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The International Comparative Legal Guide to:

Franchise 2015

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A practical cross-border insight into franchise law

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1 Relevant Legislation and Rules Governing Franchise Transactions

1.1 What is the legal definition of a franchise?

Franchising in the United States is regulated at the federal and state level. Although certain nuances exist as to the legal definition of a franchise, the following three elements must exist in order for a business relationship to qualify as a franchise: (i) the franchisee operates a business or sells goods or services that are associated with the franchisor's trademark; (ii) the franchisor has the authority to exert a significant degree of control over the franchisee's method of operation (certain state laws define this element as the franchisee's use of a marketing plan or system prescribed by the franchisor or a community of interest); and (iii) the franchisee pays a fee to the franchisor (with a few notable exceptions like the payment of a *bona fide* wholesale price for products or a *de minimis* amount of $500 during the first six months of operation under federal law).

Importantly, any licence, distribution or other similar arrangement can qualify as a franchise regardless of what the parties call their agreement or whether they disclaim any intent to form a franchise relationship. The key is whether the three elements are present. Simply put, "if it walks like a duck and quacks like a duck, it's a duck."

1.2 What laws regulate the offer and sale of franchises?

The Federal Trade Commission's (FTC) Trade Regulation Rule on Franchising (the FTC Rule) imposes a pre-sale disclosure requirement that applies in all states. A franchisor makes the necessary disclosures in the form of a Franchise Disclosure Document (FDD). In addition, several states have a franchise disclosure/registration statute or a franchise relationship statute, or both. The former requires that a franchisor make specific disclosures to the franchisee and may require that the franchisor register with the appropriate state agency prior to the offer or sale of a franchise in the state. The latter creates rules governing the conduct of the franchisor during the franchise relationship.

1.3 Are there any registration requirements relating to the franchise system?

The FTC Rule does not impose any registration requirements. It is a pre-sale disclosure rule only. As noted above, certain states require a franchisor to register its franchise opportunity with the state prior to the offer or sale of a franchise in the state. Some states only require the filing of a notice and payment of a registration filing fee. In other states, unless a state exemption is available (e.g., certain states exempt from registration (but not disclosure) a franchisor who meets significant net worth and experience requirements), the state franchise agency will review the FDD to determine its compliance with the state's disclosure requirements as further noted in the response to question 1.4. Failure to comply with a state's registration requirements can result in (i) private rights of action by franchisees for damages and other forms of relief, and (ii) administrative actions by the state, including financial penalties.

1.4 Are there mandatory pre-sale disclosure obligations?

Yes. The FTC Rule requires a franchisor to make specific pre-sale disclosures to a potential franchisee in the form of the FDD. Fifteen states also have a franchise disclosure statute that has similar pre-sale disclosure requirements. The purpose of disclosure is to provide prospective franchisees with the information that will allow them to make an informed decision about the franchise opportunity.

Generally, the FDD includes, in a prescribed format, information about (i) the franchisor and any parent or affiliate, and its officers and directors, including litigation and bankruptcy, (ii) fees to be paid to or imposed by the franchisor or affiliates and a franchisee's estimated initial investment in the business, (iii) restrictions on the sourcing of products or services used in the franchised business, (iv) financing offered by the franchisor (if any) or other pre-opening and post-opening obligations of the franchisor, including training and advertising, (v) any territory protection afforded the franchisee, (vi) trademarks and patents, (vii) franchisee's obligation to participate in the franchised business and restrictions on what it may sell, (viii) any financial performance representations provided by the franchisor, (ix) a status summary of the existing system outlets, (x) audited financial statements prepared in accordance with U.S. GAAP or in a format that the U.S. Securities and Exchange Commission has approved, and (xi) copies of the franchise agreement and other required contracts.

1.5 Do pre-sale disclosure obligations apply to sales to sub-franchisees? Who is required to make the necessary disclosures?

Yes. The FTC Rule provides that a franchisor and subfranchisor/master franchisee are jointly responsible for compliance with all franchise disclosure laws. In addition, states will require separate registration of a franchisor's offer of a master franchise and the subfranchisor/master franchisee's offer of subfranchises.

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1.6 Is the format of disclosures prescribed by law or other regulation, and how often must disclosures be updated? Is there an obligation to make continuing disclosure to existing franchisees?

