Selecting the Appropriate Vehicle for International Expansion

Jorge Mondragón, Lucía Fernández and Priscila Adalid[1]

Introduction

What is a franchise?

A franchise is a simple proven strategy for business expansion and allows the franchisor to build its brand and distribute its goods and services in a territory. Under this type of agreement, the parties thereto set forth the terms and conditions of their relationship, including the products and services to be offered to the customers, the trademarks and brands to be licensed, the royalties to be paid and other compensation fees, among other aspects of the franchised business.

For this vehicle to be binding among the parties, the parties must execute a franchise agreement, which must be in a written form and must include, at a minimum, that the franchisor grants to the franchisee a trademark licence, know-how and technical assistance for the business development.

General principles of franchises

In certain countries, franchise agreements are governed and prepared under the principle of contractual freedom, owing to the lack of specific legislation. If franchises are regulated in a determined country, parties must comply with the relevant legal provisions, the general accepted contractual principles and, to the extent allowed by the law, the terms and conditions agreed by the parties pursuant to the doctrine of contractual freedom.

Franchise agreements must be written in a business-oriented manner and must contemplate certain elements, such as the following, which are universally accepted:

- a trademark licence;
- franchisee obligations to take care of, maintain or improve the franchise's goodwill brand value;

1 Jorge Mondragón is a partner, Lucía Fernández is of counsel and Priscila Adalid is an associate at González Calvillo SC.

- the provision by the franchisor of technical assistance and know-how to the franchisee, as well as the description of the operational aspects and customer services in accordance with the franchise brand system standards; and
- the specification of royalties payment and other relevant fees (ie, fees for marketing of the brand) that need to be paid by the franchisee to the franchisor.

Types of vehicles: creation of business relationships

This section provides an analysis of certain legal documents that create a solid partnership between entrepreneurs.

Companies

Companies are legal entities duly incorporated under laws that allow people to create an independent organisation governed by them – to the extent that is allowed by law – with a common capital comprising shares or quotas. Such a company will pursue specific purposes and economic objectives, and have its own personality. Companies, when incorporated, are granted with several legal rights and obligations. Companies are entities governed by agreements that set out the terms under which the company is organised, including the type of company (eg, a corporation or a limited liability company), its scope, and the contributions, obligations, roles and responsibilities of the members thereof.

Broadly, the most common characteristics of companies are:

- the limited liability given to each of its shareholders or partners;
- the freedom to transfer shares and quotas; and
- that the management is granted to a board of directors or managers, or to a sole director or manager.

Companies are the most common type of vehicle used among businesses; they are often regulated by the law and they are established through rules in connection with the rights and obligations to which the businesses are subject. As mentioned, companies have robust legislation; commercial agreements, on the other hand, may or may not be regulated under the applicable laws. The former gives more certainty to the parties but the latter may provide more flexibility arising from the parties' contractual freedom and, therefore, such contractual freedom may promote the consolidation of a successful business.

Partnerships through commercial agreements

Joint ventures

Joint ventures are associations of two or more individuals or entities that carry on an enterprise, venture or operation as co-owners for the duration of that particular transaction or series of transactions for a limited time. To have an effective joint venture agreement, the following issues should be considered:

- scope of the agreement;
- joint interest;
- sharing of profits and losses;
- control;
- fiduciary relationship; and
- right to review the accounting by any of the co-owners.

Notwithstanding the principles that should be observed in a joint venture agreement, many pieces of legislation do not classify or define a joint venture agreement.[2]

Joint venture agreements allow individuals or entities to develop or expand a business within a territory and, as a consequence thereof, the joint venture partners incorporate specific companies whose by-laws contemplate the terms to develop the business. In this regard, the joint venture partners are often obliged to contribute capital and other resources and to manage the company, pursuant to the applicable joint venture agreement and the new company's by-laws.

