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TERMINATION OF MASTER FRANCHISE AGREEMENTS

Jeffrey A. Brimer
Faegre Baker Daniels LLP
Denver, Colorado USA

Ronald K. Gardner
Dady & Gardner
Minneapolis, Minnesota USA

I. Introduction and Terminology

This paper will present certain issues arising from the termination of a Master Franchise Agreement from the viewpoint of the Master Franchisor and Master Franchisee. Where appropriate, consideration of the viewpoint of the Subfranchisees will also be presented.

While many of the concepts discussed will be applicable to Master Franchisors based in any country, the focus will be on U.S.-based Master Franchisors enforcing a Master Franchise or Development Agreement entered into with Master Franchisees or Developers in other countries.

The terms used in this paper have the following meanings:

- “Master Franchisor” is the party granting the franchise rights to a third party pursuant to a Master Franchise Agreement.
- “Master Franchisee” is the party who is granted rights to open and operate its own units and to subfranchise the right to open and operate units to Subfranchisees pursuant to a Master Franchise Agreement.
- “Subfranchisee” is the party who is granted the right to open and operate its own unit from the Master Franchisee pursuant to Subfranchise Agreement.
- “Territory” is the geographic area where the Master Franchisee is granted the right to open, operate and, if applicable, subfranchise the rights to the System.
- “System” is the accumulation of intellectual property rights, know-how, proprietary operating procedures and other rights that the Master Franchisor grants to a Master Franchisee and the Master Franchisee subfranchises to a Subfranchisee to allow them to open and operate units in a Territory.

II. Causes for Termination

There are a number reasons why a Master Franchisor would want to terminate a Master Franchise Agreement. These include: failure to pay royalties and other fees; failure to comply with a development schedule; use of unauthorized sources of supply; sale of unauthorized goods

or services; failure to provide records and reports; misuse of trademarks; misuse of confidential information; violation of in-term and post-term non-competition provisions; failure to enforcement Subfranchise Agreements; and, violation of laws.

The type of default by the Master Franchisee will have an influence on the procedure used to enforce the Master Franchise Agreement and the remedies available to the Master Franchisor. These will be discussed in greater detail in the following sections.

III. Terms of the Master Franchise Agreement that Affect Termination

A. Governing Law

While many of the views of the Master Franchisor might also apply to the Master Franchisee, it shouldn't come as any surprise to anyone that a Master Franchisee may have a different view about the way a dispute between a Master Franchisee and a Master Franchisor should be resolved. Additionally, and again not too surprisingly, those disputes will often center on the process of dispute resolution, including such important questions as where the hearing will be heard, what law will apply, and what happens in the event the relationship between the Master Franchisor and the Master Franchisee actually comes to an end. The choices for the governing law of the Agreement are the home country of the Master Franchisor (which would be, for the US-based Master Franchisor, United States law (including the law of the State where the Master Franchisor is located), the law of Master Franchisee's country, or the law of some other country.

1. Master Franchisor's Home Country

a) Master Franchisor's Perspective

Typically, many U.S.-based Master Franchisors tend to favor U.S. laws over the laws of the Territory. This is not a decision that should be made without careful analysis of the impact of that decision. Master Franchisors should not assume that their country's laws will always be more favorable to them than the laws of the Territory or some other enforceable controlling law. For example, a California-based Master Franchisor would not want the California law on post-termination non-competition provisions applicable to a Master Franchisee in another country because California enforces these provisions in very limited circumstances.

b) Master Franchisee's Perspective

Frequently, as a consequence of the initial agreement between the Master Franchisor and the Master Franchisee, the law that will apply to a dispute is that of the Master Franchisor's home country. While this might not necessarily be an adverse development for the Master Franchisee, the one tip that I have here is to make sure that you are paying attention to this issue before you allow one of your clients to enter into a Master Franchisee/Franchisor relationship. Typically, laws rarely have an international effect, and as a result, the laws, for instance, of the United States, will do little to protect a Master Franchisee who is developing in Europe. Understanding this on the frontend will allow a Master Franchisee, who does have some bargaining leverage at the time of the initial contract, to augment any suggested laws with added contractual protections in the event a dispute might arise down the road.

If you find a client is in trouble with their Master Franchisor, and any such dispute is going to be resolved under the laws of the Master Franchisor's home country, it is critical that you get good legal advice from someone that understands the laws of that country. In other words, don't be hesitant about hiring local attorneys who are savvy in the laws of the country's laws that will govern the dispute.

2. Master Franchisee's Home Country

a) Master Franchisor's Perspective

From the Master Franchisor's perspective, factors affecting the choice of the Master Franchisee's home country as the governing law include whether there is law in the Master Franchisee's home country that requires its laws to apply to the interpretation of the Agreement; whether the Master Franchisor has a physical presence in the Master Franchisee's home country; and, which laws may be more favorable to the Master Franchisor, protect the rights of the Master Franchisor more or ensure greater enforceability of the Agreement.

b) Master Franchisee's Perspective

Conversely, it is likely going to be an advantage for your client to have the laws of its own country apply to its relationships with its Master Franchisor. However, that is not a given. Again, if you've got a prospective Master Franchisee as a client, make sure the laws of his or her own country actually are helpful to that Master Franchisee. If not, you might be better off deferring and allowing the laws of the Master Franchisor to apply. This is something that needs to be considered on a case by case basis.

If your client is in the country in which you practice, it obviously would be helpful for you to assist the client if you are familiar with the laws that apply to the relationship. Therefore, one of the reasons that you might press for the Master Franchisee's home country's laws to apply is that you practice in that country and understand the laws. However, I would caution you and suggest that that is not enough. Knowing the laws, and having the laws actually help your client, are not necessarily the same thing.

