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International Joint Venture Franchising: A Key Investment Strategy For Eastern Europe

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by

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I. Introduction

This paper analyzes international franchising as it relates to economic and cultural changes that are occurring in Eastern Europe.[1] After consideration of the general legal implications and responsibilities of franchise relationships, certain unique qualities of franchising that lend themselves to the development of a free market economy in Eastern Europe are discussed. Particular attention is given to franchising as a vehicle to foster entrepreneurialism and privatize state-owned enterprises, and the major differences between a joint venture franchise and other forms of international franchising. The advantages and disadvantages to both parties of an international joint venture franchise in Eastern Europe are discussed. Also, key contractual provisions with unique implications for an East European franchise operation are identified.

Recognizing the benefits to international firms of establishing a global competitive strategy, an analysis of basic strategic planning questions are presented in connection with Eastern Europe operations. Consideration is given to the impact that the emerging East European governments and their newly-passed laws will have on developing an investment strategy for Western firms in the region.

Further, the paper discusses four key legal issues, which are not necessarily unique to franchising but significantly affect joint venture operations in Eastern Europe. It also identifies recent efforts by Western businesses operating in the region that have attempted to find innovative solutions to these legal issues. The paper then presents a synopsis of newly enacted laws in Romania and Czechoslovakia and determines whether the changes that have been instituted in these countries address the legal issues identified in the previous section.

II. The Role of Franchising in Eastern Europe

A. What Is Franchising?

Although franchising in the United States and abroad has become increasingly important in developing and expanding business and supplying goods and services to the public, franchising is a relationship which is very difficult to define in black letter terms.[2] Webster's New Collegiate Dictionary 1980 defines "franchise" in a business context as "the right or license granted to an individual or group to market a company's goods or services in a particular territory". This definition should be supplemented with: the right to use trademarks, service marks, marketing plans--or a combination thereof--in conjunction with the licensed goods or services.[3] Nonetheless, as one legal author has noted, "there is no generally accepted definition of franchising in court decisions."[4]

Simply because we see franchises everywhere in the United States does not necessarily mean that we can easily understand what franchising is. Basically, a franchise system is a marketing process. At a minimum, franchising represents a continuing relationship between a franchisor (normally the original entrepreneur) and the franchisee (the investor who intends to replicate and expand the original business concept). The franchisor generally receives from the franchisee a payment of an "up front" fee or a "royalty on sales" or some combination of the two.[5] The franchisee obtains, in addition to a valuable trade name or logo, various kinds of business assistance, ranging from store design to national advertising support. The benefit to the franchisee, as a new business owner, is that potential customers recognize the franchisor's trade name and assume they will receive the same quality and value from the franchisee.[6]

B. Advantages and Disadvantages of Franchising

As a method of business expansion, franchising offers unique benefits to both the franchisor and the franchisee. By franchising, the original entrepreneur is afforded the opportunity to expand its concept more rapidly and with greater economic efficiency than would otherwise be possible. As each new franchisee invests in the franchise system, the capital investment in that system increases and assures the franchisor a proportional stream of income in the form of royalty payments. The franchisor, then, is able to minimize its capital risk because the financing of its franchise system expansion is accomplished through capital that is spread more incrementally among multiple operations than is possible through traditional business expansion methods.[7]

The franchisee also derives various benefits from the arrangement. The franchisee can sell a proven product or service, frequently with national and possibly international recognition. Many franchise systems provide extensive training programs and continuous supervision which help ensure the success of the franchisee's operation. These programs range from full-time training sessions to inspections of each franchise unit and can cover such areas as personnel training, operating standards, purchasing and quality control, and energy conservation procedures. As an independent businessman, the franchisee can run his own operation--often at less expense than would otherwise be possible. These advantages are reflected in start-up statistics which indicate that the annual failure rate of franchises is between 1 and 6 percent, whereas the failure rate of other new businesses in the first five years of operation is 65 percent.[8]

Franchisees also benefit from the national and even international name recognition derived from the extensive advertising and promotion campaigns of the franchisor. Each individual franchisee receives an incremental benefit because each franchise unit is presumed to adhere to the same standards of operational quality. The franchisee often receives significant cost savings from the economies of scale that are possible through the franchise system's group purchasing abilities.

Despite such benefits, there are also disadvantages to franchising. First, the franchisor has less hands-on quality control and limited ability to prevent an individual franchisee from damaging the reputation of the franchise chain. Also, some data suggests that franchising may produce lower per-unit profits for each franchised outlet compared to profits produced by independent business.[9] A disadvantage to the franchisee is that it is not completely independent. Decisions regarding advertising, promotion, inventory, and other areas are understandably beyond the unilateral control of the franchisee. Also, the franchisee is not usually guaranteed the franchise relationship in perpetuity. One study, however, has pointed out that this uncertainty has limited practical effect in that although franchise agreements range in duration from one year to no limit at all, over 34 percent of franchises in the United States are established for 20 years or longer.[10]

C. Current Status of Franchising in Eastern Europe

The revolutionary political changes that swept Eastern Europe in 1989 and 1990 have brought with them the determination of the countries in that region to put their economic past behind them and transform the central planning system into a market economy.[11] Radical reforms have been underway that are designed to create a favorable environment for the investments of companies and individuals from the West.[12] These reforms offer foreign businesses the opportunity to enter this rapidly changing market, and Western firms are intensely interested in new commercial investments in Eastern Europe. The region, which has a population of approximately 400 million, offers an enormous market.[13] Demand for Western goods and services has grown as East Europeans have become more exposed to them.[14]

Eastern Europe presents a new and unexpected market for franchisors considering international expansion, and among the many forms of doing business, franchising is gaining credibility in Eastern Europe. Although some Western companies, such as jeans-makers Lee Cooper in Czechoslovakia and Levi Strauss in Hungary, have been manufacturing in the region for years, numerous other Western franchisors have established operations in Eastern Europe since the coming of perestroika.[15] McDonald's was one of the first entrants, having opened one restaurant in the Soviet Union and five in Hungary. Other well-known U.S. companies, such as AlphaGraphics, Burger King, Micro Age Computer Stores, Mr. Chicken, Baskin-Robbins, and Pizza Hut, have established a presence in Eastern Europe. Several international hotel chains, including Radisson, Marriott, Ramada, Sheraton, and Hyatt, have established or expressed interest in franchises in the region. Rental car outlets have been established by

Europecar and Budget in Czechoslovakia, Poland, Yugoslavia, and Hungary.[16]

D. Adaptability of Franchising to Eastern Europe

Although major international chains are beginning to find ways to locate franchises in Eastern Europe, caution is nonetheless imperative. Currently, the economy in Eastern Europe is in a dismal state. The living standards are deteriorating and the basic infrastructure remains inadequate. The cost of production in the region is much higher than in the West.[17] Although government systems are in a constant state of flux, exacerbated by long-lived tensions, even antipathies, among neighboring ethnic groups who are seeking political and social autonomy, deep-rooted and conservative bureaucracies continue to stifle meaningful reforms. The international franchisor must recognize that Eastern Europe is a series of overlapping markets, each of which has peculiarities that require special attention because they are different from market divisions outside the region, and experience obtained elsewhere in the world has only limited application.

The specific needs of each country, the unique characteristics of the various segments of the population within each country, and the suitability of the product or service to a specific market should be thoroughly analyzed by the prospective franchisor. A franchisor should recognize that the prospects for its operation's economic success will be enhanced if it adjusts its products or service to reflect the unique consumer expectations in that country. For example, the McDonald's franchises in Europe first became successful because of a willingness and an ability to match their marketing and advertising methods, menu choices, and basic daily operations to the consumer demands in each specific country. Reportedly, McDonald's spent 14 years and up to 60 million dollars to open its Moscow franchise.[18] During this period, the company invested a substantial amount of time and money to ensure the quality of its products as well as to adapt those products and services to meet the preferences of the local customers. Also, Pizza Hut's franchise unit in Moscow has reportedly adapted its basic products to reflect the tastes of Soviet patrons by offering a variety of toppings which are not offered in the United States, e.g., fish.[19]

It should be kept in mind that Eastern Europe has a rich history of entrepreneurialism. Although in these countries there has been a generation or more that has had little or no experience with private ownership and managerial skills, it also true that there has remained a tradition of small businesses, especially in the retail and service areas.[20] For this reason, franchising is very well suited to Eastern Europe. Franchising lends itself well to the following process: identify a sound product or service; provide managerial and marketing training; agree to share risk; and provide a method for expansion. In other words, franchising can quickly create entrepreneurial opportunities in Eastern Europe through "teaching and doing".[21]

A U.S. franchisor, before deciding on a location in Eastern Europe, should examine U.S. trade incentives which make franchising more adaptable to the unique economic environment in the region. For example, Poland, Yugoslavia, Hungary, and Czechoslovakia have been granted Most Favored Nation trade status.[22] This permits lower duty rates on imports from those countries. The Coordinating Committee for Multilateral Export Controls (COCOM) has received a request from the United States to relax controls on exports to Eastern Europe of technology that has both a commercial and a military application, a process that will involve a complete overhaul of the existing export control regime. Further, a Generalized System of Preferences (GSP) status has been granted to Yugoslavia, Hungary, and Poland. This qualifies those countries for duty-free entry into the U.S. for certain eligible products.[23]

Further, the United States recently signed economic and trade treaties with Poland and Czechoslovakia. These treaties generally provide for a normalized framework for business and trade relations between the United States and nations that are making a transition toward a market economy.[24] It should be noted that the Polish treaty specifically recognizes a role for franchising to play in the development of business activity of the country and provides that franchisors from either country shall be accorded national treatment.[25] An agency of the United States, the Overseas Private Investment Corporation (OPIC), can provide political risk insurance and loans for business operating in Poland and Hungary.[26] Another U.S. agency, the Export-Import Bank, offers buyers of exports from Poland, Hungary, Czechoslovakia, and Yugoslavia protection against default under private loans due to political and commercial risks.[27] In addition, there are numerous private, nonprofit organizations that provide funding sources for development projects focused on Eastern Europe, such as the German Marshall Fund, the George Soros Fund, and the Central European Development Corporation.

E. Benefits of Franchising in Eastern Europe

Although it has not been recognized by local governments as such, one benefit of franchising is that it is a promising vehicle for the conversion of state-owned companies in Eastern Europe to privately-owned business operations.[28] Strong official and private interest in privatization at all levels of business and industry in Eastern Europe began to develop almost immediately after the first economic changes occurred.[29] Defined simply, privatization is the transfer of state-owned assets to private ownership.[30]

Many state-owned enterprises in Eastern Europe are structured in a manner easily converted into a franchise system. A large number of the state-owned distribution facilities, for example, are centrally operated and have branches throughout the country. A franchise network could be created by establishing each branch as an autonomous profit center with central management retaining some controls, similar to a typical franchisor.[31] The retention of control afforded by franchising is likely to be a particularly attractive feature to East European managers used to central planning. Thus, franchising offers a relatively simple method of converting an existing operating system to a privately-owned and operated business.

Privatization through franchising can also eliminate the need for a major cash investment to purchase a large state-owned enterprise. Instead, each state-owned unit would be sold to its current employees, who would thereby be able to convert their soft currency holdings into real value (in the form of equity ownership).[32] Other methods of privatization often result in private ownership merely by shifting ownership to a large single foreign purchaser. However, establishing local franchised businesses from state-owned enterprises serves to reduce the reliance on foreign capital for investment and operations in the country.[33]

Also, franchising can benefit Eastern Europe by generating employment opportunities. Unemployment in the region is certain to increase as unprofitable state enterprises are closed. Not only does franchising create jobs for the entrepreneurs who run the franchise and are engaged in its daily operations, but also for staff who operate the franchise. The possibility of establishing and owning a franchise will encourage the entrepreneurial spirit on which a market economy rests.[34]

Another benefit to Eastern Europe is that franchised businesses can grow more rapidly than nonfranchised businesses. Because it is based on providing each franchisee with a complete system of doing business, franchising provides for a rapid and extensive transfer of know-how, technology, and management skills. Whereas developing a successful independent business can take years, a franchisee begins with a proven system, assuring an acceptable quality of the goods or services provided.[35]

III. International Franchising Options

An international franchisor who is looking to expand operations to East Europe must decide whether or not the use of a joint venture franchise is the most appropriate investment vehicle. Generally, there are four alternatives available to a franchisor who wishes to establish its business on an international level: (i) a direct franchise; (ii) a subsidiary or branch; (iii) an area or master franchise; and (iv) a joint venture franchise. Each is addressed below.

