

Legal & Practical Issues: Successful Investment through [Cross-border] Franchises

Introduction

International organisations have defined franchising in various ways, but perhaps the simplest definition I have come across is that: it is a commercial **relationship between an owner of intellectual property rights, business method or advertising symbol and an individual or entity that purchases limited rights to use that identification in business for profit.** Hence, the basic elements for a franchise are:

- Grant by the franchisor of a right to engage in a specific business.
- A licence to use the franchisor's intellectual property rights, to which the franchisee's business will be substantially identified.
- A licence to use the Franchisor's marketing plan
- Payment of consideration to the franchisor by the franchisee

Dealing with a Mix-Match of Laws

There is no franchise specific law in Nigeria or South Africa, although South Africa has local franchise associations that have adopted standard codes of conduct. There is nothing under Nigerian Law to prohibit franchising or any of the techniques which are employed in developing franchise networks.

In Nigeria the common law of contract and several local Statutes when applied together form the basic framework for cross-border franchising. Some of the relevant statutes are:

- Companies and Allied Matters Act
- National Office for Technology Acquisition and Promotion Act (NOTAP)
- Trade Marks Act
- Copyright Act
- Patents and Designs Act
- National Food and Drug Administration Commission Act (NAFDAC)
- Foreign Exchange laws

It is important for both parties (particularly the local partner) to ensure compliance with the statutory regulations and obtain every Government permit required to start and carry on the specific business. i.e if engaging in food & beverage or pharmaceutical business, you must obtain NAFDAC certification for your products.

We shall consider each law as it applies in the course of this meeting, but perhaps the law that has the most impact on a franchise agreement is the NOTAP, which *inter alia* monitors on a continuous basis the transfer of foreign technology into Nigeria. The Act provides for the registration with NOTAP of all agreements for the transfer of technology to Nigerians. It specifically deals with agreements connected with usage of intellectual property rights and provision of technical assistance in any form, including training of personnel.

Section 6 gives NOTAP a wide discretion to refuse to register certain agreements and list provisions which if contained in an agreement would render it unregistrable. [Some of these provisions hinder franchising, and we shall consider to what extent and how to overcome the hurdles].

Structuring a Cross-border Franchise Transaction

No doubt one can draw up a check list of a thousand items to bear in mind when entering into a franchise transaction. Some of the more fundamental issues are considered here from a legal stand point.

A common strategic plan

Franchise relationships are inherently long term, consequently it is important for parties embarking on such a relationship to identify their long term objectives. If the franchisor's priority is profitability derived from grants, royalties, supplies or sales of equipments etc, it is likely he would be seeking a low commitment relationship. On the other hand if his objective is market expansion, then he is more likely to commit to a close working relationship akin to a joint venture structure. There are other issues such as is the franchisor willing to establish a pilot scheme? Does the franchisor wish to create a chain of outlets in the jurisdiction? What growth rate? How geographically disperse are the outline to be? How would competition affect the franchisee's performance quota and expected revenue? Answers to these issues will *inter alia* determine the extent of support and cooperation to expect, the tolerance level of the parties to teething problems the franchise faces, long term commitment to the business venture.

Preliminary due diligence

Having identified a willing partner, it is absolutely vital that a preliminary due diligence is conducted on the counter-party. This involves a thorough investigation into the business and financial history and the personal character of the potential partner.

The *franchisor* would be concerned to *find out* the registrability and use of its trademark, copyright and other intellectual property rights to be used in franchise Country; what level of protection does the local law provide; what is the market potential of its products or services; are there restrictions on exportation of foreign

exchange; would services fees and royalties be subject to local taxes; how to protect its trade secrets and know how; are the products free from government ban; are infrastructure, technology and personnel available in the franchise Country at the quality and prices which seem appropriate for the franchise?

The *franchisee* on the other hand will be keen to know how strong is the franchisee brand name in his home country? How viable in the business system or method?

A franchise must also undertake a careful study of the franchisor's business plan, operation manuals and market analysis, making necessary adaptations to suit the local market.

It is time well spent to visit and meet with existing franchisees from whom a prospective franchisee is sure to find invaluable information. He should ask owners about the support they got on an ongoing basis, as well as training; did the franchisor help with initial set up? Did their investment stay in line with their expected return? Find out whether they would do it again with the benefit of hindsight. These are opinions that will greatly impact on his decision to proceed with the transaction and also assist in negotiations with the franchisor.

