GETTING THE DEAL THROUGH®

Franchise

in 31 jurisdictions worldwide

2012

Contributing editor: Philip F Zeidman

Published by
Getting the Deal Through
in association with:

Advocare Law Office
Advocatia Abogados
Advokatfirma DLA Nordic
Anderson Mōri & Tomotsune
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Franchise 2012
Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 7908 1188
Fax: +44 20 7229 6910

ISSN 1752-3338

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

Law Business Research

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Getting the Deal Through is delighted to publish the fully revised and updated sixth edition of Franchise, a volume in our series of annual reports, which provide international analysis in key areas of law and policy for corporate counsel, cross-border legal practitioners and business people.

Following the format adopted throughout the series, the same key questions are answered by leading practitioners in each of the 30 jurisdictions featured. New jurisdictions this year include Belgium and the Czech Republic.

Every effort has been made to ensure that matters of concern to readers are covered. However, specific legal advice should always be sought from experienced local advisers. ***Getting the Deal Through*** publications are updated annually in print. Please ensure you are referring to the latest print edition or to the online version at www.GettingTheDealThrough.com.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. ***Getting the Deal Through*** would also like to extend special thanks to contributing editor Philip F Zeidman of DLA Piper LLP (US) for his continued assistance with this volume.

Getting the Deal Through
London
October 2011

The president of the company just left a message for you…

Philip F Zeidman
DLA Piper LLP (US)

You are in-house counsel for Worldwide Franchise Corporation – which, despite its name, has only franchised in its own country. You've handled its legal needs, including the legal aspects of its domestic franchising operations, relying principally on yourself and your small staff. You have occasionally called upon The Good Local Law Firm, which has some franchising expertise.

When you arrive in the office Monday morning, a telephone message from the president is already awaiting you.

'Bob, I've spent a lot of time over the weekend thinking about our expansion. We still have plenty of territory to fill in this country, but I can see the day coming when we will be nearing saturation.

'If we want to maintain our growth, it's pretty clear that the time has to come to look internationally. Some of our competitors already are, and others certainly will soon. That's exciting, but obviously also more than a little intimidating.

'I think our initial country targets should be [A, B, C and D], with the next wave probably to be [E, F, G, H and I]. But that's just based on my general knowledge, and what I've read.

'I'll take responsibility for the ultimate selections, of course, but I need your input on the legal considerations – both as to where and when and as to the structure. My guess is that we will go with an area development approach; but in [C, F, and I] it may be appropriate to consider sub-franchising. As I'm sure you would expect, I want to do this as rapidly and as economically as possible.

'Call me.'

(And now, in the spirit of candour, let us acknowledge that the message may have been more along the lines of:

'I got an e-mail from some guy who's ready to pay a boatload of money for the rights to X. I've never heard of X, but work up some papers this afternoon.'

But I digress.)

What do you do now? If the Good Local Law Firm has any experience in international franchising, you may want to call your principal contact there. But unless that experience is both broad and deep, you know that you are highly unlikely to be able to tap into knowledge covering all the countries in which the president is interested, and what you will hear will be largely anecdotal. You recall that there are some publications that rank lawyers in jurisdictions around the world on their experience and reputation in a range of disciplines – and, indeed, that one of them, *The International Who's Who Of Franchise Lawyers*, focuses on franchising.

But you know the president expects more of you than just to serve as a source of referrals to other lawyers. After all, that's why he hired you. And, in any event, it runs against your nature just to turn a new and interesting matter over to an outside lawyer, not to speak of the likely cost (a subject always high on the president's list of priorities).

At a minimum, then, you are going to want to learn something about the questions he's posed: Where can we safely and profitably franchise? Are there considerations that will dictate targeting A before C, or postponing G? And are there arguments militating in favour of one structural approach over others?

