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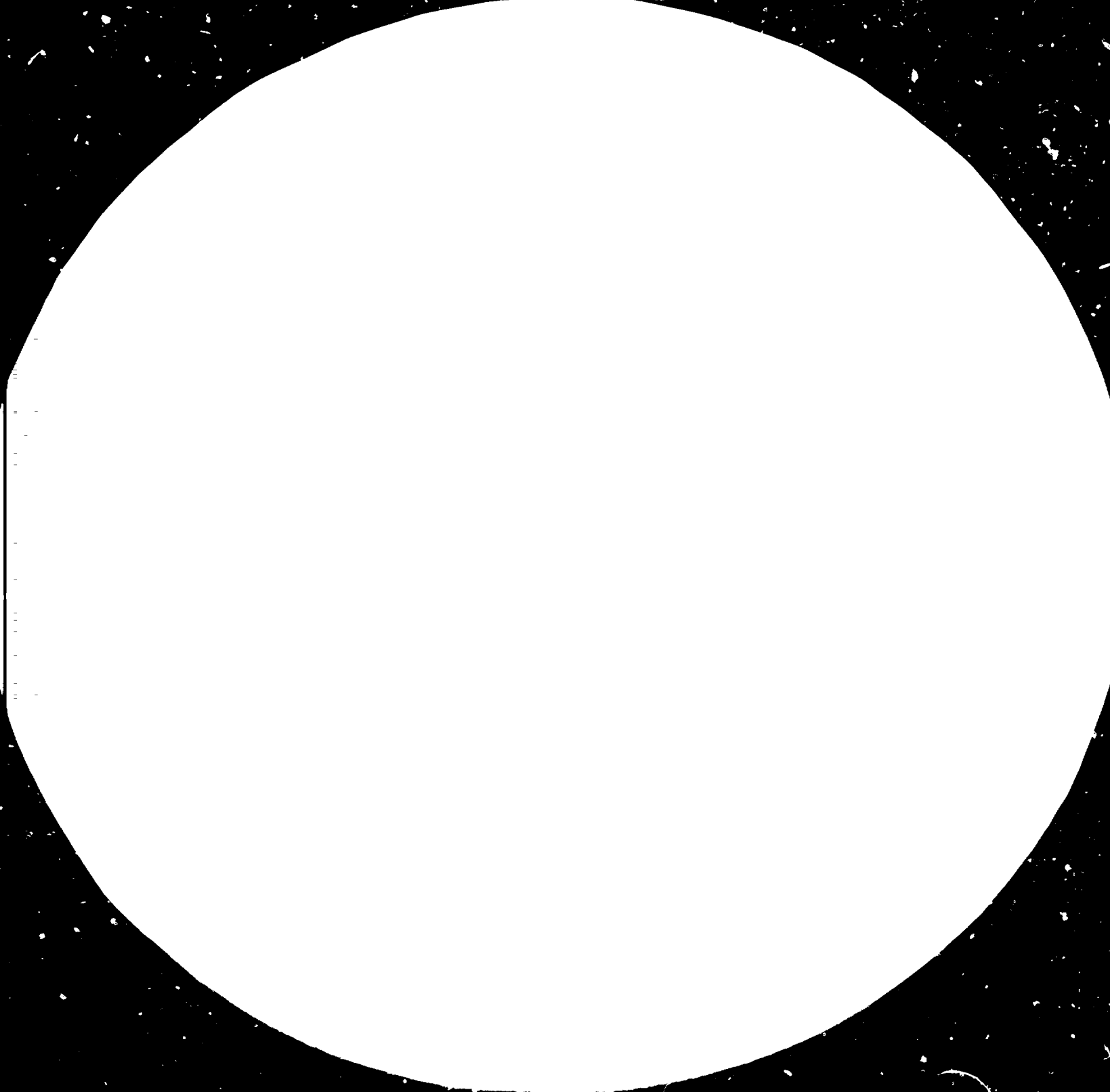
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CONTRACTUAL ARRANGEMENTS FOR THE TRANSFER OF TECHNOLOGY

IN THE FAST FOOD SECTOR \*

by

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## SUMMARY

The expansion of transnational fast food chains, although concentrated in developed countries, has been recently visible in developing countries as well, especially in Latin America and South-east Asia. Large fast food chains either operate their outlets abroad or franchise the system to the independent restaurant operators. In addition, mixed-type arrangements are used in this sector i.e. equity participation in combination with franchise agreement. Therefore the franchise contracts which are the most popular arrangements used in the fast food sector should be looked at within broader context of the overall relationship between franchisor and franchisee.

Prior to formulating specific regulations and guidelines, developing countries should define their general attitude towards transnational fast food chains. Although there are many positive aspects, the negative implications of the expansion of the chain operations in developing countries are also very serious. Both positive and negative effects should be weighed with due account of the specific conditions prevailing in a given country. Taking into account the economic, financial and socio-cultural implications of the fast food chain operations, it is recommended that all contractual arrangements used in this sector are subject matter of scrutiny by the technology transfer registries in developing countries.