Protection of Intellectual Property

A comprehensive form of trademark license accompanies every franchise, and it is by far the most important and valuable component. Just think of a "Mr Biggs" franchisee not licensed to use the "Mr Biggs" name in its advertising and sale of food. There will be little of value that the franchisee has paid for. The core element of a sound flexible franchise relationship is a clear description of the relevant intellectual property (IP), adequate measures to establish and protect intellectual property rights and mechanism for dealing with changes in the intellectual property components of the franchise system.

Where the IP is to be exploited in Nigeria, Nigerian law will govern its registration, use and policing. The primary protections given to IP in Nigeria are statutory although the common law right of passing off is also available in certain circumstances. Foreign owned trademarks are registrable in Nigeria under the Trademark Act. The Act gives protection to a registered owner of a mark and also registered user, both have a right to bring legal action against infringement.

It is not unusual for a franchisor to find that an intended franchisee had registered a trademark in his own name. When that happens the franchisor should insist that rights to the Mark be assigned back to him, particularly when a franchisor intends to develop it franchises in that market Again, in order to safeguard against a franchisee of a mark subsequently challenging a proprietor's mark each franchisee should be registered as a user. Note that failure to use a registered mark for a consecutive period of 5 years renders the mark liable to being struck off the register.

Unfortunately, the trademark Act only applies to goods and **not** to services, consequently service marks cannot be registered in Nigeria. However limited protection is provided under the common law of passing off. Over time a franchisor by licensing the use of the service mark in Nigeria may acquire goodwill which the law Courts will protect.

The franchisors operating manual, hand book, training materials and software and other resources for passing on the franchise can be protected by registration under the Copyright Act, so long as the franchisor is a citizen or is domiciled in or the work is published in a Country that is ***party to a treaty or international agreement which Nigeria is also a party.*** Although the ambit of the law is very wide (and possibly applies to every country in the world), the copyright commission have restricted its application to any country that is party to a copyright treaty to which Nigeria is also party. Where there a dispute as to which Country the Act applies, a certificate issued by the Copyright Commission is conclusive proof. As far as Trade Secrets and Know How is concerned, the only protection accorded by the law is contractual through the imposition of confidential provisions in the franchise agreement

Once the IP is protected by Statute, Nigerian Courts have the power to give all recognised remedies against infringements, such as injunctions, damages destruction of infringing products and interim relief i.e Anton Pillar orders.

Money Matters

With the promulgation of the Nigerian Investment Promotion Commission Act and the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act both of 1995, a foreigner may now, own 100% of a Nigerian enterprise and also freely repatriate proceeds. Hence, a franchisor is at liberty to set up pilots schemes (concurrently with grants of franchises) which are subsidiaries of the off shore parent company. However, prior permission of NOTAP is required in respect of repatriation of royalties and fees derived from the grant of a franchise, where the repatriation is transacted through the licensed Banks and other financial institutions. The banks will not facilitate remitting related foreign, currency payment for royalty or fees due to a franchisor without proof of NOTAP registration.

The franchisor's remuneration may also be subject to local taxes. A franchisor is liable to have deducted from royalties and fees due from the franchisee withholding tax and VAT. The franchisor in compliance with its contractual obligation to provide on-site support services will often need to send his staff to Nigeria. No tax liability will attach so long as the duty is performed on behalf of a non resident company and the staff does not remain in Nigeria for more than 183 days in an assessment year and the remuneration of the staff is taxed in the franchisor's country. In addition, Nigeria has signed a double taxation agreement with certain countries which permits a non resident liable to local taxes to qualify for credit or to have foreign taxes deducted from income taxable in Nigeria.

Negotiating Key Points of a Franchise Contract

A typical franchise agreement is intended to cover a complex, continuing relationship involving a considerable amount of money, time and effort. Some key points of the contract are identified and discussed here with a view suggest how they can be treated to bring fairness and flexibility to the relationship.

(i) Rights Granted to Franchisee

A franchising agreement goes beyond mere licensing of one or more specific IP rights. Together with services which the franchisor will normally agree to perform, the contract will grant a franchisee licence to use a tested business system covering trademark, copyrights, trade secrets including methods of operation, industrial design inventions etc.

A good agreement should allow for modification to the system or marks, to respond to legal problems, local culture or changes in marketing strategy while retaining the ultimate control over the IP by the franchisor. The agreement should address who may introduce innovations and how. Who bears the cost for changes to the system? Who owns and who has the right to use them? What limitations are imposed to the use of the marks? Who is best suited to police infringements? How will the parties cooperate generally in IP matters? Should one party be indemnified if the other does not adequately police infringements? Should the franchisor be indemnified if the franchisee misuses or negligently use intellectual property? Who should translate operations manuals and what should they contain?

