, development schedules, etc. Obviously, if you have already been selling Regions in North America, that experience should be transferable to the international sphere.

5. Payment options

In addition to setting the price, you need to give attention to payment options. Depending on a number of factors, you may wish to have the franchise fee for the area/country front-end loaded (all or most of the fee paid on signing) or back-end loaded (financed, possibly with an interest component, possibly paid per franchise sold/opened and/or adjusted as a percentage of revenues received by the Subfranchisor.)

6. Price Ranges

Prices range from the low six figures (U.S.) to well over $1,000,000, depending on the size of the potential market, the desirability of the product/service and the recognition factor of the Franchisor. Prices below the low six figures generally do not justify the expense and management involvement necessary to make the commitment to an international franchising expansion worthwhile, particularly in today's market of well-motivated and financed buyers.

5. PLANNING FOR THE EDUCATION OF THE FOREIGN SUBFRANCHISOR

It's an unwise (and naive) U. S. based Master Franchisor who assumes that its responsibilities are fulfilled by signing a foreign franchising agreement, delivering manuals and running the foreign Subfranchisor through it's normal training. Two major areas will have been missed by this approach: (1) Training the foreign Subfranchisor to be a Franchisor in your mold and (2) adapting your existing operational and franchise sales systems to the realities of a foreign market. U.S.-based training for the new foreign Subfranchisor would include, at a minimum, the following points and cover many weeks or months:

- Management Preparation and Overview
- Orientation to the Franchise System
- Franchise Sales Strategy and Techniques
- Training and Development of the Local Franchisees (Train the Trainers)
- Supplier Relations
- Opening Support by the Master Franchisor at the Subfranchisor's HQ
- Financial Controls, Analysis and Management
- Quarterly and Annual Evaluation and Strategic Plan Adjustments/Compliance

6. PRACTICAL NEGOTIATION

6.1 Preliminary Considerations

As we begin to discuss the impact of cultural differences on the negotiation process, we should note some important points for the U.S.-based Master Franchisor to consider even before negotiations are begun.

First, the prospective foreign Subfranchisor must have already been pre-qualified. It's unwise to devote a significant effort to negotiations if the prospective foreign Subfranchisor is financially or psychologically unfit to be your representative in the foreign country.

Second, the prospective foreign Subfranchisor must already be sold on and excited by the concept. Negotiations are no time to do marketing!

Third, it's important to consider what the prospective foreign Subfranchisor "brings to the table," other than cash. Does he/she have experience in franchising, experience in the specific industry in which the franchisees will be operating or owns another business that "meshes" particularly well with your business? If not, maybe a better prospect remains to be identified! Remember that you are dealing with an entire country full of potential business "partners" and you should be in no rush to find the right one.

6.2. Cultural Differences

Cultural differences are significant, although sometimes overrated. Cultural matters fall into two broad categories, relating to (a) the practicality of the retail franchised business in the target market area and (b) the impact of cultural differences on the negotiating process. Obviously, before beginning negotiations (let alone entering a foreign market), the U.S.-based Master Franchisor needs to know everything it can about the market for the franchised product/service and what adaptations may be necessary for that market. That "homework" affects the entire internationalization decision and, if well done, puts the U.S.-based Master Franchisor in a powerful position to manage negotiations. Since these market factors are generally considerations specific to the franchised business, let's turn to general cultural factors and their impact on negotiations.

Americans entering international negotiations should keep the following guidelines in mind:

- Don't be intimidated in dealing with foreign businesspersons. Their ultimate motivations and ways of doing business are largely similar to yours and, by definition, you have a product/service they need or want in their market.

- At the same time, don't be arrogant about any supposed "superiority" of the American approach to business. Too many Americans assume that the way they do business is the only way or, at least, the best way. We are citizens of a world economy and other approaches to doing business may make good sense.

- So long as the basic integrity of your system isn't compromised, be willing to make reasonable adaptations to local customs. In subfranchising you will inherently be giving up some control and must have a degree of (validated) faith in your representative in the foreign country.

- Don't automatically assume that the market for Franchises in a foreign country is less sophisticated than in North America. The 90s is an era when a large number of U.S. Franchisors are going abroad and local franchise sophistication is growing. Don't get caught "looking down your nose."

- Draw on your international contacts (or those of your international franchising attorney) to learn about the "styles" of negotiating used by different cultures. Some cultures place great value on group decision-making and will be unable to commit themselves until a consensus has been reached by many levels of management, a process that often takes a substantial period of time.

Other cultures adopt an "everything is negotiable" posture which may be evidenced by a continual effort to "improve" each detail in a deal until the point comes where the Master Franchisor calls a halt to this process. Negotiating from a perceived position of strength and utilizing your pre-existing documents and structure will minimize this process. At the same time, when the prospective foreign Subfranchisor raises a legitimate concern, you must be prepared to deal with it.

6.3. Building Trust

Americans should also realize that in many other cultures personal relationships and trust play a much larger role than a purely economic analysis. The American tendency to make business decisions largely based "on the numbers" is not always shared by other cultures and you must be prepared to build trust and a firm relationship during the negotiating process.

6.4 Controls the Master Franchisor May Not Be Able to Exercise

Finally, as part of the negotiation process, be prepared for the fact that a foreign Subfranchisor will be exercising many of the controls in the foreign country that the Master Franchisor would normally reserve for itself in North America. Among others, the Master Franchisor should be prepared to not have direct control over the following areas:

- Location selection for retail units.
- Selection of Local Franchisees (although it's wise to reserve the right to eliminate Franchisees who prove inadequate in home office training in the U.S., if your system provides such training.)
- Advertising fund disbursements (but retain audit rights.)
- Relationships with suppliers in the foreign country.

7. ISSUES TO BE ADDRESSED AND NEGOTIATED

While it's probably impossible (and certainly inappropriate) to attempt to list all of the issues which may be negotiated, the following is a list of a very few selected items with regard to which you should be prepared to negotiate and justify your position.

- Trademark Protection - Whose responsibility and cost?
- Level of Support Provided by Master Franchisor
- The Grant - What are you selling? Are you preserving alternative distribution channels or related products/services for the Master Franchisor?

- Development Schedule - How many units have to be sold/opened and by when for the Subfranchisor to preserve its rights? What happens if the schedule is not met?
- Term, renewals, conditions for renewal, etc.
- Is local Franchise Agreement to be in your usual standard form or modified in some way?
- Control of the system and relationships with suppliers, etc.
- Adaptation of the Franchise System
- Can Subfranchisor own and operate local units? What about pilot, training and marketing units?
- Subfranchising - Splitting the Pie: What percentage of initial franchise fees and royalties is the Subfranchisor to retain?
- Subfranchising - What happens to Locals on Termination of Master?
- Dispute Resolution - Use of arbitration, location, costs, etc.

8. BIBLIOGRAPHY AND SOURCES

Aside from literature having to do with a specific country or general matters in international business, the following books are specifically helpful in the area of international franchising and the legal and negotiating concerns connected with that area of business:

The International Franchise Option, Mark Abell. Waterlow Publishers, Paulton House, 8 Shepherdess Walk, London N17LB. 1990.

International Franchising, Alex S. Konigsberg, Q. C. Transnational Juris Publications, Inc. Ardsley-on-Hudson, New York. International Franchise Association. 1991.

Survey of Foreign Laws and Regulations Affecting International Franchising, Franchising Committee, Section of Antitrust Law, American Bar Association. 1989. (Beware that this is somewhat out-of-date and needs to be supplemented by advice from counsel.)

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.