You know you will be turning to outside counsel, local or otherwise or both, but first you want to feel some level of comfort with the subject matter. A crash course on franchising in all the countries he's identified would be useful, but not realistic even if one were available. You recall a series on *Doing Business in…* , covering all those countries and more, published by one of the international accounting firms, but you would have to go through separate volumes; and, you now remember, much of the coverage relates to taxation, and there is nothing on franchising. The *Martindale-Hubbell Law Digests* are more manageable logistically, but give you nothing of any depth on the subjects of your interest.

Your *CCH Business Franchise Guide* reprints a number of franchise statutes in other countries. But there is understandably little on case law or implementing regulations, and very little commentary. And, as it turns out, most of the countries targeted by the president do not have franchise-specific statutes.

You recall having seen, or seeing a reference to, some surveys of franchise laws in other jurisdictions, both statutes and case law. You locate a couple of them on a shelf in your office, and see that they are regional, apparently produced as a series of papers on a conference on franchising in Asia, or in Latin America. Here is another, purporting to cover more countries; but it's out of date, and the treatment is both inconsistent among the countries, and much too perfunctory for your needs.

What you need, you realise, is a treatment that covers franchise statutes, if they exist, both of the 'disclosure' and the 'relationship' types; implementing regulations; the principal statutes of a non-franchise nature but which will have a bearing on the transaction; key court decisions; and some practical guidance on the legal requirements to enter into the contemplated transaction. You want all that in a standardised format, so that you can draw distinctions and determine the availability of economies of scale. And you want it in a sufficiently distilled and focused form that you are won't need to read a treatise to find the few passages of direct relevance.

You listen again to the president's final words:

'Call me.'

***

Welcome to *Getting The Deal Through*, and especially to *Franchise*. In content and in format it's been designed to meet the needs you have just identified.

There are two ways to use this volume and its complementary website www.gettingthedealthrough.com:

The traditional technique might be thought of as 'vertical'. As to Country A, for example, you can simply read how the questions have been answered by a lawyer from that country who specialises in franchise law. You'll find that the questions proceed roughly in the order you are likely to have posed yourself. And you'll see that the answers seek to pinpoint what you need to know; where to learn more; and for what purposes you will most need outside counsel.

By the time you've read the chapters on Countries B, C, and D, you will have a pretty clear idea of whether there are any 'show-stopper' countries. And, short of those, you will have identified trouble spots that may dictate deferring consideration of one or more countries until some threshold issues can be explored.

But there is another, and less conventional approach, which might be thought of as 'horizontal'. This is especially useful to the in-house counsel whose company executives – like your president – are considering a programme of entry into a number of countries and want to structure a plan that will not need to be redone 'from scratch' in the case of each country.

Consider how you can utilise this approach to make decisions, which would otherwise need to be revisited in the case of each country:

- What structure will be most readily acceptable?
- Which provisions of my franchise agreement will most frequently raise issues of concern?
- How shall I organise and administer our franchise programme to minimise compliance problems?

Let's look at some specific examples of the questions you will be asking yourself, and how this book and www.gettingthedealthrough.com can guide you to the answers:

- Perhaps my deal can be structured so it will not be a 'franchise' at all. That will certainly be a help in those countries with franchise-specific laws. If there is a recurring pattern in the definitions within the franchise statutes in a number of countries, that might well dictate reconsidering how to structure the fees, for example. See question 9.
- Even if it is a 'franchise', are there any exclusions or exceptions that can avoid coverage in A? Even better, is there a recurring pattern across countries, so that I should consider it in structuring the programme? See question 12.
- What are the language requirements? If virtually every country will require use of its own language, I might as well know that now. See question 37.
- I am especially concerned about confidentiality, because of the structure of my system. In how many of these countries should I anticipate problems? And how might that affect even our initial contacts? See question 34.
- What about the terms of the agreement? If I am going to be constrained in that regard in a number of countries, that may have a bearing on such decisions as the initial fee, the royalties and a range of other matters. See question 38.
- This is a new ball game for us. We need to know how to extricate ourselves if we've selected the wrong candidates, and we need to know what the ground rules will be as to termination in the event of default. See questions 19 and 27.
- What could be just as threatening to us as difficulty in terminating would be a requirement of unending renewals, which amounts to imposing a relationship in perpetuity. See questions 27 and 29.
- And what law will govern? If only lipservice will be paid to the notion of the parties selecting the governing law, it's better to know that at the outset. See question 38.