The FTC Rule prescribes a format for the FDD that includes responses to 23 specific disclosure items (the response to question 1.4 summarises those items). The North American Securities Administrators Association and registration states have effectively adopted the FTC Rule disclosure format, although some states require a franchisor to include a few state-specific disclosures. Accordingly, most franchisors will prepare a "multi-state" FDD that they can use in all states where they intend to offer and sell franchises and will supplement it with state-specific addenda for those states that require additional state-specific disclosures.

The FTC Rule requires a franchisor to update its FDD on an annual basis (120 days after its fiscal year-end). States also require a franchisor to renew its registration on an annual basis (90-120 days after its fiscal year-end or one year from the effective date of the registration). The FTC Rule and state law require a franchisor to update its FDD and file an amendment in the registration states if there is any material change in the information disclosed in the FDD (i.e., a change that has a substantial likelihood of influencing a prospect in the making of a significant decision relating to the franchise). Notably, these federal and state disclosure requirements apply only to prospective franchisees and do not impose any ongoing disclosure obligations to existing franchisees.

1.7 Are there any other requirements that must be met before a franchise may be offered or sold?

The FTC Rule and state law require that a franchisor provide a prospective franchisee an FDD at least 14 calendar days prior to the franchisee signing a franchise agreement or other binding contract or making any payment to the franchisor or an affiliate, or earlier if requested by the prospective franchisee (a few state laws require earlier disclosure). Franchisors can make disclosure electronically (email, CD-ROM, download from website) as long as they comply with the FTC Rule's procedural requirements.

1.8 Is membership of any national franchise association mandatory or commercially advisable?

Membership in a national franchise association is not required, although many franchisors in the U.S. join the International Franchise Association (IFA). Franchisees are also members of IFA.

1.9 Does membership of a national franchise association impose any additional obligations on franchisors?

IFA has a code of conduct and a statement of guiding principles. Neither of these have the force of law, although they may have some influence on how franchisors and franchisees conduct business.

1.10 Is there a requirement for franchise documents or disclosure documents to be translated into the local language?

The FTC Rule and state law require that the FDD be written in plain English. Although this requirement's intended result is an FDD that avoids legalese, it also means that the FDD, the franchise agreement and related documents should be prepared in the English language.

2 Business Organisations Through Which a Franchised Business can be Carried On

2.1 Are there any foreign investment laws that impose restrictions on non-nationals in respect of the ownership or control of a business in the United States?

There are no blanket restrictions on foreign investment in the U.S. The laws that impact foreign investment are information-gathering or disclosure laws (e.g., International Investment and Trade in Services Survey Act of 1976, the Foreign Direct Investment and International Financial Data Improvements Act of 1990, the Agricultural Foreign Investment Disclosure Act of 1978 and the Domestic and Foreign Investment Improved Disclosure Act of 1977). However, the government (at the federal and state level) has imposed limits on foreign investment in certain industries and with respect to certain businesses where there is a potential impact on national security (e.g., maritime, aircraft, banking, resources and power industries and on certain parties to government contracts). The Committee on Foreign Investment in the United States (CFIUS) has authority to review any merger or acquisition with or by a foreign person that may result in foreign control of any person engaged in interstate commerce, if such transaction may have impact on national security.

2.2 What forms of business entity are typically used by franchisors?

The most common types of business entities used by franchisors are "C" corporations and limited liability companies (LLCs). The choice of an entity is driven by legal, financial and tax considerations. Both forms protect owners from personal liability for the debts of the entity (they limit owners' personal liability to the amount of the owners' investment). While governance of corporations is state law-based, governance of LLCs is largely contract-based. Shareholders of C corporations (and electing LLCs) are subject to double-taxation (income is taxed at the corporation level and then shareholders pay tax on distributions received), but shareholders of C corporations are not themselves considered engaged in U.S. business. LLCs are generally treated as flow-through entities for tax purposes with no entity-level income tax; members (owners) of LLCs are considered to be personally engaged in U.S. trade or business and are taxed directly on their *pro rata* share of income of the entity, and have to file U.S. tax returns personally. LLCs offer more flexibility in terms of income allocation, governance, movement of assets out of the entity, etc. Other U.S. entity forms include "S" corporations (flow through entities providing limited liability to its owners but with restrictions as to who can qualify as an owner; e.g., foreign owners cannot invest in "S" corporations), and limited liability partnerships (LLPs) (flow-through entities similar to LLCs, which also subject their partners to direct U.S. tax liability, but usually with less management and structuring flexibility and greater liability exposure to the managing partner).