Quite often the know-how and trade secrets account for the competitive superiority of the franchisor. It is thus a much valued asset which the agreement must protect and provide for rights and obligation of the parties concerning it. This would involve the franchisee undertaking non-disclosure of trade secrets; insisting that the franchisee obtain confidentially agreements from managerial employees; ensuring that all operation manuals and training materials are maintained at all times at the business premises etc. stipulate specific remedies in the contract for breaches.

In addition, many franchise agreement provide territorial protection against intrabrand competition. The franchisee should negotiate a right to be protected against competition from other franchisees or the franchisor itself within a defined territory. These days clauses are being introduced that prohibit a franchisor from "*effecting substantial changes in the competitive circumstances if a franchisee*" except for good cause. The franchisee should also ensure that other licensees is issued on comparative terms.

(ii) Remuneration of Franchisor

Typically, the consideration for the franchisor's transfer to **IP** rights, know-how and provision of services to the franchisee is money.

A franchisee should be careful not to overestimate the value of the trademark and franchise as a whole. The question is, to what extent will the trademark facilitate entry into the Nigerian market and to what extent will the trademark improve the franchisee's competitive hedge in the market. It should be remembered that a brand is only as valuable as the recognition it enjoys in the local market and the reputation of the goods or services with which it is associated clear exactly what is being paid for e.g do the fees include provision of promotional items and advertising? Remuneration can be agreed in one or more of the following ways:

Initial or "up-front" fee - is payable to the franchisor at the inception of the relationship. Parties may negotiate a lump sum, or instalments with or without interest, over a period of time. Where the agreement proposed sets out a formula for working out this fee, a local franchisee should ensure that accurate and adequate information are available locally to apply the formula.

Royalties - are "service fees" which recur during the tenor of the franchise. Usually these fees are measured by the revenue derived by the franchisee from the operation of the business i.e gross sales [net sales]. Adjustment will be made for bad debts, after sale taxes etc. Sometimes royalties are a fixed monthly amount, sometimes a base amount with a percentage over-ride, sometimes a percentage amount with a ceiling and sometimes based on sliding scale (based on various factors). Whatever the formula the agreement will normally require the franchisee to accompany the payment with an account in the prescribed format.

Other fees - these are a variety of fees and charges which arise during the term of the franchise. They include, training fee, renewal fees, audit and inspection fee, required product or service purchases. Sometimes a slight mark up is placed on product and service purchases to augment the franchisors Royalty.

(iii) Recordkeeping and Reports

The franchisor has keen interests in the accuracy of its franchisee's record keeping, and the delivery of correct reports on the financial results of the franchisee's operations. Failure of the franchisee's business may jeopardise the franchisor's expansion plans into the territory. Consistent production of substandard goods and services may erode the goodwill in the franchisors mark. As seen above the franchisor has direct economic interest in revenues. Thirdly interest lies in the ability of the franchisor to use its franchisee's accounting reports as the basis for earnings predictions to be delivered to prospective franchisees. This is an important marketing tool for the franchisor.

The contract terms should cover the following record keeping issues:

- accounting standards to be applied by all franchisees;
- frequency of reporting;
- standards, specified in operations manual;
- franchisor audit rights;
- consequences for discovery of serious under reporting;

These days we often find that the franchisor will provide manual or computerised record keeping system. As part of the package of services provided, other franchisors will provide computer generated statements.

(iv) Franchisor Support Services

A substantial transfer of the technical and business know-how occurs through the support received by the franchisee while establishing the business and continuing assistance of the franchisor during the tenor. The franchisor's training program is the real vehicle by which the franchisor imparts to the franchisee the skills and knowledge to start and operate the business being franchised.

The parties should have a very clear understanding *ab initio* of the degree of support services the franchisor will provide. Will the franchisor actually export supplies to the franchisee or would it merely turn over its list of tested suppliers? Who undertakes site selection and development and what role will the other party play? Will the franchisor provide training and on-site support for the opening of all new outlets or only for the first few? What levels of qualification and capabilities must key officers who train franchisees possess?

The franchisee's competitive advantage is significantly attributable to the support services it receives. For instance periodic performance evaluations and inspections serve to ensure compliance with quality standards and specifications and also identify problem areas which the franchisor can assist in solving. It's thus prudent that the franchisee push for the franchisor's commitment to a high level of support, whilst bearing in mind the cost implications.