The study has revealed that the franchise contract plays the key role among contractual arrangements used in the international fast food chain operations. However, the function of such arrangement is entirely different depending on whether it is a "pure" franchise or it supplements equity ownership. Therefore franchise contracts should be always evaluated within broader context of the overall relationship between franchisor and franchisee. The principal differences among various types of franchises should also be taken into account.

Since the provisions of the standard franchise agreements used by transnational fast food chains are drafted in such a way as to protect the interest of the franchisor, a co-ordinated effort of the franchisee and respective government agency in the process of negotiation is necessary in order to improve

the position of the local restaurant operator vis-a-vis head company of the chain system. Higher precision is necessary especially with respect to clauses defining the scope of services and conditions under which such services are provided to the franchisee. This may help avoiding additional, unnecessary payments to the franchisor.

The survey of the sample of the franchise agreements revealed that a substantial degree of control is being exerted upon franchisee's operations by the franchisor. While evaluating respective provisions, the registries should look with special care into the clauses requiring the approval by the franchisor of all sources of supply of ingredients, equipment, etc. Such clauses play a similar role to the tie-in provisions in the licensing agreements as those approved are usually foreign suppliers.

Future work of UNIDO on the transfer of technology in the fast food sector should concentrate on two areas. First, those TIES member countries having extensive experience with fast food chain operations should conduct field studies on the possible implications of such operations (i.e. technological, economic, financial, socio-cultural etc.). Secondly, after collecting additional information on the franchise agreements used in the fast food sector, the UNIDO secretariat should elaborate detailed guidelines for the negotiation and evaluation of such agreements.

## INTRODUCTION

After the second world war, a rapid expansion of fast food chains has taken place in developed market economy countries. In the 1960s the internationalization of the operations of major restaurant chains has started mostly in developed market economy countries. On the other hand, the growing urban population in developing countries resulted in the increased demand for fast food restaurant services beyond the scope which could be satisfied by traditional small-scale operations. As a result, the expansion of the activities of large transnational fast food chains in these countries has begun in the late 1960s and in the 1970s.

The foreign-associated fast food outlets have been established mostly in selected Latin American and South-east Asian countries but the current expansion programmes of major transnational restaurant chains indicate that the number of outlets in developing countries may increase substantially in the near future.

Until now the problems connected with the transfer of technology in the food servicing sector receiving little attention of the policy makers and business community as compared to the same issues in the manufacturing sector in developing countries. The food servicing sector has, as a rule, lower priority in terms of modernization programme through the influx of foreign technology. Therefore, the process of the transfer of technology connected with the establishment of the foreign-associated food servicing outlets either has been left uncontrolled by the respective regulatory agencies or the scope of intervention was very limited due to the lack of relevant regulations and/or the lack of experience and methods of evaluation of contractual arrangements used for the transfer of technology in this sector. It might be argued however, that taking into account indirect and side effects, the uncontrolled expansion of the foreign-associated fast food restaurants in developing countries may bring serious negative economic and social consequences. Therefore, the Seventh Meeting of Heads of Technology Transfer Registries, held in December in New Delhi, requested the UNIDO secretariat "to undertake and present, as soon as possible, the study and guidelines on treatment and evaluation of franchise agreements of various types, specifically in fast food chains, hotels and similar industries".<sup>1/</sup> The present study might also serve as a contribution to the UNIDO programme aimed at facilitating transfer of technology to the small-scale industry in developing countries.<sup>2/</sup>

Following the recommendations of the Seventh Meeting of Heads of Technology Transfer Registries, the UNIDO secretariat requested several developing countries - members of the Technological Information Exchange System (TIES) to provide background information on the subject. Relevant data has been obtained from Argentina Malaysia, Mexico and Venezuela.<sup>3/</sup>

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<sup>1/</sup> Report of the Seventh Meeting of Heads of Technology Transfer Registries, New Delhi, 7-10 December 1982, UNIDO, ID/WG.383/8, para 3 (j).

<sup>2/</sup> For the outline of the programme see "Prospect of co-operation between small and medium-size industrial enterprises in developed and developing countries in the field of transfer of technology", UNIDO, IS.186, 1980.

<sup>3/</sup> UNIDO secretariat also requested from the several largest fast food chains the copies of the standard franchise agreements which they use in their international operations and the replies are currently being collected.



Bearing in mind the limited scope of the background information available for the UNIDO secretariat, the present version of the report is a preliminary one. It was prepared in order to stimulate the discussion on the subject among the members of TIES, define existing gaps and enhance the flow of additional data. The final version of the guidelines should incorporate the results of the discussion and additional information collected by the UNIDO secretariat from the member countries and other sources.