Agency agreements: development agents

Common law defines an agency agreement as:

> *the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act.*[3]

Civil law defines an agency agreement as:

> *a commercial mandate in which a principal requests an agent to perform a mercantile act or agreement on the former's behalf. This relationship may be agreed in writing or verbally, but in the latter case, it needs to be ratified in writing before the performance of the act is completed.*[4]

It should be noted that the above definition pertains to Mexican law, which is a civil law system.

The most common example of an agency is a sales representative agent, who assists the principal in establishing the proper connections with individuals or companies for the purchase and sale of the principal's products. This allows the principal to expand its business in a territory.

In this regard and from a franchise perspective, development agents are considered agents of a franchisor in a specific territory, and having a development agent in the territory provides the franchisor with a way of expanding its franchise business there. Moreover, the agent usually helps the franchisor understand the territory's market. An agent may be responsible for marketing and selling new franchises. Furthermore, the agent may also provide training and ongoing support to franchisees. This is on the understanding that the agent will be compensated for the activities indicated above.

Franchises: international expansion

For a franchise agreement to be binding upon the parties, the franchisor must comply with the requirements set forth in the relevant laws of the territory (if such applicable laws exist) where the franchised business will be operated and the agreement must not contravene public policy. The franchisor and franchisee are allowed to agree upon the best business terms pursuant to the

2 Walter H Jaeger, Partnership or Joint Venture, 37 *Notre Dame L Rev* 138 (1961). See: http://scholarship.law.nd.edu/ndlr/vol37/iss2/3.

3 Justice Berzon of the United States Court of Appeals in *Batzel v Smith*, 333 F 3d 1018 – Court of Appeals, 9th Circuit 2003; see: www.duhaime.org/LegalDictionary/A/Agency.aspx.

4 León Tovar, Soyla. *Contratos Mercantiles. México*. Oxford University Press, 2005.

legal principle of party autonomy and contractual freedom. In this regard, the contractual structure of franchises operates in accordance with the franchisor's business and development plan.

By virtue of the foregoing, the franchise market follows the international trends in the industry and the following are the main types of agreement to set up a franchise (franchise agreements): single-unit franchise agreement; multi-unit franchise agreement; and master franchise agreement. In addition to the foregoing, area development agreements, which are not considered franchise agreements, can be used by franchisors to develop their business in a specific territory.

Franchise agreements usually regulate the following issues:

- as the franchisor's main obligations, providing the know-how, technical assistance, training and guidelines, as well as the licence granted to the franchisee to use the franchise's intellectual property;
- as the franchisor's main rights, receiving fees and royalty payments from the franchisee, supervising the business and requesting franchisees to comply with all business standards;
- as the franchisee's main obligations, complying with fees or royalty payments to the franchisor, keeping the franchisor safe and free of liability from any intellectual property infringement, if applicable complying with data protection measures and complying with the franchisor's business standards; and
- as the franchisee's main rights, to obtain training and business guidelines, know-how and technical assistance from the franchisor, as well as the licence to use trademarks and other intellectual property rights.[5]

Single-unit franchise agreement

In single-unit franchise agreements, the franchisor grants to the franchisee a licence over trademarks, and provides know-how and technical assistance so that the franchisee may develop and operate only one franchise unit at a specific location or within a defined zone. A single-unit franchise creates a direct relation between the franchisor and the franchisee, who operates the unit franchise. These franchises are normally used for service business, such as food service, lodging, real estate, home inspection and automotive services.

The rights and obligations that the parties assume for this type of agreement are simple and usually include those indicated above for franchisors and franchisees. Furthermore, these agreements may or may not provide for a radius protection for the franchisee, depending on the industry. Also, this contractual relationship grants the franchisor full control over the franchised business, in the understanding that the franchisor will be dealing in a direct manner with the franchisee and, therefore, the franchisor may directly supervise the franchisee's compliance of its obligations arising from the agreement.