A. Direct Franchising[36]

In a direct franchise arrangement, individual outlets are franchised directly from the home country[37] into the target country.[38] The franchisor enters into a franchise agreement with each individual franchisee and provides the basic support directly. Normally, this vehicle is used if a franchisor anticipates that (i) its activities in the target country will be limited, and (ii) individual franchisees in the target country can be effectively serviced directly by employees of the franchisor operating from the home country. To determine whether a direct franchise may be appropriate, the factors to be considered include (i) complexity of communications necessary to maintain the relationship between franchisors and franchisees, (ii) reliability of available communications facilities in the target country; and (iii) availability of local entrepreneurs who can operate a franchise autonomously with limited supervision from the home country.[39]

From the perspective of the individual franchisees in the target country, direct franchising is the least preferred vehicle for a variety of reasons. First, franchisees would likely have the responsibility for taxes on royalties and for other payments due the franchisor. Second, direct franchise arrangements require the franchisee to undertake the risk that the franchisor will not have the logistical capability to properly service the franchisees' needs for support from the home country. Third, the franchisee must undertake the additional risk that in the event of a dispute, legal recourse against the absentee franchisor may be limited to remedies available in the host country.[40]

Because, to date, none of the East European countries have adopted specific legislation affecting franchising (including direct franchising), entering into a direct franchise agreement with a franchisee in an Eastern European country is not specifically regulated. Under these circumstances, all that is required is compliance with the laws governing all commercial relationships, in general.[41]

For all the same reasons, international direct franchising is not preferred by the franchisee but is generally the most profitable for the franchisor. Not only is most of the risk undertaken by the franchisee, but in a direct franchise system, the up-front franchise fee and continuing royalty fee need not be shared with any partner or in any other manner.[42]

Of course, the enhanced potential for profits in a direct franchise is markedly tempered by the fact that the franchisor must contend with the significant risks of losing control of a direct franchise operation, without the benefit of an interested local party. The potential for legal, cultural, logistical, and communications difficulties is obvious, and only careful thought and planning can reduce these risks. Where communications are hampered by the geographic distance between the franchisor and franchisee(s), the franchisor will find that as franchising activity in the host country increases in activity and scope (requiring additional staff and a larger organization), the franchisor is likely to find it increasingly difficult to service its franchisees in the host country, and will thus be forced to incorporate a subsidiary or set up a branch office in the host country. Many times, however, the reason for a franchisor's establishing a direct franchise is to take advantage of tax benefits that would not be available if the operation was incorporated or set up as a foreign branch. Therefore, to maintain the tax benefits, a franchisor would be reduced to hiring the services of independent contractors in the host country to sell, service, and administer the franchise's activities in the host country. Engaging outside contractors, however, poses the serious risk to the franchisor of losing control of its franchise activities in the host country, potentially resulting in lawsuits, loss of trademark rights, dilution of the unique aspects of the franchise system, and other serious problems.[43] These are some of the very problems that potential franchisors hope to avoid by establishing a direct franchise in the target country.

B. Franchising Through a Subsidiary or Branch

A second alternative which is available to an international franchisor is establishing a subsidiary or branch operation. In this arrangement, the franchisor establishes a branch office or incorporates a wholly-owned subsidiary in the target country, through which individual franchise outlets are established, generally in the manner in which the franchisor franchises in the home country.

The decision to establish a branch office or subsidiary will primarily be influenced by tax considerations and the existence of specific laws in both the home and target countries relating to such matters.[44] A branch or subsidiary operation is the vehicle most widely used where the home and host countries are geographically close and the customs, language, and legal systems of the two countries are similar (e.g., as between the United States and Canada). The key advantage of this franchising option is that it allows the franchisor to directly control all of the franchising activity in the host country--including the manner in which franchisors use the franchisor's trademarks, and the franchised system generally. This aspect is particularly significant where customers do a large amount of traveling between the host and home countries, due to their geographical proximity, and would easily be made aware of any abuse of the franchisor's trademarks or its franchise system.[45]

Another advantage to this alternative (as in the case with direct franchising) is that if the franchised business in the host country is successful, the franchisor will receive all of the economic benefits from the operation because there is no joint venture partner with whom to share profits. However, the franchisor accepts all of the risks--financial or otherwise--in the event the business fails.[46]

Prior to choosing a branch or subsidiary operation, the franchisor should ensure that it has both the financial resources and the management personnel to establish an organization that would be responsible for the franchising operations in the target country. The franchisor should obtain the services of a sufficient quantity and quality of management personnel to be assigned to the target country for significant periods. It is not advisable for a franchisor who wishes to establish a branch operation or a wholly-owned subsidiary in the target country to rely solely on management personnel who have only worked in the target country. Such employees would not be likely to have sufficient knowledge of and intimacy with the franchisor's business and the franchise system in general.[47]

Under a branch or subsidiary arrangement, the franchisor would, for all practical purposes, be responsible for compliance with all existing laws (not merely those relating to franchising), to the extent that such laws would affect the performance of any business in the target country. In addition, all written material, including training manuals, the franchise agreement, reporting forms, and other documentation must comply with the laws of the target country, and each item would be the sole responsibility of the franchisor.[48]

C. Area or Master Franchising

In an area or master franchise arrangement, the franchisor grants to a selected company or person located in the target country an area or master franchise to establish and develop its franchise in the target country. This arrangement is best provided for through the negotiation of a master franchise agreement, which is an "umbrella-type" agreement that grants to a master franchisee in the target country the exclusive rights to open up franchise outlets and to grant franchises to others in the target country (i.e., the subfranchisees).[49] Thus, in a Master Franchise Agreement, the master franchisee is granted the express right to subfranchise others while having the right to open franchise outlets on its own. The master franchisee, for most purposes in the target country, stands in the shoes of the franchisor and is, in essence, the franchisor of the franchise system in that country.[50] For these reasons, the master franchisee normally accepts the greater financial burden as well as the management responsibility for establishing and supervising the franchise system in the target country.[51] Thus, it may be advisable for the franchisor who does not have the necessary management personnel to select the area franchise option over the previously discussed options.

Other factors that weigh in favor of establishing a master franchise arrangement over other options include difficulty in travel and communications, and differences in language, culture, tastes, customs, habits or attitudes between the home and host countries. The political stability of the host country also must be taken into account. In situations where a government's commitment to free enterprise is in question, a franchisor may not want to put its own investment capital at risk. Also, it should be remembered that the costs for establishing and maintaining an international franchise operation are very likely to be significantly higher than the amount that was originally expected--particularly in a region where the culture and attitudes are markedly different. Thus, franchisors who have limited financial resources or who are looking to keep the initial amount of their capital investment in a risky target country to a minimum should prefer the master franchise alternative over other international franchising options.[52]

Because of the amount of responsibility that is generally given to an area franchisee, the master franchise agreement is correspondingly more complex and detailed than the agreements that are necessary to establish either a direct or an area/master franchise operation. For example, a major problem often encountered in negotiating an area franchise agreement involves limitations on the exclusive license to develop the franchise business in the target country that the master franchisee typically receives. In return for the exclusive license, the franchisor normally requires a minimum performance schedule which dictates that a certain number of franchise outlets must be opened during each year of the term of the area franchise agreement.

The franchisor is better off accepting a minimum performance standard rather than the typical covenant of best efforts to develop the franchise business in the country. If something other than a minimum performance standard is accepted, the franchisor could effectively be prevented from doing business in the host country during the entire term of the franchise agreement granting exclusivity.

It is problematic for the parties to determine what is a reasonable performance schedule, given the opposing interests of the parties and the difficulty in projecting the likely success of the franchise business in the host country.

To solve this negotiating problem, the area franchise agreement should provide that, in the event the area franchisee is in default under the performance schedule, such default, rather than operating to terminate the agreement, should only require that the area franchisee lose its exclusive rights to develop the franchise business. On default, this would have the effect of prohibiting the area franchisee from opening any further franchise outlets without the consent of the franchisor, and, in turn, the franchisor would be permitted on its own to open up franchise outlets or license others to do so in the host country. In countries where government authorities are permitted to review contractual documents before granting approval of foreign franchises, this type of contractual drafting, which reduces the likelihood of a dissolution of the franchise operation, is viewed very favorably.[53]

There are other problems that are encountered in the drafting and structuring of an area franchise agreement. Because of similar problems which arise in drafting the standard documents for an international joint venture franchise arrangement, these problems are discussed in the following chapter on joint venture franchising.

IV. Franchising Through Joint Ventures

The governments in Eastern Europe began opening their economies to foreign investment more than twenty years ago.[54] In 1967, Yugoslavia became the first East bloc nation to pass a foreign investment law.[55] The objectives behind such laws were to: (i) expand potential export markets; (ii) modernize existing industries; (iii) produce new technologies; (iv) improve the technical quality of goods and services; (v) promote research and development; and (vi) introduce new management and production techniques.[56]

These goals have yet to be achieved in any country in Eastern Europe. However, the governments of each country in the region have recently adopted new legislation regarding the establishment and operation of joint ventures between local and foreign partners.[57] Of course these joint venture laws vary from country to country, but in general they are meant to encourage foreign investment without releasing all control of the operation to the foreign party. The Western investor, by entering into a joint venture with an East European company, generally hopes to (i) open new markets; (ii) lower production costs; (iii) gain access to low cost labor and natural resources; and (iv) increase sales in the host country.[58]

Under the laws of most countries (including the United States), there is little legislation which specifically addresses joint ventures. Professor Williston, the noted contract law scholar, has defined a joint venture as:

> ... an association of two or more persons based on contract who combine their money, property, knowledge, skills, experience, time and other resources in furtherance of a particular project or undertaking, usually agreeing to share the profits and losses and each having some degree of control over the venture.[59]

In many countries a joint venture is not treated as a distinct legal entity but rather is merely a business relationship between two or more parties that can be implemented through such vehicles as a general or limited partnership. Recently, however, several East European countries have enacted legislation which is specifically directed to the formation of joint ventures with foreign participation. Generally, these laws do not attempt to govern the relationship between the joint venture partners but rather, as in the case of the new Polish law, address the establishment of a joint stock company in which there is participation by a foreign investor.[60]

Because these laws are intended to provide liberal incentives to foreign investors, a joint venture franchise arrangement could provide the most suitable framework for governing the franchisor-franchisee relationship in the region. Unlike other forms of international franchising, a joint venture establishes the franchise business in the target country. This is normally accomplished by first establishing a corporation in the target country. The shares of this company are owned and controlled jointly by the foreign franchisor and, usually, a corporation that is controlled by nationals of the target country. In addition to entering into a joint venture agreement, an area franchise agreement is typically entered into between the joint venture company and the franchisor. By entering into an area franchise agreement, the joint venture company is generally required to either: subfranchise the business in the target country; own all of the franchise outlets in the target country; or provide for a combination of both.[61] Regardless of ownership, it is the joint venture company that acts as the franchisor in the target country. Agreements such as the area franchise agreement, which are entered into between the franchisor and the joint venture company, are typically independent of the joint venture agreement, and thus are likely to continue to exist even though the franchisor may subsequently sell his interest in the joint venture or otherwise cease to be a party to the joint venture agreement.[62]

One factor a franchisor must consider before establishing a joint venture franchise in an unfamiliar international environment is the availability of financing. In order to develop the franchise system in the target country, significant initial capital is needed. This investment capital is normally used for such purposes as performing market research, hiring employees, opening offices, and preparing a training manual adapted to local culture. Also, this initial investment could be applied to soliciting and choosing franchisees, and providing assistance to franchisees in locating suitable locations for their franchises. In addition, financing is needed to ensure that the franchise system is properly adapted to the unique customs and tastes of the new foreign market. Thus, where the franchisor does not have the necessary initial capital, a joint venture franchise is a preferred arrangement because it can more easily be structured to rely on the capital contribution of the local partner or take advantage of its borrowing power as a newly established joint venture company in the region.[63]

There are other factors in an international setting that dictate a preference for a joint venture arrangement over other franchising options, including when:

o the franchisor lacks sufficient qualified management personnel to establish a franchise in the target country; by using available management personnel, the franchisor likely would place the franchise operations within its own country at risk;

o the distance between the host and target countries is so great that travel and communication are difficult and costly;

o the franchisor is unfamiliar with and incapable of sufficiently dealing with the differences in language, culture, legal systems, tastes and commercial customs between the home and target countries;

o the franchisor must retain an equity interest in the franchised operation while at the same time limiting its exposure to financial or other risks of the operation;

o through a joint venture structure, the joint venture company is able to receive significant tax benefits, or is able to import certain products or inputs for the franchising operation that it otherwise would not be permitted to import.[64]

There are many advantages as well as disadvantages in international joint venture franchising that should be explored before the decision is made to enter into a joint venture agreement. It should be kept in mind, within the context of a foreign franchisor and target country partner to an international franchise, that what may be considered a disadvantage to one partner is often viewed by the other partner as an advantage. The following are strong advantages to an international joint venture franchise:

o the franchisor is able to associate with a joint venture partner who is familiar with the culture and legal system of the target country;

o in a country that has enacted specific franchise legislation directed at foreign franchisors, it is possible to construct the joint venture agreement so that noncompliance with the franchise legislation may be avoided;

o the franchisor is able to spread the capital risks associated with locating the franchise operation in the target country;

o more flexibility is usually afforded both parties to a joint venture franchise arrangement;

o it is easier in a joint venture structure to qualify to do business as a franchisor in most countries;

o assistance from the target country government is often more easily accessible under a joint venture framework;

o typically, in a joint venture arrangement, a more qualified joint venture partner or subfranchisor is found because the franchisor shares in the risks of establishing the franchise system in the target country;

o a joint venture arrangement allows for control by the franchisor of its franchise system and trademarks; this is an important advantage to the franchisor in that a major disadvantage of a master franchise arrangement is the potential loss of control by the franchisor of its franchise system and trademarks;

o because joint venture franchises are often not controlled by a foreign national, more favorable tax treatment is available to joint venture franchisors; countries seeking to encourage foreign investment often provide attractive tax incentives to joint venture companies; and

o often, through a joint venture arrangement, there is easier access to raw materials or products used locally in the franchise operations.