## I. CONTRACTUAL ARRANGEMENTS IN THE INTERNATIONAL FAST FOOD CHAIN OPERATIONS

### 1. Trends in expansion of the fast food chain operations

The idea of the chain operations in the fast food industry originated in the 1950s in the USA but quickly expanded in other developed countries. The success of the standardized fast food restaurants located most often in the densely populated urban areas and offering standardized menu, unified decoration, servicing system etc. depended on several factors. First, the increase of standard of living resulted in the dining-out tendency also among lower and middle classes which could not be accommodated in the expensive restaurants. The second most important factor was the drastic expansion of travel either for tourism or for business purposes. For a traveller who does not have much time and does not want to take the risk of eating in unknown places, a standardized chain outlet was an attractive alternative. In addition, the major fast food chains attempted successfully to appeal to children and youth. This was mainly done through location of the fast food outlets in the amusement areas, close to sport centres, as well as aggressive advertising campaigns, etc. As a result, the fast food outlets in the urban areas served as the meeting places for the young generation. Among the largest fast food chains originating mostly from USA are: McDonald's, Burger King, Kentucky Fried Chicken, Pizza Hut, Wimpy and Wienerwald. The example of McDonald's system may serve as a success story in the fast food industry. The system has been established in 1955 and in 1974 it encompassed over 3200 restaurants in 18 countries. Currently McDonald's is the largest chain food system in the world.

With the growing competition in the USA and the increased similarity of consumption patterns and life styles in Europe and Japan, the largest fast food chains have initiated foreign operations in the 1960s. The survey conducted in the USA in the early 1970s has indicated that among 46 largest U.S. restaurant chains, 19 (41 per cent) had already established outlets abroad.<sup>4/</sup> The expansion took place in the first instance in Canada, Western Europe and Japan. In developing countries fast food outlets associated with large international chains were located mostly in Latin America and South-east Asia. As a result, among over 3200 outlets within McDonald's system, over 300 was located outside USA in 1974. In 1978 there were over 1,000 Kentucky Fried Chicken located outside USA in addition to 4,500 domestic outlets. The surveys of the future development of the major fast food chains indicated clearly a strong tendency for foreign expansion. The past experience shows that in the developing world, the possible target countries for the expansion of the fast food chain operations are densely populated countries with relatively higher per capita incomes and with large urban centres.

## 2. basic contractual arrangements

While discussing contractual arrangements used in the fast food chain operations, a distinction has to be made between arrangements in the "pure" form and variations and combinations of arrangements used in practice. The pure arrangements are the franchise contract and wholly owned subsidiary outlet.

### a. Franchise contract

The essence of the franchise agreement is the authorization of the franchisee by the franchisor to engage in business in a manner associated with and identified by a trade name. Although there is no uniform definition of franchise, the one given below seems to cover all essential aspects of such contractual arrangement:

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<sup>4/</sup> See B.J. Walker, M.J. Etzel, "The Internationalization of U.S. Franchise Systems: Progress and Procedures", *Journal of Marketing*, Vol. 37 (April 1973), pp. 38-46.

"Franchise means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

- (a) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing-plan or system prescribed in substantial part by a franchisor; and
- (b) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating or its affiliate; and
- (c) the franchisee is required to pay directly or indirectly, a franchise fee."<sup>5/</sup>

Two major types of franchises might be distinguished: "product distribution franchising" and "business format franchising". The franchise arrangements used in the fast food industry belong to the second category. The "business format" or "entire system" category "describes the system used by a company (franchisor) which grants to others (franchisees) the right and license (franchise) to market a product and engage in a business developed by it under franchisor's trade names, trademarks, servicemarks, know-how and method of doing business. In addition, the franchisor may sell the products and sell or lease the equipment and/or the premises necessary to the operation or designate or approve sources therefor. This in essence is a licensing of trademarks and the grant of a "bundle of rights": the franchising of entire business systems (such as those for restaurants, fast food establishments, convenience stores, motels laundries, dry cleaning shops, automobile repair shops, etc)".<sup>6/</sup>

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<sup>5/</sup> See "Franchise Investment Law and Related Rules", State of California, Department of Corporations, Commissioner of Corporations, January 1971, p. 5.

<sup>6/</sup> J.L. Fels, "Investigate Before Investing. Guidance for Prospective Franchises", International Franchise Association, Washington, 1971, p.2

According to the above quoted definitions, the concept of the licence and franchise are closely interrelated, although the franchise agreement covers broader relationship between partners as compared to trademark and/or know-how licences.<sup>7/</sup> The major provisions of the franchise agreements will be discussed in detail in Chapter III.

b. Wholly-owned subsidiary outlets

An alternative to the franchise agreements with independent restaurant operators are the wholly-owned outlets controlled by the parent company being the head of the fast food chain. It is interesting to note that even in case of chains predominantly using franchise arrangements, the largest and/or most profitable outlets are controlled directly by the parent company. As a result, profits derived from the company-owned units are often much higher than the fees derived from the franchise operations. In recent years growing conflicts between franchisors and franchisees have risen which have negatively affected the effectiveness of such arrangements. Therefore the trend is consequently already apparent towards company-owned outlets in the fast food industry. The total number of restaurants chains increased from 16,200 in 1960 to over 38,000 in 1970. The number of company-owned outlets increased during the same period from 200 to 4,000.<sup>8/</sup>

3. Variations and combinations of contractual arrangements

In practice a variety of different contractual arrangements are used which either represent a variation of one of those mentioned above or is a combination of basic contractual arrangements.

