World Applied Sciences Journal 37 (9): 746-752, 2019
ISSN 1818-4952

DOI: 10.5829/idosi.wasj.2019.746.752

Trade Secrets, Franchising and International Franchise Disputes

[1]*Ana Čović,* [2]*Aleksandra Daria Petrović and* [3]*Andrijana Čović Ilić*

[1]The Institute of Comparative Law, Terazije 41, 11000 Belgrade, Serbia
[2]Faculty of Business and Law of University Union-Nikola Tesla,
Knez Mihajlova 33, 11000 Belgrade, Serbia
[3]Metropolitan University, Faculty of Management,
Tadeusa Koscuska 63, 11000 Belgrade, Serbia

Abstract: Trade secret is part of the intellectual property of the company. Trade secrets are of the great importance, but because they are invisible their contribution is difficult to measure. The secret is that, as a body in precise configuration and assembly of its components, it is not generally known or readily available to persons who usually deal with the type of information discussed and prevents the continued use and disclosure of trade secrets. Goods that are manufactured based on trade secrets that have been obtained illegally are removed from the market. Failure to meet expectations is the most common cause of dispute and generally occurs between six and eighteen months after the conclusion of the contract.

Key words: Trade Secrets · Franchise · Franchisor · Franchisee · International Disputes

INTRODUCTION

Trade secret is any practice or process in a company that is unknown to the public. The information contained in the trade secret gives the company an economic advantage over its competitors and is a product of internal research and development. Unlike a patent, trade secrets are not known to the public. They can be found in various forms, such as processes, instruments, schemes, designs, formulas, recipes, computer codes, methods and practices that are not evident to others. Trade secret is part of the intellectual property of the company. Trade secrets are of the utmost importance, but because they are invisible their contribution is difficult to measure.

Some of the factors typically considered in determining whether business information qualifies as a trade secret are [1]:

- The extent to which the information is known outside of the business
- The extent to which it is known by employees and others involved in the business
- The extent of measures taken by the business to guard its secrecy
- The value of the information to the business and its competitors
- The amount of effort or money expended in developing it
- The ease or difficulty with which it could be properly acquired or duplicated by others.

The law defines what can be considered a trade secret. In some jurisdictions, trade secrets are known as "confidential information" and trade secrets are confidential trade documents. Top Secrets - Secrets of paramount importance are strictly kept in state institutions. In the text below, we will base ourselves on the protection of trade secrets by law, under the auspices of the World Trade Organization, the European Union, the English Trade Secrets and the laws of the United States of America.

The important economic incentives that trade secret law may provide are invention and commercialisation, efficient protection and acquisition of knowledge and knowledge spillovers [2].

The World Trade Organization (WTO) has a separate legal agreement signed with all countries that are members of this organization (162 countries). This agreement, called TRIPS - Trade Related Aspects of Intellectual Property Rights, is the Annex to the agreement signed in Marrakech on 15 April 1994. The TRIPS Agreement

Corresponding Author: Ana Čović, The Institute of Comparative Law, Terazije 41, 11000 Belgrade, Serbia.

requires World Trade Organization members to submit copyrights covering authors and other legal holders, including holders of related rights, geographical indications, industrial designs, patents, trademarks, trade names and confidential information. TRIPS also has dispute resolution, remedies and enforcement procedures.

WTO TRIPS 1994 defines trade secrets as [3]:

- The secret is that, as a body in precise configuration and assembly of its components, it is not generally known or readily available to anyone who usually deals with the type of information being discussed;
- Has commercial value because it is secret and
- Under the circumstances, has been subject to reasonable steps by a person lawfully controlling the information to keep it confidential.

The Council of the European Parliament adopted the Directive on 8 June 2016 on the basis of a proposal from the European Commission and the Directive aims to standardize the national laws of the Member States of the European Union in the fight against unlawful acquisition, disclosure and use of trade secrets. It also defines the relevant forms of bad interpretation and explains that reverse engineering and parallel innovation must be guaranteed, since trade secrets are not a form of exclusive intellectual property right. The proposal for a directive found that remedies through which victims whose trade secrets were disclosed and misused could seek protection as [4]:

- Preventing the continued use and disclosure of trade secrets;
- The removal from the market of goods produced on the basis of trade secrets that have been obtained illegally and
- Compensation for damage caused by the illegal use and disclosure of a trade secret

While the definition of a 'Directive' is in line with existing definitions of EU Member States, countries such as the United Kingdom, Germany, Poland and Hungary do not require trade secrets to be of commercial value.