2.3 Are there any registration requirements or other formalities applicable to a new business entity as a pre-condition to being able to trade in the United States?

Once a business entity is formed (by filing governing documents with the Secretary of State of the state of formation), the entity will need to apply for employer tax ID (by filing a form S-4) with the U.S. Internal Revenue Service. If the entity will operate its business in multiple states, it may have to qualify to do business in each such state by

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obtaining a certificate of authority and appointing a registered agent to accept service (i.e., be subject to a lawsuit) in such state on behalf of the entity. As an employer that pays taxable wages or has employees who report tips, the entity must periodically withhold and deposit income tax and social security (FICA) taxes. The entity must also register as an employer with the applicable state department of labour and also obtain workmen's compensation insurance for its employees. Depending on the type of the business, the entity may also be required to obtain various other permits or licences to conduct business (e.g., a sales tax permit or vendor's licence).

3 Competition Law

3.1 Provide an overview of the competition laws that apply to the offer and sale of franchises.

Section 1 of the U.S. Sherman Act prohibits unreasonable contracts, combinations, and conspiracies in restraint of trade. Additionally, all 50 states have statutory analogues to the Sherman Act, or a body of unfair trade practices law that may apply to the franchisor-franchisee relationship. Secondarily, the federal Robinson-Patman Act prohibits price discrimination by a manufacturer among competing customers, and requires that manufacturers offer advertising and promotional services and programmes to customers in a proportionately equal manner. Finally, the FTC has authority to bring unfair trade practices cases under the Federal Trade Commission Act.

3.2 Is there a maximum permitted term for a franchise agreement?

No, there is not.

3.3 Is there a maximum permitted term for any related product supply agreement?

No, there is not.

3.4 Are there restrictions on the ability of the franchisor to impose minimum resale prices?

Although the U.S. Supreme Court held in a 2007 case (*Leegin Creative Leather Products, Inc. v. PSKS, Inc.*) that under the Sherman Act, minimum resale price maintenance would be addressed under the so-called rule of reason, and would only violate the antitrust laws if shown to have an adverse effect on inter-brand competition, more than a dozen states' antitrust laws, including those of California and New York, continue to treat minimum resale price maintenance as *per se* unlawful.

Franchisors have generally been able to impose uniform pricing on franchisees with respect to the servicing of national accounts. National account agreements are typically between a franchisor and a large, national customer and provide that customer with national pricing and other terms. The two principal factors courts have looked to in concluding that a national account programme is not an unreasonable restraint on trade have been whether programme participation on the part of franchisees is voluntary, and whether the franchisor bears a significant share of the economic risk associated with servicing the national accounts. National account pricing programmes structured in these ways should generally withstand federal antitrust challenge.

Some manufacturers have imposed so-called Unilateral Pricing Policies (UPP) on resellers, attempting to rely on a 1919 Supreme Court holding that a supplier of goods is free *unilaterally* to announce a price at which it will insist that its goods be resold and will terminate sales to any reseller who undercuts that price. Pre-*Leegin*, it had been difficult for suppliers to avail themselves of this doctrine without running afoul of the *per se* rule against resale price maintenance agreements, as factually the two scenarios can appear very similar.

Finally, many suppliers, franchisors and others, employ Minimum Advertised Pricing policies (MAP) on resellers or franchisees. Such policies typically set a minimum price at which the supplier's goods may be *advertised*, in print, over the air, or on the internet, but do not restrict the price at which a reseller ultimately sells a product. MAP policies are treated under the rule of reason and have generally withstood antitrust challenge.

3.5 Encroachment - are there any minimum obligations that a franchisor must observe when offering franchises in adjoining areas or streets?

The U.S. competition laws generally do not place any limitations on a franchisor's right to grant an exclusive geographic territory to franchisees or create a duty on a franchisor to provide a protected trade area to a franchisee. Geographic restrictions on a franchisee's operations are analysed under the Sherman Act's rule of reason and are considered reasonable restraints on competition. Similarly, ancillary geographic restraints such as limits on sales from mobile vehicles, and limits on drop-shipping to remote customers, are generally found lawful under the rule of reason analysis.