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<sup>7/</sup> One has therefore to be very careful with the names of the contractual arrangements and the definitions of privileges granted. Quite often a typical franchise is called a "licence agreement". As for the rights granted, three alternative formulations can be found covering in principle the same privileges: (1) granting of a licence; (2) granting of a franchise; and (3) granting of licence and franchise.

<sup>8/</sup> H. Gross, W. Skaupf, "Franchising in der Praxis", Econ Verlag, Düsseldorf, 1976, p.40.

a. Unit and area franchises

Two types of franchises can be distinguished. Unit franchises are single retail outlets owned and operated by individual entrepreneurs. In contrast, an area franchise provides the franchisee with control of a geographic region with the right to establish unit franchises and sell additional unit franchises within the region to individual entrepreneurs.<sup>9/</sup>

An analysis of recent experience indicates that large fast food chains are simultaneously using both types of franchises in their foreign operations. In the case of contracts being investigated in the present study the Venezuelan agreement definitely represents the area franchise, as it grants the local partner the exclusive right to operate fast food outlets in the whole of Venezuela. The franchise agreements in Argentina are in principle unit franchises, however the franchisee may operate more than one outlet within a strictly defined territory. The Malaysian case is somewhat more complicated. Here the franchisee is an independent Malaysian company operating nation-wide and the franchise is granted for one specified outlet only. It may be expected that for the subsequent outlets, separate standard agreements will be signed.

b. Joint ventures

Except for wholly-owned outlets, joint ventures are often used in foreign fast food operations. Among five Mexican agreements concluded with large transnational fast food chains, (approved or under approval) in two cases the foreign partner controlled 49 per cent of the equity capital of the local firm, whereas in the three other cases, the local partners were the wholly-owned subsidiaries of the supplier.

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<sup>9/</sup> See B.J. Walker, M.J. Etzel, op. cit., p.42

c. Combination of equity participation with franchise and/or trademark licence

Even if the parent company directly owns the fast food outlets, such direct control is often supplemented by the franchise agreement, licence on the use of trademarks or technical service agreements, etc. This happens most often in foreign operations. The following factors can be named which may explain the use of such combinations:

- the existence of such agreements between related partners enables the foreign partner to remit part of the profit abroad in the form of franchise, licence and management fees;
- this may serve as an additional form of control of day-to-day operations, which is extremely important in the case of joint ventures where conflicts between local and foreign partners are frequent and often result in the failure of such ventures.

Under franchise agreements the manner in which a fast food outlet should be operated is precisely defined which limits the possible areas of conflict and strengthens the position of the foreign partner in disputes with the local partner.

The large fast food chains often use, in combination with equity participation, a trademark licence rather than franchise. It should be noted however, that in many developing countries the registries negatively view the pure trademark licences, in which case franchise agreements may better serve the purpose of additional control and the transmitting of financial resources abroad by transnational chains. An alternative solution often used is the agreement covering trademark licences, provision of technical documentation (manuals) and administrative assistance. In essence, this arrangement is very similar to the franchise although the term "franchise" is not used.

## II. MAJOR POLICY OPTIONS FOR DEVELOPING COUNTRIES WITH REGARD TO FAST FOOD CHAIN OPERATIONS

### 1. The arguments for and against the fast food restaurants in developing countries

Before entering into discussion on the specific provisions of the various contractual arrangements used in the international fast food chain operations, basic policy options should first be resolved. The most important dilemma in this respect is whether developing countries should follow the pattern of the fast food sector's development in the advanced countries and stimulate the establishment of fast food outlets, or whether such a development pattern should be avoided in favour of other, more suitable arrangements. Major arguments for and against the foreign-associated fast food restaurants in developing countries are given below.

#### a. arguments favouring fast food chains.

- (i) fast food chains represent the most effective way of satisfying growing needs for the mass consumer food services in urban areas. With the growing urban population in developing countries such needs cannot be effectively satisfied by the traditional gastronomic outlets;
- (ii) chain restaurants may attract foreign businessmen and tourists who are used to similar outlets in their home countries being at the same time hesitant to eat in local restaurants;
- (iii) the chain operations may provide the framework for effective transfer of technology to the food servicing sector dominated by the small-scale family establishments.

b. Arguments against foreign-associated fast food chains.

- (i) the fast food chain operations may result in the increased consumption of foods which are not suitable for dietary habits in developing countries and therefore may negatively affect the health of the consumers;
- (ii) the fast food chain operations may endanger the existence of traditional restaurants and other food servicing outlets;
- (iii) another negative effect is the increased import of intermediate products and components for the fast food operations;
- (iv) in general, the fast food chain restaurants may contribute to the proliferation of western consumption patterns and life styles which are not compatible with the cultural heritage of the developing countries.