3. Neutral Country

a) Master Franchisor's Perspective

Using the law of a country where neither the Master Franchisor nor Master Franchisee is located requires a complex analysis to determine if such choice will be enforced. In the U.S., parties to a contract cannot select the law of a state where neither party is located unless there is some reasonable relationship between that state and the performance of their agreement. To make the law of another country applicable, the laws of all three countries – where the Master Franchisor is located, where the Master Franchisee is located and the "neutral" country – must be examined to determine if this decision is enforceable and the consequences of this decision. If it is not, then the law applicable to the interpretation of the Master Franchise Agreement could be an issue in the dispute resolution process.

b) Master Franchisee's Perspective

If the Master Franchisor simply refuses to accede to a demand that the Master Franchisee's home country laws apply, but you have determined that the Master Franchisor's home country laws are just not acceptable, it is quite common to find and suggest that the laws of a neutral country apply to any future dispute. Most Master Franchisors that I have dealt with will agree to this, so long as they are given an adequate opportunity to research the laws that you suggest, and/or make alternate suggestions. Remember, when you are negotiating what law will apply, the Master Franchisor is hoping to get money from your client – the prospective Master Franchisee. At that point in time, you have as much bargaining leverage that you are ever going to have. Make sure that you use it.

Regardless of what law ends up applying, and I said this once before, make sure that you engage counsel who is familiar with that law if and when a dispute breaks out. It is a huge mistake to expect that just because you are a smart and educated lawyer that you can understand the laws and procedures of another country. If you are going to have to play in someone else's home country, get someone who is familiar with the process and the laws in that country in order to help you and your client.

B. Dispute Resolution Process

The format for dispute resolution will determine the process for resolving disputes in the performance and interpretation of the Master Franchise Agreement. In most cases, the parties are free to determine how they will resolve their disputes. Some countries, such as Korea (Fair Franchise Transactions Act, Chapter 4) and Australia (Code of Franchising Clauses 24-31), have a mandatory dispute resolution process. The trend over the past several years has been an increasing use of arbitration to resolve most disputes between parties based in different countries. Many countries, including the United States, have laws favoring the use of arbitration¹. The New York Convention on Enforcement of Foreign Arbitral Awards² has been adopted by most countries, making the process for enforcement of arbitration awards much easier and more predictable.

Other approaches to dispute resolution can be built into the Agreement to help expedite the resolution of disputes and control costs of doing so. When several different formats for resolution of disputes are used, it is important to identify the issues are required to be resolved by each format very clearly. Even though a Master Franchise Agreement may require arbitration of most disputes, there are certain disputes that are resolved better by getting injunctive relief from a court with proper jurisdiction to stop the Master Franchisee from engaging in the activity prohibited by the Agreement as fast as possible. Although most arbitral forums give arbitrators the power to issue injunctive orders, the steps necessary to set up the arbitration may take too long to make an arbitrator's injunction award effective by the time it is awarded and then enforced in a Court. Filing an action in the appropriate Court of competent jurisdiction, which can be done within a day or two, may be significantly faster and prevent further damage to the

¹ Federal Arbitration Act, Title 9, US Code, Section 1-14.

² See http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html.

System. It is, therefore, important to select the proper Court in with to bring an action for injunctive relief. As discussed more fully below, an order from a Court in the Master Franchisor's or Master Franchisee's jurisdiction may not be enforced by the courts in the country of the other party.

1. Informal Dispute Resolution or Negotiation

a) Master Franchisor's Perspective

The Master Franchise Agreement can include provisions for an informal process for dispute resolution that does not involve any third parties, Courts or formal arbitration organizations. From a cultural perspective, parties outside of the US are often more willing to assume responsibility for resolving their disputes without resorting to a formal dispute resolution process. The parties can require that if a dispute cannot be resolved by the people within the respective companies responsible for administering the Agreement, the Chief Executive Officers of each company must meet for a designated period of time to attempt to resolve the dispute before formal processes can be initiated. In addition to the parties who must be present to resolve the dispute, the Master Franchise Agreement should address how the process is initiated; the place for the meeting (including whether the meeting can be conducted by telephone conference call or must be in person); when the meeting should be held; the minimum length of time the parties agree to devote to resolving the dispute; any other required participants in meeting; and, whether the parties can be represented by counsel.

b) Master Franchisee's Perspective

Because of the complexities involved with international litigation, it is not surprising that in most cases, the most effective and efficient way to resolve a dispute between international players is through an informal dispute resolution or negotiation process. This can be done in virtually any way you can imagine, but in its most base form, consists of negotiation directly either between the parties, or their lawyers. This type of negotiation also allows the most flexibility, as parties can be quite creative in their problem solving, and whatever issue they might have with one another can be put on the table and, hopefully, resolved. The panel shares the view that parties do their clients a disservice if they don't attempt to resolve all disputes informally prior to the institution of formal proceedings – unless there is an absolute strategic reason to shoot first and ask questions later. However, assuming that more formal processes need to be pursued, whether mediation, arbitration or litigation, seasoned representatives of Master Franchisees know that they may need to use one or all of these in order to get their client the most leverage.