The following aspects of a joint venture franchise arrangement are significant disadvantages:

o the franchisor, as a foreign national, is normally treated less favorably by the local government authorities as a participant in an international transaction with a local national;

o laws of most countries do not easily accommodate dispute resolutions between joint venture parties; if not impossible, it is at least very expensive to both parties to dissolve a partnership on the basis of an irreconcilable dispute;

o in cases where termination is sought, it is very difficult for the franchisor to receive satisfaction through a typical buy-sell provision of the joint venture agreement which requires one party to buy out the other;

o in joint ventures providing for equal control between the partners, the joint venture company could easily be placed in a situation where it is stalemated and unable to make important management decisions; and

o particularly in some soft currency countries, difficulties are typically encountered in repatriating profits without the unanimous consent of the joint venture partners.[65]

Many franchisors, in considering the option of a joint venture franchise compared to the more traditional international franchising alternatives, will limit their analysis to the factors associated with the above-described advantages and disadvantages to joint venture franchising. While consideration of such factors is important, it also is important for the franchisor to consider other problems inherent in a joint venture agreement.

Problems which can result in the dissolution of the joint venture company often are attributable to differences in the degree of equity participation and voting control allocated between the partners. Although it is possible in a joint venture arrangement to have the percentage of equity participation between the partners differ from the percentage of voting control, it is nonetheless advisable that the voting control of the joint venture company rest equally between the joint venture partners. This, of course, means that each of the joint venture partners will have equal representation on the board of directors. Equal representation on the board of directors, however, also means that no one shareholder has control of the joint venture company and, accordingly, all decisions of the board of directors could end up in a deadlock, which could bring operations to a standstill.[66]

In attempting to resolve a deadlock among the board members of a joint venture company, one option is to authorize an independent third party to cast the deciding vote. This option is not recommended in the context of an international joint venture, because the future of the joint venture operation would be placed in the hands of a person who does not have a financial stake at risk in the company.[67]

In an international joint venture franchise arrangement, there is an important reason from the perspective of the foreign franchisor for not structuring a joint venture agreement so that the foreign franchisor is a minority voting rights shareholder. In such a minority voting rights position, the foreign franchisor could easily be deprived of one of the primary motivations for entering into a joint venture as a vehicle for its foreign franchise, i.e., the ability to exercise some residual control over the manner in which the joint venture company and its franchisees are managing and to ensure the quality of the franchise system in the host country.

From the perspective of the joint venture partner who is a national of the host country, it also is important to maintain 50 percent of the voting control of the joint venture company. If the host country partner is placed in a minority voting control position, that partner will be made vulnerable not only in regard to the control of the joint venture agreement but also with respect to the control of the operations associated with the master franchise agreement. In effect, the foreign franchisor would control the joint venture company and by doing so also control the parties in connection with the area franchise operations. Thus, the joint venture partner who is a national of the host country would, in essence, operate merely as a "glorified manager".[68]

The most distinct disadvantage to a foreign franchisor that adopts a joint venture as the means of expanding its franchise system occurs in the event of a material disagreement between the joint venture parties that results in the host country partner seeking to terminate the joint venture relationship. This problem is typically addressed in the buy-sell provisions normally contained in the shareholders' agreement entered into pursuant to the joint venture agreement. There are three types and combinations of buy-sell provisions that are likely to be used in connection with a joint venture franchise arrangement.

First, a buy-sell provision with a right of first refusal allows a joint venture partner to sell its shares to a third party--provided that it first offers the remaining partner the right to buy the shares under the same terms and conditions offered to the third party. Because the problems existing between the original partners are likely to remain even if one of the partners sells its interest, a right of first refusal is not the best method for terminating a joint venture relationship. The only time a buy-sell provision based on a right of first refusal works well is when it involves the majority shareholder selling its shares and in doing so is not limited by an agreement that restricts its rights as the majority shareholder. This is not, however, the typical situation in an international franchise agreement where both parties are likely to have equal voting rights control.[69]

Another common buy-sell provision is the use of what is known as a put formula. Under this arrangement, a joint venture party who wishes to sell its shares has the right under the shareholders' agreement to force the remaining shareholder-partner to purchase its shares at a price based on a predetermined formula. This alternative is not recommended for a joint venture arrangement because it would permit a joint venture party, at the first indication of difficulty in the franchise operation, to bail out by forcing the remaining joint venture shareholder to purchase its shares as required by the put formula. In an attempt to make this provision more acceptable, a winding-up provision is often added to a put formula. A winding-up provision permits the shareholder-partner to whom the put is made the right to reject the offer to purchase the other shareholder-partner's shares. The consequence of such refusal, however, requires a winding-up of the joint venture company.[70]

In international franchising, this is an unrealistic option. A dissolution of the joint venture company will have catastrophic consequences for the sub-franchisees in the host country as well as for the franchise system in the host country.

A third buy-sell provision is commonly referred to as a shotgun formula. This formula is widely used and is well-suited for international joint venture arrangements. Under a shotgun formula provision, the joint venture partner who wishes to sell is required to make an offer for the sale of its shares to the other partner. The making of the offer gives the other partner the option to either accept the offer and thereby sell his shares, or purchase the shares of the offering partner at the same price and upon the same forms and conditions as were contained in the offer. Normally, it is provided in the shareholder agreement that if the partner to whom the offer is made fails to exercise one of the two options available, it will have been deemed to have exercised the option to accept the offer which was presented. As a result, the partner who makes the offer to purchase (or to sell out) will, out of self-interest, base its offer on a fair price and under fair terms and conditions. The offering partner recognizes that if it sets the price too low or at terms and conditions that are too unfavorable, the other party will choose to purchase the shares at that reduced price.[71]

Although the shotgun formula is the most widely used of the buy-sell option formulas, it can nonetheless easily place the foreign franchisor at a disadvantage vis-a-vis the host country national. The basis for this disadvantage is that the operations and daily management of the franchise business are normally performed by the joint venture partner who is a national of the host country. Because the host country national partner knows that the foreign franchisor partner is not in a position to operate the franchise business--because of a lack of knowledge and understanding of the language, culture, and customers--it also knows that it is in a superior bargaining position compared to that of the foreign franchisor.[72] This fact permits the host country partner to present a low offer for the foreign franchisor's shares because it would be very difficult for the foreign franchisor to become a buyer because of the difficulty it would incur in operating the franchise business in the host country.

When, however, the franchisor does have the ability to step in and manage the franchise system in the event of a buy-out of its joint venture partner, these inherent disadvantages of the shotgun formula are greatly reduced, if not eliminated.[73] The laws of each country where the foreign franchise is expected to operate should nonetheless be analyzed, because in some countries it is illegal for a foreign franchisor to assume operational control over the joint venture franchise. This, of course, would again place the foreign franchisor at a significant disadvantage.

If the disadvantages of a shotgun formula buy-out provision are too difficult to accept, a foreign franchisor may choose not to contractually address the procedures for dealing with a disagreement between joint venture partners in a franchise arrangement. This would have the effect of forcing the partners to continue to operate in a business essentially against their wills or, if permitted by the laws of the host country, resort to winding-up procedures. This alternative is not recommended. To adopt this approach would allow any serious dispute between the partners to ultimately result in the operations of the joint venture company being brought to a standstill.[74]

The consequences of the inability of the joint venture parties to get along in international franchising arrangements are much more drastic than in other international commercial transactions. In the event that a serious dispute arises between the joint venture partners, not only is the entire franchise system put at risk, but each individual franchise in the host country, which is owned and operated as an independent business, is also put in jeopardy.[75]

For a joint venture to succeed in an environment such as Eastern Europe, neither of the joint venture partners must be at a disadvantage vis-a-vis the other partner. Therefore, the joint venture arrangement should be structured so that both partners are actively involved in the daily management of the business and affairs of the joint venture company. It is only when the management of the joint venture company's operations is carried out by only one partner that the remaining partner is placed at a disadvantage. To avoid that situation and the attendant problems to the joint venture operation, both joint venture partners must have relative equality in all areas of management and operations of the joint venture franchise operation.[76]

In regard to franchises in Eastern Europe, it is recommended that until a free enterprise system becomes more established, the joint venture agreements between a foreign franchisor and an East European host country partner make clear that the joint venture company will own all of the franchise outlets. As the joint venture company, however, acquires needed experience in operating the franchise outlets in the host country, master franchise agreements can be negotiated. Thus, the joint venture company would finally subfranchise franchise outlets to qualified host country nationals.[77]

With the opening of East Europe to Western initiatives, it is expected that the use of joint venture arrangements between foreign franchisors and East European businesses, notwithstanding their inherent difficulties discussed above, will likely become the preferred vehicle for Western business expansion in the region.[78] Also, franchising has traditionally been an accepted means for expansion of Western business without major financial investments by the franchisor; however, due to the lack of financial resources available for investment in the East European countries, many franchise arrangements in Eastern Europe will require the franchisor to provide initial financing to develop the franchise system. This is likely to dictate that most franchise transactions in Eastern Europe will not be in the form of a direct franchise granted to an independent developer, but more likely will be accomplished through the establishment of a joint venture.[79]

Because the foreign franchisor is likely to be required to provide both the management know-how and the initial capital, the contribution of the host country partner to the joint venture partnership must be carefully evaluated. It is possible that the host country partner would contribute real estate rights, management and staff, and certain limited resources. The newly adopted joint venture legislation of each country in Eastern Europe differs with respect to percentage of ownership and the control that the foreign partner is allowed and, in some cases, as to the minimum contribution required by the foreign partner. Moreover, the prolonged absence of market forces and realistic pricing mechanisms, combined with accounting standards that were not based on profits but rather on state directives, make valuing in-kind contributions by an East European joint venture partner very difficult.[80]

V. Strategic Planning Considerations

It is important that international franchisors establish a "competitive strategy" to remain profitable in today's marketplace. All firms competing in any industry have a competitive strategy, whether they realize it or not. This strategy may have been developed explicitly through an organized planning process, or it may have evolved implicitly through the decisions made by company leaders at various points in the company's history. In companies in the United States and abroad, great emphasis is being placed on engaging in the formulation of an explicit business strategy--to ensure, <u>inter alia</u>, that all divisions of the company are directed and coordinated to accomplish a common set of goals.[81]

Developing a competitive strategy becomes critically important to franchisors as they begin competing in international markets. A major attraction of a global competitive strategy is that it provides greater possibilities to identify "competitive advantages" within the industry in which the firm is competing. Thus, firms create a competitive advantage by seeking out or identifying new and better ways to compete in an industry. When a firm is able to bring a new method of international competition "to market", ultimately an act of innovation has usually occurred.[82] Innovation can be anticipated in several ways, including "product changes, process changes, new approaches to marketing, new forms of distribution, and new conceptions of scope."[83] Thus, it is important that an international franchisor identify and understand the unique competitive benefits that are created by choosing to expand through a franchise system over other foreign investment approaches.