These and other aspects should be taken into account while formulating general policies towards fast food chains by the respective regulatory agencies. At the moment it is difficult to offer specific suggestions as much depends on the conditions prevailing in a given developing country and the past experience with transnational fast food chains.

2. Foreign equity participation in the fast food sector

The question is whether foreign equity should be allowed in the fast food sector and this has to be seen within the context of the general attitude of a given country towards direct foreign investment. In addition, a distinction should be made between the foreign equity in the fast food outlets and foreign equity in the company playing the role of the national or regional head of a fast food chain. In the former case, it might be argued that the restaurant services have traditionally been recognized as an area for expansion of local business. Therefore the inflow of the foreign equity capital to the food servicing sector should be limited. In the latter case, the situation



is somewhat different. Bearing in mind that the company playing the role of the national or regional representation of the fast food system usually coordinates training programmes for the outlets and provides technical and managerial assistance, at least some equity participation of the parent company might be desirable for the effective transmission of technical know-how and managerial expertise.

### 3. Unit or area franchises

The advantage of unit franchises is that under such an arrangement, direct contacts between the franchisee and the foreign franchisor are maintained. This may not however, ensure an effective flow of technology and skills due to the geographic distance and the lack of adequate efforts on the part of franchisor, who usually operates hundreds or even thousands of such outlets in various countries. Therefore area franchises (either country-wide or regional) seem to better facilitate the transfer of foreign technology into the fast food sector in developing countries.

### 4. Registration of the franchise contracts in the fast food sector

In view of the rapid expansion of transnational fast food chains in developing countries and taking into account the economic, financial and socio-cultural implications of such operations conducted under franchise agreements, it is recommended that franchise contracts become the subject of scrutiny by the technology transfer registries in developing countries.

## III. MAJOR PROVISIONS IN THE FRANCHISE AGREEMENTS IN THE FAST FOOD SECTOR

An analysis of the major provisions in the franchise agreements is based on the sample of five contracts from three developing countries, namely, Argentina, Malaysia and Venezuela. Since three Argentine contracts were concluded with the same transnational fast food chain and are almost identical, the comparison has been made principally between three contracts labelled A, B and C respectively.

1. General formulation of the rights and obligations of partners

a. Rights granted to the franchisee

In contract A and B, the Franchisor grants to the Franchisee the licence and franchise to use its trademarks and systems. In contract C, a trademark licence has not been named explicitly but supposedly it was covered under the franchise authorization.

b. territory

The limitation of territory of the franchise differs substantially between contracts surveyed, since they belong to different categories of franchise.<sup>10/</sup> Thus, in the three A contracts, the area is very precisely defined (e.g. part of the city limited by the streets specified in the contract). In contract B, the franchise is granted to one outlet only, operating within a strictly defined territory, and in contract C the franchisee is authorized to operate restaurants over the whole territory of the host country.

c. Sub-licensing and sub-franchising rights

The provisions of sub-licensing and sub-franchising rights are quite important for the franchisee in view of the future expansion of its operations. In principle, such provisions were not applicable in contract B as the franchise was granted to the Franchisee for the specified outlet only. Contract A precisely stipulated that the sub-licensing and sub-franchising rights are not granted to the Franchisee. The respective provisions in contract C are probably typical for area franchises: "This Agreement and licence are personal dealings with the Franchisee and the latter may not assign this Agreement or any right or interest in the licence granted, or allow an assignment or transfer to occur, whether directly, indirectly or contingently, by agreement or by ministry of the law without the prior written consent of the Franchisor. The assignment of any

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<sup>10/</sup> See page 8

right, except what is provided for in this Agreement, will constitute an important violation of this Agreement.

Notwithstanding the foregoing prohibition against making an assignment, it is agreed that the Franchisee may sub-license one or several restaurant sites to a subsidiary company in which he has a controlling right, with Franchisor prior approval in writing. In the event of a sub-concession of this kind, the sub-concessionaire will be bound by this Agreement."

It is interesting to note that in contract C, sub-licensing (sub-franchising) is not excluded in principle but requires prior written consent from the Franchisor. In addition, a preference is given to the sub-franchises for the subsidiary companies of the Franchisee.

d. Exclusivity

The exclusive rights are granted in all contracts surveyed but detailed specification of such rights differ depending on the type of franchise. In contract C, which is a classic example of the area franchise, the exclusive right is granted to develop and operate chain restaurants over the whole territory of the recipient country. In contract A and B, the exclusive rights are limited to a strictly defined territory.

e. Obligations on the part of the Franchisee to operate the restaurant(s) in a prescribed manner

The uniformity of operations is the major source of success of the large transnational fast food chains and therefore the provisions safeguarding such uniformity were found in all contracts surveyed. Usually the principles of the system are described in the preamble and the Franchisee agrees to adhere to those principles.

f. Non-competition

The Franchisor is normally interested that the Franchisee engages his full attention to running chain outlets and therefore the provisions prohibiting the Franchisee to engage in similar business practices to that being franchised are included in all contracts. It should be emphasized that such a prohibition is often extended beyond the duration of the contract, i.e. 18 months after the contract ends (A) and one year after termination or expiration in contracts B and C.

g. Possible approaches by the regulatory agencies

The general stipulations of the rights and duties of partners in a franchise agreement have to be carefully evaluated because they provide the background for more specific clauses directly affecting the position of the Franchisee vis-a-vis the Franchisor.