2. Mediation

a) Master Franchisor's Perspective

Engaging a third party, neutral, mediator to help the parties resolve the dispute may be a more efficient process than either arbitration or litigation and helps to produce a result that may be more acceptable to both parties – rather than having a winner and a loser. Many of the arbitration organizations also have procedures for conducting mediations. The Master Franchise Agreement provision should address the types of disputes subject to mediation, the mediation

organization and rules that will be followed; how the mediator is selected; the place where the mediation will be conducted; the length of time devoted to mediation; the participants in mediation; the language to be used in the mediation; whether the parties can be represented by counsel; and, whether the mediator will be required to provide a report to the parties if the dispute is not resolved.

b) Master Franchisee's Perspective

Mediation is a non-binding, assisted negotiation. Like an informal negotiation, it allows the parties to fashion a lot of remedies that are not available to them in arbitration or litigation. However, it is somewhat more “process oriented” than informal negotiations.

In mediations between international parties, one of the most important things is clear communication. In the event a bilingual mediator is available, that is probably the best approach if language is a barrier. Conversely, parties should be willing to spend the extra money on a good translator. Mediations simply do not work if the parties do not understand what the issues are, what the other side is trying to communicate, and the nuances of both the issues and the proposed solutions. This, of course, can raise the price for mediation (which, in some cases, is the sole reason you might want to mediate – to keep the price down), but the conflicts that arise from a mediation that goes awry because of bad communication are often worse than the issues that brought parties to the dispute in the first place.

3. Litigation

a) Master Franchisor's Perspective

If the parties do not want to use mediation or arbitration to resolve their disputes, then they will have to resort to litigation in the applicable court system to be able to enforce the Master Franchise Agreement. Litigation does not have the flexibility in terms of selection of judges, rules for conducting the proceedings, place where the proceedings will be conducted, the language in which the proceedings will be conducted, the scope of pre-hearing discovery; and, whether an opinion will be rendered by the judge. All of these are set by applicable court rules, codes and laws. What litigation does permit is the right to appeal the decision of the Court that heard the dispute. This is not typically available in arbitration unless the parties agree upon an appeal process. In the United States, most states and the federal court system have two levels of courts of appeal above the trial court. In some situations, however, even if arbitration is the chosen method of dispute resolution, litigation may still be necessary, such as to obtain immediate injunctive relief that is not available from an arbitrator or cannot be obtained as quickly as a court proceeding or to enforce an arbitration award.

b) Master Franchisee's Perspective

A recent article that suggested that disputes between international parties are better off litigated than arbitrated. The author opined that the difficulty in enforcing an international arbitration award outweighed the hurdles that face a party who decides to litigate on foreign turf.

While that is an interesting thought, and could potentially be true depending on the countries involved, I would be very slow to agree to a formalized process in a foreign country,

where the process is one that I didn't completely understand. If required to litigate by contract, or because the idea of an international arbitration award is daunting, I would want to make sure to get the finest representation my client could possibly acquire in the country in which the litigation had to proceed. This is not inconsistent with the advice that I provided previously in this paper, but is maybe even more urgent if your client is facing litigation (as opposed to any other dispute resolution mechanism) in a foreign venue.

Another potential advantage of litigation over arbitration is the opportunity to get discovery. In United States, for example, lawyers are given wide latitude to collect documents and testimony from relevant parties, in order to help make their client's case. Often times, as a sacrifice to "efficiency," arbitrators are slow to embrace even rudimentary discovery requests. Therefore, to the extent that the dispute that your client is having with its Master Franchisor is one where the Master Franchisor holds most of the documents, and/or needs to be cross-examined prior to trial in order for you to make your case, litigation, under a process like that available in the United States, might indeed be preferable to arbitration.

All of that said, I still believe that most international cases should be arbitrated. Because the parties can fashion the process a little bit more to their liking, and because lawyers from different countries who are familiar with different rules can fashion a set of rules, by agreement, that work for both of them, arbitration is probably a better way for most international disputes between Master Franchisees and Master Franchisors to get resolved.

4. Arbitration

a) Master Franchisor's Perspective

As noted above, arbitration has become the most favored process for resolving disputes under International Master Franchise Agreements. The process has significant flexibility. The parties can determine the type of issues subject to arbitration; the number of and process for selecting arbitrators; the place to conduct the arbitration proceedings; the language in which the arbitration proceedings will be conducted; the scope of pre-hearing discovery; and, whether the arbitrators are required to prepare a report explaining the basis for their award.

The parties can agree to resolve all disputes by arbitration or exclude certain disputes or the process for obtaining certain remedies from arbitration and resolve those disputes or seek those remedies in a different forum. If they are going to exclude certain disputes, they must describe the type of disputes to be resolved by other dispute resolution formats carefully so that disputes do not arise over whether the dispute is subject to arbitration or other dispute resolution formats. The common types of disputes that are excluded from arbitration involve those where the dispute is solely over the payment of a liquidated debt or where remedies other than money damages are being sought.

If a dispute is not subject to resolution by arbitration, then the most common form of other dispute resolution is traditional litigation in a court with jurisdiction over the matter and the parties.

b) Master Franchisee's Perspective

As international relationships grow, and Master Franchisor/Master Franchisee relationships become more prominent, the number of arbitrations between those types of parties is also proliferating. Fortunately, there are a bevy of rules that the parties can consult in order to make an arbitration run more smoothly. Those rules, include among others, UNICTRAL, the ICDR rules (an arm of the American Arbitration Association), the London Court of International Arbitration, the Hong Kong International Arbitration Centre, and the Singapore International Arbitration Centre. Each of these sets of rules has their own unique approach to international arbitration, and practitioners should make sure to consult these rules and compare them when negotiating a potential arbitration clause on behalf of their Master Franchisee client. One may have a preference for of their home country (for instance, this author, as an American lawyer, prefers the ICDR), however, when negotiating with the other side, just getting a set of rules that are fair will usually be enough.³

When examining the rules, one should make sure to pay attention to the scope of the arbitration, the amount (or lack thereof) of discovery, the filing fees required, and how the Organization views the enforceability of its awards. These are universal questions that will apply to every dispute submitted to international arbitration.