Make no mistake about it. This slender volume will not make you an expert in the 'law of franchising' in A or B. And it will certainly not make you authoritative on the many other disciplines that will have a bearing on your franchise programme. What it can do, however, is to distil from otherwise inaccessible or indigestible masses of material what you would need to know about the interface between franchising and, for example, the choice of business form (see question 3); the tax system (5); trademark law (7); and competition law (39).

You may – ultimately you almost certainly will – need to consult with local counsel and tax counsel as well as your principal franchise counsel. And, you may well conclude that, with respect to any particular country, the author of the chapter in this book is the logical point of contact. But, armed with the material provided here, you will be able to do so in a far more informed, disciplined and cost-effective manner.

Now, Bob, it's time to return that call.

Australia

John Sier and Philip Colman
Mason Sier Turnbull

Overview

1 What forms of business entities are relevant to the typical franchisor?

A corporate structure in the form of an incorporated company in accordance with the Corporations Act 2001 (Cth) is the most common form of business entity used by franchisors in Australia. Foreign franchisors have, in our experience, established wholly owned Australian subsidiary companies to conduct their Australian operations. Although the structure is simple to establish, at a cost of around A$1,000, there is the requirement that there be at least one Australian-resident director. As a director has significant power in respect of a company's day-to-day operations, the appointed director must be someone who can be trusted and is able to be controlled. Other than this requirement, the structure is relatively easy to establish and can be set up within 48 hours. Other structures include trust structures, partnerships or joint ventures that may be appropriate, depending upon the specific circumstances.

2 What laws and agencies govern the formation of business entities?

In Australia, the Corporations Act 2001 (Cth) governs the formation of corporate entities. The government authority administering the Corporations Act is the Australian Securities and Investments Commission (ASIC), an independent Australian government body reporting to the Commonwealth parliament and the treasurer in respect of the regulation of financial markets, securities and corporations generally.

We have seen a trend for franchisors with larger franchised networks (most with aggregrated brands and systems) to publicly list – although the global financial crisis has slowed, if not halted, this trend. The Australian Stock Exchange (ASX) has traditionally been responsible for the market supervision of publicly listed companies. However, from 1 August 2010, responsibility for market supervision transferred to ASIC.

3 Provide an overview of the requirements for forming and maintaining a business entity.

If the business entity is a company, the establishment process is generally via the registration of a company at a cost of around A$1,000. It is possible to establish a company yourself, and the ASIC website, at www.asic.gov.au, will provide all relevant details in relation to the formation and operational maintenance of a company. It is also relevant to register the trademarks to be used by the company at this early stage. Ongoing annual reporting requirements to ASIC are required by the Corporations Act 2001. The company's financial records must be retained for a period of seven years. The franchisor also needs to apply for a tax file number (TFN) and register for goods and services tax (GST). An Australian business number (ABN) is evidence of such registration. Further information regarding setting up an Australian business can be found at the government website www.business.gov.au.

4 What restrictions apply to foreign business entities and foreign investment?

Subject to the foreign investment laws briefly discussed below, foreign business entities are not precluded from operating as a franchise system within Australia provided they comply with Australian law (and particularly, laws governing franchising). A foreign business entity may establish an Australian subsidiary.

If the Australian subsidiary is an Australian private company, at least one director of the company must reside in Australia. If the company is an Australian publicly listed company, that company must have at least three directors (two of whom must reside in Australia).