When structuring this kind of agreement, and to allow the franchisor to maintain a long-term relationship with the franchisee, based on our experience it is common for a franchisor to include, among others, the following provisions in the franchise agreement:

- the term and, if applicable, the renewal procedure of the franchise agreement;
- any reservation of rights (including reservation of territory, customers rights and restrictions, control over the premises);

5 Hershman, Stuart, et al, *Structuring a Unit Franchise Relationship*, Chapter 2, p54.

- all fees and other payments to be made to the franchisor;
- the intellectual property that is being licensed to the franchisee;
- events of early termination for cause;
- indemnity clauses; and
- training programmes.

Multi-unit franchise agreement

In multi-unit franchise agreements, the franchisor grants to the franchisee a licence over trademarks, and provides know-how and technical assistance so that the franchisee may develop and operate two or more franchise units at specific locations or within a defined zone. Typically, multi-unit franchises are used for businesses that require a single operator in a defined territory. Radius protection may be granted to the franchisee, but usually the franchisee is not granted an exclusive right over a territory. This prevents encroachment, advertising and intra-brand competitive problems that might arise if multiple franchisees develop the same business in a single market.

A framework agreement is usually executed in multi-unit franchises, which includes all the obligations regarding the development, opening and operation of the franchise units. Afterwards, each time a new franchised unit is opened under the framework agreement, a site addendum is usually executed between the franchisor and franchisee to regulate the approved location and the term of duration for that specific unit. Furthermore, it is common to include a provision that allows the franchisor to terminate this framework agreement, and therefore its right to operate all the franchised units if the franchisee breaches any of its obligations.

Master franchise agreement

In a master franchise model, the parties enter into an agreement considering a specific area of expansion, and the master franchisee is in charge of developing the franchised business in a delimited area, state or country. This type of agreement also prevents encroachment, advertising and intra-brand competitive problems that might arise if multiple franchisees develop the same business in a single market.

A master franchisee is usually granted the following rights:

- the exclusive right to develop franchise units in a specific territory;
- the right to sub-franchise, including the right to sub-license the use of the trademarks; and
- the right to use the trademarks and know-how, and to receive technical assistance.

Also, it is a common practice that the parties agree to a mandatory development schedule that sets forth the minimum number of unit franchises that the franchisee, directly or through sub-franchisees, should develop.

Therefore, the master franchisee usually has the right to execute a sub-franchise agreement with each recruited sub-franchisee, and it is common for the sub-franchise agreement to reflect the main terms and conditions included in the master franchise agreement. Notwithstanding the foregoing, the franchisor may reserve the right to approve the sub-franchisees and the location where each sub-franchised business will be developed and may dictate the economic relationship between the sub-franchisor and sub-franchisee (eg, fees charged to sub-franchisees).

Area development agreement

Under this agreement, the franchisor grants the developer the right to develop the franchised business in a defined and reserved territory, on the understanding that to open a franchise unit, a specific franchise agreement must be executed. Usually, the developer, directly or through a joint venture with a third party, executes this franchise agreement. Having two different agreements protects the franchisor if the developer or franchisee breaches any obligation of any of the agreements.

If the franchisor is executing an area development agreement with a developer, the agreement usually includes among its provisions:

- the exclusivity rights, including territory, and exceptions thereof;
- the number of units that must be developed;
- time frames and calendar for development;
- the franchisor's development assistance;
- fees and other payment obligations;
- site selection and approval responsibilities;
- the transfer of the development rights from the developer to a third party; and
- termination provisions and consequences.

Furthermore, it is common to include a provision that states that in the event that the developer breaches any obligation under the area development agreement, the franchisor may terminate its development rights, but the franchise agreement executed under the former shall remain in force.

For the purposes of expanding a franchised business, having a development programme is an effective way to grow, as long as the development is properly designed and implemented by the franchisor and developer.

Pros and cons of franchise vehicles for international expansion

Single-unit franchise agreement

Advantages

- The franchisor has control over the unit, meaning that it may supervise directly to ensure that all the franchise rules, standards and guidelines are met.
- The franchisor may have a direct approach towards the management of the unit and, therefore, may provide the franchisee with better insight into its operating business.
- The franchisor may learn of the market through the unit franchise to prepare a more aggressive expansion.
- The revenue obtained from all franchised fees and royalties is directly paid to the franchisor.
- The expansion relies on more than one franchisee, so the risk of failure is distributed among various operators.