From a strategic standpoint, franchising is well-suited to adapt to the structural changes which continue to occur in Eastern Europe. For a Western company to successfully operate in the region, competitive advantages based on pure cost benefits are not likely to be sustainable for the long term. Merely imitating international competitors and basing competitive advantage on cheap labor or raw materials, a strategy which is often used by firms from developing nations, is possible in less sophisticated industries but is seldom the basis for sustained economic development.[84] In the long run, competitive advantage is achieved through constant improvement and upgrading. Because of the shortage of investment capital in Eastern Europe, Western companies are likely to provide most of the initial financing for joint venture operations and therefore must view their participation from a long term perspective. Thus, any competitive advantages must be expanded and improved. A firm operating in these countries should strive to become a moving target by creating new advantages "as fast as competitors can replicate old ones."[85]

As an example of a long-term international strategy that paid off, the Japanese automakers have been very successful over the past three decades at exploiting long-term strategies. Even while they were succeeding in penetrating international markets with inexpensive, quality cars produced with lower labor costs, these Japanese companies were upgrading. They continued to build large, modern plants which enabled them to obtain sizeable economies of scale. They developed and improved a host of quality and productivity practices that led to better product quality, repair records, and customer satisfaction than their competition. These automakers have most recently advanced to the top of product technology and have successfully introduced new luxury automobiles.[86]

This successful long-term strategy underscores the importance of joint venture franchisors developing a long-term global strategy as it relates to Eastern Europe. A global strategy is simply defined as "one in which a firm sells its product in many nations and employs an integrated worldwide approach to doing so."[87] There is no typical global strategy because there are numerous ways of competing globally that usually involve choices, such as where to locate and how to coordinate activities. A joint venture is viewed as one type of "strategic alliance" (or "coalition") that is prominently used in carrying out global strategies.[88] A strategic alliance is generally agreed to be "long-term agreements between firms that go beyond normal market transactions but fall short of merger."[89]

Generally, the purpose in entering into a strategic alliance, such as an international joint venture arrangement, is to gain specific benefits. For example, by joining forces with a host country national in marketing, component production or assembly, major economies of scale or learning can be achieved. Another benefit that is often gained is access to local markets or compliance with government laws relating to local ownership. Finally, a benefit achievable through a joint venture alliance is to more fairly allocate risk.[90]

Strategic joint venture alliances should be limited in scope and duration. Such international alliances are often transitional devices and are not a panacea for firms looking to expand. Firms which are global leaders rarely rely on an international partner for abilities or assets essential to maintaining a competitive advantage in the industry. Further, the most successful alliances are those that are highly specific in focus and "oriented toward access to particular country markets or to particular technologies."[91] This reinforces the notion that, as a strategic alliance, an international joint venture might easily be the most appropriate foreign investment vehicle for a foreign franchisor who is seeking to fully exploit its perceived comparative advantages in Eastern Europe.

There are, however, some basic strategic planning questions that one should answer in determining whether a joint venture is the most appropriate vehicle to maximize the comparative advantages that are expected from a decision to disperse activities internationally. These questions, which should be explored before selecting the first country of operations, include:

o Is licensing a preferred alternative? Licensing would not require an investment of cash or plant and machinery. Normally, the licensee in the host country would agree to finance its own production line, and the licensor would agree to purchase a specified part of the output. Although the investment is less, the licensor would have less control over the quality of the finished product in a licensing arrangement compared to a joint venture.[92]

o Is exporting a preferred alternative? Consideration should be given to deciding what other export markets the company desires to penetrate. If the targeted locations are in Eastern Europe, it is unlikely that there will be sufficient hard currency for payment for the desired increase in exports to those countries.[93]

o If a joint venture is selected, which Eastern European country would be the best for the proposed venture? Each country in the region is very different in social and political structure. Some countries are significantly more advanced in their industrial and infrastructural developments. The accounting, auditing, taxation, and legal systems are still being developed in the region. Preference should be given to those countries that are more advanced in these areas or are able to assure the foreign investor that these matters will be negotiated fully to its satisfaction in advance. Because any foreign investment in Eastern Europe is not likely to be profitable unless it is based on a long-term commitment, great consideration should be given to the prospects for developing and maintaining long-term relationships in the country.[94]

o What are the prospects for locating a reliable host country joint venture partner? In some East European countries, the contracting joint venture partner is often a division of a government ministry. Caution should be exercised to ensure that the individuals who sign the joint venture agreements are properly authorized to legally bind the contracting entity.[95]

o What are the contributions by both parties to the joint venture partnership and how are they valued? It is difficult to fairly value such in-kind contributions as land or buildings in the host country because there is not historical market for such items. More problems arise if the contribution of the East European partner has not been valued in hard currency. If the local currency is later devalued, which is likely, the contribution of the foreign partner becomes disproportionate to the East European partner.[96]

o How efficient is the work force in the host country? Although the local labor force will be much cheaper than the labor force of the home country of the Western partner, it should be determined whether the savings in wages is adequate, given the lack of training, skill, or efficiency of the local workers.

o Because it is likely that the foreign partner will likely be responsible for start-up financing, given the shortage of capital in the region, it should be determined how this initial capital will be financed. It is possible that local credits or direct financing may be available from government ministries. If not, a preferred rate of financing may be available from Western banks, depending on the policy interest in stimulating investment in the specific country.[97]

In developing and sustaining a competitive global strategy, a Western firm must give significant consideration to activities of both the home and host governments which are likely to affect its expansion in Eastern Europe. First, a Western firm's relationship with governments of targeted locations should be carefully assessed in developing a competitive global strategy. Host governments have a variety of mechanisms that can impede or enhance the operation of global firms.[98] Policies of host governments have a major effect on the goals of foreign companies through such efforts as regulations on direct foreign investment, exchange and import controls, restrictions on the inflow and outflow of skilled personnel, tax incentives, and others.[99] Second, both the Western firm and its home government should be analyzed together in that there is usually a complex relationship between the two that can involve many forms of regulation, subsidy, and other assistance.[100]

Thus, before investing in a country, a foreign franchisor should attempt to evaluate the role of both the home and host country governments and determine whether their policies are likely to serve as a helper or supporter of the franchise operation over the long term. It should be understood that the many ways in which a government initially tries to help or promote the activities of business can, in the long run, actually hurt the economic growth of firms (e.g., an artificial devaluation of the currency or sustained subsidies). Such policies can create disincentives, ensuring that firms fail to take the necessary steps to create a sustainable competitive advantage and working to slow the advancement of the economy.[101] This government dependency makes it difficult to persuade a firm to accept the risks associated with expansion of operations without such support. Thus, government assistance can create a demand for sustained assistance.

Instead, a better role for government is to push and motivate businesses to achieve greater productivity through efficiencies and economies of scale leading to increased profitability. This type of government policy focused on strong competitive pressure is essential to the development of a free market system in Eastern Europe. Recognizing that economic integration with the West will not occur in the short term, government policy in Eastern Europe should be focused on long-term economic success and should seek a vital role for pressure and even adversity, which often serve as the catalysts for the development of a growing economy. By pushing even newly established firms to raise their aspirations and move to a higher level of competitive prowess, even though this may be an unsettling and even unpleasant process, the governments in the emerging free market economies of Eastern Europe are likely to do more to foster sound economic growth in their countries than the most lucrative government subsidy that could be instituted.[102]

In considering the prospects for a supportive relationship between a U.S. joint venturer and a host country government of Eastern Europe, it should be kept in mind that progress in economic reforms in the region will take years. Until such reforms are in place, there are initiatives that a Western investor can take to minimize the harsh effects of the lack of economic reforms in the country. For example, if the host country government has a reform policy in place which would jeopardize the joint venture operation (e.g., a requirement that joint ventures with foreign participation source their components within the host country), the foreign partner should consult with the appropriate government ministry in advance to seek an adjustment of the policy.

Such reform policies can be a major problem for franchisors that have strict requirements for adapting the franchise system in a foreign country. Many foreign companies, when faced with a lack of available manufactured inputs which meet requisite quality standards, are vertically integrating their East European operations so that they control all aspects of their operations.[103] For example, McDonald's delayed the planned opening of one of its Moscow franchises because it was unable to secure beef of the quality necessary to meet the standards of McDonald's system. As a result, McDonald's will soon be operating its own cattle farm in the Soviet Union.[104]

The Most Favored Nation ("MFN") trade status classification of the United States[105] typifies government activity that affects a franchisor's ability to sustain a competitive global strategy. For example, MFN trade status could be a major economic obstacle to an export-oriented joint venture located in an East European country that does not have MFN status.[106] This is particularly true where the U.S. joint venture company in Eastern Europe would like to import some of the products produced by the joint venture to the U.S. In most instances, the high U.S. tariffs imposed on such imports would create an insurmountable price barrier, thereby making the imports noncompetitive in the

U.S. market.[107] But if the East European joint venture was going to produce products that would be sold only in the host country or in countries outside the United States, the importance of MFN status is minimized. However, U.S. companies may have internal problems regarding investments made in non-MFN countries. Many multinational U.S. companies have indicated that they would prefer not to do business with a country viewed with "disfavor" by the U.S. government. As one business representative commented, "Why should U.S. firms investigate joint ventures with the Soviet Union when the U.S. government signals disfavor?"[108]

There are other ways that MFN status for an East European country may affect the implementation of a U.S. joint venture's global strategy for the region. Most U.S. companies evaluate potential business opportunities by comparing them with other, already developed and proven markets. Therefore, some businessmen seriously question why U.S. companies would invest in an East European joint venture under any circumstances, considering the more attractive market and general business environment in Latin American countries or India.[109] Obtaining MFN status might also serve to remove a major psychological irritant suffered by East European countries, since they have long viewed the lack of MFN status as somewhat of an insult and a sign of nonacceptance by the United States.[110]

Prospective joint venturers in Eastern Europe should also be aware of largely unexpected consequences likely to occur if the perceived stigma of lack of MFN status were removed. It is believed that the symbolic act of granting MFN status to an East European country might generate, as a response, the opening to foreign investors of choice sectors of the local economy that have generally been closed to foreign participation--such as the extraction of minerals and other natural resources.[111] Consideration should also be given to the likelihood that a grant of MFN status would indirectly signal Western commercial banks that there has been an implicit U.S. approval of the creditworthiness of the East European nation, thereby resulting in an outpouring of credit to the newly designated country. Although this would expand the number of sources willing to provide investment capital to the region, this increased availability of hard currency in the country (from both investment credits and export revenues) would quickly disappear as a result of the inefficient and unreformed economic systems still present in the region. If this occurs, MFN status should be expected to have the effect of slowing down the development of a more stable and predictable economic environment.[112]

VI. Legal Issues Affecting International Franchising

Despite the emergence of franchising in many areas of the world, there has been only limited legislation and governmental involvement in franchising regulation outside the United States.[113] Although to date none of the East European nations have adopted specific legislation affecting franchising, there are general commercial laws and regulations that significantly impact franchising arrangements in these countries. Many of the legal issues involving franchising to the region are not necessarily unique in that they arise in most international contractual arrangements. Moreover, most of these issues are, to some degree, similar with respect to all Eastern European countries.