Foreign investment is governed by the Foreign Investment Review Board (FIRB). Whether or not foreign investment approval is required depends upon the type of investment and whether the investment is above a monetary threshold. Most residential real estate acquisitions require prior approval of FIRB, as do certain acquisitions of commercial real estate. Acquisitions of shares in or assets of businesses valued at more than the applicable monetary threshold (which as of 1 January 2010 is A$231 million for non-US investors) require FIRB approval. For US investors, the free trade agreement between Australia and the USA has established different criteria and threshold values depending on whether the investment is within a 'prescribed sensitive sector' of industry. In most instances, these scenarios will not apply to a prospective foreign franchisor unless it proposes to enter the Australian market via an acquisition. Further information can be obtained from the FIRB website at www.firb.gov.au.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Taxation legislation in Australia does not distinguish between franchising and other forms of business. The franchise relationship is affected by income tax, capital gains tax, goods and services tax, stamp duties and other federal and state taxes and charges that might apply, depending upon the legal structure chosen by the franchisor.

Income tax laws are integral in selecting the appropriate structure for the franchise network. Relevant acts are the Income Tax Assessment Act 1936 (Cth) and the Income Tax Assessment Act 1997 (Cth). Furthermore, A New Tax System (Goods & Services Tax) Act 1999 (Cth) imposes goods and services tax on all suppliers of goods and services under franchise agreements.

State taxation, stamp duty, payroll tax and workers' compensation are also important considerations in the franchise business.

Where foreign entities are involved, issues such as withholding taxes in respect of the payment of offshore royalties become relevant. The amount of withholding tax on payment of royalties to the US, UK or France, for example, is at the rate of 5 per cent. As this is far less than the corporate tax rate in Australia at 30 per cent, which corporate profit is then paid out as a fully franked dividend, any credit available for the Australian tax paid is dependent on the shareholding and the double tax treaties in the relevant countries.

Careful planning is therefore required to ensure the best outcome for a foreign franchisor expanding to Australia. Further information can be obtained from the Australian Tax Office website at www.ato.gov.au.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Workplace relations laws exist at federal and state level and regulate the employment of staff by franchisors and franchisees alike throughout Australia. These laws set minimum wage levels that must be paid to all staff, minimum and maximum hours that can be worked and when they can be worked, the provision of minimum annual, sickness and long-service leave entitlements and loadings and penalties that must be paid to staff depending on their job classification and spread of hours. Franchisors and franchisees can avoid many of these obligations through the use of an enterprise agreement – a workplace agreement registered with the federal government.

Federal laws also deal with issues such as unfair and unlawful dismissal, discrimination and harassment, union right of entry and transmission of business.

Several state laws continue to operate, including laws in relation to occupational health and safety, long-service leave and workers' compensation.

Depending upon the type of franchise, franchisors must be particularly mindful of their responsibilities in relation to occupational health and safety. Franchisors may be held to have control over a workplace because they dictate the manner in which the franchise business is operated. Franchisors should seek specialist advice regarding their liability in this area.

In certain circumstances, a franchisee may be a deemed an employee of the franchisor. A requirement that any franchisee incorporate as a pre-condition to entering into the franchise agreement generally eliminates this risk.

7 How are trademarks and know-how protected?

Trademarks, know-how and trade secrets are all protected by intellectual property laws in Australia. Intellectual property includes patents, designs and copyrights, as well as other forms of recognised proprietary knowledge. Applications to register ownership or an interest in intellectual property must be made through IP Australia (an Australian government agency responsible for administering patents, trademarks, designs and plant breeders' rights). A preliminary search of the trademark you wish to use can be conducted on the website www.ipaustralia.gov.au. This site also provides some detailed information about intellectual property in Australia and the registration process.

8 What are the relevant aspects of the real estate market and real estate law?

Franchisors whose franchise model requires business premises often take a direct head lease from the landlord and grant a sub-lease or licence to occupy the premises to their franchisees. In this way the franchisors are able to control the site in the event of default by the franchisee. Certain disclosure obligations must be made in favour of a subtenant or licensee under the various state-based retail leasing legislation. The disclosure statement usually details the more important aspects of the lease or sublease, including rent outgoings and other obligations. Failure to provide the required disclosure can allow the tenant or subtenant to avoid its obligations under the lease in certain circumstances. It is also necessary to provide the head landlord's disclosure statement in most state jurisdictions to ensure full disclosure is made.