There may be minimum obligations under state franchise laws and general contract principles. For example, placement of a franchisee in another franchisee's protected territory is a violation of the Minnesota Franchise Act. Some franchisee advocates argue that placing a new franchisee in proximity to an existing franchisee may violate the implied covenant of good faith and fair dealing, but the courts have generally rejected the claim and most franchisors include specific language in their franchise agreements to preclude a "good faith" claim under those circumstances.

The key principle is that a franchisor should be very clear in its FDD and franchise agreement as to what rights it is granting to a franchisee and what rights it reserves for itself or its affiliates with no overlap or gap between the two.

3.6 Are in-term and post-term non-compete and non-solicitation of customers covenants enforceable?

Yes, if reasonable in scope and duration, if they cause no unreasonable anticompetitive impact, and if they are reasonably ancillary to the franchisor-franchisee business relationship with a few notable exceptions like the state of California. In-term covenants of this nature would be unlikely to be found to violate the antitrust laws. Post-term covenants that cover a geographic range significantly larger than the trade area of the franchisees' location(s) could be problematic, and the likelihood that a post-term covenant will be considered unreasonable increases as its duration extends into multiple years.

4 Protecting the Brand and other Intellectual Property

4.1 How are trade marks protected?

Trademarks are protected at common law and by federal law under the Lanham Act (15 USC sec. 101 *et seq.*). A company acquires

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common law trademark protection by using the mark in commerce in connection with the offering of goods or services. The geographic extent of protection for common law trademarks is only as wide as the scope of the actual market area of such use. Trademarks may be registered with the U.S. Patent & Trademark Office. One of the principal benefits of registration is nationwide priority over common law users who adopt the mark after the application date. Thus, registration is particularly valuable for franchisors who wish to expand their businesses across numerous states.

4.2 Are know-how, trade secrets and other business-critical confidential information (e.g. the Operations Manual) protected by local law?

Yes. Trade secrets are generally defined at common law as information that provides a competitive advantage obtained as a result of its confidential nature and which is the subject of reasonable measures to maintain its secrecy. Trade secret protection is governed by state law. Numerous states have adopted, in one form or another, the central provisions of the Uniform Trade Secrets Act. Thus, while there is a fair amount of uniformity in the essential elements of trade secret law among the states, there are important differences depending on which state's law applies. To the extent know-how or other business-critical confidential information is not protected as a trade secret, franchisors must rely on contractual confidentiality provisions.

4.3 Is copyright (in the Operations Manual or in proprietary software developed by the franchisor and licensed to the franchisee under the franchise agreement) protected by local law?

Yes. Copyright is protected exclusively by federal law under the Copyright Act (17 USC 101 *et seq.*). Copyright protects against copying of original works of authorship, which should include the original elements of software and operations manuals. However, to ensure proper ownership of such copyrights, franchisors should employ appropriate agreements (including proper assignment and work made for hire clauses) with vendors or other parties who produce such materials.

5 Liability

5.1 What are the remedies that can be enforced against a franchisor for failure to comply with mandatory disclosure obligations? Is a franchisee entitled to rescind the franchise agreement and/or claim damages?

Only the FTC may bring an enforcement action against a franchisor for violation of the federal disclosure requirements. However, most states have consumer fraud statutes (called Little FTC Acts) that create a private cause of action against a franchisor that violates the FTC Franchise Rule. State franchise disclosure laws typically also have an antifraud provision that allows a franchisee to sue for fraud or misrepresentation in the sale of a franchise.

To recover damages for violation of a disclosure statute or common law fraud, a franchisee must generally prove that the franchisor's fraud caused damages, i.e., that the franchisee in some way relied on the false representation or failure to disclose. A franchisee may, however, rescind or void its purchase of a franchise even if it did not rely on the fraudulent conduct, but the courts place limitations on the ability to pursue such equitable relief. For example, the franchisee must not unreasonably delay seeking to rescind the purchase.

5.2 In the case of sub-franchising, how is liability for disclosure non-compliance or for misrepresentation in terms of data disclosed being incomplete, inaccurate or misleading allocated between franchisor and franchisee? If the franchisor takes an indemnity from the master franchisee in the Master Franchise Agreement, are there any limitations on such an indemnity being enforceable against the master franchisee?