A. Real Property Acquisition

In all franchise transactions, it is usually necessary to have a real estate component, whether the land is leased or owned by the franchise operation. Most of the land in Eastern Europe is owned by the state and used by state-run enterprises. Because transfer of title requires no recording, finding out who owns a piece of property can prove to be impossible.[114] The notable exception is Poland, because even during the years of Communist rule, some land did belong to private owners, and, as a result, there still exist mechanisms for resolving land disputes. In Bulgaria, companies with foreign participation may acquire, with government permission, construction rights over immovable property for a fixed term or for the duration of the performance of their designated economic activities. Upon liquidation of the operation, the Bulgarian partner has preemption rights to buy the immovable property. If he declines to do so, the right to purchase is acquired by the state. The prices of the immovable property on the land are freely negotiable. However, ownership of the land, its minerals, forests, or water may not be acquired.[115]

If a joint venture arrangement requires that one of the partners (most likely the host country national) acquire the land for use by the franchise operation, there is a risk that the acquisition, whether a lease or a purchase, would be subject to claims bought by former owners of the land. In East Germany, the government has attempted to resolve this potential conflict by nullifying all preexisting or historical claims to land, and declaring that the government owns all titles to real estate. Although not losing their rights completely, East German claimants are relegated to seeking monetary compensation from the government.[116]

Because the location of a franchise unit is inextricably linked with the goodwill of the franchise system, the acquisition of real property is critical to both franchisors and franchisees. Moreover, this issue puts even more financial pressure on the foreign franchisor when it has financed or put up hard currency security for a lease or acquisition of land for franchise locations, which is often the case. Therefore, it is essential that both parties at the outset work to ensure the right of the franchise to exclusive use of acquired real estate without interruption through the duration of the contract.[117]

B. Currency Convertibility and Repatriation

One of the primary obstacles to successful joint ventures in Eastern Europe is the difficulty in earning hard currency. Inconvertibility may be the biggest stumbling block to increased trade with Westerners in the region.[118] Inconvertibility of currency is the reason most joint ventures to date involve activities in the service industry. This has resulted in service-oriented joint ventures providing assistance predominantly to Westerners who pay in hard currency, thereby allowing the joint venture to avoid the convertibility problem.[119]

To fully appreciate and understand the problem of currency convertibility in Eastern Europe, some background information is necessary. Currency convertibility usually means "the ability of a holder of a currency to freely exchange it for another country's currency at a market rate."[120] In past eras, convertibility has referred to a promise by the government to convert its domestic currency into gold on demand. Before the movement toward economic reforms in the region, the centrally planned economies of Eastern Europe maintained inconvertibility to keep their economies separate from those in the West. Because self-sufficiency was the goal, foreign trade was discouraged. All prices were set by central planners and as a result did not serve the economic function of allocating resources. Thus, under these conditions, convertibility was both undesirable and impossible. Now, convertibility is viewed by the reform-minded governments as a major vehicle for expediting the transition to a rational price system and stimulating foreign investment, which in turn could bring hoped-for Western technology and management skills to the region.[121]

From the West's perspective, convertibility is a prerequisite for major trading with and investment in Eastern Europe. Although there is vast potential for marketing Western goods to the region, inconvertibility of the currencies (which reflects underlying balance of payment problems) makes exporting to such countries difficult. This reluctance to trade with Eastern Europe due to inconvertibility problems creates a dilemma for economic planners. These countries must first earn hard currencies by exporting to the West before they can purchase Western exports. Most of the products manufactured in Eastern

Europe, however, are not of the requisite quality to attract Western purchasers. Moreover, hard currencies earned from exporting must first be used to service the large foreign indebtedness of countries such as Poland and Hungary.[122]

Accordingly, the lack of convertibility is a major obstacle to Western joint ventures in the region. Hard currencies are essential to Western firms for repatriation of profits, obtaining supplies and equipment in the West, and payment to Western employees. Convertibility is likely to remain a problem in the region for some time.[123] It is an important consideration that must be dealt with by firms contemplating a joint venture.[124]

Although there is no quick solution to inconvertibility for Western firms, innovative measures to get around this problem have been taken with some success. For example, the American Trade Consortium, a group composed of Archer Daniels Midland, Chevron, RJR Nabisco, Eastman Kodak, Johnson & Johnson, and Mercator (a New York merchant bank), each intending to negotiate joint ventures in the region, established a system allowing members to trade rubles and other currency among themselves. Export-oriented joint ventures, such as Chevron's oil export venture, are required to sell their cash to members of the consortium with joint ventures that focused primarily on selling to the local market. The hard currency pool generated by Chevron and the other members also was able to satisfy the requirement that a joint venture earn enough hard currency to cover any profits that it repatriates.[125]

Also, Western participants to joint ventures in the region have learned that if the product that is being produced by the joint venture has been identified as desirable by the host country government, a solution to the currency problem can often be reached--with the assistance of an appropriate ministry official. If a host country government is anxious to induce a Western joint venture manufacturer to sell its products locally, it is possible the government will provide such assistance as locating a local product that is of sufficient quality so that the Western company can export it and earn hard currency as payment for its local sales. The Soviet Union has an ample amount of Indian rupees from military sales to India with which it could pay foreign companies if no other readily convertible currency is available. In other instances, the host country joint venture partner may assist the Western partner by using its local currency to purchase exportable raw materials on behalf of its Western partner.

Another possible means for Western participants in joint ventures to earn hard currency from their foreign operations is countertrade and barter. These processes merely involve payment with goods instead of with hard currency. For example, PepsiCo has signed a contract to establish more Pizza Hut restaurants in the Soviet Union. Under the agreement, PepsiCo will receive Soviet vessels as payment. This permits PepsiCo to sell the vessels for hard currency and then use some of that currency to purchase goods and services necessary to maintain the quality standards of the Pizza Hut franchise.[126] Nonetheless, the long-standing problem with countertrade involving East European products is that very few items are marketable outside the region because they are not competitive with Western products.

While currency inconvertibility does not preclude joint ventures in Eastern Europe, it is a major hurdle which, if removed, would undoubtedly encourage more trade and investment in the region. One must carefully examine the issue of currency convertibility before deciding to enter into a joint venture in Eastern Europe.[127]

C. Protection of Intellectual Property

At the heart of every franchise system are trademarks and service marks. The franchisor must ensure that these valuable assets are adequately protected in a joint venture franchise operating in Eastern Europe. Franchising a system internationally also usually involves such intellectual property rights issues as the protection of trade names (and the goodwill they create), copyrights, and trade secrets and know-how (which usually include processes and work methods of the franchise system).[128] In providing for contractual protection of these rights, the subfranchisor in the host country often will have to prepare translations of operational training manuals and other protected information. Normally, these manuals contain details of the franchisor's know-how and trade secrets. Although these manuals are prepared by the host country subfranchisor in its own language, the copyright in the translation should always be vested contractually in the franchisor.[129]

In general, protection of the franchisor's intellectual property rights is available if the franchises will be located in countries that are signatories of the Paris International Convention for the Protection of Intellectual Property. This treaty ensures that all foreign entities from signatory countries who apply for protection will receive the same treatment as domestic applicants for intellectual property protection.[130]

Most East European countries have enacted trademark laws that should provide franchisors with adequate protection. For example, service marks are registrable in each of these countries.[131] In addition, most Eastern European countries are members of the Berne Convention, which provides that the copyrights of franchisors from the signatory countries are protected in Eastern Europe without such formalities as filing or special notices.[132]

Unlike the U.S., most countries permit registration of a trademark without use.[133] Although statistics are unavailable, in practice trademarks are often registered in foreign countries by persons domiciled in such foreign countries who are not the owner of the franchise trademark. In the Far East, for example, this practice is often viewed more as a sound business practice than stealing a trademark. Thus, firms initiating an international franchise have been forced to purchase their trademarks in the host country prior to concluding a franchising agreement.[134]

It is advisable that in advance of negotiating an international franchise arrangement, a foreign franchisor should ensure that its trademarks are properly registered in the target country. Also, if the target country uses a different language, the trademark should be registered in the languages of both the home and the target countries.[135]

The major problem in protecting the intellectual property rights of a franchise operating in Eastern Europe is enforcement. The systems for enforcing these rights and the availability of judicial remedies for infringement are not well established in any of the East European countries.[136]

D. The Governmental Approvals Process

In most countries it is common to require foreign franchisors to register with one or more government agencies. In Eastern Europe, a newly organized international franchise operation will require a number of permits and approvals before it can become operational.[137] This process, however, is intensely confusing and frustrating in Eastern Europe. Before the recent reforms began, foreign trade was usually controlled by a single ministry. This ministry served as an intermediary between foreign companies and local enterprises. Foreign trade was conducted on the basis of central planning, usually at the expense of efficiency and economic sense. Greater emphasis was placed by these foreign trade ministries on fulfilling inflexible and unrealistic plans than on advancing the economic interests of the parties.[138]

As part of the current economic reforms, most East European countries abolished their foreign trade ministry's monopoly over foreign trade, thus allowing all state enterprises to engage directly in foreign trade. To administer this broadened scope of foreign trade activity, attempts have been made to fully reorganize the foreign trade apparatus in these countries. The result, however, in several of these countries has been mass governmental turmoil, which has created uncertainty over which governmental office has the authority to enter into and perform contracts. As various agencies in these centrally planned governments are dismantled, the principals of these agencies quickly re-emerge and begin to compete with each other for newly-created positions which control key resources in the country.[139]

As a result, foreign firms must now deal with an unfamiliar and untested government structure. The roles of the new agencies and how they are to interact with each other has not been established. The personnel who run these new agencies are often unfamiliar to foreign firms and are uncertain of their responsibilities.[140] Some U.S. business representatives have indicated that decentralization of the foreign trade apparatus in these countries has, at least over the short term, made doing business more difficult than before. Managers in charge of enterprises with foreign-trade rights do not know whether their governmental office has the controlling authority to enter into and perform contracts. Consequently, they become afraid to make decisions, and this results in a painfully slow approval process.[141]

This competition between governmental authorities is demonstrated even at the local level. In Moscow, just ten days after its opening, a Pizza Hut restaurant was reportedly closed briefly by local health officials--allegedly for sanitary violations. It is believed the closing, however, was the result of a jurisdictional dispute with the Moscow City Council, which is the Soviet partner in the joint venture with PepsiCo, the parent company of Pizza Hut.[142]

New decrees and regulations revising and more clearly establishing the responsibilities for foreign trade administration continue to appear. These new foreign trade regimes, however, also present opportunities for foreign investors to the region. The relative absence of detail and lack of experience of the emerging trade apparatus can provide the foreign investor more latitude to work out specific protections and benefits through contractual arrangements, which are unlikely to be hampered by legal restrictions or inhibiting precedents.[143]

E. Competition Issues

Local competition laws create special problems for many international franchise arrangements. It is imperative that foreign franchisors obtain advice on these issues from target country lawyers.[144] Several Eastern Europe countries are in the process of adopting competition laws designed to prevent monopolistic abuses after privatization of the economy. The intent of these new laws is to foster healthy competition by making anticompetitive practices illegal.[145]

The typical anticompetitive practices that franchisors have historically been associated with are restraints against competition and unreasonable protections of the franchisor's know-how. No franchisor is interested in training franchisees so that they are equipped to trade competitively with the franchisor. Therefore, the franchisor has used the basic defensive weapons of contractual restraints against "in-term" and "post-term" competition, and protection for the franchisor's know-how.[146] Generally, these provisions are known as covenants not to compete. They are designed to prohibit franchisees from associating with any business similar to the franchisor's during the term of the franchise agreement. The in-term restrictions normally have no geographic limitation. Post-term restrictions, however, limit the geographic area of competition for a specific length of time after the franchise relationship has terminated. Contractual provisions designed to protect the franchisor's know-how commonly prohibit franchisees from engaging in a similar business within a geographic area for a specific length of time after the franchise relationship has terminated.[147]

The nature and extent of protections that are available to the franchisor's know-how in any given region should be thoroughly analyzed. In-term restraints are usually easier to enforce than those that become effective post-term. Therefore, post-term restraints should be carefully drafted to ensure that they are reasonable in regard to both the area within which they are enforceable and the length of the enforcement period.[148] The reasonableness of know-how protection is generally based on whether the know-how was confidential or actually in the public domain. In franchising, the individual elements of the franchise system may lack the necessary degree of confidentiality for reasonableness but the application of the comprehensive know-how package to the franchise operation normally is sufficient.[149]

The new competition laws emerging in Eastern Europe are not directed specifically at franchise transactions but are generally applicable. By their nature, franchise agreements are restrictive. Thus, many of the inherent practices of a franchise arrangement, such as exclusive territories, tied sales, agreement on prices, and other controls, can easily be affected by new antitrust laws and regulations in the region.[150] For example, Poland has a demonopolization law and is working to establish an independent government agency to enforce its requirements.[151] Also, potential franchisors to the region should keep an eye on the anti-trust developments within the European Community. It is likely that East European countries, in anticipation of gaining associate status (and eventually full membership), will model their antitrust system and policies on those of the European Community.[152]

VII. Joint Venture Laws

Eager to attract foreign investment, East European countries have undertaken sweeping changes in their foreign investment laws. Though most of Eastern Europe has had legislation governing foreign investment for over a decade,[153] these countries have recently replaced these laws with new decrees that are geared toward encouraging the formation of foreign joint ventures. Although none of these countries have enacted laws directed specifically to franchising, these joint venture laws, which cover all general commercial activities in the country, will be applicable to international franchising operations.

