DISTRIBUTION AND SUPPLY ARRANGEMENTS IN INTERNATIONAL FRANCHISE NETWORKS

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I Introduction

Because product supply tends to either support or undermine the underlying goal of franchising – *i.e.*, uniformity – product supply issues are front and center in many if not most franchise arrangements. Franchisors face countless practical considerations in international transactions, ranging from traditional import and export issues to payment concerns. Decisions about these arrangements are made in the context of a legal landscape that can require companies to consider the impact of laws pertaining to the offer and sale of goods, competition laws, the grant of licenses to a third party to produce proprietary products, and other commercial considerations. Increasingly, however, other laws – such as those combating terrorism, money laundering, and bribery – have come to play a significant role in how international transactions take place, in terms of planning, implementing, and carrying out day to day operations.

The U.S. and U.K. have very few laws directly applicable to international supply agreements. Although there are significant laws protecting consumers (*e.g.,* the Unfair Terms In Consumer Contracts Regulations 1999 in the U.K. and the Federal Trade Commission Act in the U.S.) these typically will not apply to business to business contracts for the supply of goods.

In the U.K., the Unfair Terms Act 1977 limits all businesses ability to exclude or limit liability by reference to a contractual term but this act applies only to domestic contacts. The 1977 Act has no application to international contracts for the sale of goods. These contracts are defined as contracts where

- the parties to the contract have places of business in different countries – and it should be noted that the important factor is the place of business of the contracting party and not the place of business of its agent who signs on a party's behalf; and

- the goods either cross from one country to another or offer and acceptance takes place in a different country.

The only relevant statute in International Supply Agreements (if English Law is applicable) is the Sale of Goods Act 1979, which implies the following terms:

- the seller has the right to sell the goods, no third party has any rights over the goods which the seller has not disclosed to the buyer and the buyer will have quite possession of the goods (section 12);

- the goods conform to their description (section 13)

- the good are of satisfactory quality (section 14.2 (a)). This means that they must meet the standards that a reasonable person would regard as satisfactory, taking into account their description price, appearance, finish, freedom from minor defects, safety, durability and fitness for all normal purposes;

- the goods will be reasonably fit for any purpose that is expressly or impliedly made known to the seller (section 14 (3));

- the goods correspond with a sample which has been provided to the buyer in terms of quality and are free from any defect which would make the quality unsatisfactory which was not apparent on a reasonable examination of the sample.

Further, if a supply contract is silent on a particular matter relating to the performance of the contract then unless there is extraneous evidence of the parties intention certain terms will be implied so that for example if no price for the goods is agreed a reasonable price will be set, if no time for payment is provide then payment will be made on delivery, if no place for delivery is agreed then delivery shall be deemed to take place at the seller's place of business and if the contract does not address when title in goods are to pass to the buyer title is deemed to pass when the goods are ascertained and the parties intend title to pass.

II Competition and Antitrust Considerations – Generally

While largely outside the scope of this analysis, it is nonetheless important to note that one of the most vexing issues in buy-sell relationships can be the application of antitrust and competition principles in general. Franchisors that engage in product manufacture and distribution either directly or by subcontracting and licensing that function to a third party inevitably face antitrust issues. These can range from horizontal price fixing, vertical price fixing, to tying,

A United States

Antitrust law has at times been in favor, and at other times out of favor, as the source of claims in franchise and distribution cases. Although antitrust claims have met with only mixed success, parties engaged in distribution must nonetheless pay attention to antitrust considerations.

In many cases, courts have generally backed away from applying a rigid "*per se*" analysis of antitrust-based claims by franchisees, and instead have shown an increasing preference for analyzing these claims under the more flexible "rule of reason." This approach is followed or suggested in several recent cases involving the allegations of vertical restraints in cases such as territorial restraints,[1] tying allegations,[2] and pricing restrictions.[3] Recent case law also suggests that courts recognize business realities regarding matter such as agreements concerning dealer termination,[4] agreements concerning termination of suppliers,[5] and conspiracy.[6]

Moreover, the Supreme Court extended the "rule of reason" analysis to maximum vertical price fixing as well. In *State Oil Co. v. Khan*, 118 S. Ct. 275 (1997), the Court, in a

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1 *Trans Sport, Inc. v. Starter Sportswear, Inc.*, 964 F.2d 186 (2d Cir. 1992).

2 *Town Sound & Custom Tops v. Chrysler Motors Corp.* 959 F.2d 468 (3d Cir.) (en banc), *cert. denied*, 506 U.S. 868 (1992).

3 *Acquaire v. Canada Dry Bottling Co. of N.Y., Inc.*, 24 F.3d 401 (2d Cir. 1994).

4 *Business Electronics. Corp. v. Sharp Electronics Corp.*, 485 U.S. 717 (1988); *Monsanto Co. v. Spray-Rite Serv. Corp.*, 465 U.S. 752 (1984).

5 *NYNEX Corporation v. Discon, Inc.*, 119 S. Ct. 493 (1998).

6 *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.,* 475 U.S. 574 (1986); *Copperweld Corp. v. Independence Tube Corp*., 467 U.S. 752 (1984).

unanimous decision, reversed the long-standing policy[7] that viewed maximum vertical price fixing as *per se* unlawful. The Court determined that the practice of maximum vertical price fixing should be subject to a rule of reason standard and held unlawful only when the practice has demonstrable anticompetitive effects.

B UK/EU Competition Laws

Supply contracts of normal duration do not normally give rise to competition law issues. Long term agreement can however do so because they may well contain clauses such as exclusive supply or minimum purchase obligation or which restrict the supplier's right to sell to the buyer's competitors.

In the United Kingdom the Competition Act 1998 ("the Act") is the main competition statute. The Act introduces two main prohibitions. The first referred to as the chapter1 prohibition, prohibits and regulates agreements (whether written or oral) which prevent, restrict or distort competition and which may affect trade within the United Kingdom. The second prohibition referred to as the chapter 2 prohibition regulates conduct by those undertakings which are in a dominant position. If such conduct is an abuse of that dominant position and the conduct may affect trade within the United Kingdom. The chapter 1 prohibition is based on article 81 of the EC Treaty and the chapter 2 prohibition is based on article 82 of the EC Treaty. The stated aim of the legislators was to ensure that UK competition legislation adopted a similar approach to that of the European Community on which many other member states have based their own competition legislation. Indeed section 60 of the Act sets out the principles which must be applied by the United Kingdom authorities and courts when applying the provisions of the Act with a view to ensuring consistency with community law.

Breach of the chapter 1 prohibition results in an agreement being void and the parties to the agreement may be liable to penalties of up to 10% of their UK turnover. Further third parties who have been harmed by such agreements can claim damages in the UK courts.