Since such general provisions seem to favour the Franchisor, an attempt should be made to ensure equality of rights and duties between both partners. In the case of country-wide area franchises, the regulatory agencies should insist on sub-franchising rights. The formulation on sub-licensing rights in contract C (see pages 13 and 14) should be viewed as the minimum acceptable by the registries. The non-competition clauses extended beyond the duration of the agreement should be eliminated.

2. Services provided by the Franchisor

With regard to the services provided by the Franchisor, a distinction has to be made between obligatory services which the Franchisor is bound to provide and the Franchisee is obliged to use, and optional services which may be provided upon request of the Franchisee.

a. Obligatory services

- Basic training programme

In contracts B and C, the respective provisions clearly stipulate that prior to assuming the responsibilities, the key personnel of the Franchisee should undergo specialized training offered by the Franchisor. In contract A, the formulation is less clear; the Franchisor is obliged to provide such services but nothing is being said about the rights of the Franchisee to accept or reject such services.

An interesting clause on the establishment of training facilities in the host country with the assistance of the Franchisor was found in contract C: " An educational installation will be created in host country for the future training and education of the Franchisee's employees and managers. The programme will be developed with the help of the faculty and will be taught by personnel employed by the Franchisee and specially trained by the Franchisor. It is hoped to construct and commission this facility as soon as possible after the Franchisee has opened his initial restaurants and in it will be trained the greater part of the personnel required to provide the system restaurants in the host country with personnel".

- Operating manuals and recipes

Under the franchise contract the most important elements of technology transferred are contained in operating manuals and secret recipes. The Franchisee is obliged to strictly follow the rules for operating the restaurant and preparing the meals as defined by the Franchisor. Since such recipes and formulae are the major source of competitive advantage of the whole fast food chain, all three contracts surveyed include provisions stating that the Franchisee should keep secret all information contained in the manuals.

In order to underline the ownership rights of the Franchisee, the operating manual is usually supplied to the Franchisee on loan and should be returned after expiration or other termination of the contract.

b. Optional services

The franchise contracts surveyed list additional services which might be provided to the Franchisee upon request. These include assistance in the selection of suitable premises for the fast food outlets, additional training programmes beyond obligatory ones, communication of new developments, techniques and improvements in the preparation of foods, technical assistance in the area of management, marketing, accounting, etc.

c. Possible approaches by the registries

The proper specification of the types of services and conditions under which they are provided is very important for the effective assimilation of technology and may contribute to the lowering of the cost of such services. Therefore the contract should specify precisely what kind of training is obligatory, as the Franchisee may further claim that such services are remunerated with the basic franchise fee. Vague formulations may result in additional unnecessary payments, e.g. general statement in the Introduction of contract C: "The Franchisee wishes to use the wide and highly technical consultancy and advisory services offered by the Franchisor". On the other hand, it would be advisable to include, whenever possible, the provision which was also found in contract C on the establishment of the local training facility with the assistance of the Franchisor. With due account to the rights of the Franchisor to retain the secrecy of his recipes and formula, an attempt should be made to eliminate all provisions which directly or indirectly hinder the effective transfer and assimilation of technology. In order to avoid the leakage of secret information, the Franchisor usually limits the number of copies of the operating manual supplied to the Franchisee (one copy per outlet is usual). For the proper assimilation of technology it is required that a substantial number of the Franchisee's personnel has access to the secret formula and recipes. The registries should therefore insist that a sufficient number of copies of the operating manual be provided free of charge. (The Franchisee cannot simply duplicate the manual as this would violate the copyrights of the Franchisor).

### 3. Payments to the Franchisor

The following categories of payments to the Franchisor were found in the franchise agreements surveyed:

- franchise fees
- reimbursement for services provided by the Franchisor
- contribution to the advertising programme

The summary of the provisions related to the remuneration of the Franchisor is presented in Table I.

#### a. Franchise fees

##### - Initial fee

The initial fee is paid prior to the opening of each fast food outlet. In the case of the contracts surveyed, the initial fees ranged between US\$ 5,000 and US\$ 30,000. Only in contract C, was a justification for the payment of an initial fee given: "The Franchisee recognizes that Franchisor will incur substantial direct expenses in connection with the initial development and pre-inaugural support services and agrees to reimburse Franchisor for those direct expenses up to an amount of US\$ X per each chain restaurant".