There has been numerous articles and information recently produced focusing on countries in the region, such as the Soviet Union, Poland, and Hungary, which are widely perceived as hospitable to Western investment.[154] Therefore, this paper reviews the new laws affecting joint ventures in less-publicized countries in Eastern Europe that nonetheless show promise as markets for joint venture franchising. Accordingly, the following will summarize the laws of Romania and Czechoslovakia which affect direct foreign investment. The descriptions of these countries' laws will focus on and cover: types of investments permitted; authorization and registration procedures; establishing the business and daily operations; currencies and repatriation of profits; and protections against expropriation and intellectual property rights.

A. Romania

1. Overview. Five months after the fall of dictator Nicolae Ceaucescu, Romanians freely elected a new government. More than any other nation, however, among the emerging democracies in Eastern Europe, Romania has had a difficult time reversing the political and economic effects of the Ceaucescu years. The new regime is building on several economic reform measures which were instituted prior to the elections of May 1990. The new government expects that it will complete Romania's transition to a market economy by the end of 1992, but expects significant modernization of the economy to take another 5 to 8 years.[155]

2. Types of Investments Permitted. Under the revised foreign investment statute, capital may be invested in almost any sector of the economy, including agriculture, scientific research, tourism, trade, transportation, banking, insurance, and "other services".[156] Foreigners may invest in both new companies and existing Romanian enterprises. The priority areas for successful foreign

joint ventures include consumer goods; medical equipment and medicines; energy; telecommunications; agriculture, food processing, and packaging; and travel and tourism.[157]

The Foreign Investment Law allows foreigners to own up to 100 percent of an existing Romanian venture, or to open a wholly-owned subsidiary or representative office. The division of shares in any joint venture is up to the participating parties.[158]

3. Joint Venture Approvals. The registration and authorization process for new ventures in Romania has been streamlined. Companies with foreign participation must obtain authorization from the following sources: the Ministry of Trade and Tourism, the Ministry of Finance, and the industry-specific government department. Companies in a production field, such as oil or gas, also must obtain an approval from the Ministry of Resources and Industry. A feasibility study also must accompany each application for government authorization.[159]

If the foreign company seeks to open a representative office, permission must be obtained in advance. An application for a representative office license must be filed with the Ministry of Trade and Tourism, which has 30 days to approve or deny the application.[160]

All new ventures with foreign participation must register with the Ministry of Finance to obtain "formal status". A registration tax of $500 in hard currency is payable on all such ventures at the time of registration. In addition, approved representative offices must register with the Ministry of Trade and Tourism, which has 30 days to issue or deny the license.[161]

4. Real Estate and Business Operations. Neither foreign individuals nor joint ventures with foreign participation may own land in Romania. Thus, unless the Romanian joint venture partner contributes land, the venture has no choice but to rent.[162] Recently proposed legislation, however, if enacted by the Romanian parliament, should increase access to real estate for foreign companies. Reportedly, the proposed legislation would, as a first step, privatize farm land, then later permit privatization of commercial real estate.[163]

Joint ventures with foreign participation are not limited in the number of foreign employees that they can hire. The foreign investment law, however, provides that the "expatriate personnel necessary to implement the foreign investment shall be employed only in management and expert jobs."[164] Before foreign employees begin working in Romania, they must first obtain a work license from the Ministry of Labor. Choice of currency and the amount of wages that are paid to employees may be negotiated freely by the joint venture company. The parliament, however, is reportedly considering passing a minimum wage law for Romanian workers.[165]

There are three major labor unions in Romania of which foreign companies should be aware. The largest, the National Free Trade Union Confederation of Romania, has significantly contributed to the development of legislation by the parliament. The amount of union activity in Romania varies depending on the industry sector and geographic location. Although this is not attributable to the power of unions, most Romanian factories have switched from a six-day to a five (or five-and-a-half)-day work week since the new government came to power.[166] Although this cutback has caused some production delays, generally the change has been worthwhile, primarily because of improved worker morale. Recently, Romania's workforce has been rated at near the quality that is available to employers in Hungary and Czechoslovakia; however, such comparisons are unavoidably based on a limited range of experience.[167]

5. Currencies and Profit Repatriation. Capital contributions made by a foreign joint venture partner may be either in hard currency, Romanian lei, or in-kind. The Romanian Foreign Investment Law provides that such in-kind contributions include "intellectual property rights (such as patents, trademarks, copyright), management techniques, [and] know-how."[168] In addition, the law provides that a foreign investor's contributions to joint venture equity may be imported into Romania duty-free. Foreign joint ventures must establish and maintain both a hard and soft currency

account with a "legally credited" bank operating in Romania.[169]

Any hard currency profit made by a foreign joint venture company in Romania can be legally repatriated by the foreign partner. At present, the foreign partner is annually permitted to repatriate profits earned in Romanian lei in an amount up to 8 to 15 percent of the value of the company's capital investment in Romania.[170] It is possible to repatriate additional profits, with assistance form the governmental authorities, through countertrade or barter agreements. Because foreign companies operating in other East European countries, e.g., Hungary, can at least theoretically repatriate 100 percent of all profits earned in any currency, the Romanian parliament is under growing pressure to enact legislation that would significantly liberalize the current repatriation rules.[171] Also, a dividends tax requires "that a tax of 10 percent be paid on all profits repatriated outside the country."[172]

6. Intellectual Property and Expropriation Concerns. Under the terms of the U.S.-Romanian Trade Agreement of 1975, all intellectual property rights of the foreign joint venture partner operating in Romania are legally protected. Romania is a signatory to both the Paris International Convention for the protection of Intellectual Property and the Universal Copyright Convention. The obligations to uphold the rights of intellectual property

owners imposed by these conventions are incorporated by reference to the Trade Agreement.[173]

The Foreign Investment Law provides no explicit protections to the foreign investor in the event of expropriation or nationalization, nor does it provide any rules for compensation.[174] Therefore, all foreign firms seeking to establish a joint venture in Romania should address this issue in all applications and contracts with the Romanian government prior to executing a joint venture contract.

B. Czechoslovakia

1. Overview. Now officially named The Czech and Slovak Federal Republic, Czechoslovakia, in November 1989, rejected its communist government and chose playwright-turned-politician Vaclav Havel and the Civic Forum party to lead the country on a course to establish a democratic, free-market government. President Havel's government has launched a series of economic reforms aimed at creating a market economy that will capitalize on Czechoslovakia's industrial traditions, skilled work force, low foreign debt, and fiscal monetary control. Czechoslovakia, located in the heart of Europe in close proximity to the rich markets of western Europe, fully expects to become a member of the European Community in five to ten years.[175] Until then, the country must find new markets to replace their troubled

trading partners, the former East Germany and the Soviet Union. Help is expected from the United States as a result of the bilateral trade agreement signed between the two countries in November 1990 granting MFN trade status to Czechoslovakia. President Bush also announced a U.S. $60 million fund to help invigorate the Czech private sector. This significant appropriation will establish the Czechoslovak-American Fund, which is a nonprofit endowment designed to promote the development of a private sector through investments and loans to small and medium-sized enterprises and joint ventures with U.S. firms.[176] This Fund should provide meaningful assistance to U.S. franchisors seeking to expand their franchise operations to Czechoslovakia.

2. Types of Investments Permitted. Czechoslovakia has had a law regulating foreign participation in Czechoslovakian joint ventures since November 8, 1988.[177] In April 1990, the interim government amended the joint venture statute to permit foreigners to acquire 100 percent of existing joint ventures, or to set up wholly-owned companies.[178] There is no minimum amount of foreign participation required to establish and maintain a foreign joint venture. If the joint venture is set up as a joint-stock company, it is required to be capitalized with a minimum of 100,000 krowns (approximately U.S. $15,900).[179]

Foreign joint ventures are permitted in every sector of the economy, except activities related to defense and national security. Most western firms have activities with the most promise for generating hard currency, such as light manufacturing, food processing, and tourism. Other industries that appear well-suited for foreign investment are telecommunications, transportation, ecological monitoring systems, banking services, agricultural equipment, and fertilizers.[180] Although Czechoslovak authorities have indicated that joint ventures producing items for hard currency export or operating in a key sector of the economy (such as electronics and environmental protection) will receive preferred attention, there is no indication that such ventures receive more favorable tax treatment than those in other sectors.[181]

In addition, opportunities for franchising will increase as a result of recent privatization efforts in Czechoslovakia. On February 26, 1991, the Parliament approved legislation ending 40 years of state control over Czechoslovakia's economy by permitting foreign and domestic ownership of the 4,500 industrial enterprises, valued at U.S. $130 billion. Companies illegally nationalized by communists after 1948 will be returned to the original owners or their descendants. Other Czechoslovaks will be permitted to own portions of other enterprises through an intricate system of government-issued coupons.[182] In addition, foreign investors will be permitted to purchase shares of the state-owned enterprises as they are transforming to joint stock companies. Also, a small company privatization act will soon be enacted which will allow more than 100,000 shops, service stations, and other small businesses to convert to private ownership through a system of public auctions. It is reported that only "Czechoslovak citizens and legal entities with the exception of joint venture companies" can take part in the auctions.[183]

3. Joint Venture Approvals. The approvals process has been significantly simplified. Prior to the amendments of May 1, 1990 to the new joint venture law,[184] permission to establish a joint venture was required from several ministries. A special joint venture authorization office of the Federal Ministry of Finance is responsible for coordinating a review by other ministries and for making approval decisions within 60 days.[185] Companies are not required to submit feasibility studies with their applications. The Czechoslovak State Bank issues licenses for joint ventures involving the banking sphere.[186]

Once authorization is obtained, joint venture companies must next register in the locality (Czech or Slovakian) in which they will operate. Foreign investments in existing Czechoslovak enterprises do not require advance authorization, but registration is required.[187] Foreign joint venture participants can obtain assistance regarding authorization, registration, and other questions relating to the start-up of operations from the Agency for Foreign Investment and Assistance. The Agency was recently established by the Czech government to provide support for all forms of foreign investment, including "purchases of Czech enterprises and securities and joint ventures."[188]

4. Real Estate and Business Operations. Similar to the prohibitions in Romania, foreigners are not permitted to own real property in Czechoslovakia. Thus, foreign joint ventures must rent or lease, unless a Czechoslovak partner contributes land or equity. Arguably, however, joint venture companies are legally permitted to purchase land in the Czechoslovak partner's name because Czechoslovak joint ventures are recognized as "legal persons."[189] If the activities of the joint venture are important to the overall economic priorities of the government, the Agency for Foreign Investment and Assistance can allow the joint venture company to purchase real estate.[190]

There are no laws or restrictions on the number of foreign employees that a joint venture company may hire or on the salaries that they may be paid. Salaries for Czechoslovak employees, however, must comply with existing salary rates established by the government. But the joint venture company can request permission (which is invariably granted) to pay Czechoslovak workers an additional 25 percent above the salary scale and pay a bonus as well.[191]

Additionally, joint ventures in Czechoslovakia must provide information to the government for the purposes of accounting and statistics. The accounting and statistical data information system is, at present, very complex. Although over time the system will be simplified, the immediate accounting and statistical responsibilities will require a joint venture company to employ a local accountant who is knowledgeable about the current system.[192] A likely problem in the managing of a franchise operation is finding a Czechoslovak franchisee that, as a local company, has experience in maintaining a balance sheet or financial statements. The franchisor should consider, therefore, providing training and technical assistance for Czechoslovak local management in basic business and accounting practices.[193]

5. Currency and Profit Repatriation. On January 1, 1991, the Czechoslovak krown was pegged to a number of convertible currencies and became internally convertible. This is a first step toward establishing a convertible currency and will no doubt substantially improve the ability of foreign investors to import and export goods while properly managing their finances.[194]

Joint venture companies are permitted to maintain hard currency bank accounts in the country. However, the joint venture law requires that they offer to sell a portion (currently 30 percent) of their hard currency earnings to the State Bank. This will proportionally reduce the amount of hard currency profits that are available for repatriation.[195]

Further, the current joint venture laws do not guarantee the conversion and transfer of profits earned in local (soft) currency.[196] Some reformers are advocating immediate removal of all limitations on profit transfer for foreign investors as a step toward convertibility. Others, however, feel that the issue should be handled more slowly through bilateral investment treaties with individual countries.[197] The current laws, however, provide that repatriation of such local currency profits is possible provided that the State Bank has sufficient liquidities of hard currency exchange.[198]

Also, joint venture companies are required to maintain a reserve fund to protect against future inability to pay debts. This requires that five percent of after-tax profits be deposited in the reserve fund, which must at all times contain at least 10 percent of the joint venture's basic capital. Although the fund is required to contain both convertible and local currencies, there is no indication of whether there is a required ratio or a minimum level of hard currency.[199]

6. Intellectual Property and Expropriation. Czechoslovakia is a signatory to the same international conventions as the United States, including the Paris International Convention for the Protection of Intellectual Property and the Universal Copyright Convention. Unlike Romania, Czechoslovakia has taken significant steps to further strengthen its domestic protections system. Recently, legislation has been introduced for the first time in areas of patents, copyrights, proprietary information, and integrated circuit layout designs.[200]

In regard to expropriation, the joint venture law states that the property of a company operating in Czechoslovak territory may be confiscated or restricted "only in accordance with a Law," presumably an act of the Parliament.[201] The law, however, does provide for full compensation either in the currency of the original investment or the currency of the foreign partner's home country.[202]

VIII. Conclusion

The new governments of Eastern Europe want and need foreign investment. They have chosen, through their new foreign investment laws, to encourage that investment by promoting the formation of joint ventures. Franchising is inherently well-suited to take advantage of the investment incentives being offered through these joint venture laws. In addition, the workforce in Eastern Europe is culturally well-positioned for franchising because it has a strong tradition of entrepreneurship and of small business. As the demand for Western goods and services increases, Eastern Europe presents international franchisors with an unexpected but attractive market.