Disadvantages

- The brand expansion within a territory may be slower than with other business models.
- The revenues obtained may be less than with other business models, as the other types of agreements include the obligation of opening multiple units under the same agreement.
- There is a greater risk of not being able to expand the franchised business swiftly, since the expansion relies on opening one unit at a time.
- The franchisor may have greater expenses, particularly administrative expenses, as it has to manage a direct relationship with the franchisee.

Multi-unit franchise agreement

Advantages

- The franchisor has direct control over all units as it executes all the franchise agreements directly with the applicable franchisee.
- The franchisor may directly supervise that all the franchise rules, standards and guidelines are met.
- The franchisor may have greater expansion over the franchised territory.
- By having multiple units, the franchised trademark's goodwill and value are improved.
- This agreement creates a long-term relationship with the franchisee and, therefore, a higher commitment by the latter.
- The revenue obtained is increased by having multiple units. The revenues obtained from all franchised fees and royalties are directly paid to the franchisor.

Disadvantages

- The franchisor may have greater expenses, particularly administrative expenses, as it has to manage a direct relationship with the franchisee.
- The expansion relies exclusively on one franchisee, which means that in the event the franchisee fails to comply with its obligations under the framework multi-unit franchise agreement, the general business expansion may be unsuccessful.
- Considering that usually exclusivity rights are not granted to the applicable franchisee, the business model may not be attractive.

Master franchise agreement

Advantages

- This agreement creates a long-term relationship with the master franchisee and, therefore, a higher level of commitment and contractual partnership.
- The franchisor may aim for a more aggressive business expansion.
- The franchisor has to supervise only the master franchisee, as the master franchisee is usually responsible for the sub-franchisees' acts and omissions.
- By having multiple units, the franchised business and the relevant trademark's goodwill and value are improved.
- The master franchisee is responsible for making the necessary cash contributions to develop the franchised business in the territory.
- The franchisor may have fewer administrative expenses as the franchisee takes over certain responsibilities (eg, training and supervision) that are usually carried out by the franchisor.
- The franchisor can expand its business without the risk of debt or loss of equity.

Disadvantages

- The franchisor has no direct control over all the franchise units, as the master franchisee will execute all of the sub-franchise agreements.
- The supervision of the sub-franchisees is the responsibility of the master franchisee, so the franchisor may have less control over the franchised business in the territory.
- The revenues obtained from all sub-franchisees are not directly paid to the franchisor. The master franchisee usually pays the franchisor a percentage of the applicable fees and

payments received from sub-franchisees. This can mean that the franchisor may receive less revenue or less control thereof.

- The termination of a master franchise agreement may be complex if the master franchisee breaches its obligations, particularly in connection with the business relationships with the sub-franchisees.
- The master franchise agreement termination or the master franchisee's failures may have more impact on the franchise's goodwill, brand and image in the applicable territory than with other business models.

Area development agreement

Advantages

- The franchisor has direct control over the franchised business expansion.
- The franchisor may aim for a more aggressive business expansion.
- The franchisor may achieve faster growth, as someone who knows the market is assisting in the business expansion.
- In the event that the developer is not able to comply with its development obligations, but the existing franchised units are still suitable franchises under the applicable franchise agreements, the development agreement may be terminated, but the applicable franchise agreements may remain in force.

Disadvantages

- The development agreement's termination or the developer's failures may have more impact on the franchise's goodwill, brand and image in the applicable territory than with other business models.
- If the division of responsibilities is not correctly established, the functions of the franchisor and the developer may overlap.
- The franchisor may have greater expenses, particularly administrative expenses, since it has a direct relationship with the developer and with each franchisee.
- The expansion relies mainly on one developer, so if the developer fails to comply with its obligations under the development agreement, the expansion may be unsuccessful.