Under the FTC Rule, franchisors and master franchisees are both responsible for compliance with the Rule (i.e., for ensuring that required disclosures are made and are accurate) and are jointly and severally liable for each other's violations. Therefore, the franchisor is directly liable for its own disclosure violations and could be liable for violations by the master franchisee, too. If an indemnity is provided by the master franchisee, it will be enforceable; however, depending on how it is drafted, it may not provide the franchisor with a complete protection from liability for its own direct liability for disclosure violations.

5.3 Can a franchisor successfully avoid liability for pre-contractual misrepresentation by including disclaimer clauses in the franchise agreement?

Possibly. Franchisors uniformly seek to reduce their exposure to fraud claims through disclaimers in the franchise agreement and related documents. The enforceability of the disclaimer varies from state to state. As a general rule, a mere integration clause in a franchise agreement will not bar a fraud claim, but a specific disclaimer that the franchisor made, or that the franchisee relied upon, a particular representation will preclude a fraud claim based on that representation. In short, appropriate use of properly drafted disclaimers is a smart business practice, but franchisors should not view disclaimers as salvation against actual wrongdoing.

5.4 Does the law permit class actions to be brought by a number of allegedly aggrieved claimants and, if so, are class action waiver clauses enforceable despite the expense and inconvenience of individual arbitrations?

Yes, although a court must first "certify" the class action, meaning that it must conclude, among other things, that issues common to the proposed class members predominate over issues that are unique to individual class members. For example, courts generally will not certify a fraud class action because issues like individual reliance predominate over common issues. Franchisors often seek to preclude multi-party lawsuits or arbitration, stating in the franchise agreement that the franchisee may not join with other franchisees in asserting a claim. The franchise agreement often specifically precludes class actions. Class action waivers may not be enforceable under a particular state law in a lawsuit, but they are enforceable in arbitration. The U.S. Supreme Court has held that the Federal Arbitration Act makes class action waivers enforceable and overrides any state law to the contrary.

6 Governing Law

6.1 Is there a requirement for franchise documents to be governed by local law? If not, is there any generally accepted norm relating to choice of governing law, if it is not local law?

The franchise laws of certain states require that a franchise agreement

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be governed by local law. Otherwise, the parties are free to specify in the franchise agreement the governing law of their choice, provided that a U.S. court may disregard the choice of law selection if it is contrary to public policy. Typically, a foreign franchisor will form a U.S. subsidiary to grant franchises in the U.S. and the law of the state of organisation of such U.S. subsidiary would be the governing law of the franchise agreements, except as otherwise required by state law. The choice of law selection in a franchise agreement will not preclude the application of any mandatory provisions of U.S. state franchise laws.

6.2 Do the local courts provide a remedy, or will they enforce orders granted by other countries' courts, for interlocutory relief (injunction) against a rogue franchisee to prevent damage to the brand or misuse of business-critical confidential information?

A franchisor may seek injunctive relief, including emergency/preliminary injunctions, against a former franchisee who is misusing the franchisor's trademarks and/or confidential information. A franchisor may also seek injunctive relief in connection with enforcing an in-term or post-term restrictive covenant, to the extent such provision is included in the franchise agreement and is found valid and enforceable. U.S. courts generally will recognise final and valid foreign judgments, although enforceability can be challenged for several reasons, including assertions that the foreign court did not have personal jurisdiction over the defendant, proper notice was not provided, or the venue was not impartial.

7 Real Estate

7.1 Generally speaking, is there a typical length of term for a commercial property lease?

No. The term of a commercial property lease varies based on business considerations, financing requirements and franchisor requirements.

7.2 Is the concept of an option/conditional lease assignment over the lease (under which a franchisor has the right to step into the franchisee/tenant's shoes under the lease, or direct that a third party (often a replacement franchisee) may do so upon the failure of the original tenant or the termination of the franchise agreement) understood and enforceable?

Yes. Landlords are typically familiar with the rights of the franchisor to step into the franchisee/tenant's shoes under the lease or direct the franchisee/tenant to assign the lease to a third party. Often the concept is included in the lease and a rider, addendum and other agreement among the landlord, franchisee/tenant and franchisor is executed. A recent trend worth noting is that landlords have been more aggressive in requiring franchisors to cure defaults (including past due amounts) as a condition of the franchisor exercising option or assignment rights.