If you find your client involved in a dispute in which these rules, or some other, have already been implemented, I again can't stress enough how important it is to get someone who is familiar with the rules to assist. Parties, who, for instance, are parties to an agreement with the London Court of International Arbitration Rules applying, should promptly get hold of a lawyer who has tried at least one case under those rules. There is no substitute for experience when it comes to dispute resolution in a particular forum.

The other issue to be quite cognizant of – perhaps the preeminent issue, in fact – is how arbitrators are selected. Perhaps no decision is more crucial to the outcome of a case than who the arbitrator ends up being. With that in mind, each of these sets of rules has a different methodology for choosing an arbitrator, and the amount of input the parties have in choosing the arbitrator. Again, consult with local experts about the potential arbitrators that are being offered, and get as much information about the processes you can before agreeing to any particular set of rules.

As a last resort, because arbitration is a process governed by agreement of the parties, if you stumble into something that is just unacceptable to you in the set of rules that have been thrust upon you, never hesitate to pick up the telephone and communicate with the other side about how you would like to change the process to the benefit of both parties. If an organization wants to appoint its own arbitrator, most parties can quickly agree that they would prefer to work on coming up with someone that is mutually acceptable, rather than just accepting whoever the

³ Many papers exist comparing and contrasting these rules, and the author is currently in the process of writing an additional paper for this year's American Bar Association Forum on Franchising. I would be happy to provide copies of that analysis once it is done later this summer to anyone who would like to provide me with their contact information.

rule provider might appoint. Likewise, if both parties can agree on some limited discovery, and both believe that would be advantageous to them and their clients, the parties can tell the arbitrators that they would like a little discovery, even if the rules don't allow for that type of a process. In short, be proactive, and work the System as best you can to the benefit of your client. (Note: This is particularly important for those of you representing Master Franchisees. The contract that your client signed likely was written by the Master Franchisor, and just as likely favors the Master Franchisor at the outset. Do not accept an unbalanced playing field simply because that is the contract that walks into your office to begin the process. Do as much as you can to level the playing field, gather as much information as you can about the process, and otherwise work to put your client in the most advantageous position possible – recognizing that the other side did the same thing at the outset of the relationship!)

C. Location for Resolution of Disputes

The choice of the location for resolution of disputes by informal negotiations, mediation or arbitration is one that the parties have more latitude to decide themselves. When the parties have agreed to resolve all disputes through court proceedings, then the applicable laws on venue in the jurisdiction will affect the decision. They can agree to resolve disputes in the city where the Master Franchisor is based, where the Master Franchisee is based or in some neutral location. For example, a Master Franchisor based in Denver, Colorado and a Master Franchisee based in Continental Europe may agree on New York or London, cities where neither party is located; but, where there are sufficient number of mediators and arbitrators with experience in resolving international franchise disputes.

In the United States, in most commercial disputes, the courts will enforce the parties' agreement to resolve disputes in a particular venue. But, that is not always the case. Courts tend to reject forum selection clauses only if they find that the clause is unreasonable or has been incorporated into the contract as a result of fraud, undue influence or uneven bargaining powers; or that the selected forum is so difficult and inconvenient that the complaining party for all practical purposes is deprived of its day in court; or that enforcement of the clause would contravene a strong public policy of the state in which the suit is brought. Furthermore, in the United States, the parties must determine if they want to resolve the dispute in the state or federal court system. That decision, however, is also subject to laws and court rules. The United States Federal Courts do not have general jurisdiction over all disputes. The applicable federal court must have jurisdiction over the subject matter of the dispute. As for state court proceedings, as stated above, courts will generally enforce forum selection clauses, even if there is a lack of contact between the selected forum and the dispute. Master Franchisors should be aware, however, that a court may reject a forum selection clause if it finds that the venue selected is inappropriate or overly burdensome on the Master Franchisee – a standard that is more easily met if there is no nexus between the agreement and the forum selected.

1. Master Franchisor's Headquarters

a) Master Franchisor's Perspective

The bias of most U.S.-based Master Franchisors is to resolve disputes in the United States. Not only is it more convenient for the staff of a U.S.-based Master Franchisor; but, US-

based Master Franchisors may also assume that a Court or arbitrator in the US, especially near their headquarters will be more likely to favor them. This is not always the case, however. The problem with court resolution of disputes is that there is no international treaty providing for enforcement of judgments (except among European Union member states).

b) Master Franchisee's Perspective

As a general statement, the location of a dispute does not matter much – unless the Master Franchisor is very well connected in its city (so you have the possibility of the local decision-makers wanting to favor the Master Franchisor), or the location puts such an extreme economic burden on the Master Franchisee to litigate in the Master Franchisor's home town as to make a meaningful process difficult to achieve. Accordingly, it is my general practice that, if I can get enough information on a fair neutral (whether it be a judge or an arbitrator), I will not contest venue in the franchisor's home locale.

That being said, if I have a prospective Master Franchisee who is negotiating the venue of a dispute before a contract is entered into, I will attempt to eliminate any potential problem by negotiating the fact that the dispute has to be either heard in the Master Franchisee's locale, or at least a neutral location.

It is my observation that Master Franchisors will attempt to "bully" their Master Franchisees from challenging them, by making it as difficult as possible (e.g., by locating the dispute resolution in the Franchisor's hometown.) After a contract is signed, a Master Franchisee can challenge, in some jurisdiction, this procedure, but rarely will a judge or arbitrator do anything about such a complaint. The more effective way of dealing with this is to negotiate the provision away to start with, or if that is not an option, simply to gather as much information and "out hustle" your opponents into getting a neutral who will help you as best as possible.