##### -Basic franchise fee

A basic franchise fee is usually calculated as a percentage of gross sales, and in the contracts surveyed this ranged between 4 and 5.5 per cent. Two important problems should be mentioned in this respect. First, the basis for calculation of the fee may be interpreted in various ways. In many countries the respective regulations do not allow for the collecting of fees for cigarettes and/or alcoholic beverages. Thus, in contract B, the basis for calculating the franchise fee excludes the sale of cigarettes. In contract A, it was stated that if the collection of fees from the sales of beer is not allowed, an increased (by 0.5 per cent) percentage should be applied on the sales of food and non-alcoholic beverages. The proper definition of the basis of franchise fee is of the utmost importance for the Franchisor and the host country.

Table I

## Summary of the provisions related to remuneration of the Franchisor

Contract Form of remuneration	A			B	C
	1	2	3		
Initial fee (US\$)	25,000	25,000	15,000	5,000	10,000 or 30,000 depending on the type of outlet
Basic franchise fee	5% of gross sales with possible adjustment	5% of gross sales with possible adjustment	5% of gross sales or 5.5% of gross sales excluding alcoholic beverages	5% of gross sales excluding cigarette sales	4% of gross sales
Remuneration for the training services provided by the Franchisor	All costs covered by the Franchisee	All costs covered by the Franchisee	All costs covered by the Franchisee	Cost of basic training of 2 employees free of charge. All additional training on the account of the Franchisee	Basic training course provided free of charge except for the travel and accommodation
Contribution to the advertising programme	3% of the gross sales	3% of the gross sales	not specified	5% of gross sales	4% of gross sales
Currency of payments	US\$	US\$	US\$	US\$	US\$

Source: Survey conducted by the UNIDO secretariat in 1983



It may be argued that fast food restaurants should not in principle contribute to the increased consumption of alcohol and cigarettes, and that there is no ground for remunerating the Franchisor for expanding sales in that direction. It is therefore recommended that the franchise fee be calculated as a percentage of gross sales, excluding sales of cigarettes and alcoholic beverages.

In two contracts limits to the amount of the franchise fees were specified. In contract A, an upper limit was given for the amount of payments to the Franchisor during a given year. Contract B stipulated that the franchise fee should never be lower than US\$ 100 per month.

b. Remuneration for the training services provided by the Franchisor

The three contracts surveyed differed substantially with regard to the remuneration of such services. In contract A, the Franchisee bore the cost of training programmes organized by Franchisee. In contract B, the basic cost of initial training of two employees of Franchisor is covered by the Franchisee. All subsequent training and expenses relating thereto for other than two initial trainees will be at the Franchisee's expense. In contract C, a basic training course is provided by the Franchisor free of charge except for travel and accommodation expenses which accrue to the sole account of the Franchisee. It has to be pointed out that the above outlined differences among contracts cannot be explained by the differences in fees applied, as the initial and franchise fees in contract A are relatively high in comparison to other contracts.

As pointed out earlier, much depends on the precise formulation of the services to be provided by the Franchisor. In addition, a direct link should be provided between services rendered and remuneration of the Franchisor. This applies specifically to the start-up assistance and training which should be provided free of charge with the assumption that it was already remunerated in the form of an initial fee. Although the amounts fixed for additional copies of the operating manual are relatively small, it is a matter of principle that these should be provided free of charge.

c. Contribution to the advertising programme

Since the Franchisee not only advertises his restaurant but the chain as a whole, the advertising expenditures should be considered as an indirect contribution to the Franchisor. This approach is justified by the fact that except one contracts surveyed, a minimum amount for advertising expenditures is specified and was calculated as a percentage of gross sales. In contract A, the minimum was fixed at 3 per cent of gross sales, in contract B it was 5 per cent and in contract C, 4 per cent. In contracts A and C, the Franchisee was obliged to spend a minimum amount for advertising in the local media, whereas in contract B, the Franchisee contributed financially to the regional advertising programme administered by the Franchisor. In the latter case it was unclear whether the payments for advertising were to be transmitted abroad or not.

Basically the cost of promoting the system should be covered by the Franchisor from the fees collected from the Franchisees. It should also be noted that in the case of the limited number of chain outlets in a given host country, high advertising expenditures may not be economically justified. Thus the registries should carefully examine the contractual requirements for advertising and if necessary decrease the minimum quota. Again, gross sales, excluding cigarettes and alcoholic beverages should be taken as the basis for calculating minimum advertising expenditures.

d. Payments in a foreign currency

All contracts contain specific provision that all payments to the Franchisor should be made in US dollars.

4. Control of the Franchisee's operations

The uniformity of operations has been viewed as the most essential element contributing to the image of the chain system. As the Franchisee agrees to adhere to the standards and rules of operation established by the Franchisor, this provides a basis for detailed provisions defining the scope of control of the Franchisee's

operations. Such a control usually encompasses the approval of plans and designs prior to construction, control and the food servicing operations, control of purchasing, financial control and auditing, and control of ways and means of advertising activities. According to data presented in Table 2, the rights of the Franchisor to control the Franchisee's operations are precisely defined in the contracts surveyed and usually cover the whole spectrum of activities.

The problems of the scope and methods of control have to be related to the general policy issues with regard to the fast food chain operations in developing countries. It might be argued that the often claimed independence of restaurant operators under franchise agreement is quite limited and in practice their position is not very much different from the wholly-owned outlets.