The English Law on Trade Secrets requires that confidential information be a component of the necessary quality of confidentiality and only be disclosed in circumstances that impose a duty of confidentiality. The commercial value of the secret is not necessary to be kept confidential. In terms of confidential information in employment, trade secret is information that an employee is required to keep confidential, even after termination of employment, without time limitation. This is of utmost importance in business and the measures taken to protect business secrecy.

United States trade secrets have been defined and kept under the auspices of the Economic Espionage Act of [5] and fall under state jurisdiction. The US defines trade secret as:

- Obtains independent real or potential economic value from not being generally known or easily identifiable by another person who can obtain economic value from discovering and using the same and
- Is the subject of reasonable efforts to preserve its secrecy.

The Defend Trade Secrets Act of 2016 (DTSA) enacted May 11, 2016, is a United States federal law that allows an owner of a trade secret to sue in federal court when its trade secrets have been misappropriated [6].

Examples of Trade Secrets: Google Inc. the search engine algorithm exists as a company intellectual property in computer language code. The algorithm is strictly guarded to protect its operations and is constantly being modified and refined by the company.

Coca-Cola Company has decided to keep its recipe a business secret instead of patenting it. To patent it would lead to the disclosure of the ingredients and would do enormous damage to the business. Corporate espionage happened in 2006 when one of Coca-Cola's employees stole the formula and tried to sell it to Pepsi's biggest competitor. Pepsi management has told Coca-Cola Company of this attempt to misuse and trade secrets have been successfully thwarted.

Characteristics of patent, trade secrets, copyrights, trademarks and designs:

- Patent characteristics (new, not obvious)
  When it comes to patent, intellectual property rights are protecting innovation and duration of the protection is 20 years. It is not permitted to use, sell or make patent without permit. Registration is necessary.

- Trade secret characteristics (value, long lasting, reasonable effort)
  Protects information, doesn't have time limitation. It is not permitted to take, use or make public. Registration is not necessary and if a company decide to register, price is affordable.

- Copyright characteristics (originality)
  Protects expression and it lasts for a lifetime of author plus seventy years after author's death. It is forbidden to make a copy in large amounts. Registration is not necessary but it helps and the price of registration is low.

- Trademark characteristics (Use of different goods and services)
  Protects source, registration is not necessary but it is very useful and lasts until trademark is in use. It is forbidden to make a trademark that is confusingly similar. Price of the trademark registration is medium-low range.

- Design characteristics (new, not obviousand not practical)
  Registration is necessary and protects outside look of the product. Duration is from 14 to 15 years. It is not permitted to make same design. Price of the registration is medium range.

Trade Secrets and Franchisingl: The franchise industry is a particularly risky category for the disclosure of trade secrets and great importance must be given to this segment in order to protect it. Franchisors and their employees, as well as franchisees with their employees, can be a particular threat to the security of trade secrets, even if they are not malicious. Security breaches are mostly due to employee misconduct due to negligence and the so-called phishing attack method on social networks is also one of them. The threat is certainly greater if the employees are malicious than those who make the mistake of not intentionally.

Because it is sometimes inevitable for a franchisor to share some of its business secrets with third parties, in order to enable them to operate effectively in the franchisees supply chain, it is critical to make adequate arrangements to protect business secrets. Of course, the initial step in protecting business secrets is through customized confidentiality and Non-Disclosure Agreements, but it is clear that the standard draft agreement is not a secure approach and must be tailored to the business of the particular company.

Preparation of relevant documents includes:

- Thorough investigation of all contract requirements, precise identification of trade secrets to be disclosed and to whom and
- Audit of the third party with whom the contract is signed. The audit aims to determine whether it is a stable and respectful company with a record of previous similar business collaborations that have proven successful. Also, it is important to determine corporate status, whether an additional " non-disclosure agreement " with subcontractors, partners or third parties is required.