There are various "exemptions" to the Act. Some of these will not be relevant to supply contracts but some will. These are:

- Parallel exemption – a parallel exemption applies to an agreement which is already covered by a European Commission individual or block exemption or

[7] The maximum vertical price fixing policy was established in *Albrecht v. Herald Co.*, 390 U.S. 145 (1968).

would be so covered if the agreement had an effect on trade between member states. Accordingly if a supply contract falls within the EC's block exemption for vertical agreements it will also be exempted from the Competition Act.

- Market share – the Senior UK Competition official has indicated that with certain exceptions an agreement will generally not have an appreciable effect on competition and therefore will not be prohibited by the chapter 1 prohibition if the parties combined market share does not exceed 25% provided that the agreement neither directly nor indirectly fixes prices or shares markets or imposes minimum resale prices or is part of a network of similar agreements.

- Vertical agreements – the most significant exemption which applies to supply agreements arises by virtue of section 50 of the Competition Act which enables the exclusion by Order of "vertical agreements" from the chapter 1 prohibition. The Order excluding vertical agreements adopts a similar approach to that adopted by the European Commission in its vertical agreements block exemption. For the purposes of the Order a vertical agreement is an agreement between "undertaking each of which operates for the purposes of the agreement at a different level of the production or distribution chain and relating to the conditions under which the parties may purchase, sell or resell certain goods". These agreements are taken out of their chapter 1 prohibition unless the agreement directly or indirectly has the object or effect of restricting the buyers ability to determine its sale price. The government has however announced its intention to remove the vertical agreements exemption and rely simply on the EU's vertical agreement block exemption.

The EU's block exemption adopts a similar definition to vertical agreements to the one referred to above. It is important to remember that the exemption will not apply if a parties market share in the relevant geographic markets is 30% or more, nor will it apply if the supply agreement contains any of the "hard core" restrictions. Certain "grey list" restrictions can be included without the agreement being held to be void out such provisions will nevertheless be subject to scrutiny under article 81.

The hard-core restrictions that would cause a supply agreement in its entirety to fall outside the exemption are:

- Resale Price Maintenance, save that a supplier may impose maximum resale prices or may recommend resale prices (as long as neither of these equate to a fixed or minimum sale price in practice).

- Prima facie any restrictions on territories/customers to which a buyer can make sales or provide services. This includes in particular bans on passive sales outside an exclusive territory/customer group. Passive sales include internet sales in most circumstances. However, note, that the following are expressly carved out from this hardcore restriction and therefore may be included without any problem:

- A ban on active sales (including unsolicited emails or targeted internet advertising) to a territory or customer group allocated exclusively to another buyer or to the supplier itself.

- A ban on sales to end users imposed on a wholesale buyer.

- Where goods are supplied or use not resale e.g. components, a ban on the buyer from reselling the products to customers who would use them to manufacture the same type of goods as those produced by the supplier.

- In an agreement concerning the supply of products for use any restriction on the ability of the supplier to supply the products concerned to independent repairers or service providers or to end users.

Grey list

There are some provisions that the block exemption does not consider to be "hardcore restrictions", but which may, nevertheless, give rise to difficulties. In respect of these "grey" provisions, the benefit of the block exemption is lost in relation to the offending clauses, but the rest of the agreement is not tainted by the invalidity of these clauses. The "grey" provisions need to be analysed from first principles under Article 81(1). This contrasts with the existing block exemptions, under which the inclusion of restrictions on competition beyond those permitted in the white lists takes away the benefit of the block exemption from the whole agreement and the whole agreement has to be analysed under Article 81(1).

The "grey" provisions are:

- "Non-compete" obligations applying during the term on an agreement that lasts over 5 years or are of indefinite duration. A non compete obligation is defined as an obligation on the buyer to purchase more than 80% of its total requirements of products/services of a certain type from the supplier. In certain situations a total ban on a buyer dealing in competing products may however, be permissible. The Guidelines to the block exemption make it clear that such total bans may be permitted if they are necessary "to maintain the common identity and reputation of the franchised network".

- Post termination non-compete obligations, unless limited in scope (as set out in the Regulation), necessary to protect know-how and lasting no longer than 1 year after termination.

III Other International Considerations

A Anti-Corruption Laws

1 *U.S.: The Foreign Corrupt Practices Act*

The Foreign Corrupt Practices Act ("FCPA"), 15 U.S.C. § 78dd-1, *et seq.*, was adopted in 1977 and amended in 1998, and was designed to prohibit bribes to officials of a foreign government or political party (or candidates for a foreign political office) in an effort to obtain business or to retain business. The law applies not only to business entities but also to officers, directors, and agents of those entities, and provides for penalties of up to $10,000 or 5 years in prison. With respect to corporate offenders, the fine may be as high as $1 million.

Certain kinds of payments are not covered by the FCPA, including "minor facilitating payments" meant to "expedite or secure the performance of routine governmental action by a foreign official, political party or party officer." For example, a payment to an official to secure the rapid processing of a routine business-related application may not run afoul of the FCPA, although a similar payment to ensure that the application is approved would be forbidden. The FCPA also imposes record-keeping requirements upon companies conducting business overseas. Companies must keep and maintain books and records that fairly and accurately reflect transactions and the disposition of assets. The law also requires companies to establish and implement internal controls to facilitate compliance.

U.S. companies engaging in international product distribution should take steps to comply with the FCPA and may want to implement procedures that go above and beyond those required by the Act. For example, a company might require that any proposed payment to a foreign official be approved in advance by the company's general counsel, who can conduct the necessary inquiry to assure that the payment does not cross the line from being a permissible "facilitating payment" to an illegal bribe. Books and records should obviously be maintained completely and accurately. If the company retains foreign sales representatives ("FSRs"), it should not do so without the general counsel's approval. Further, companies should avoid hiring FSRs who have a reputation for paying bribes, who are related to government officials, or who refuse to agree to materially comply with the FCPA.

Franchisors should be aware that U.S. Department of Justice lawyers have informally expressed the view, as recently as May 2003, that the actions of a licensee may be attributable to a licensor if the licensor is aware of and in any way facilitates or disregards an act of bribery. This revelation may be a significant development in the Justice Department's approach to enforcement of the FCPA, and while it remains uncertain how and in what circumstances the FCPA might be so enforced, it is equally certain that there are few companies that will want to risk being the test case.