In Victoria, there is an obligation to inform the Office of the Small Business Commissioner within 14 days of entering into a retail premises lease. Careful consideration of the franchisor's obligations under the various state-based retail leasing legislation is therefore critical for foreign-based franchisors.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The Trade Practices (Industry Codes – Franchising) Regulations 1998 (the Franchising Code of Conduct), being a regulation under the Competition and Consumer Act, regulates rights and obligations under a franchise agreement.

The Franchising Code of Conduct defines a franchise agreement as an agreement:

- that takes the form, in whole or in part, of any of the following:
  - a written agreement;
  - an oral agreement; or
  - an implied agreement;
- in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor;
- under which the operation of the business will be substantially or materially associated with a trademark, advertising or a commercial symbol:
  - owned, used or licensed by the franchisor or an associate of the franchisor; or
  - specified by the franchisor or an associate of the franchisor;
- under which, before starting business or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:
  - an initial capital investment fee;
  - a payment for goods or services;
  - a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or
  - a training fee or training school fee; but excluding:
    - payment for goods and services at or below their usual wholesale price;
    - repayment by the franchisee of a loan from the franchisor;
    - payment of the usual wholesale price for goods taken on consignment; or
    - payment of market value for the purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.

However, the following relationships are specifically excluded from the definition of a franchise agreement:

- employer and employee;
- partnership;
- landlord and tenant;
- mortgagor and mortgagee;
- lender and borrower; and
- the relationship between the members of a cooperative registered, incorporated or formed under Australian state and federal cooperatives legislation.

10 Which laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises is regulated by the Franchising Code of Conduct. The Australian Competition and Consumer Commission (ACCC) is the government agency that administers and enforces the Competition and Consumer Act and the Franchising Code of Conduct.

11 Describe the relevant requirements of these laws and agencies.

The most significant requirement under the Franchising Code of Conduct is the requirement for the franchisor to give to prospective franchisees and franchisees renewing their agreements a disclosure document. The disclosure document requires the franchisor to give disclosure of a number of matters to the franchisee at least 14 days before receiving any non-refundable money from the franchisee or before the franchisee enters into a franchise agreement. These matters include details of the franchisor and its directors and associates, including their business experience, details of litigation involving the franchisor or its directors, the franchisor's financial information, a summary of the various payments and costs associated with buying, establishing and operating the franchise and a summary of the obligations of the franchisor and franchisee under the relevant franchise agreement.

The disclosure document must be in the prescribed form not only as to the information to be disclosed but also as to the layout of the document. A copy of the franchise agreement (in the form in which it is to be executed) must also be included with the disclosure document.

Franchisors must update their disclosure document at least annually within four months of the end of each financial year. For most franchisors the financial year concludes on 30 June, and therefore the update must take place by 31 October each year. Various amendments have been made to the Franchising Code since it originally commenced. The latest set of amendments has been in effect since 1 July 2010.

The Franchising Code of Conduct also regulates certain terms and conditions of the franchise agreement. This includes, among others, terms associated with the transfer and termination of the franchise agreement and dispute resolution procedures. The Franchising Code also sets out a prescribed procedure for the offer and sale of franchises. Further details are described below.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There are two exemptions or exclusions from the operation of the Franchising Code:

- where another mandatory industry code, prescribed under section 51AE of the Competition and Consumer Act, applies to the franchise agreement; or
- if the franchise agreement is for goods or services that are substantially the same as those supplied by the franchisee before entering into the franchise agreement and the franchisee has supplied those goods or services for at least two years immediately before entering into the franchise agreement and the sales under the franchise are likely to provide no more than 20 per cent of the franchisee's gross turnover for goods or services of that kind for the first year of the franchise.