There is a reactive and proactive influence to protect business secrets:

- Reactive impact is the need for franchise agreements to be concluded in the context of relevant legal jurisdiction to protect the franchisee's trade secrets and
- On the proactive front, the result of the law is that information is likely to become commercially usable in its own right. For example, individual franchisors are already exploring new billing structures based on their ability to classify a set of data specifications as 'trade secrets'.

The conclusion is that franchisors must protect themselves legally but also monitor after the start of business with third parties how the cooperation develops or changes while in the possession of trade secrets. Contracts need to be updated or re-signed, especially if employees are changing. If the term of the contract expires, obligations should be ensured upon termination of the contract and especially those related to the return of confidential documents and data.The franchisor action does not end with theintroduction of the franchisee to the business, because he is still interested in promoting the franchisein question and in monitoring and controlling thefranchiseeconduct and what is done to preservereputation of its business and intellectual property [7].

International Franchise Disputes: International franchise system is far more complex than the local franchise system. The inability to adapt a brand to the new market, the consequences and damage that can happen to an entire business increases when a particular company decides to franchise their products and services beyond the borders of their country and legislation. Due to the uniqueness of the relationship between the franchisor and the franchisee, it is advisable that the legal contract also be unique. The need for a unique franchise agreement is reflected in the obligations that must be established for both parties, as well as in ensuring the standards and integrity of the franchisor brand. In most cases, when a company operates internationally, it is more of a decision to entrust its brand through the Master franchise than to individual franchise units and various business partners of the so-called franchisee.

Causes of Franchise Disputes:

- Not meeting expectations - is the most common form of dispute and generally occurs between six and eighteen months after the conclusion of the contract. Failure to meet expectations through general disappointment is not the cause of a legal dispute, but if the franchisee says that he or she was deceived at the outset, prior to signing the contract, by misrepresenting the business, then he or she is entitled to claims for damages. The concept of misrepresentation exists in many jurisdictions. The franchisee needs to have written evidence against the franchisee. If it succeeds in proving that the franchisee is right, remedies depend on the legislation and may include the right to cancel the contract, the refund given by the franchisee to the franchisee and claim damages for loss of business opportunity.
- Inappropriate choose a franchise partner - The most common mistake a franchisor make when deciding to expand his business into new territory is the hassle of choosing a partner. In most cases, the franchisor enters into a partnership with the first company to show interest in his product or service. The key to finding a potential business partner is to audit his or her previous business, evidence of successful business in the local market, preferably in a related or the same business industry. It is very important for partners to have clear communication regarding the choice of the language in which they negotiate and draft contracts and later that their teams operate in one language because the franchise requires daily contact between development teams. When it comes to international franchises, English is the most widespread business, but Spanish is also far behind especially when doing business in Latin American countries. It is interesting that certain countries that belonged to the former Soviet Union, where Russian was mandated, regardless of the local language, are still finding purpose in its application in the business where franchise teams operate in Russian (for example, Kazakhstan and Azerbaijan).
- Failure to meet minimum performance requirements - Minimum Performance Requirements could be the number of franchise units opened annually or sales of products and services. The failure of the franchisee to obtain a minimum of performance gives the franchisee the right to terminate the contract or reduce the territory in which the franchisee operates. Basically, in such cases, the franchisor makes new negotiations with the franchisee in order to continue the partnership, although development in a certain territory is slower than expected.
- Lack of franchisor support - When it comes to a local franchise, franchisee support towards the franchisee can be extremely limited. On the other hand, in the context of an international franchise, support is detailed and extensive. The lack of support from the franchisor and the lack of fulfillment of expectations are closely linked. For example, a franchisee is not entitled to a high degree of support in a legal contract and is misled by the franchisee's verbal promise to receive it.
- Failure to maintain brand standards - It is customary for master franchisees to have complaints about maintaining the brand standards already established in their country. The brand requirements and the way of doing business must be adapted for successful business in a certain territory. Acceptable modifications are fine as long as they do not damage the brand reputation the franchisor has built.