2 Current UK Law

As with the United States, the United Kingdom has passed laws relating to corruption which can principally be found in three statutes, collectively known as the Prevention of Corruption Acts:

1. The Public Bodies Corrupt Practices Act 1889

2. The Prevention of Corruption Act 1906

3. The Prevention of Corruption Act 1916

Generally, the Prevention of Corruption Acts make it a criminal office to either offer or accept a bribe within the UK. These statutory provisions have been combined with the common law of bribery of a public official - the offer or acceptance of any gift by a person in a public office in the hope that such a gift will influence the officer's behaviour. Each Act deals with a slightly different aspect of corruption although inevitably, there is some overlap. The Prevention of Corruption Acts do not extend outside the UK.

a. International Co-Operation And Efforts To Eradicate Bribery And Corruption

The UK Government has been involved in a number of international initiatives aimed at eradicating bribery and corruption:

- The OECD Convention on the Bribery of Foreign Public Officials in International Business Transactions ("the OECD Convention") - which is discussed below.

- The Council of Europe's Civil Law Convention on Corruption and Criminal Law Convention on Corruption.

- The Group of States against Corruption ("GRECO").

These international initiatives all seek to establish how to prevent corruption on an international scale.

b. The OECD Convention

As indicated below, the OECD Convention aims to tackle the prevention and deterrence of corruption and in particular the bribery and corruption of public officials and is generally considered to be the most important international initiative aimed at combating bribery and corruption. It aims to create a system whereby all signatories adopt national legislation that criminalises the bribery of a public official whether that official is a domestic official or a public official from overseas. The UK ratified this Convention in December 1998. No further legislation was enacted in the UK because it was felt that existing law sufficiently covered the areas dealt with by the OECD Convention. Ratification of the Convention meant that it came into force in the UK on 15 February 1999. Germany and France have also ratified the OECD Convention.

c. The Council Of Europe Conventions

The Conventions[8] were adopted in January 1999 by the Council of Europe, an intergovernmental, cross-border organisation. Unlike the OECD Convention it hopes to encompass all areas of bribery of both public officials and private individuals and companies. The UK has signed both conventions and it is believed that these conventions will result in the harmonisation of the laws relating to both public and private persons.

The Criminal Law Convention on Corruption[9] aims to criminalise in a co-ordinated fashion a large number of corrupt practices and promote international co-operation in the prosecution of such offences. It covers many forms of bribery and corruption including the bribery of domestic and foreign public officials, members of parliament, civil servants and

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[8] Criminal Law Convention on Corruption ETS No. 173 and Civil Law Convention on Corruption ETS No. 174.

[9] ETS No. 174.

money laundering the proceeds of corruption. The co-operation envisaged by the Convention includes extradition and the provision of information and assistance in the investigation and prosecution of corruption offences.

The Civil Law Convention on Corruption requires signatories to provide in domestic law that any persons suffering damage as a result of corruption has the right to bring an action for damages. Issues dealt with include the validity of contracts, protection for "whistle blowers" collating of evidence and liability of the State of corrupt acts by public officials.

d. GRECO

In November 1997 the Council of Europe adopted Resolution (97) 24[10] and called for an effective body to monitor the principles referred to in the previous paragraph. In May 1998 Resolution (98) 7 authorised the establishment of GRECO and members and non members of the EU were invited to participate in adopting the agreement establishing GRECO. It became operational on 1 May 1999.[11]

GRECO's main functions are to monitor through evaluation and peer pressure the observance of the guiding principles highlighted above. There are currently 34 members including most European States and the USA. The UK joined on 18 September 1999.

e. Anti-Terrorism Crime And Security Act 2001

The Anti-Terrorism Crime and Security Act 2001 whilst not dealing with bribery and corruption alone, seeks to extend the provisions of the Prevention of Corruption Acts. The main changes are:

1. The extension of jurisdictional authority of the UK courts in order to encompass corrupt practices committed either wholly or partly outside the UK itself.

2. The Prevention of Corruption Acts will apply to acts of bribery and corruption that involve foreign public officers, equivalent to the UK officials set out in the Prevention of Corruption Act 1916.

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[10] Twenty Guiding Principles for the Fight Against Corruption.

[11] By Resolution (99)5.

The above changes ensure that the UK courts have jurisdiction over crimes committed by UK nationals and UK companies where those crimes are committed outside the UK even if the businesses in question have no connection with the UK.

3 *OECD: The Anti-Bribery Convention*

Outside the United States, the Organisation for Economic Cooperation and Development ("OECD") has established the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (the "OECD Convention").[12] The OECD Convention, which went into force in February 1999, has thus far been ratified by thirty-two countries (including the U.K. and the U.S.).[13] Like the FCPA, the OECD Convention seeks to criminals the making and acceptance of bribes to or by government officials. The OECD Convention was designed to allow the OECD and its member countries to "move in a co-ordinated manner to adopt national legislation making it a crime to bribe foreign public officials." It defines bribery broadly, requires countries to enact significant anti-bribery penalties, and establishes a system for international cooperation and mutual assistance to promote compliance.

However, slight differences in how some countries have adopted the OECD Convention make it difficult to comply. For example, some countries don't permit "facilitation payments." These variations are problematic for companies that do business in multiple foreign jurisdictions. The safest course is to consult legal counsel on a country-by-country basis to see if and how the OECD Convention applies.

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[12] The text of the OECD Convention is available on the OECD's website, at *http://www.oecd.org/oecd/pages/home/displaygeneral/0,3380,EN-document-88-3-no-no-7198-88,00.html*.

[13] *See http://www.oecd.org/pdf/M00025000/M00025443.pdf* for a report on the countries that have taken actions to implement the OECD Convention

B Anti-Terrorism Laws

1 *The USA PATRIOT Act*

The unfortunate reality of 21st Century business is that it takes place in the context of the "post-September 11th" world – including attacks in the U.S. on that date, as well as the bombing that took place in Bali, Indonesia on October 12, 2002.

In the aftermath of the terrorist attacks that took place in the U.S. on September 11, 2001, President G.W. Bush issued Executive Order 13224 on September 23, 2001. Executive Order 13224 was supplemented by a new piece of legislation – the "USA PATRIOT Act" (an acronym for the title of the legislation, which was a bill "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism" Act). The USA PATRIOT Act (also referred to as the "Patriot Act") was signed into law on October 26, 2001.