Eastern Europe has much to gain through franchising in the region. Culturally, franchise systems operating in East European countries can spur the integration of those societies into the international economy. Franchising can facilitate a grant of ownership rights and decision-making power to small unit operators throughout the region, a process which has an enormous political significance in emerging market economies. Because of its structure, franchising offers a unique method for converting state-owned enterprises to privately operated businesses. A shared sense of societal values between economies is created through sharing the technologies, trademarks, and advertisements associated with a franchise. By quickly and efficiently creating relationships between one economy and another, franchising can foster greater cooperation and better understanding between countries of Eastern Europe and the West.

Although business prospects warrant optimism, caution is imperative. Deep-rooted bureaucracies, inadequate infrastructures, shortages of supplies, and political and social instability make operations in the region difficult and expensive. A prospective franchisor must, therefore, take a long-term approach to business success in Eastern Europe. A franchisor should carefully examine the circumstances and conditions surrounding the prospects for a joint venture franchise in the unique and unfamiliar environment in Eastern Europe. The characteristics of the population and its demand for the product or service should be thoroughly investigated before a franchise is established in the region. Even with careful planning, a new franchise operation in Eastern Europe is not likely to quickly become profitable, and patience will be required.

NOTES

1. The term "Eastern Europe", as used in this paper, refers to the following countries: Albania, Bulgaria, the Czech and Slovak Federated Republic (Czechoslovakia), Hungary, Poland, Romania, Yugoslavia, and, to a limited extent, the former German Democratic Republic (East Germany). Also, notwithstanding the title of the paper, the term will also be used in certain instances to refer to the Soviet Union.

2. For a historical analysis of the development of franchising in the United States and abroad, see D. Zendel, "Franchising: A Global Phenomenon", 76 Trademark Reporter 137 (Mar.-Apr. 1986) [hereinafter cited as "Franchising: A Global Phenomenon"].

3. Id.

4. H. Brown, Franchising Remedies and Realities 1 (1972).

5. W. Pengilley, "International Franchising Arrangements and Problems in Their Negotiation", 7 Northwestern J. of Int'l. L. and Bus. 185 at 187 (Fall-Winter 1985) [hereinafter cited as "International Franchising Negotiation"].

6. P. Zeidman, "Countries in the Process of Development and Change: The Role of Franchising", Eastern Bloc Joint Ventures at 154 (D. Winter, ed., 1990) [hereinafter cited as "Countries in the Process of Change"].

7. Id.

8. Id.

9. However, there is some evidence that this trend has reversed itself. Id. at 156.

10. Id.

11. For a historical discussion of the legal and political order that is emerging in each country of Eastern Europe, see, J. Quigley, "The Transformation of Eastern Europe and the Convergence of Socialist and Capitalist Law", 26 Willamette L. J. 937 (Fall 1990).

12. In fact, newly elected governments in Eastern Europe are not only learning about competition between companies and industries, but also that which exists between countries for increasingly scarce foreign investment. See, "East Europe Competing for Western Jump-Start", Washington Post, March 14, 1990, at H1.

13. "The New Frontier", Export Today, March/April 1990, at 24.

14. See "Western Joint Ventures in East Europe", EuroSphere (publication by KPMG Peat Marwick), Sept./Oct. 1990, at 11 [hereinafter cited as "Western Joint Ventures"].

15. R. de Metz, "'Ostpolitic'--Plenty of 'Glasnost' But Little 'Perestroika'", 11 Business L. Review 22, 27 (Jan. 1990).

16. "Franchisers See Future in East Bloc", Wall St. J., June 5, 1990, at B1. See "Eastern Europe Lays Foundation for International Travel Industry", Washington Flyer, Nov./Dec. 1990, at 31; "Happy Franchising, Comrade", Franchising World, Nov./Dec. 1988 at 18; "Eastern Europe Opens to Franchising", USA Today, Apr. 5, 1990, at 9A. For a discussion of bureaucratic problems encountered by Marriott Corp. in Budapest, Hungary, see "Red Tape Dulls Appetite for Hungary Deals", Wash. Post, Mar. 28, 1991, at B1.

17. P. Zeidman and M. Avner, "Franchising in Eastern Europe and the Soviet Union", article for publication in the DePaul University Bus. L. J. symposium on "Investment and Business Concerns in Evolving Eastern Europe and the Soviet Union", at 3 (Jan. 1991) [hereinafter cited as "Franchising in Eastern Europe"].

18. Id. at 8, 9.

19. Id. at 9.

20. For a well-documented account of entrepreneurialism in Eastern Europe during the past fifty years, see J. Kister, Communist Entrepreneurs (1989).

21. "Countries in the Process of Change", supra note 6, at 157.

22. The status of other countries in Eastern Europe in connection with Most Favored Nation treatment is explained at note 106 infra.

23. D. Bialos and E. Shapiro, "Doing Business in the Soviet Union and Eastern Europe: An Update of U.S. Legal and Regulatory Developments", in Doing Business in Eastern Europe (M. Epstein, L. Irish and R. Shanks, eds., 1990) [hereinafter cited as "Doing Business in the Soviet Union"].

24. The official titles of the agreements are: "Treaty Concerning Business and Economic Relations Between Poland and the United States" (Sept. 20, 1989); "Agreement on Trade Relations Between the Czech and Slovak Federal Republic and the United States" (April 12, 1990). See "Franchising in Eastern Europe", supra note 17.

25. See P. Zeidman and A. Loewinger, "Role for Franchising Envisioned in Recent Treaty Between Republic of Poland and the United States", 5 J. Int'l. Franchising and Distribution L. 46 (Sept. 1990).

26. OPIC is a "self-sustaining" agency of the United States government which encourages private investment in developing countries. OPIC offers political risk insurance against expropriation and currency inconvertibility and organizes investment missions to developing countries. See "Franchising in Eastern Europe", supra note 17.

27. See "Doing Business in the Soviet Union", supra note 23.

28. P. Drucker, "Junk Central Europe's Factories and Start Over", Wall St. J., July 19, 1990, at A13.

29. "Countries in the Process of Change", supra note 6, at 157.

30. "Franchising in Eastern Europe", supra note 17, at 10.

31. Id. at 11.

32. See "First Sale of State Holdings a Disappointment in Poland", N.Y. Times, Jan. 14, 1991, at D1.

33. "Franchising in Eastern Europe", supra note 17, at 12.

34. Id. at 13.

35. Id. at 9.

36. Of course, the company which seeks to expand internationally can decide not to engage in a franchise at all; instead, it may decide to establish its own operations in the foreign country. In order to do this, the company would have to possess the manpower and financial resources to establish and sustain the operation. It should be kept in mind, however, that a successful company-owned network could later provide the basis for expansion within the country through franchising. See M. Mendelsohn, "Techniques of International Franchising, Legal Issues and Forms of Agreements", Eastern Bloc Joint Ventures at 159-60 (D. Winter, ed., 1990)[hereinafter cited as "Techniques of International Franchising"].

37. For purposes of this paper, "home country" shall refer to the country in which the franchisor currently operates and originally established its franchise system.

38. For purposes of this paper, "target country" shall refer to the country in which the franchisor wishes to expand its franchise business, whereas "host country" shall refer to the country in which the franchisor has expanded its franchise business.

39. See A. Konigsberg, "Practical Legal Aspects of International Franchising", 13 Int'l. Bus. L. 297 (August 1985) [hereinafter cited as "Practical Legal Aspects"].

40. Id. at 299. This problem occurs when a United States franchisor who directly establishes international franchise units from the United States files proceedings under Chapter 11 of the U.S. Bankruptcy Code. However, the problem of the extraterritorial applicability of Chapter 11 proceedings could have been avoided and the international franchise operations could possibly have continued unaffected if the franchising activities had been carried on in the host country through a subsidiary, rather than a direct franchise arrangement.

41. Because it is predicted that in ten years "trade reintegration between Eastern and Western Europe will be all but complete", it is a good idea for the long-term investor to consider the European Common Market's treatment of international franchising. See "Trade Reintegration Predicted Between Eastern, Western Europe", Bureau of Nat'l Affairs--Daily Executives Report, Dec. 14, 1990, at A-7. For a comprehensive treatment of the efforts of the European Economic

Commission to expand the European Common Market to include retail and service franchising, _see_ P. Ridgeway, "Franchising in the European Common Market Under the New Franchise Agreement Regulation", 9 _Franchise L.J._ 7 (Summer 1989); D. Schmitz and A. Van Hamme, "Franchising in Europe--The First Practical EEC Guidelines", 22 _Int'l. L._ 717 (Fall 1988).

42. "Practical Legal Aspects", _supra_ note 39, at 300.

43. _Id_. at 299.

44. _Id_. at 300. _See_ also "Techniques of International Franchising", _supra_ note 36, at 160. For an analysis of the taxation under U.S. law of American companies engaged in international transactions in Eastern Europe, _see_ H. Liebman, "Taxation of East European-Source Joint Venture Income", _Bulletin_ at 460 (publication of International Bureau of Fiscal Documentation, Oct. 1987).

45. Such abuse would have a direct and profound effect on the franchisor's product reputation in the home country. "Practical Legal Aspects", _supra_ note 39, at 301.

46. _Id_.

47. _Id_. at 299.

48. _Id_. at 301.

49. _See_ A. Konigsberg, "Agreements Commonly in Use in International Franchise Arrangements", 1 _J. Int'l. Franchising and Distribution_ 162 (June 1987) at 162 [hereinafter cited as "Agreements Commonly"].

50. "Techniques of International Franchising", _supra_ note 36, at 161.

51. "Agreements Commonly", _supra_ note 49, at 163.

52. _See_ "Practical Legal Aspects", _supra_ note 39.

53. _See_ "Agreements Commonly", _supra_ note 49.

54. Romania enacted joint venture legislation in 1971. Hungary passed a foreign joint venture law in 1972 but excluded the manufacture of goods from its coverage. Poland passed its first version of a joint venture law in 1972. Bulgaria passed a decree permitting foreign joint ventures on Bulgarian soil in 1980. _See_ P.

Buzescu, "Joint Ventures in Eastern Europe", 32 Am. J. Comp. L. 407 (Summer 1984).

55. 1 Am. Rev. East-West Trade 43 (Jan. 1968).

56. J. Scriven, "Cooperation in East-West Trade: The Equity Joint Venture", 10 Int'l. Bus. L. 105, 106-07 (Apr. 1982).

57. It should be noted that the East German joint venture law has been superseded by the commercial laws of West Germany. See P. Ebke, "Legal Implications of Germany's Reunification", 24 Int'l. L. 1130 (Winter 1990).

58. S. Tiefenbrum, "Joint Ventures in the USSR, Eastern Europe, and the People's Republic of China as of December 1989", 21 Int'l. L. and Politics 667, 671 (Winter 1989).

59. W. Jaegar, ed., A Treatise on the Law of Contracts (vol. 2), at 544-45.

60. Law of 23 December, 1988 on Economic Activity with the Participation of Foreign Parties: The Polish Foreign Investment Law, as amended by the Law of 28 December, 1989.

61. "Practical Legal Aspects", supra note 39, at 302-03.

62. "Techniques of International Franchising", supra note 36, at 176.