7.3 Are there any restrictions on non-national entities holding any interest in real estate, or being able to sub-lease property?

Yes. As mentioned in Section 2 above, federal law prohibits foreign persons and entities from owning directly many types of federal oil, gas and mineral leases, and also provides authority for the President to block foreign acquisitions of U.S. companies in situations, among others, where U.S. national security, natural resources, energy security, or critical infrastructure are involved. CFIUS has the authority to investigate these proposed acquisitions.

Also, the Foreign Investors in Real Property Tax Act provides that the foreign owners of U.S. real estate (or foreign investors in entities whose value is predominantly attributable to U.S. real estate) are generally subject to U.S. tax, as if they were engaged in a U.S. trade or business, upon the sale of such real estate or sale of their ownership interests in such entities.

7.4 Give a general overview of the commercial real estate market. Specifically, can a tenant reasonably expect to secure an initial rent free period when entering into a new lease (and if so, for how long, generally), or are landlords demanding "key money" (a premium for a lease of a particular location)?

Generally, the real estate market is improving, but commercial tenants are often able to obtain a free rent period upon lease execution in most locations. There are still some highly-sought-after locations where landlords are able to charge a premium.

8 Online Trading

8.1 If an online order for products or request for services is received from a potential customer located outside the franchisee's exclusive territory, can the franchise agreement impose a binding requirement for the request to be re-directed to the franchisee for the territory from which the sales request originated?

Yes. This online order example underscores the importance of the franchisor stating very clearly in its FDD and franchise agreement what "territory" rights are granted to the franchisee and what rights the franchisor reserves to itself and its affiliates. One best practice that franchisors should consider is to avoid using the term "exclusive" territory as franchisees who hear or see the word "exclusive" believe that the franchisor will do nothing in the franchisees' territory.

8.2 Are there any limitations on a franchisor being able to require a former franchisee to assign local domain names to the franchisor on the termination or expiry of the franchise agreement?

No. A franchisor can and should require a former franchisee to assign local domain names to the franchisor on the termination of the franchise agreement. Such provisions complement the more basic requirements that a franchisee must cease all use of the franchisor's trademarks upon termination of the franchise agreement when the license to use such marks expires.

9 Termination

9.1 Are there any mandatory local laws that might override the termination rights that one might typically expect to see in a franchise agreement?

Yes. Although the FTC Rule is not a franchise relationship law, as noted in the response to question 1.2, certain states have relationship laws that prescribe grounds on which a franchisor may

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terminate a franchise and may impose a statutorily prescribed cure period. Typically, these state laws require a franchisor to have good cause to terminate a franchise agreement (good cause generally exists if a franchisee has breached a material obligation under the franchise agreement) and may provide a franchisee a cure period (30 to 90 days) to cure the default with a few exceptions for immediate termination with no opportunity to cure. Because these state laws trump any default and termination provisions in a franchise agreement, it is important for a franchisor to exercise care in evaluating how to proceed if a franchisee is in default of its obligations under the franchise agreement.

10 Labour Laws

10.1 Is there a risk that a franchisee or a franchisee's employees might be treated as the employees of the franchisor, so that the franchisor has vicarious liability for their acts and omissions? If so, can anything be done to mitigate this risk?

As a general matter, franchisees are independent contractors, not employees, of the franchisor. Given the controls inherent in a franchise relationship, there is some risk that a franchisor may be held vicariously liable for the actions of its franchisees or their employees. Additionally, depending on the structure of the franchise relationship and the amount of control exercised, a franchisor may be subject to a determination that it is the employer of the franchisee, or the joint employer of the franchisee's employees. Franchisors can mitigate these risks by ensuring that the controls being exercised by the franchisor are for the limited purpose of protecting the franchisor's trademarks and goodwill. The controls should be limited to system controls and quality standards imposed to ensure uniformity and consistency across the brand. Franchisors should avoid imposing controls over the hiring, firing, compensation, and supervision of the franchisee's employees.

These vicarious liability, joint employer and employee/independent contractor issues are critically important to franchisors and the franchise business model. It is not business as usual in today's business and regulatory environment. It is incumbent upon a franchisor, therefore, to carefully consider how to apply the key pressure points in an effective and proactive manner.

11 Currency Controls and Taxation

11.1 Are there any restrictions (for example exchange control restrictions) on the repatriation of royalties to an overseas franchisor?