The Patriot Act is a complex law that addresses many different subject matters that touch directly and indirectly upon national security issues. Of particular interest to franchisors are the provisions directed to "financial institutions" and those provisions that address the transfer of funds – in an effort to combat money laundering efforts by terrorists and terrorist organizations. The Patriot Act contains a broad definition of the term "financial institution," and generally prohibits "any transaction or dealing by U.S. persons or within the U.S. in property or interests in property" of suspected terrorists and persons or organizations associated with suspected terrorists. "Financial institutions" are broadly defined and include such dealings as issuing, redeeming, or cashing travelers or other checks, or lending funds or financing another party's obligations.[14]

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[14] Some types of franchise systems are explicitly covered by the definition of a "financial institution," including the following: (i) businesses engaged in vehicle sales (including automobiles, airplanes and boats); and (ii) currency exchanges. Additionally, certain franchise systems and franchise affiliates may satisfy the definition of "financial institution," through dealings outside the scope of their primary franchise business, when they conduct either of the following businesses: (i) issuing, redeeming or cashing travelers' checks, checks, money orders, or similar instruments (*e.g.,* convenience stores that sell money orders or hotels that cash travelers' checks for a fee may be covered); and (ii) loan or finance company functions (*e.g.,* a franchisor affiliate that operates as a finance company). Because of the breadth of the definition of "financial institutions" contained in the Patriot Act, companies must consider the possibility that they might be deemed to be covered under the law as a "financial institution."

Under the Patriot Act, “suspected terrorists” include persons listed in the Annex to Executive Order 13324,[15] and also includes persons designated by the U.S. Secretary of State to have committed, or who pose a significant risk of committing, acts or terrorism against the U.S. or U.S. nationals. “Terrorists” under the Patriot Act also include persons that the U.S. Secretary of the Treasury determines have assisted in, sponsored, or supported acts of terrorism. The term “SDN” – standing for “specially designated nationals” is used to refer to these individuals.

Because the Patriot Act applies not only to U.S. persons and entities, but also to transactions taking place in the U.S. and overseas, the law may have implications for both U.S. and non-U.S. companies engaging product distribution. The legal penalties for non-compliance are potentially severe: civil and criminal penalties may be imposed under U.S. law, as well as the laws of other nations. Moreover, a payment made in a transaction to a company that turns out to be an SDN may be confiscated and fines imposed by the U.S. Treasury Department’s Office of Foreign Assets Control (“OFAC”). Even if legal penalties are not imposed, a transaction with a prohibited person or entity may generate negative publicity that could do serious harm to a company’s reputation.

Because of these potential ramifications, companies should consult with counsel and consider taking certain precautionary measures, such as:

- Learn about all of the parties to a transaction, including not just the corporate entities, but also all of their direct and indirect owners, lenders, financial backers, etc.
- Conduct reasonable due diligence as to the parties with whom a transaction is about to be undertaken.
- Check the names of the parties to a transaction against the names on the list appended to the Executive Order. If a name matches, consult with counsel to determine whether it is necessary to file a report with OFAC.
- Consider the possible application and impact of anti-terrorism laws that apply in other countries.

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[15] See *http://www.treasury.gov/offices/enforcement/ofac/sanctions/terrorism.html* for the current Annex or at the OFAC website, *http://www.treas.gov/offices/enforcement/ofac/sdn/t11sdn.pdf*. The Annex has been updated at least thirty times since it was originally issued.

- Develop and implement a compliance program to ensure compliance with these procedures.

- Determine whether it is necessary to impose upon, and enforce compliance with, similar procedures with respect to companies and persons authorized to act on the company's behalf.

- Require contracting parties, whenever appropriate, to certify that they are not SDN's and that they, in turn, will neither hire nor transact business with SDN's.

Establishing and following good and proper procedures for managing transactions in light of these laws not only may prevent a legal violation and public relations disaster, but could also position a company to satisfy its obligations to shareholders and regulators (*e.g.,* under the Sarbanes-Oxley Act of 2002) and to mitigate legal and business consequence should there be an accidental or inadvertent violation of the law.

2 *International Conventions and Other Laws*

In addition to the USA PATRIOT Act, the United Nations and a number of countries have established anti-terrorism conventions, laws, or regulations. The majority of such laws were put in force in the late 1990's following the bombing of two U.S. embassies in Africa, but most particularly after the September 11, 2001 and October 12, 2002 Bali tragedies. From September through November 2001, the U.N. Security Council passed Resolutions 1368 (condemning the September 11, 2001 terrorist acts), 1373 (seeking cooperation to "combat threats to international peace and security caused by terrorist acts"), and 1377 (declaring a global effort to combat terrorism).

Prior to the above resolutions, in December 1999, the U.N. General Assembly unanimously adopted the International Convention for the Suppression of the Financing of Terrorism (the "Terrorism Financing Convention").[16] The Terrorism Financing Convention promotes international cooperation in the investigation, arrest, extradition, and prosecution of persons who engage in terrorist financing. Countries that adopt the Terrorism Financing Convention must adopt national laws which impose stiff penalties on individuals who finance terrorist acts. 132 countries signed the Terrorism Financing Convention, and many (more than thirty as of April 2003) ratified the Terrorism Financing Convention by passing enabling legislation.

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[16] The text of the Terrorism Financing Convention can be found on the U.N.'s website at *http://untreaty.un.org/English/Terrorism/Conv12.pdf.*

In addition to the above-described efforts at the United Nations, a number of countries have enacted some form of anti-terrorist legislation in recent years, including, for example: Australia (Criminal Code Amendments, 2002); Canada (Anti-Terrorism Act, 2001); England (Anti-Terrorism, Crime, and Security Bill, 2001); France (Anti-terrorism amendments, 2001); India (Prevention of Terrorism Ordinance, 2001); Israel (Prevention of Terrorism Ordinance, 1948, amended 1980, 1986, 1993); Japan (Anti-Terrorism Special Measures Bill, 2001); and Pakistan (Anti-Terrorism (Amendment) Ordinance, 2001).

As with the USA PATRIOT Act in the United States, companies engaging in multi-national product distribution elsewhere must take steps to insure compliance with relevant laws in every country in which they do business. This paper can only describe the general requirements of these laws; companies are advised to consult counsel to determine how the USA PATRIOT Act and other laws may apply to their transactions.

C Anti-Boycott Laws

International product distribution deals must also be considered in light of U.S. anti-boycott compliance law. This law, enforced by the U.S. Department of Commerce, is designed to prevent U.S. companies from complying with boycotts that are official opposed by the U.S. government for political reasons. These regulations are particularly important with respect to transactions in the Middle East, where many governments sponsor or endorse boycotts of products from Israel or companies that do business there.[17]

The Commerce Departments Office of Antiboycott Compliance ("OAC") is charged with investigating violations of the anti-boycott laws, such as dealing with companies that are subject to a boycott, or practicing religious discrimination. OAC also is also empowered to seek civil and criminal penalties; individuals or companies that comply with unsanctioned boycotts of friendly countries may be subject to fines. There are reporting requirements associated with boycott requests – even where the company does not comply with the

[17] Some countries mandate a certificate of compliance with the Arab League Boycott as a condition to making certain government filings, such as routine trademark applications (Syria). The U.S. Internal Revenue Service includes on its list of "boycotting countries" Bahrain, Iraq, Kuwait, Lebanon, Libya, Oman, Qatar, Saudi Arabia, Syria, the U.A.E., and Yemen. *See* Internal Revenue Code (IRC) § 999(a)(3).

request – and companies that do not report those requests may be subject to penalties and tax consequences.[18]

Although U.S. anti-boycott laws principally affect U.S. companies, they may also apply to non-U.S. entities that do substantial business in the United States and to international branches of companies established, or doing business in, the United States. Violations of the anti-boycott laws can be very subtle, and great care must be taken to maintain compliance. For example, a contract requiring that a party make a "negative certificate of origin" (a certification that the party has not procured parts or products from a boycotted country) has the effect of complying with the boycott, thus opening the company to possible prosecution. Companies must carefully review all contractual language, including "boilerplate" provisions, to insure that it does not run afoul of the anti-boycott laws.