Conclusion

For the purposes of international expansion, franchisors need to seek a legal framework that meets their business and expansion plan, considering the risks and benefits each model entails. Franchisors must carefully consider and analyse the level of control they want to have over the territory's franchised business. In this sense, franchisors have a wide variety of options to expand their franchised businesses, and a franchisor may use a combination of these options.

To conclude, when preparing for international expansion, franchisors must bear in mind four main questions when selecting the appropriate legal vehicle:

- What is the franchisor's business plan in the territory?
- Does that business plan require aggressive expansion in the territory?
- How much is the franchisor willing to invest to expand the franchise business in the territory?
- How much control over the territory's franchised business is the franchisor willing to relinquish?

Jorge Mondragón
González Calvillo SC

Jorge Mondragón has been a partner at González Calvillo since 1998, heading the firm's franchising and distribution practice group. During his more than 25 years' experience he has developed a corporate/commercial practice focus on business, transactional, franchising, licensing and data protection matters, advising Mexican and foreign clients in a wide range of transactions, from their start-ups in Mexico throughout all their main operations and management activities.

He is active in national and international legal associations, including the International Franchise Association, the American Bar Association's Forum on Franchising and the National Corporate Counsel Association (ANADE), in which he has acted as a member of executive committees and participated as an expert speaker in corporate and business law in seminars, symposiums and conferences thereof.

Mr Mondragón's legal practice has been recognised by international legal publications such as *Who's Who Legal*, being considered as a thought leader, and he regularly participates with Lexology Getting The Deal Through on its comparative legal guides.

Mr Mondragón obtained his law degree with honours from the National Autonomous University of Mexico (1993) and a postgraduate degree in corporate law from the Mexico Autonomous Institute of Technology (1996).

Lucía Fernández
González Calvillo SC

Lucía Fernández has been of counsel since 2020, and has more than 12 years' experience in the corporate sector, including data protection, e-commerce, franchising, licensing and distribution, government procurement, joint ventures and strategic alliances, as well as regulatory, advising particularly in connection with consumer protection and advertisement.

Mrs Fernández is actively involved in advising both Mexican and international clients regarding the start-up and operation of their businesses in Mexico in connection with corporate governance, corporate strategy design and implementation, the incorporation of companies, including SPVs, joint ventures, and other forms of associations. She also gives advice regarding all legal aspects of e-business, particularly on the commercial aspects thereof, such as terms and conditions, service agreements, data transmission, data privacy policies and personal data protection, including the preparation of data privacy policies and data management guidelines.

Her experience also includes assistance to clients with regard to their franchise licence and distribution business, including the corporate, contractual and intellectual property matters to be taken into consideration for the structuring thereof and the marketing of their products and services.

Mrs Fernández is a member of not-for-profit and professional associations, such as AbogadasMX and the National Corporate Counsel Association (ANADE). She obtained her law degree from the University of Monterrey and an LLM from New York University.

Priscila Adalid
González Calvillo SC

Priscila Adalid has 11 years' experience in corporate law, M&A, spin-offs, franchising, data protection and e-commerce.

Ms Adalid's practice is focused on advising clients (both domestic and foreign) on how to incorporate, operate and expand their business in Mexico, outlining and implementing relevant corporate strategies to meet their needs and reach their business goals.

She assists clients in their day-to-day legal and compliance activities, with an emphasis on commercial aspects. Her work includes drafting franchise agreements, terms and conditions, service agreements, data protection analysis and policies thereof.

She is a member of the not-for-profit organisation AbogadasMX and the National Corporate Counsel Association (ANADE), and obtained her law degree from the National Autonomous University of Mexico (2012) and a master's degree in corporate law from the Panamerican University (2019).

González Calvillo SC
Montes Urales 632, Piso 3
Lomas de Chapultepec
11000 Mexico City
Mexico
Tel: +52 55 5202 76 22
jmondragon@gcsc.com.mx
lfernandez@gcsc.com.mx
padalid@gcsc.com.mx
www.gcsc.com.mx