The United States permits the transfer of funds to overseas recipients, including foreign franchisors, without the formal exchange control procedures in place in many countries. U.S. financial institutions do have to report transfers of funds abroad in excess of $10,000 to various governmental agencies. Financial institutions that transfer funds abroad also require confirmation that the foreign recipient institution is a participant in the U.S. disclosure program under the recent "Foreign Account Tax Compliance Act".

11.2 Are there any mandatory withholding tax requirements applicable to the payment of royalties under a trade mark licence or in respect of the transfer of technology? Can any withholding tax be avoided by structuring payments due from the franchisee to the franchisor as a management services fee rather than a royalty for the use of a trade mark or technology?

Yes. U.S. tax law imposes a 30% withholding rate on payments abroad of royalties under an intellectual property licence. This rate can be reduced, or in some cases eliminated, if a U.S. tax treaty applies to the U.S. licensee and foreign licensor. The reduced withholding rates under applicable treaties generally vary between 15% and 0%. Eligibility for a treaty's lower withholding rate is certified to the U.S. licensee/franchisee by the foreign recipient/licensor first filing the applicable IRS Form (e.g., Form W-8BEN or W-8BEN-E with the U.S. licensee). Payments for U.S. source management services are normally subject to the standard U.S. 30% withholding rate, unless reduced by the rare tax treaty (e.g., U.S.-India tax treaty).

11.3 Are there any requirements for financial transactions, including the payment of franchise fees and royalties, to be conducted in local currency?

Generally, no. The *business operations* of the U.S. franchise units will be conducted in U.S. currency. However, when transferring payments of franchise fees and royalties out of the U.S., U.S. banks generally follow two approaches: (1) many major U.S. banks can wire most foreign currencies to the major foreign destinations (the sender will likely need to have an account at the wiring U.S. bank and must pay a fee for the wire plus purchase the desired foreign currency at the sending bank's FX rate); or (2) if the foreign currency cannot be wired, the U.S. bank can wire U.S. dollars abroad (for a fee), and the local recipient bank will then purchase the desired foreign currency at its FX rate on the local or spot market. In either case, transfers of (or a series of planned transfers totalling) US$10,000 or more will be reported by the wiring U.S. bank to appropriate governmental agencies. Also, the wiring bank must satisfy itself that the requisite U.S. tax withholdings have been properly accounted for with respect to the wired funds.

12 Commercial Agency

12.1 Is there a risk that a franchisee might be treated as the franchisor's commercial agent? If so, is there anything that can be done to help mitigate this risk?

The risk is relatively small and can be mitigated by careful drafting of the franchise agreement and by appropriate conduct of the parties. The franchise agreement should provide that neither party has the right to act as or hold itself out as the agent of the other, incur debts on behalf of the other or bind the other to any obligation. The parties must conduct business as independent contractors and in accordance with the terms of the franchise agreement. If the franchisee sells goods, then the franchisee should take title to those goods and resell them in its own name to its customers. If the franchisee provides services, then the franchisee should provide those services itself, in its own name, and should not contract or subcontract to have the

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services provided by the franchisor or its affiliates. The franchisor's compensation for the goods or services it provides should be paid directly by the franchisee and not by the franchisee's customers. The proper separation of roles, responsibilities, and authority will help avoid the U.S. franchisee being found to be an agent of the foreign franchisor and thus avoid the franchisor being considered engaged in a U.S. trade or business for U.S. tax purposes or otherwise for legal purposes.

13 Good Faith and Fair Dealings

13.1 Is there any overriding requirement for a franchisor to deal with a franchisee in good faith and to act fairly according to some objective test of fairness and reasonableness?

The common law principle that all commercial contracts include an implied covenant of good faith and fair dealing generally applies to franchise agreements. This implied covenant provides that a party to the agreement must not perform in a manner that is inconsistent with the other party's reasonable business expectations and does not deprive the other of the benefits of the agreement. Courts, however, will not impose the implied covenant to override the express terms of the contract. One area to note is where franchisors reserve the discretion to act or make decisions, as some courts will use the covenant of good faith and fair dealing to assess whether a franchisor has abused its discretion. A franchisor, therefore, needs to understand the contours of the implied covenant and how franchisees might use the implied covenant, so that the franchisor can assess any risks and appropriately grow, evolve and protect its franchise brand and system. The difficulty is that an objective test is tough to apply in these situations as what the franchisee feels is fair and reasonable is through the lens of its business, while the franchisor is making decisions that typically apply to the overall brand and franchise system.