D Other Outward-Directed U.S. Laws

"Outward-directed" laws may also have an impact on companies' efforts to negotiate, conclude, and perform international transactions with companies or individuals in certain countries.[19]

1 *Trading with the Enemy Act*

The Trading with the Enemy Act ("TWEA") (50 U.S.C. App. §§ 1-44) prohibits trading or transporting material to any nation (or any company within that nation) which is

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[18] Under IRC § 999(b)(3), intentional failure to report international boycott activities may subject a company and its executives to fines and imprisonment, as well as the loss of certain tax advantages provided under the IRC. Reports are to be made on IRS Form 5713.

[19] A few examples of additional U.S. laws that may have an effect on companies seeking to enter into international transactions are the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-06; the Iraqi Sanctions Act, P.L. 101-513, 104 Stat. 2047-55; the Cuban Liberty and Democratic Solidarity Act (also referred to as the LIBERTAD Act), 22 U.S.C. §§ 6021-91; the Antiterrorism and Effective Death Penalty Act, 18 U.S.C. §§ 2332d and 2339b; and the Foreign Narcotics Kingpin Designation Act, 21 U.S.C. §§ 1901-08. On May 8, 2003, OFAC issued a series of General Licenses amending the Iraqi Sanctions Regulations, 31 C.F.R. Part 575, and permitting certain transfers of funds, transactions, and other actions consistent with the restoration of civilian control and the restoration of order in Iraq. See *http://www.treas.gov/offices/enforcement/ofac/actions/20030508.html*.

at war with the United States. TWEA provides for criminal liability up to $100,000 ($1 million for companies) and ten years in prison, and civil penalties up to $55,000. In addition, the property that is the subject of the violation may be seized and forfeited to the federal government. Over its 85-plus years on the books, TWEA has been used as a basis for numerous foreign embargoes, including the U.S. embargoes of Burma (Myanmar), Cuba, and North Korea.

2 *Alien Tort Claims Act*

The Alien Tort Claims Act of 1789 ("ATCA") (28 U.S.C. § 1350) allows non-U.S. citizens to bring a civil action for torts "committed in violation of the law of nations or a treaty of the United States." This sweeping statute, passed by the first Congress in 1789, can be interpreted to grant U.S. courts jurisdiction over civil tort claims that occur worldwide so long as those claims allege a violation of international law. The ATCA was little used or noticed until 1978 when a Paraguayan man, Joel Filartiga, sued the Paraguayan police man (who was then a resident of New York) who had allegedly tortured his 17-year old son to death. *Filartiga v. Pena-Irala*, 630 F.2d 876 (2d Cir. 1980). Even though the alleged action took place in Paraguay and involved only Paraguayan citizens, Filartiga eventually prevailed in his suit and was awarded $10 million in damages. Filartiga never received his damages, but the police officer was eventually deported. The ruling opened the U.S. courts to victims who had previously been unable to sue due to jurisdictional requirements.

Following the *Filartiga* case, plaintiffs outside the U.S. began using ATCA to bring claims for all manner of international abuses. For example, a group of Philippine citizens used ATCA to sue the family of Ferdinand Marcos for alleged acts of torture during his regime. Claims under the ATCA are difficult, in part due to the difficulty in obtaining service of process on the defendants, problems with sovereign immunity, and the possibility that the defendant may have few assets in the United States with which to satisfy a judgment. Despite these challenges, the ATCA is attractive to foreign litigants because U.S. courts allow for the possibility of punitive damages, class-action suits, and jury trials.

More recently, plaintiffs in the U.S. and abroad have begun using the ATCA to bring claims against multi-national companies for alleged environmental or human rights abuses. Claims have also involved allegations that U.S. defendants are liable by virtue of their control of a foreign subsidiary or licensee. In *Sinaltrainal v. The Coca-Cola Co.,* 2003 WL 1839782 (S.D. Fla. Mar. 28, 2003), the survivors of an employee at a Colombian soft drink plant who was killed by a paramilitary unit brought a claim under the ATCA and other laws against Coca-Cola, its Colombian subsidiary, the local bottler (a licensee of Coca-Cola), and the bottler's managers. The plaintiff's claimed that Isidro Segundo Gil ("Gil") had been killed by a paramilitary unit in Carepa, Colombia, because Gil, a union leader, was attempting to organize the employees at the local Coca-Cola bottling plant.

In ruling on the defendants' motion to dismiss the ATCA claims, the court held that while the claims against the local Colombian bottler and its managers could go forward, the plaintiffs had failed to demonstrate subject-matter jurisdiction over Coca-Cola or its Colombian subsidiary. The court found that the bottling agreement between Coca-Cola, Coca-Cola Colombia, and the local bottler failed to prove the plaintiff's allegation that Coca-Cola had "total control" over the bottler, and therefore, "[p]laintiffs cannot prove that the Coca-Cola U.S.A. or Coca-Cola Colombia violated international law by conspiring or acting jointly with the paramilitary . . . to murder Gil under color of law." *Id.* at *7.

Despite the favorable outcome for Coca-Cola in *Sinaltrainal*, companies engaged in international product distribution should be aware that they may face liability for their agents' actions outside the United States.[20]

3 *Cuban Embargo, etc.*

In addition to TWEA, discussed above, several other U.S. laws (primarily administered by the Treasury Department's Office of Foreign Assets Control ("OFAC")) have the effect of restricting trade with certain nations. With respect to Cuba, for example, the Cuban Assets Control Regulations (15 C.F.R. Part 515) ("CACR") were issued by the Kennedy administration under the authority of the TWEA in 1963 in response to certain "hostile actions" by the Cuban government. The CACR are still in force today,[21] and affect all organizations located in the United States (and international subsidiaries), as well as citizens and permanent residents no matter where located. The CACR are designed to isolate the Cuban government economically. Penalties for violating CACR include up to ten years in prison and $1 million in fines ($250,000 for individuals).