Special attention should be given to the clauses requiring the approval of all sources of supply of ingredients, equipment, etc. Indirectly, such clauses are similar to tie-in provisions in the licensing agreements as those approved are mostly foreign suppliers. Therefore the registries should insist on including the provisions favouring local purchases of ingredients. Otherwise the approval of the franchise contract might be interpreted as the permission to import ingredients and equipment for the fast food operations.

#### 5. Duration and extension of the agreement

No unified pattern was found among contracts surveyed with respect to the duration of an agreement. In two A contracts the franchise was granted for 20 years and in one case for 10 years. The duration of contract B was 5 years and contract C was also for 5 years but with two consecutive extensions with a duration of 5 years each. A duration of 20 years seems to be too long and in such cases additional provisions on the review of the agreement after an initial 10 years should be included in the contract.

#### 6. Applicable law

All contracts stipulated that the agreement should be governed and construed under and in accordance with the laws of the host country.

Table 2

Control of the operations of the franchised outlets by the Franchisor

Area of control	C o n t r a c t		
	A	B	C
Pre-opening stage	Obligatory approval of plans and specifications before construction	Not specified	Approval of plans and designs required
Control of the food servicing operations	Right for inspection granted. Franchisee obliged to follow the recommendations included in inspection report	Right to inspect the premises at any reasonable time	Right for inspection granted. Franchisee obliged to make improvements suggested in the inspection report
Control of purchasing	Spices supplies only from approved sources	Written approval of all supplies required	Not specified
Control of financial operations	Right to inspect books and accounts granted	Right to inspect Franchisee's records granted	Right to examine and audit the Franchisee's books and accounts granted
Control of promotion and advertising activities	All designs, forms advertising materials should be first approved by the Franchisor	All advertising and promotion material to be used in the form as provided by the Franchisor	All advertising material should be first approved by the Franchisor

Source: Survey conducted by the UNIDO secretariat in 1983.

## CONCLUSIONS AND RECOMMENDATIONS

The preliminary investigation of the contractual arrangements used for the transfer of technology in the food servicing sector revealed many difficult problems the partners in developing countries face while negotiating such contracts with foreign firms. In view of the expected expansion of the fast food chain operations and the importance of such operations for the whole economy, more attention should definitely be given to the problems of technology transfer in this sector by the respective government agencies in developing countries.

The major issue which should be resolved in the first instance is the formulation of the overall policies towards fast food chain operations in developing countries. For the benefit of developing countries at the early stage of development of the fast food chain operations, it might be useful to study in detail the effects of such operations in developing countries where such chain outlets have been established. It would be useful to know, for example, what the real effects of the establishment of the fast food outlet are on the transmission of knowledge and skills, on the competitive position of the traditional food outlets in a given region, spin-off effects and socio-cultural implications. For that purpose the UNIDO secretariat should elaborate detailed methodology for such field studies which should be conducted by several TIES member countries with extensive experience with fast food operations. The results of the country case studies could be further summarized by the UNIDO secretariat and presented for the next TIES meeting.

The preliminary investigation of the major provisions of the franchise agreements revealed that a substantial degree of standardization exists in this field. Large transnational fast food chains usually approach their partners with a standard agreement being used by a given chain in its worldwide operations. Some provisions found in the sample contracts would definitely require redrafting in order to protect the interests of the local partner and the interests of the host country as a whole. It is therefore recommended that, after collecting additional information on the franchise agreements used in the fast food sector, the UNIDO secretariat should elaborate detailed guidelines for the negotiation and evaluation of such agreements with proposals for alternative formulations of the most essential provisions.

It has to be emphasized however, that in view of the scarcity of published information on technology transfer in the fast food sector, the quality and usefulness of the work of the UNIDO secretariat depends to a large degree on the field study contributions prepared by the individual TIES member countries.

Outline of the standard franchise agreement used by the leading transnational fast food chain

I	License Granted
II	Training and Development
III	Manual
IV	Standards of Operation and Supervision by Company
V	Erection of Building and Commencement of Business
VI	Company's Marks
VII	Advertising
VIII	Purchase of Ingredients, Supplies and Materials
IX	Franchise Fees
X	Books to be Kept by Operator, Meaning of Gross Receipts, Profits and Loss Statements, Etc.
XI	Covenant Regarding Other Business Interests
XII	Spice Formulation and Secret Recipes
XIII	Lease Approval
XIV	Transfer of Interest
XV	Default and Termination
XVI	Rights and Obligations of Parties on Termination of Expiration
XVII	Partnership and Corporate Operators
XVIII	Insurance
XIX	Relationship of Parties and Indemnification of Company
XX	Notices
XXI	Interpretation and Execution of Agreement and Waivers
XXII	Arbitration, Choice of Law and Submission to Jurisdiction
XXIII	Change of Law
XXIV	Written Approvals and No Warranties
XXV	Survival of Terms and Conditions