63. See "Practical Legal Aspects", supra note 39.

64. A. Konigsberg, "The Use of Joint Ventures in International Franchising", 5 J.Int'l. Franchising and Distribution L. 2, 4-5 (Sept. 1990) [hereinafter cited as "The Use of JVs"].

65. Id. at 5-6; see "Practical Legal Aspects", supra note 39.

66. "Practical Legal Aspects", supra note 39, at 303-04; "The Use of JVs", supra note 64, at 7.

67. "The Use of JVs", supra note 64, at 7.

68. Id.

69. "Practical Legal Aspects", supra note 39, at 303.

70. Id. at 303-04; "The Use of JVs", supra note 64, at 8-9.

71. "The Use of JVs", supra note 64, at 6.

72. Id.

73. Id. at 8.

74. Id. at 6-7.

75. Id. at 8.

76. "Practical Legal Aspects", supra note 39, at 305.

77. "The Use of JVs", supra note 64, at 8-9.

78. Id.

79. See "Franchising in Eastern Europe, supra note 17.

80. Id.

81. For a comprehensive analysis of the process and techniques for formulating a competitive strategy for a firm competing in a specific industry, see M. Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors (1980) [hereinafter cited as "Competitive Strategies"].

82. M. Porter, The Competitive Advantage of Nations, at 45 (1990) [hereinafter cited as "Competitive Advantage"].

83. Id.

84. Id. at 780.

85. Id. at 51.

86. Id.

87. Id. at 54.

88. Id. at 65. Strategic alliances, other than joint ventures, include various kinds of interfirm relationships such as licenses and long-term supply agreements. Id. at 65-66.

89. Id. at 65.

90. Id. at 66.

91. Id. at 67.

92. J. Murphy, "Foreign Trade Reforms and Structure of Joint Ventures", Eastern Bloc Joint Ventures, at 5 (D. Winter, ed.) [hereinafter cited as "Foreign Trade Reforms"].

93. Id.

94. "Western Joint Ventures", supra note 14, at 11.

95. "Foreign Trade Reforms", supra note 92, at 6.

96. Id.

97. Id.

98. "Competitive Strategies", supra note 81, at 291-92.

99. "Competitive Advantage", supra note 82, at 657-60.

100. Id.

101. Id. at 681.

102. Id. at 675, 681.

103. "Survey of Views on the Impact of Granting Most Favored Nation Status to the Soviet Union", Report of the U.S. International Trade Commission to the Senate Committee on Finance (Jan. 1990) at 2/18 [hereinafter cited as "Survey of Views"].

104. Id.

105. In essence, MFN treatment in trade, which is extended by the U.S. government to a country, is a grant of the same tariff concessions and privileges that the U.S. government has extended to any other of its trading partners. MFN treatment is actually nondiscriminatory treatment rather than more favorable treatment. It has been granted by the U.S. since 1934 by law to almost all trading partners unconditionally and without limitation. MFN status also constitutes a reciprocal obligation between parties to bilateral trade agreements or the GATT. For a discussion of the history of the MFN status for East European countries and the U.S.S.R., see V. Pregelj, "Most Favored Nation Treatment", Congressional Research Service Review at 24-25 (May/June 1990).

106. Countries in Eastern Europe that have so far received MFN status include: Czechoslovakia, East Germany (as a result of unification with the Federal Republic of

Germany), Hungary, Poland, and Yugoslavia. A bill (H.R. 689) was recently introduced by Rep. Kennelly (D-CT) in the U.S. House of Representatives that would grant MFN treatment to both Romania and Bulgaria. In 1988, Romania unilaterally withdrew its status as an MFN country. The U.S. currently does not have relations with Albania, although steps are being taken to resume relations.

107. "Survey of Views", supra note 103, at 2/19.

108. Id. at 2/16.

109. Id. at 2/16-2/17.

110. Id. at 2/21.

111. Id. at 2/16.

112. Id. at 2/21.

113. For a discussion of franchise law outside the United States, see "Franchising: A Global Phenomenon", supra note 2.

114. This uncertainty regarding the ownership of property in Eastern Europe has had a damaging effect on foreign investment in general. See W. Blau and P. Rawert, "East Germany: Legal Steps Toward a Market Economy", 18 Int'l. Bus. L. 309 (Jul./Aug. 1990).

115. D. Winter, "Overview of the Joint Venture Legislation of Eastern Europe", Eastern Bloc Joint Ventures at ix, xii [hereinafter cited as "Overview of Joint Ventures"].

116. "Franchising in Eastern Europe", supra note 17, at 14.

117. Id.

118. "Survey of Views", supra note 103, at 2/17.

119. Id.

120. A. Wilson, "Currency Convertibility in Eastern Europe and the Soviet Union", Congressional Research Service Review at 31 (May-June 1990) [hereinafter cited as "Currency Convertibility"].

121. Id.

122. Id.

123. "Survey of Views", <u>supra</u> note 103, at 2/18.

124. It is suggested that some of the problems of currency inconvertibility and exchange controls--particularly if such occur or are announced by the government during the term of the joint venture--can be provided for in the joint venture agreement. <u>See</u> "Practical Legal Aspects," <u>supra</u> note 39.

125. "Survey of Views", <u>supra</u> note 103, at 2-18.

126. <u>See</u> E. Lahey, Jr., "A Look at a Major Licensing and Distribution Arrangement", <u>Doing Business in Eastern Europe</u> (M. Epstein, L. Irish, and R. Shanks, eds., 1990).

127. For several prerequisites for making currencies convertible in centrally planned economies, <u>see</u> "Currency Convertibility", <u>supra</u> note 120.

128. <u>See</u> R. Lipstein, "International Franchising and Distribution: U.S. and Foreign Law Considerations", 16 <u>Int'l Bus. L.</u> 414 (Oct. 1988) [hereinafter cited as "International Franchising and Distribution"].

129. "Techniques of International Franchising", <u>supra</u> note 36, at 162.

130. <u>See</u> "International Franchising and Distribution", <u>supra</u> note 128.

131. "Franchising in Eastern Europe", <u>supra</u> note 17, at 18.

132. <u>See</u> A. Von Funer, "Technology Transfer in Different Societies", <u>Doing Business in Eastern Europe</u> (M. Epstein, L. Irish, and R. Shanks, eds., 1990); "Rush is on to Secure East Europe Trademarks", <u>N. Y. Times</u>, Sept. 7, 1990, at A7.

133. "International Franchising and Distribution", <u>supra</u> note 128, at 415.

134. "Practical Legal Aspects", <u>supra</u> note 39, at 311.

135. <u>Id</u>.

136. "Franchising in Eastern Europe", <u>supra</u> note 17, at 18-19.

137. <u>Id</u>. at 17.

138. "Overview of the Joint Venture", _supra_ note 115, at xiv.

139. _Id_. at xv.

140. _Id_.

141. "Survey of Views", _supra_ note 103, at 2-21.

142. "Franchising in Eastern Europe", _supra_ note 17, at 18.

143. "Overview of the Joint Venture", _supra_ note 115, at xvi.

144. "International Franchising Arrangements", _supra_ note 5, at 200-201.

145. "Franchising in Eastern Europe", _supra_ note 17, at 19.

146. "Techniques of International Franchising", _supra_ note 36, at 162.

147. "Franchising: A Global Phenomenon", _supra_ note 2, at 147.

148. "Techniques of International Franchising", _supra_ note 36, at 162.

149. _Id_.

150. _Id_.

151. "Franchising in Eastern Europe", _supra_ note 17, at 19.

152. _Id_.

153. Most of the major foreign investment enactments are reproduced in U.N. Economic Commission for Europe, _East-West Joint Ventures: Economic, Business, Financial and Legal Aspects_ at 122-89 (1988).

154. The number of entries in the _Index to Legal Periodicals_ overwhelmingly favor these three countries. _See_ D. Gordon, "The Polish Foreign Investment Law of 1990", 24 _Int'l. L._ 335 (Summer 1990).

155. D. Genser, _Changing Legal Climate for Foreign Investment in Romania_ at 29 (publication of the U.S. Dept. of Commerce, Nat'l Technical Infor. Service, Oct. 1990) [hereinafter cited as "Changing Climate in Romania"].

156. Foreign Investment Law of Romania, Sec. 1, Art. 4 (Oct. 1990) [hereinafter cited as "Romania Investment Law"].

157. L. Sava, "A Second Look at Romania Brings Surprises", Bloc at 34 (Jan./Feb. 1991).

158. "Changing Climate in Romania", supra note 155, at 30.

159. Id.

160. Id.

161. Id.

162. J. Gurley, "Will U.S. Investors Find Romania? Here's Some Help", Bloc at 31 (Jan./Feb. 1991) [hereinafter cited as "Will U.S. Find Romania?"]

163. Id.

164. "Romania Investment Law", supra note 156, at Art. 35.

165. "Changing Climate in Romania", supra note 155, at 31.

166. "Will U.S. Find Romania?" supra note 162, at 32.

167. Id.

168. "Romanian Investment Law", supra note 156, at Art. 2(c).

169. "Changing Climate in Romania", supra note 155, at 30-31.

170. "Romanian Investment Law", supra note 156, at Art. 17(a-d). The amount between 8 and 15 percent of capital contribution that is permitted to be repatriated by the foreign investor is based on whether the investment was made in an area that has been determined by the Romanian government to be of "special importance for the national economy." Id.

171. "Will the U.S. Find Romania?" supra note 162, at 31.

172. "Changing Climate in Romania", supra note 155, at 32.

173. Id.

174. Id.

175. R. Guttman, "Czechoslovakia's Ambassador to the United States, Rita Klimova", Europe Magazine at 15 (March 1990).

176. See "Country Profile: Czechoslovakia", EuroSphere at 4 (publication of KPMG Peat Marwick, Jan./Feb. 1991) [hereinafter cited as "Country Profile: Czechoslovakia"].

177. An Act on Enterprises with Foreign Property Participation, Law No. 173 (enacted Nov. 8, 1988, effective Jan. 1, 1989), reprinted in Czechoslovak Chamber of Commerce and Industry, Enterprise With Foreign Property Participation Act (trans. ed. 1988) [hereinafter cited as "New Czech JV Law"].

178. D. Genser, Changing Legal Climate for Foreign Investment in Czechoslovakia at 10 (publication of the U.S. Dept. of Commerce, Nat'l Technical Infor. Service, Oct. 1990) [hereinafter cited as "Changing Climate in Czechoslovakia"].

179. Id. at 11.

180. G. McDermott, "Czechoslovakia: Waiting for American Businessmen", Bloc at 23 (Jun./Jul. 1990).

181. "Changing Climate in Czechoslovakia", supra note 178, at 11.

182. "Czechoslovakia's Parliament Approves Privatization Law", Wash. Post, Feb. 27, 1991, at A16.

183. "Country Profile: Czechoslovakia", supra note 176, at 4, 5.

184. See "New Czech JV Law", supra note 177.

185. See "Law Concerning Enterprises with Foreign Capital Participation", Czechoslovakia: Paving the Way to a Free Economy at 4 (publication of KPMG Peat Marwick, May 1990).

186. "Changing Climate in Czechoslovakia", supra note 178, at 11, 12.

187. Id.

188. "Country Profile: Czechoslovakia", supra note 176, at 5.

189. "Changing Climate in Czechoslovakia", supra note 178, at 12.

190. See "Country Profile: Czechoslovakia", supra note 176.

191. "Changing Climate in Czechoslovakia", supra note 178, at 12.

192. M. Radvan, "Joint Ventures Under Czechoslovak Law", Eastern Bloc Joint Ventures at 141-42 (D. Winter, ed., 1990).

193. "U.S. Firms Advised to be Patient in Pursuing Business in Czechoslovakia", Bureau of Nat'l Affairs, Daily Executives Report at A-3 (Nov. 14, 1990).

194. "Changing Climate in Czechoslovakia", supra note 178, at 10.

195. D. Arbess, "Making a Wager in Czechoslovakia", Bloc at 24 (Jun./Jul. 1990) [hereinafter cited as "Making a Wager in Czechoslovakia"].

196. "Changing Climate in Czechoslovakia", supra note 178, at 14.

197. "Making a Wager in Czechoslovakia", supra note 195, at 14.

198. "Changing Climate in Czechoslovakia", supra note 178, at 14.

199. Id. at 13.

200. Id. at 15.

201. "New Czech JV Law", supra note 177, at Art. 22.

202. "Changing Climate in Czechoslovakia", supra note 178, at 15.

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