Under the CACR and other related laws, most products are restricted from export to Cuba, except for publications, informational materials, food and agricultural commodities, and medicine or medical supplies. Restricted products may not be exported to Cuba either directly or through third countries. Similarly, Cuban goods may not be imported to the

[20] *See also Estate of Rodriquez v. Drummond Co.*, 2003 WL 1889330 (N.D. Ala. Apr. 14, 2003) (court refused to dismiss claim involving alleged murder of employees involved in efforts to unionize a workplace in Colombia at the hands of persons alleged to be the defendants' agents).

[21] The CACR are largely codified under the LIBERTAD Act, 22 U.S.C. §§ 6021-91.

United States either directly or through third countries. The regulations also prohibit companies or persons subject to U.S. jurisdiction from dealing in property in which Cuba or a Cuban national has an interest. All property or assets which come into the possession or control of persons subject to U.S. jurisdiction are automatically frozen by operation of law.

These restrictions have been both tightened and relaxed during the last 40 years; during the Carter administration the travel ban was lifted entirely, only to be reinstated in 1983 by President Reagan.

The current list of restricted countries includes, among others, Angola, the Balkans, Burma, Cuba, Iran, Iraq, Liberia, Libya, Sudan, Sierra Leone, and Yugoslavia (now Serbia and Montenegro). Companies subject to U.S. jurisdiction that are considering engaging in product distribution in Cuba or other embargoed countries must consult counsel to determine the limits of legal activity under CACR and similar laws.

E The UN Convention on Contracts for the International Sale of Goods (the "Vienna Convention")

1 *U.S. Perspective*

The Vienna Convention (or the "CISG") was finalized on April 1, 1980, and entered into force in the U.S. on January 1, 1988. CISG attempts to establish uniform standards for international dealing, and has been adopted by a number of countries. For jurisdictions and transactions where CISG applies, it gives the contracting parties a common sales law. It should be noted that CISG does not apply with respect to consumer sales and securities transactions, which are not covered.

Because the United States has ratified CISG, for U.S. companies, the provisions of CISG may supercede conflicting rules in the Uniform Commercial Code ("UCC") when the other contracting party is located in a foreign country that has also ratified CISG. However, despite this default application, CISG also gives parties the right to disclaim its application to a given contract. Thus, U.S. parties may choose not to have CISG apply to their contracts, and instead may designate some other law to govern the agreement (for example, the UCC-derived sales code of a U.S. state). However, because CISG allows parties to disclaim application of national or state sales laws, it can be viewed as a tool for greater flexibility in drafting a contract according to the specific needs of the parties.

Naturally, U.S. companies will be more familiar with U.S. sales law, and will desire to have this law apply. For the same reason, contracting parties from another country will prefer that their law apply. In this respect, CISG allows the parties to compromise by choosing a "neutral" middle ground that is recognized in both countries. Unless the U.S. party has the distinct upper hand in negotiations, adopting CISG may be a good way to avoid application of a completely unfamiliar foreign law. Because CISG allows the parties to disclaim or vary any of its terms, it allows for substantial freedom in drafting.

Another factor to consider when deciding whether to adopt CISG is that it does not address certain areas of "sales law" that may be addressed in the UCC or in other sales codes. For example, CISG does not contain any provisions concerning the perfection of security interests. When considering adopting CISG, parties should consult with counsel to determine if there are any core issues which are not addressed by the Convention. To the extent that CISG is silent on a particular issue, this may be overcome in some cases by building the necessary terms directly into the contract. Overall, however, many U.S. companies conclude that in international transactions, it is usually best to disclaim application of the CISG.

2 *U.K. Perspective*

The UK has struggled whether to ratify the Vienna Convention and as at today's date has not ratified the Convention. The concerns of the United Kingdom concerning the Convention were summarised by the Law Society of England and Wales.[22] The Law Society indicated that the Convention:

- would not produce uniformity because it will be subject to differing national interpretation;
- would not be used by sophisticated commercial traders who would find it easy to avoid the provisions of the Convention;
- would more commonly apply by default, given the working of the conventions "opt-out" provisions; and
- would result in a diminished role for English law within the international trade arena.

The Convention sets out rules which govern the formation of international sales contracts and which determine the rights and obligations of each party to such contract. Article 1(1) provides that the Convention applies to "contracts of sale of goods between

[22] Law Reform Committee of the Council 1980 convention on the international sale of goods.

parties whose places of business are in different states”. This apparently simple definition of course gives rise to substantial difficulty where parties have more than one place of business and further article 1(2) restricts the application of the rule in article 1(1) when the fact that the parties have their places of business in different states does not appear either from the contract or from the dealings between them or from information disclosed by the parties at any time before or at the conclusion of the contract. Nor does the Convention apply to consumer sales or to contacts where services are the preponderant part. It is not therefore always clear when the Convention will apply.

In the view of English lawyers the convention creates difficulties in the following areas:

- Exclusion of its terms – it is not clear whether exclusion must be express or can be implied. English law has no difficulty in implying exclusion but difficulties may arise in establishing to whether the parties did in fact intend to exclude the Convention.

- Interrelation with English contract law – the convention does not provide a self contained and independent set of obligations. It deals with the formal requirements of the contract and remedies. It therefore overlaps with the general rules of contract and sale of goods law to a significant extent. The danger in English eyes is that the two regimes may not sit properly together. Specific areas of concern relate to sellers’ obligations (the Convention makes no direct reference to any international forms of contract such as C.I.F or F.O.B.), remedies generally and in particular the buyers remedies for non conformity of the goods late performance and partial performance.

In view of the above difficulties and the fact that the United Kingdom has not ratified the Vienna Convention it is unusual for English parties to enter into a contract subject to the Convention. Indeed English lawyers will only rarely recommend to their clients that they should do so.

IV Choice of Law

A Electing the Law of a U.S. State

1 *Which State and What Nexus?*

The general rule applied to choice of law selection in the U.S. is that a designation of a particular state's law to govern an agreement must have some nexus to the parties and the arrangement to which the choice of law will apply. While the law from state to state is based on fundamentally similar principles and concepts, states have considerably different provisions in their laws and a rich history of judicial interpretation that can vary considerably from one state to the next. Moreover, even within the federal court system, there are unresolved differences among the rulings of the thirteen different circuits of the U.S. Court of Appeal.

As just one example of the difference among the states, although the courts in most states have adopted the implied covenant of good faith and fair dealing, that is not the case in all states. *Compare Kirke LaShelle Co. v. Paul Armstrong Co.*, 263 N.Y. 79, 87, 88 N.E. 163, 167 (1933) (New York's highest court concluded that "there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract.") *with Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 596 (Tex. 1992) (in which the Texas Supreme Court rejected a general duty of good faith and fair dealing in a franchise agreement).