2. Master Franchisee's Headquarters

a) Master Franchisor's Perspective

While the bias of most Master Franchisors is to resolve disputes either in their home jurisdiction or a neutral jurisdiction, there are valid reasons for agreeing to resolve disputes in the Master Franchisee's jurisdiction. First and foremost, is the ability to enforce any arbitration award or court order against the Master Franchisee, because the Master Franchisee will have very few, if any, opportunity to claim the decisions of its courts or an arbitration conducted in its home country are not enforceable under the law of the Master Franchisee's country. Second, especially where the Master Franchisor is either seeking to terminate the Agreement due to a default or enforce performance by the Master Franchisee, the substantial evidence will be located in the Master Franchisee's jurisdiction.

b) Master Franchisee's Perspective

If you have the luxury of negotiating the agreement on the frontend, you should try and have any dispute resolved in your client's home venue. That will give you and your client a leg up on information about potential decision makers, much less expense and greater convenience

when it comes to calling witnesses related to your client's business, and otherwise cause the Master Franchisor to come to you. This is ideal, but rarely, rarely occurs. Again, a prospective Master Franchisee would have to really flex his economic muscle at the front of a relationship like this in order to secure this type of venue, as a general rule.

3. Neutral Country

a) Master Franchisor's Perspective

Resolving disputes in a neutral country is usually the result of a compromise where neither party is willing to allow disputes to be resolved exclusively in the other's home country.

b) Master Franchisee's Perspective

Obviously, a solution to all of this is to negotiate a hearing in a neutral location. This can obviously happen at the time of formation of the contract, or, to the extent that you want to threaten a fight over venue, you might get the Master Franchisor to agree to a neutral location rather than incur the expense of a fight after a dispute has arisen.

One of the best practices I have seen is a provision that says that the party who initiates the dispute must have that dispute resolved in the other parties' home venue. In other words, if the Master Franchisee wants to complain, then the dispute will be heard in the Master Franchisor's home venue. Conversely, if it is the Master Franchisor who is complaining about a breach, the Master Franchisor must come to the Master Franchisee. This encourages both sides to avoid needless disputes, as it adds added expense to the person that wants to complain.

In a perfect world, in my opinion, all disputes would be on a neutral territory – giving neither side an advantage. You should strive to try and achieve this objective if your only other choice is the other side's locale.

IV. Consequences of Termination of Master Franchisee

The Master Franchisor will seek to terminate the Master Franchise Agreement when the actions by the Master Franchisee are so serious and damaging to the relationship that continuation of it is impossible. An action to terminate could also be combined with an action for damages to recover unpaid fees, expenses and lost profits and injunctive relief to enforce the termination and post-termination non-compete and confidentiality provisions of the Master Franchise Agreement.

Master Franchise Agreements contain a variety of different obligations on the Master Franchisee, including development of additional units, operation of units, and supporting Subfranchisees. As a result, termination of these Agreements does not have to be absolute, but can be partial. That is, certain rights may be terminated and others allowed to remain in place.

A. Master Franchisee goes independent

1. Master Franchisor's Perspective

Allowing a Master Franchisee and its Subfranchisees to continue operate units similar to the System is often the least favorable option. Even if the units can be sufficiently de-identified so that they no longer resemble the original appearance of offer exactly the same goods and services, it is almost impossible to totally separate the units from the former franchise. Plus, the Master Franchisor no longer has the revenue stream from the Subfranchises and has a competitor in place if it ever wanted to re-enter the area.

So, why would a Master Franchisor allow the Master Franchisee to go independent? The Master Franchisee may be willing to pay the Master Franchisor a large amount of money. The Master Franchisee and Subfranchisees may have created so many problems for the Master Franchisor that it simply wants to shed itself of these problems and the costs they create. Finally, the Master Franchisor may feel that without the ability to use the System, the Master Franchisee and Subfranchisees are weak competitors.

2. Master Franchisee's Perspective

When a Master Franchisor terminates a Master Franchisee, the Master Franchisee has many options. Among them, with the least amount of hassle (assuming that there is no enforceable non-compete and/or the Master Franchisee and Master Franchisor can agree on the contours of allowing the franchisee to go forward without a fight about a non-compete), is the Master Franchisee simply going independent. What I mean by this is that the Master Franchisee continues to run his or her business, and essentially continues to run its own operations and/or setup competing operations with the Subfranchisees switching to the new System.

Whether or not this is a viable option will depend on several things: (1) is there a non-compete that has to be dealt with (including the questions of whether or not local law even recognizes non-competes); (2) does the Master Franchisee have the capital and/or the interest to essentially set up a competing System; and (3) does the Master Franchisees contractual relationships with the Subfranchisees make such a conversion possible without the express assistance of the Master Franchisor? These are not questions that can be answered without specific documents in front of us, but these are the types of questions that need to be asked if the Master Franchisee is to consider going independent.

B. Master Franchisor takes over area

1. Master Franchisor's Perspective

When the Master Franchisor takes over the area from the Master Franchisee, here are numerous issues to address. The Master Franchisor may have to make a significant investment to purchase existing units operated by the Master Franchisee and establish a local presence to support these units and Subfranchisees. The Master Franchisor also inherits the issues with the System and any existing problems with Subfranchisees.

In some situations, this option may not be available to the Master Franchisor without affiliating with a local party. In some countries, foreign ownership is prohibited. In others, foreign investments may be permitted, but a local party must have controlling interest.