The Franchising Code will only apply to franchise agreements that satisfy all elements of the definition of 'franchise agreement' contained therein (see question 9).

Foreign franchisors granting only one franchise or master franchise in Australia were exempt from the Franchising Code, but that exemption was removed by amendments that took effect on 1 March 2008.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The Franchising Code of Conduct does not include any operational requirements that a franchisor must meet before it may begin offering franchises for sale. From a practical viewpoint, franchisors are unlikely to be successful in growing their franchise network unless they have been in the business or industry for some time and have established a proven business system, a marketable product or service, effective marketing and growth strategies and good relationships with suppliers. The Franchising Code of Conduct does, however, prescribe certain requirements that must be met before a franchisor can issue each individual franchise, including the requirement that the franchisor must receive certain written statements from the prospective franchisee or its legal, accounting and business advisers, or both, prior to entering into the franchise agreement.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

If a sub-franchisor proposes to grant a sub-franchise to a prospective sub-franchisee, the head franchisor and the sub-franchisor must either:

- each give separate disclosure documents to the prospective sub-franchisee; or
- give a joint disclosure document.

If the sub-franchisor elects to provide its own separate disclosure, the disclosure document is to be in the form required by the Franchising Code and the sub-franchisor must also provide to the franchisee a copy of the head franchisor's disclosure document that must give disclosure of the terms of the franchise agreement between the parties. If the sub-franchisor and head franchisor agree to give a joint disclosure document, it must also address the respective obligations of the head franchisor and sub-franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The disclosure document must be updated each year within four months of the end of the franchisor's financial year.

During any given year, updates to the disclosure document are generally not required but if certain 'materially relevant facts' arise, disclosure of them must be given to all franchisees within 14 days. Materially relevant facts include changes to the majority ownership or control of the franchisor changes to the intellectual property of the franchise network and certain types of enforcement proceedings by public agencies such as the ACCC judgments against the franchisor, insolvency events and the giving of enforceable undertakings to the ACCC.

The disclosure document must be given to a prospective franchisee not less than 14 days before the franchisee enters into a franchise agreement or agreement to enter into a franchise agreement, or pays any non-refundable money to the franchisor or an associate of the franchisor.

16 What information must the disclosure document contain?

The disclosure document must be set out and numbered, and must contain prescribed information and answers to prescribed questions. The form of the disclosure document is set out in clear detail in annexure 1 and annexure 2 of the Franchising Code (although the annexure 2 disclosure document can only be issued where the franchised business has an expected turnover of less than A$50,000 per annum), and includes:

- information pertaining to the franchisor and its associates or directors, including address details and details of business experience;
- litigation history;
- payments to agents for the recruitment of franchisees;

- details of existing franchisees and details of the number of franchises transferred, terminated, not renewed, bought back by the franchisor and franchises that have ceased to operate (including details of past franchisees) for the preceding three financial years;
- franchise site or territory selection procedures;
- intellectual property ownership;
- supply of goods and services to and by franchisees;
- marketing or other cooperative funds;
- payments due under the franchise agreement and otherwise to establish and operate the franchise;
- summaries of the franchisors and the franchisees' obligations;
- other material conditions of the agreement;
- circumstances in which the franchisor has unilaterally varied a franchise agreement or one that may be unilaterally varied in the future;
- whether confidentiality obligations are imposed on the franchisee and, if so, details of the matters that the obligations may cover;
- arrangements to apply at the end of the franchise agreement;
- whether amendments to the franchise agreement will apply on transfer or renewal;
- financial details and earnings information of the franchisor;
- a copy of the franchise agreement in the form in which it is to be executed; and
- any other relevant information that the franchisor wishes to give.