In international transactions, as a general principle, choice of law clauses are enforceable as long as the choice has some relationship to a goal other than an attempt to deprive the other party of any ability to defend or pursue a lawsuit, and was not otherwise fraudulently obtained. Enforceability of such clauses emanates from the contract law premise that the agreement of the parties in a commercial contract controls. In *Roby v. Corporation of Lloyd's*, 996 F.2d 1353 (2d Cir. 1993), the Second Circuit recognized that the "Supreme Court certainly has indicated that both forum selection and choice-of-law clauses are presumptively valid when the underlying transaction is fundamentally international in character." *Id.* at 1362. (citing *M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972)). The Second Circuit recognized that in *Bremen,* the Supreme Court explained that American parochialism would hinder the expansion of American business and trade, and would generally interfere with the smooth functioning and growth of global commerce. *Roby* at 1362-63. The court continued, stating that "[f]orum selection and choice-of-law clauses eliminate uncertainty in international commerce and insure that the parties are not unexpectedly subject to hostile forms and laws. *Id.* at 1363. Moreover, "international comity dictates that American courts enforce these sorts of clauses out of respect for the integrity and competence of foreign tribunals." *Id.* (citing *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth,* 473 U.S. 614, 629 (1985).

Other authors outline additional limits on the enforceability of choice-of-law clauses. Raymond T. Nimmer notes that the Restatement (Second) of Conflicts of Law, § 187, limits the concept of contractual choice in the following terms:

> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties . . . will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> (a) The chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties choice, or
>
> (b) Application of the law of the chosen state will be contrary to the fundamental policy of a state which has a materially greater interest [than] the chosen state in the determination of a particular issue[23] and which, under the Rule of [Restatement] § 188, would be the state of the applicable law in the absence of the effective choice law by the parties.[24]

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[23] A familiar concept is that choice of law provisions may not be honored to the extent that applying the chosen law would conflict with the public policy of another relevant forum. *See, e.g., Stanton v. Rich Baker Berman & Co., P.A.*, 876 F. Supp. 1373, 1381 (D.N.J. 1995).

[24] *See* Raymond T. Nimmer, *Choice of Law: Contract Provisions*, Information Law ¶ 12:29 (2002). Moreover, § 2A-106 of the Uniform Commercial Code invalidates choice of law rules in consumer cases unless the choice relates to the consumers residence or the place of delivery.

2 *UCC Issues*

When choosing the law of a U.S. state to govern a contract, the parties are also generally electing the sale of goods provisions of the UCC as adopted by that state (unless the parties have elected to use the CISG to govern their agreement, as discussed elsewhere in this paper). For American companies, this choice may seem like an obvious one: the company and its counsel will be most familiar with the laws of its home state. In addition, for companies engaging in product distribution in a number of different countries, choosing home law may reduce the effort required to administer or litigate contracts in several jurisdictions.

Electing to use the UCC has other advantages as well. For example, in the U.S., there is an established body of law in every state concerning the interpretation of the UCC. By relying on this law, a contracting party can draft in relative confidence because it knows how a court is likely to interpret certain provisions. Although contracts dealing with foreign jurisdictions will inevitably be governed at least in part by the laws of the other country without regard to the choice of law in the agreement (for example, law applicable to intellectual property, restraints on competition, taxes, currency conversion, etc.), electing to use home law and the UCC will lend a measure of predictability to contract interpretation.

On the other hand, there may be reasons to adopt the law of the local jurisdiction from time to time. For example, depending on the specifics of the deal in question, it is possible that local law may be more favorable to a specific transaction. Of course, any such advantage would have to be weighed against the factors outlined above in favor of adopting the U.S. law, which would automatically involve application of the UCC.

Whether the UCC applies at all may be an issue of fact. For example, the UCC generally is only held to apply to contracts where the sale of goods is the dominant factor in the contract (in contrast, for example, to the sale of services, such as the license of marks, advertising, etc.).[25] Accordingly, before concluding whether the UCC applies, one must first determine whether the sale of goods was indeed the dominant factor in the agreement.

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[25] *See, e.g., Swire Pacific Holdings, Inc. v. Dr. Pepper/Seven-Up Corp.*, Bus. Franchise Guide (CCH) ¶ 11,138 (Tex. Ct. App. 1997) (citing *G-W-L, Inc. v. Robichaux*, 643 S.W. 2d 392 (Tex. 1982) (overruled on other grounds)).

B Incoterms

The increasing volume and complexity of international sales has also resulted in an increase in disputes flowing from misunderstandings in sales contracts when terms are used inappropriately. The purpose of Incoterms is to set out clearly the meaning of frequently used terms in international sale contracts.

Often parties to a sales contract are not aware of the different trading practices and/or different interpretations given to recognised trade terms. As a result the International Chamber of Commerce first published in 1936 a set of international rules for the interpretation of trade terms, since then there have been a number of revisions – the latest of which were made in 2000.

Incoterms' role is limited to issues relating to the rights and obligations of parties to a sales contract with respect to the delivery of tangible goods – not services or intangibles such as software.

Often international contracts of sale include other contracts such as contracts of carriage, insurance and finance. Incoterms have no application to these ancillary contracts to the contract of sale. That having been said parties' use of a particular Incoterm does of course have a knock-on effect on contracts which are ancillary to the supply contract. For instance if a seller has agreed to a CIF contract then that contract can only be performed if the goods are shipped by sea because under a CIF contract a bill of lading or other maritime document must be presented to the buyer – this cannot happen if goods are, say, transported over land . Further of course documentation required under a documentary credit would also depend on the means of transport intended to be used.

It should be noted that Incoterms do not deal with a significant number of issues which often occur in supply contracts such as the transfer of title, breaches of contract, the consequences of breaches and limitations of liability.

When parties intend to use Incoterms by reference into their contract it is important that an express reference is made to the current version of Incoterms – Incoterms 2000. At the risk of stating the obvious a failure to refer to the current version may result in a dispute as to which version applies.

There are basically 4 groups of Incoterms. The first, which is referred to as the E Group, contains "ex-works" contracts where a seller only makes goods available to the buyer at the seller's own premises. The second group, where the seller is required to deliver goods to a carrier appointed by the buyer (the F Group), include "free carrier", "free alongside ship" and "free on board terms". The third group – C terms – obliges the seller to arrange for carriage but without assuming any risk for loss or damage to the goods or additional costs due to events occurring after shipment and dispatch. These terms are "cost and freight", "carriage paid" and "carriage and insurance paid". The final set of terms – the D terms – impose considerable obligations on the seller to bear all costs and risk needed to deliver goods to their place of destination – "delivered at frontier", "delivered ex-ship", "delivered ex-quay", "delivered duty unpaid" and "delivered duty paid".