2. Master Franchisee's Perspective

When the relationship between a Master Franchisor and a Master Franchisee ends, there are all sorts of issues that have to be sorted out. Chief among them is what happens to the territory, and the relationship that exists with any Subfranchisees that the Master Franchisee has managed to establish. Typically, my clients (all Master Franchisees), want to stay in business, and want to continue to enjoy the royalty stream that they have created through the creation of a subfranchise network. That, of course, is complicated by the fact that the Master Franchisee can no longer use the Master Franchisor's trademarks and/or trade secrets.

Assuming for the moment that the System in question is one that can be converted very easily to a more generic trademark, or has a trademark owned by the Master Franchisee his or herself, and that the Subfranchisees are willing to go along with the change, one of the easiest outcomes is for the Master Franchisee to take his Subfranchisees and begin an independent business. The reason this outcome is desirable for both parties is that a Master Franchisee keeps his income stream, and a Master Franchisor is free to resell the territory to anybody who they can get to buy it, unencumbered by a prior relationships or bad blood that may exist between the Subfranchisor and the franchisor. (It should be noted that frequently Subfranchisees will side with Master Franchisees in their fight with the Master Franchisor. These people are generally from the same country or at least the same continent as each other, and will typically see, particularly American franchisors, as a mutual adversary. While that is not always the case, it does occur, and your client should be prepared to capitalize on that sentiment if possible.)

C. Master Franchisor sells or transfers rights to Territory to a third party

1. Master Franchisor's Perspective

A negotiated transfer of the Master Franchisee's rights to the Master Franchisor or third party may be a remedy. In this case, the Master Franchisee is allowed to sell what it has developed to the Master Franchisor or third party, thereby recovering some or all of its investment. This remedy can also be part of the Master Franchisor's rights on termination or non-renewal.

2. Master Franchisee's Perspective

Another option is for the Master Franchisee to simply sell his or her business to a third-party buyer. Under these conditions, the third-party buyer likely remains as the Master Franchisee, in a relationship with the Master Franchisor. In essence, this is an assignment of the Master Franchisee's rights to a third-party in exchange for some cash.

This approach is one that most Master Franchisors will embrace so long as the assignee is someone who meets their qualifications. A Master Franchisor, who is in the process of terminating Master Franchisee, faces many challenges, including a lack of local contacts, a misunderstanding or lack of information about the culture, and an inability to communicate

effectively and efficiently with the Subfranchisees. Allowing someone else, who does understand the country, culture and language, but, may in fact have a relationship with the Subfranchisees, solves these problems.

Conversely, a Master Franchisee would like to see this outcome because, rather than having their rights simply terminated and having to walk from their investment for nothing, they are able to salvage at least some, if not all, of the value of their business.

A more challenging transfer would be for the Master Franchisee to sell to a third-party who does not intend to act as a Master Franchisee. In essence, the Master Franchisee sells off to someone who is not bound by any non-compete, who then takes control of the Subfranchisee relationships and moves forward without the Master Franchisor. Typically, this type of a relationship will yield a greater economic return – although it comes at the risk of the Master Franchisor taking adverse action against the Master Franchisee, the assignee, or, worse yet, the Subfranchisees. In order to effectuate this strategy, one has to be very comfortable that the local laws are not going to enforce a non-compete and/or that the assignee is not going to be using trade secrets that would be protected by the laws governing the relationship. If those criteria are met, this may be the way to go, it will, as I mentioned, generally yield a higher return on the sale of the business.

D. Master Franchisor removes Master Franchisee’s exclusivity rights

1. Master Franchisor’s Perspective

A remedy similar to the one discussed immediately above is the removal of exclusive rights to develop a Territory. The existence of this remedy may be a sufficient motivator for the Master Franchisee to comply with its obligations. Standing alone, however, it faces the same drawbacks as reducing the size of a territory; that is, what is left is not sufficiently attractive to allow the Master Franchisor to award the rights to that area to a new Master Franchisee.

2. Master Franchisee’s Perspective

Frequently, rather than hassle with the actual termination of a Master Franchisee, Master Franchisors will simply strip Master Franchisees of their exclusivity in a particular area, and put an intra-brand competitor on top of the Master Franchisee in response to poor performance. In response to this action, the Master Franchisee has a few options.

First, the Master Franchisee can consider all of the “leave the System” ideas that I have just expressed – go independent, take over the area and rebrand, or sell his rights to a third-party. Of course, the Master Franchisee can also decide to stay and compete.

The most aggressive thing the Master Franchisee can do is sue the Master Franchisor for violation of exclusivity rights. While it is the case that many contracts that govern Master Franchise relationships will specifically say that the Master is not exclusive, contracts can typically be modified through parties conduct, and if the Master Franchisor has recognized exclusivity for some period of time, and the Master Franchisee has relied on that exclusivity in making the expenditure of time, effort and money to expand the brand, the Master Franchisee may be able to make the claim that the franchise relationship has been modified in such a way as

to guarantee exclusivity. This is a successful argument in the United States, and one that I would expect would be successful in other places – particularly when the equity of the situation weighs heavily in favor of the Master Franchisee.

Likewise, if the stripping of exclusivity will lead to the economic demise of the Master Franchisee, a claim for wrongful termination might exist.