Possible Solutions in Order to Resolve Disputes Between Franchisor and Franchisee

Discussion: It is understandable that neither party wants the legal contract terminated unless there is no other choice. Prior to each decision, the franchisor or the franchisee is required to contact the other party and try to resolve the discussion with the hope that an agreement will be reached. For this type of discussion, it is best to arrange a meeting where both parties will meet live and talk, because when it comes to an international franchise, the franchisor and the franchisee are located in different countries. In most cases franchise agreement contain a clause in the event of a dispute, as well as a procedure for how to resolve the dispute if it arise. If the meeting between the franchisor and the franchisee fails, a new meeting should be held, but this time between the legal representatives of this party, who will try to reach a compromise with the negotiations. In certain cases, when it comes to breach of confidentiality and misuse of intellectual rights, discussion is not advisable and the franchisor is forced to enter a lawsuit or arbitration.

Mediation: In most jurisdictions a mandatory clause in a franchise agreement is mediation, in order for the franchisor and the franchisee to resolve their disagreements. Mediation is done by an individual who is not connected to either side and the success rate is extremely high. The benefits of mediation are that it opens up channels of communication, reduces time spent on problem solving and costs that would be significantly higher if litigation occurred. Also, mediation allows privacy for both parties and avoids potentially publicly damaging publicity. Disadvantages of mediation are certainly a time of happening, because if mediation happens too early in the escalation of a conflict, there is a possibility that both parties will not want to reach an agreement. A common disadvantage of mediation is the inability to find a mediator who has experience in franchising and leads to misunderstandings of major issues and can be detrimental to problem solving.

Arbitration: It represents a way of resolving disputes and is an alternative to trial. It is of a private character and is negotiated when the parties cannot reach an agreement through discussion and mediation. The nature of the arbitration is consensual or willing. Based on the arbitration agreement, a body independent of the parties is constructed, the arbitral tribunal being given the task of resolving the dispute as soon as possible by application of law. The arbitral tribunal shall consist of arbitrators chosen by the parties, or an institution entrusted by the parties with the organization of the arbitration. The arbitrators must be completely independent of the parties and impartial in their work. The parties may choose the location for arbitration hearings, which is not the case with litigation. Jurisdictions in Hong Kong, Singapore or Geneva are very popular neutral sites for the settlement of international disputes through arbitration. Arbitration may be institutional, where both parties agree to apply a law established in a particular arbitration-specific institution that can offer a list of arbitrators for recommendation.

The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, better known as the New York Convention [8], was adopted by the United Nations on June 10, 1958 and entered into force for a year later. The Convention consists of 159 member states and requires the courts to approve the entry into force of private contracts in arbitration, as well as to recognize and enforce arbitral awards made in other states.

Litigation: Each contract sets out in advance which court has jurisdiction in the event of a court case. One of the main disadvantages of litigation is that it must be reported and this leads to publicity that can harm the franchisor and the franchisee, but even more franchisor because of his brand.If both parties are members of the European Union, litigation can take place in any state and a court ruling enters into force thanks to Brussels Regulation 1215/2012 (Brussels Regulation 1215/2012) - Regulation of the European Parliament and of the Council rendered on 12 December 2012 on jurisdiction, recognition and enforcement of judgments in civil and commercial matters. However, if one party is located in a European Union country and the other in the United States, the recognition of a court judgment is far more complicated because there is no reciprocal recognition of a treaty between the US and the European Union. In such cases, arbitration and its recognition by the New York Convention is certainly a better solution.

Termination of the Contract: The most difficult way to solve a dispute between the franchisor and the franchisee is to terminate a business agreement. Not only does the franchisor face the loss, but he can also get sued by the franchisee in which he will claim compensation. The main decision after termination of the contract is to resolve problems in the territory where the franchisee operated the business. The answer depends on the value of the market and the impact on the brand reputation. If the market already has several franchised units operating, the franchisor in most cases chooses to retain them. The way to accomplish this is to allow the franchisee the right to operate in already open outlets provided he or she is not allowed to open new franchise units. However, this can cause complications because in this case the recipient and the franchisee are still connected by a certain form of business cooperation and difficulties arise when the franchisor chooses to re-franchise in the same territory to a third party.

If the severity of the problem that led to the termination of the contract was extremely high, the franchisor has three options:

- To nominate a new representative for the territory;
- Takeover of the business from franchisee and perform self-management and
- Termination of the business in the disputed territory in any form.