It is beyond the scope of this paper to explain each of the Incoterms' and to highlight changes brought about by Incoterms but in summary:

- The "E"-term – the seller has simply to place the goods at the disposal of the buyer at the agreed place – usually at the seller's own premises. Often, the seller loads the goods onto the collecting vehicle but "ex works" does not oblige the seller to do so. If the buyer wants the seller to load, this should be made clear in the contract.

- The "F"-terms – require the seller to deliver the goods for carriage as instructed by the buyer. The point at which the parties intend delivery to occur in the Free Carrier ("FCA") term has caused difficulty because of the wide variety of circumstances which may surround contracts covered by this term. As a result when the place named in the contract as the place of delivery is the seller's premises, delivery is complete when the goods are loaded on the buyer's collection vehicle and, in other cases, delivery is complete when the goods are placed at the disposal of the buyer but not unloaded from the seller's vehicle.

- The delivery point under Free on Board ("FOB") and under Cost and Freight ("CRF") and Cost Insurance Freight ("CIF") has been left unchanged in Incoterms 2000 even though the concept under FOB to deliver the goods "across the ship's rail" may seem inappropriate in many cases, it is understood by merchants and applied in a manner which takes account of the goods and the available loading facilities.

- There is an important change relating to Free Alongside Ship ("FAS") terms. The seller is now obliged to clear the goods for export.

- The "C" terms require the seller to contract for carriage on usual terms at his own expense. Therefore, a point up to which he would have to pay transport costs must necessarily be indicated after the respective "C" term. Under the CIF and Carriage and Insurance Paid ("CIP") terms the seller also has to take out insurance and bear the insurance cost.

- It is in the nature of C term contracts that, while the seller is bound to pay the normal transport cost for the carriage of the goods by a usual route and in a customary manner to the agreed place, the risk of loss of or damage to the goods, as well as additional costs resulting from events occurring after the goods have been appropriately delivered for carriage, fall upon the buyer. The "C" terms therefore contain two "critical" points, one indicating the point to which the seller is bound to arrange and bear the costs of a contract of carriage and another one for the allocation of risk.

- There are only two terms which deal with insurance, namely CIF and CIP. Under these terms the seller is obliged to procure insurance for the benefit of the buyer. In other cases it is for the parties themselves to decide whether and to what extent they want to cover themselves by insurance. It may be impossible for a seller to know the suitable insurance cover and, therefore, the minimum cover under CIF has traditionally been chosen with the possibility for the buyer to require the seller to take out additional insurance. Minimum cover is unsuitable for the sale of manufactured goods where the risk of theft of the goods would require more than the minimum cover available.

- The "D" terms - under these terms the seller is responsible for the arrival of the goods at the agreed place or point of destination at the border or within the country of import. The seller must bear all risks and costs in bringing the goods to each point.

- Under the "D" terms except Delivered Duty Paid ("DDP") the seller does not have to deliver the goods cleared for import in the country of destination.

- Traditionally, the seller had the obligation to clear the goods for import under Delivered Ex Quays ("DEQ") since the goods had to be landed on the quay and thus were brought into the country of import. But owing to changes in customs clearance procedures in most countries, it is now more appropriate that the party domiciled in the country concerned undertakes the clearance and pays the duties and other charges. Thus, a change in DEQ has been made.

V Practical Considerations

All franchisors seek to maintain the quality of the goods supplied by their franchisees and/or the equipment and fixtures and fittings at franchisees premises. This is an area which no franchisor could afford to leave unregulated. Accordingly franchisors have, at least, three options in relation to such supplies. First, franchisors can oblige franchisees to make use of their authorised and existing suppliers; second, franchisors can permit franchisees to make their own supply arrangements (usually subject to obtaining the franchisor's consent to such suppliers); and third, franchisors can look for equivalent suppliers in the franchisee's territory and make arrangements with them. In all cases, however, supply contracts – whether international or domestic – will be required.

Turning to the first option, which experience suggests is the one adopted by most franchisors at least in the early days of their international expansion, franchisors require franchisees to use their already established "home" suppliers. The advantages of this approach are:

- it involves the least "effort" on the part of the franchisor. The franchisor has an existing supplier and is therefore fully aware of the supplier's ability to meet its quality requirements and to deliver products promptly and competitively;
- the franchisor will have built up an existing trading relationship with the supplier;

the franchisee will not be able to establish a commercial relationship with the supplier, which excludes or is more significant than the relationship with the franchisor (this could be significant should the franchise relationship be terminated);

- the franchisor is able to control the relationship between the supplier and the franchisee;
- the negotiations between the franchisor and the supplier will be in the franchisor's mother tongue; and
- the franchisor may benefit from further discounts/commission arrangements.

Notwithstanding the above advantages not all products will be able to be sourced internationally either because they involve a substantial service element like shop fitting, cheaper suppliers are available in the franchisees' territory or products are required to be delivered with short delivery times. In addition:

- the franchisor's home supplier may be inexperienced in international supply contracts; and
- there may be different product regulations in the franchisees territory to those applicable in the franchisor's home territory.

The second option is to allow franchisees to source products. It would be most unusual for franchisors to allow franchisees a free hand in terms of sourcing products or at least in relation to those products which are significant for the brand image of the franchise network. Accordingly franchisors frequently permit franchisees to contract with local suppliers subject to the Franchisors' approval. The advantages of this approach are:

- the franchisor is not actively involved in searching for suppliers, (although this may make the franchise less attractive to the franchisee who would be likely to view provision of a source of supply to be one of the franchisors obligations). Further of course the franchisor could be involved in substantial expenditure of time and effort in approving a supplier.

The disadvantages of this approach from a franchisor's perspective are that:

- the franchisor may have no direct contractual link with the supplier. This could be significant should the franchise arrangements be terminated;

- the franchisor may not be aware of issues or problems arising from the supply contract; and

- the franchisor may find it harder to introduce improvements/modifications to products.

The third option, whereby the franchisor seeks suppliers in the franchisees home territory, has the following disadvantages:

- it is time consuming for a franchisor;

- the franchisor will not receive discounts/commissions calculated on a global supply basis;

- intellectual property concerning the products may have to be made available to the franchisee's supplier;

- the franchisor would have no track record of supply/quality; and

- the supplier may be wary about dealing with an unknown and foreign entity with no track record with that supplier.

The advantage of this option is that the franchisor will have a direct involvement in the selection of the supplier and may have a contract with the supplier.

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