E. Master Franchisor reduces size of the territory or modifies development schedule

1. Master Franchisor's Perspective

In a situation where the Master Franchisee has done a good job of opening an operating units but simply has too much geographic area to support, and, therefore, is failing to meet its development schedule; instead of terminating the entire relationship, a solution may be to reduce the size of the geographic area or the number of units that the Master Franchisee is required to open. This is an effective remedy only if the Master Franchisee is a good operator or is adequately supporting Subfranchisees. The Master Franchisor may want to bring in a new Master Franchisee for the parts of the original territory that were taken away. This is effective only if the original Master Franchisee has not picked the prime locations throughout the area, leaving the new Master Franchisee to develop in secondary locations. It also creates the situation where two different Master Franchisees are operating in the market and may not operate their units exactly alike. This leads to confusion in the market and possible damage to the image of the brand.

Where the economic conditions in the Territory have changed and the original expectations of the Master Franchisor and the Master Franchisee are not capable of being fulfilled, then a modification to the development schedule may be the best solution. It avoids the conflicts of having multiple Master Franchisees in one market and allows the Master Franchisee to use its available resources where they are most effective. So, instead of having to devote significant efforts to opening new units and investing their own or Subfranchisee's capital, they can emphasize improvement in unit sales and operations. This may improve the profitability of the Master Franchisee and the fees paid to the Master Franchisor more than simply opening new units. Modifications to the development schedule do not necessarily mean that the number of units to be opened is reduced. The term of the Master Franchise Agreement can be extended and the remaining number of units to be opened is spread over a longer period of time. Of course, if economic conditions improve, the Master Franchisee may be able to accelerate the openings and end up opening more units than originally anticipated.

2. Master Franchisee's Perspective

The Master Franchisor may also decide that rather than terminate, or strip a Master Franchisee of exclusivity, that the territory that the Master Franchisee operates in can be reduced in size or development rights taken away. For ways to respond to this threat, I refer the reader to the prior section, where the exact same issues were in play. If there is a course of dealing that modified the agreement, this may be a breach of contract, and if the modifications are so great as

to imperil the financial existence of the Master Franchisee, the Master Franchisee may have a claim for wrongful termination.

F. Damages payable to Master Franchisor

1. Master Franchisor's Perspective

Master Franchisors will seek monetary damages as compensation for claims against Master Franchisees for past due royalties and other fees, damages or lost profits, additional fees and costs and attorneys fees incurred to bring these claims. A Master Franchisor may also seek damages instead of termination or some other remedy.

2. Master Franchisee's Perspective

If the Master Franchisor's conduct has, or will, cause significant economic harm, another potential option is for the Master Franchisee to institute legal action to collect damages that result from that conduct. This is a more typical dispute between a Master Franchisor and Franchisee, and one that should not be undertaken lightly. All of the admonitions that I have provided previously about getting good local help, making sure you understand the rules of engagement that will govern any dispute, and being able to prove conclusively that the damages being suffered by the Master Franchisee in fact flow from the conduct of the Master Franchisor, are in play here. I should note that the threat of a viable claim by a Master Franchisee against a Master Franchisor is a very strong threat indeed. Franchisors who are trying to expand their System internationally do not want the international community knowing that they are in fights with their former Masters, and frequently would prefer to avoid these fights – meaning they are willing to negotiate resolutions that are more acceptable to the Master Franchisee than might otherwise be the case. Because of this leverage, it is important to understand how viable a claim really is, and to make certain that if such a claim is to be asserted, that the threat be real. Of course, these assessments can only be done with the help of knowledgeable advisors, including local lawyers and accountants.

V. Impact of Termination on Subfranchisees

When a Subfranchisee does not perform its obligations under a Subfranchise Agreement, the rights a Master Franchisor has to enforce terms and conditions of a Subfranchise Agreement will depend upon the rights negotiated in the Master Franchise Agreement. The provisions on subfranchising in the Master Franchise Agreement should give the Master Franchisor certain third party beneficiary rights in the Subfranchise Agreements to make sure Subfranchisees comply with their Subfranchise Agreements, especially when the Master Franchisee refuses to enforce the terms of the Subfranchise Agreement or does not do so in a manner that provides complete protection to the Master Franchisor's rights.

Other remedies the Master Franchisor can consider for addressing breaches by Subfranchisees include the following:

Direct Enforcement by Master Franchisor: The consequences of this broad right must be carefully examined under local law to make sure that the Master Franchisor is not assuming too much liability because of having this right. Master Franchisors will not want to be required

to provide direct support and other services to the Subfranchisees unless, as part of the termination of the Master Franchise Agreement, they are taking an assignment of the Subfranchisee Agreements. In this case, however, they will want to be careful not to assume past liabilities of the Master Franchisee to the Subfranchisees, making the Master Franchisor, in effect, a guarantor of the Master Franchisee. This right may be necessary if the Master Franchisee abandons its obligations under the Master Franchise Agreement to the Master Franchisor and the Subfranchisees.

Action against Master Franchisee to Require Enforcement of Subfranchise Agreement: This action would be directly against the Master Franchisee to obtain a mandatory injunction to require the Master Franchisee to perform its obligations and enforce the terms of the Subfranchisee Agreements. Local law in the Territory will determine if such an action can be maintained against the Master Franchisee. Even though such actions may be brought in the United States against the Master Franchisee, before bringing such an action, a Master Franchisor must determine, with the assistance of local counsel, if the order from the U.S. courts will be enforced in the local courts.

Termination of Subfranchisee: The Master Franchisor may have the right to terminate a Subfranchise Agreement; but, whether that is enforceable against the Master Franchisee and Subfranchisee could be subject to local law in the Territory.

Termination of Master Franchisee: Instead of, or in addition to, having the right to terminate Subfranchise Agreement directly, the Master Franchisor can provide in the Master Franchise Agreement that the failure of the Master Franchisee to enforce the terms of the Subfranchise Agreement is a ground for default and termination of the Master Franchise Agreement. Although a drastic remedy for what may be an isolated breach by a Subfranchisee, this right may be necessary to prevent the Master Franchisee from failing to enforce the Subfranchise Agreements and, thereby, risking that the Subfranchisees will damage the brand irreparably.