(v) Advertising and Marketing

In preparing a franchise agreement it is necessary to contemplate and make provisions for how the business will be promoted in the franchisee's country. Should it be the responsibility of the franchisee and what role should the franchisor play? Over the years a few programmes have evolved which may be combined:

- programs with franchisor creating the advertising, but not placing in media;
- programs administered by the franchisor;
- local advertising by the franchisee
- Regional franchisee cooperative programs

Care must be taken to select or create a combination most suited for the franchisee's circumstances and the local market.

Creating of Advertising - Many franchisors, especially those with smaller franchise system, collect fees from their franchisee which are pooled and used by the franchisor to create and produce advertising materials, but not to purchase media. The adverts, usually printed material and radio jingle are sent to the franchisee for placement in their local market. This allows the franchisor to maintain uniformity of the image conveyed by the advert and also gives the franchisee the discretion to choose which media is best for their needs in the local market.

Franchisor Advertising Programs - this concentrates mainly on a national or regional program, but this is often inappropriate in countries where the franchisee system is yet to grow.

Franchisee Required Advertising - the agreement may require that the franchisee devote a minimum amount to advertise the business. The requirement vary from placing adverts in yellow pages to more elaborate requirements which may specify that a percentage of gross sales is spent on local advertising. The franchisor would normally retain the right to approve all advertising.

Cooperative Advertising Programs - sometimes the agreement permits the franchisor to mandate a 'regional cooperative advertising programme in which all franchisees must participate. The cooperative rules and regulations will be provided.

(vi) Sale/Transfer of Existing Franchise

Because of the normally superior bargaining power of the franchisor, the contract will permit the franchisor to freely assign the agreement and delegate its performance to others, whilst at the same time exact numerous terms on the right of the franchisee to transfer the franchise.

Paramount amongst these terms is the right of the franchisor to approve of the successor franchisee and also the terms and conditions of the sale. The rationale is that if the terms are too onerous, the successor will ultimately be unable to meet both the obligations of the original franchise and that imposed upon the transfer. Other terms which are imposed include *inter alia* transfer fees, pre-emption rights, satisfactory completion or training or new franchisee. Transfers between existing franchisees would probably be exempt from these rigorous conditions.

What would amount to a "transfer" can also be a matter for debate. Would it extend to assignments under mergers and consolidations, the issue of new shares or other ownership interest, management agreements, voting agreements and the like? Transfer is typically defined in terms of a percentage of the ownership interest in the franchisee, but should also be defined to include change of the unrestricted power to direct the

management and policies of the franchisee directly or indirectly, whether through ownership of equity interest, by contract, or otherwise.

(vii) Termination and Dispute Resolution

The characteristics of the franchise relationship *is* such that the parties are best served by putting in place dispute resolution mechanism to facilitate resolution of differences in a way that minimises damage not only to their respective interest but also that of other related parties. It is a good idea to categorise breaches in terms severity and consequence. Disputes regarding implementation or compliance may be more a matter of degree rather than blatant instances of fundamental non compliance. The areas of non-compliance while serious may not totally jeopardise the relationship or the working of the system. Appropriate remedies may be provided which avoids or reduces the need to terminate the contract.

However, whenever conflict does arise in cross-border franchising, the first thing a commercial lawyer will address is the "worst case scenario", which generally involves litigation, arbitration or at best a consideration of options to put an end to the relationship. Counsel has to review, then, not only the problems of enforceability of a judgment obtained in another forum, but whether it is not preferable to sue in another forum and the time constraints and related legal cost that will be incurred. There are also issues as to what governing Law will apply and how are those Laws likely to be construed by the Courts.

For the forgoing reasons and more the choice of Forum and Law are two of the most contested issues during negotiations. As one can imagine, each party is more comfortable with the law of its own jurisdiction. Our experience is that since the main interest which is to be protected is the trademark(s), know-how and other intellectual property, which are governed by the laws of the franchise location, the parties are more likely to be influenced by these factors:

- Quality of prospective judges / arbitrator
- Integrity and predictability of the legal process
- Local laws which may affect contractually chosen forum and laws i.e NOTAP
- Availability of interim preservative remedies
- Access to witnesses and evidence etc

Quite often parties seek to balance their interests by providing that a dispute should be brought in the jurisdiction of the responding party and that the law of that jurisdiction should apply.

Conclusion

In our experience the key to establishing and maintaining a workable relationship between a franchisor and franchisee is good faith and trust plus continuous and effective communication. There must be a common vision on the long term objectives

of the parties. This can only be achieved if the parties think through and talk through in detail their respective expectation from each other. A lawyer cannot create good faith and trust, but good advice, a fair and skillfully constructed contractual agreement can provide a solid foundation for a sustainable and profitable relationship.