14 Ongoing Relationship Issues

14.1 Are there any specific laws regulating the relationship between franchisor and franchisee once the franchise agreement has been entered into?

As noted in the response to question 1.2, several states have franchise relationship laws that create rules governing the conduct of the franchisor during the franchise relationship. Those laws vary from state to state but can impact the following aspects of the franchise relationship: termination only upon notice and an opportunity to cure; restrictions on rights of renewal and transfer (as further noted below in Sections 15 and 16); limiting discrimination among franchisees; protecting franchisee rights of association; and voiding any waiver of protections provided by the statute (venue, choice of law, certain types of releases of claims). These relationship laws are traps for the unwary, although franchisors can navigate these laws appropriately with an understanding of the practical effect of the laws and proactive strategy rather than reactive attempts to unwind decisions.

15 Franchise Renewal

15.1 What disclosure obligations apply in relation to a renewal of an existing franchise at the end of the franchise agreement term?

It is common practice for a franchise agreement to include some type of renewal right as long as the franchisee satisfies the franchisor's renewal conditions. Typically, the right of renewal requires the franchisee to have complied with its obligations during the initial term, sign the then current franchise agreement, and meet other qualifications like a remodel of the franchise business. A franchisor must disclose in its FDD that the franchise agreement that a franchisee must sign on renewal may include different terms and conditions than the one signed for the initial term. A franchisor must comply with the FDD registration and disclosure requirements if it requires a franchisee to sign a new agreement upon renewal. The only limited exception to disclosure might be if no new agreement is required and there is no interruption or change to the franchisee's business.

15.2 Is there any overriding right for a franchisee to be automatically entitled to a renewal or extension of the franchise agreement at the end of the initial term irrespective of the wishes of the franchisor not to renew or extend?

The contractually agreed-to renewal terms and conditions will govern. Franchisees typically are not entitled to an automatic renewal or extension, although in a few states like New Jersey and Wisconsin, franchisees are afforded broader renewal rights, including the benefits of advance notice from the franchisor if the franchisor intends not to renew.

15.3 Is a franchisee that is refused a renewal or extension of its franchise agreement entitled to any compensation or damages as a result of the non-renewal or refusal to extend?

Compensation or damages generally are not available to franchisees as a result of non-renewal, except in those few states that may require a franchisor to buy back inventory from the franchisee or provide some other similar limited form of relief.

16 Franchise Migration

16.1 Is a franchisor entitled to impose restrictions on a franchisee's freedom to sell, transfer, assign or otherwise dispose of the franchised business?

Yes. Most franchise agreements will require that a franchisee notify the franchisor of its intention to sell the business and that any proposed buyer must meet certain conditions (e.g., sign the then current agreement, the buyer must be financially qualified and attend training, the business must be remodeled). The franchise agreement also might grant the franchisor a right of first refusal to acquire the business prior to the sale to a third party.

16.2 If a franchisee is in breach and the franchise agreement is terminated by the franchisor, will a "step-in" right in the franchise agreement (whereby the franchisor may take over the ownership and management of the former franchisee's franchised business) be recognised by local law, and are there any registration requirements or other formalities that must be complied with to ensure that such a right will be enforceable?

Many franchisors include in the franchise agreement some type of "step-in" right as one of their post-term remedies. Although there are no formal registration or similar requirements, in practice the franchisee often refuses to allow a franchisor simply to step-in or a franchisor is not operationally ready to do what is necessary to take

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over the operation of the business. In these situations, then a franchisor must be prepared to seek injunctive relief and demonstrate how the franchisor and the brand will be irreparably harmed if relief is not granted. As noted in other sections, the prudent franchisor also looks for other options to protect the brand, including making arrangements for other franchisees to serve the brand customers.

16.3 If the franchise agreement contains a power of attorney in favour of the franchisor under which it may complete all the necessary formalities required to complete a franchise migration under pre-emption or "step-in" rights, will such a power of attorney be recognised by the courts in the country and be treated as valid? Are there any registration or other formalities that must be complied with to ensure that such a power of attorney will be valid and effective?

Powers of attorney typically are not used under these circumstances.

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