A. Conversion of Subfranchisees to new brand

1. Master Franchisor's Perspective

Like the discussion of allowing the Master Franchisee to go independent, allowing the Subfranchisee to convert to a new brand has the same problems. If the subfranchisee converts to another franchised concept, then it will be sufficiently changed so that it does not resemble or offer the same goods or services as the former franchise.

On the other hand, where the Master Franchisor wants to exit the market or terminate the Master Franchisee, allowing the Subfranchisees to convert to another brand solves the Master Franchisor's problem of what to do with the Subfranchisees, especially where the Master Franchisor does not want to make an investment in the Territory to support the Subfranchisees and expand the System in the Territory.

2. Master Franchisee's Perspective

Much of what I have to say in this section I have said previously, so I will endeavor to recap or summarize in brief fashion.

In response to termination of a Master Franchisee by a Master Franchisor, the Master Franchisee does have several options. First, which I covered above, is to go to its Subfranchisees and convert those Subfranchisees to a different brand. This can be another franchise brand (assuming the Master can rapidly establish a relationship in the same industry), or, and independent brand set up by the Master Franchisee. (This latter proposal takes a tremendous amount of time and capital – so it is not always a viable option.) Additionally, this only works if the Subfranchisees contractual rights with the Master Franchisor allow such a quick exit from the System. Make sure to get good local legal advice on the enforceability of any restrictive covenants within the Subfranchise Agreement.

B. Creation of new company by Master Franchisees and Subfranchisees

1. Master Franchisor's Perspective

This is also similar to allowing the Master Franchisee to go independent.

2. Master Franchisee's Perspective

As just alluded to, one of the possibilities is for the Master Franchisee and the Subfranchisees to go off and form their own company. Getting the Subfranchisees involved financially in this sort of endeavor can significantly reduce the demands on capital, as well as time that would otherwise be put upon the Master Franchisee. Spreading the risk, and engaging the Subfranchisees as potential partners in the endeavor will also decrease the risk that Subfranchisees will retaliate against the Master Franchisee for ending its relationship with the Master Franchisor.

In my experience, concern for the fate of the Subfranchisees when the Master Franchisee is being terminated is paramount to most Master Franchisees. By essentially involving the Subfranchisees as “partners” in any new endeavor, the Master Franchisee fulfills several objectives – decreasing its own risk, capital commitment, and time; engaging the Subfranchisees in a solution; and presenting a united cultural and “in-country” front to a Master Franchisor who would not be happy to lose its entire operation to some sort of independent operation in a country in which it believes it had expanded lawfully and through the correct means.

C. Termination of Subfranchise Agreements by Master Franchisee

1. Master Franchisor's Perspective

Unless the Master Franchisor is also terminating the Master Franchise Agreement with the intent to cease operations of the System in the Territory, a Master Franchisor will rarely want to terminate individual Subfranchise Agreements. The Master Franchisor will, however, want to do this right the Master Franchisee is failing to act sufficiently to enforce the Subfranchise

Agreement and the actions or the Subfranchisee are such that sufficient damage is being done to the System than action needs to be taken by the Master Franchisor.

2. Master Franchisee's Perspective

The other side of this coin is the Master Franchisee terminating the Subfranchisees, and taking whatever business it might be able to salvage for itself. This type of option is only available where the contract between the Master and the Subfranchisees is going to allow for such a drastic measure, and where the Master Franchisee believes that it can adequately fend off attacks from both the Subfranchisees and the Master Franchisor for its conduct.

Perhaps a more reasoned approach would be for the Master Franchisee to buyout the Subfranchisees if it is going to take the territory independent on its own.

D. Abandonment of Area by Master Franchisee

1. Master Franchisor's Perspective

Depending upon the circumstances, the Master Franchisor may oppose or support the Master Franchisee's abandonment of the area. The Master Franchisor will oppose abandonment when the Master Franchisor wants to maintain a presence in the area and, therefore, if the Master Franchisee abandons, the Master Franchisor may be forced to incur significant costs or devote substantial amounts of employee time to deal with the problems resulting from the abandonment.

The Master Franchisor will support the abandonment when the Master Franchisor wanted to terminate the Master Franchisee or withdraw from the market. In this case, the Master Franchisor does not have to take action itself to stop the Master Franchisee from operating.

2. Master Franchisee's Perspective

Finally, there are certain cases where it just makes economic sense to walk away from the territory. Where Master Franchisees have expended a negligible amount of money, and/or the ability to convert is non-existent, while simultaneously recognizing that the franchisor doesn't have money to pay a damages claim, might lead someone to decide to fold up their tent and go home. This is rarely the case, but we would be remiss if we did not suggest that it is an option that needs to be looked at in certain cases.

VI. Conclusion

A. Master Franchisor's Perspective

Termination of a Master Franchise Agreement is a dramatic action that requires very careful analysis of and preparation for the consequences resulting from the termination. It is often very costly and time consuming. It also takes very good legal advice from the Master Franchisors counsel and local counsel. Finally, notwithstanding the negotiated terms of the Master Franchise Agreement that may seem to favor the Master Franchisor, local law and conditions will often favor the Master Franchisee.

B. Master Franchisee's Perspective

The takeaways? Get good local advice. Understand the rules that you are playing with and negotiate them to your favor when you have leverage. Don't take any options off the table – the threat of litigation gives you a lot of leverage. And, did I mention, get good qualified local advice? I thought so.