CONCLUSION

Trade secret is part of the intellectual property of the company. Trade secrets are of the utmost importance, but because they are invisible their contribution is difficult to measure. The secret is that, as a body in precise configuration and assembly of its components, it is not generally known or readily available to persons who usually deal with the type of information discussed and prevents the continued use and disclosure of trade secrets. Goods that are manufactured based on trade secrets that have been obtained illegally are removed from the market.

Failure to meet expectations is the most common cause of dispute and generally occurs between six and eighteen months after the conclusion of the contract. Failure to meet expectations through general disappointment is not a cause of litigation, but if the franchisee says that he was deceived at the outset, prior to signing the contract, by misrepresenting the business, then he has the weight and the right to claim damages. The concept of misrepresentation exists in many jurisdictions. The franchisee needs to have written evidence against the franchisor, so it can be concluded that franchisors must protect themselves legally but also monitor after the start of the business with third parties how the cooperation develops or changes while in the possession of trade secrets. Contracts need to be updated or re-signed, especially if employees are changing.

Unlike patents, trade secrets do not require strong institutions ex-ante, firms protect their trade secrets themselves through internal measures, butthey do require strong institutions in the event of a misappropriation [9]. In the absence of trade secret law, the competitor would be spend as much as possible to obtain the secrets, up to a point where it is cheaper to independently develop and the owner would spend as much as possible to protect the secrets, up until the point where it is less costly to lose the secret than to protect it [10]. In franchise industry, both sides could be a particular threat to the security of trade secrets, even if they are not malicious. Security breaches are mostly due to employee misconduct due to negligence and the so-called phishing attack method on social networks is also one of them. The threat is certainly greater if the employees are malicious than those who make the mistake of not intentionally.

Because it is sometimes inevitable for a franchisor to share some of its business secrets with third parties, in order to enable them to operate effectively in the franchisees supply chain, it is critical to make adequate arrangements to protect business secrets.As national economies become interconnected and interdependent upon one another, the importance of international trade rises and also the importance of protect one's trade secrets on a global scale [11].

If the organization bases its strategy on intellectualcapital, it also develops the ability to constantly learn, adopt and find innovation, customer care, quality ofemployees, but also the flexibility of an organization thatis constantly improving [12].

The conclusion is that franchisors must protect themselves legally but also monitor after the start of business with third parties how the cooperation develops or changes while in the possession of trade secrets.

REFERENCES

1. Bio Process International, 2004. A Brief History of Trade Secret Law, Part 1, Ernie Linek.
2. Lippoldt, D. and M. Schultz, 2014. Trade Secrets, Innovation and the WTO, E15Initiative. Geneva: International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum.
3. The Franchise Law Book, 2018. Fifth Edition, Ed. Mark Abell, Publisher Tom Barnes, Law Business Research: UK.
4. European Commission, Internal Market, Industry, Entrepreneurship and SMEs, https://ec.europa.eu/growth/industry/intellectual-property/trade-secrets_en
5. Economic Espionage Act of 1996., https://www.govinfo.gov/content/pkg/PLAW-104publ294/pdf/PLAW-104publ294.pdf
6. Defend trade secrets act of 2016., https://www.congress.gov/114/plaws/publ153/PLAW-114publ153.pdf
7. Čović, A., A.D. Petrović and A. Ilić-Čović, 2019. Franchise Agreement and Mutual Obligations Between the Franchisor and Franchisee, Middle-East Journal of Scientific Research, 27(7): 580-586.
8. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (The New York Convention) https:// uncitral.un.org/ en/ texts/ arbitration/ conventions/foreign_arbitral_awards
9. Barbe A. and K. Linton, 2016. Trade Secrets: International Trade Policy and Empirical Research.
10. Risch M., Why Do We Have Trade Secrets? 2007. Marquette Intellectual Property Law Review, Volume 11(1): 3-74.

11. Landman, T., 2019. Trade Secret Protection in Japan and the United States: Comparison and Recommendations, Brooklyn Journal of International Law, 44(2): 714-761.

12. Čović, A., A.D. Petrović and A. Ilić-Čović, 2019. Franchise Trade from the Aspect of Intellectual Property, Patents, Licenses and Related Rights Know How, Middle-East Journal of Scientific Research, 27(8): 630-636.