17 Is there any obligation for continuing disclosure?

Under the Franchising Code of Conduct, obligations for continuing disclosure arise if certain 'materially relevant facts' arise, in which case, disclosure of them must be given to all franchisees within 14 days. Materially relevant facts include changes to the majority ownership or control of the franchisor, changes to the intellectual property of the franchise network and certain types of enforcement proceedings by public agencies such as the ACCC, judgments against the franchisor, insolvency events and the giving of enforceable undertakings to the ACCC.

18 How do the relevant government agencies enforce the disclosure requirements?

The ACCC relies upon receiving complaints from persons who consider that disclosure requirements have not been met. The ACCC's Compliance and Enforcement Policy can be found at www.accc.gov.au. Having investigated and found a breach of the Franchising Code of Conduct, the ACCC may seek administrative resolution, issue an infringement notice (a fine), seek enforceable undertakings or instigate court proceedings.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Aside from negotiating and reaching an agreement with the franchisor if the violation has caused loss to the affected franchisee, a franchisee may:

- report alleged breaches to the ACCC in the hope that the ACCC will take up the matter with the franchisor; or
- litigate (usually seeking remedies such as a declaration that the franchisor has failed to comply with the Franchising Code of Conduct, orders declaring the franchise agreement void, rescission orders, orders for the refund of money or damages).

If the violation of the disclosure requirements is discovered within seven days of the franchisee entering into the franchise agreement or paying money to the franchisor (whichever is earlier), the franchisee can exercise its statutory cooling-off right to terminate the franchise agreement. Otherwise, the franchisee has no right to terminate the franchise agreement.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The sharing of liability for disclosure violations is ultimately determined by the court depending on culpability. The Competition and Consumer Act, which underpins the Franchising Code of Conduct, provides for accessorial liability for persons (whether they are directors, employees, contractor or even professional advisers) against whom it can be proved were knowingly concerned in the violation or aided and abetted the violation. Courts have held that for accessorial liability to exist, the actions of those said to be accessories must be deliberate and intentional.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The offer and sale of franchises is generally affected by the principles of common law and, in particular, contract law. It is also regulated by the Competition and Consumer Act that contains provisions regarding misleading or deceptive conduct. In some states, there are laws that affect the sale of small businesses, including franchised businesses. In the Australian State of Victoria, for example, the Estate Agents Act 1980 (Vic) requires a vendor's disclosure statement to be provided to a prospective purchaser of a small business if the purchase price is less than A$350,000 (this statement is commonly known as a 'section 52 statement'), failing which a purchaser may void the purchase contract provided they do so within three months of signing the contract and have not already taken possession of the business.

Franchised businesses are also often affected by the local council regulations in the area in which the business is located, particularly planning regulations.

Other industry codes or laws may also apply, depending upon which industry the franchise business is concerned with. For example, where the franchise is a real estate franchise, motor vehicle dealership or building franchise, further industry regulations will apply on a state-by-state basis.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Other than the franchisor's obligation to provide a prospective franchisee with its current disclosure document, a copy of the Franchising Code of Conduct and a copy of the franchise agreement in the form that the prospective franchisee will be required to sign, there are no general obligations for pre-sale disclosure that would apply to franchise transactions.

Depending on the location and purchase price of the business being sold, a purchaser of a franchised business may receive the vendor's section 52 statement described above that contains some financial information about the business.

There may also be industry-specific regulations regarding pre-sale disclosure that will apply to franchise transactions if the franchised business being sold operates within a particular industry.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If the franchisor engages in fraudulent or deceptive practices, the franchisee may seek remedies under the Competition and Consumer Act (in particular under the prohibition on misleading and deceptive conduct) and in common law on the grounds of misrepresentation.

If a breach of the Competition and Consumer Act is involved, franchisees may also seek the intervention of the ACCC.

Under the common law, a right to terminate the franchise agreement may exist where the party has entered into the franchise agreement induced by a false representation. As a practical matter, the affected party must act quickly, otherwise it may be argued that the affected party has affirmed the franchise agreement and the right to terminate will be lost.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The only franchise-specific law that regulates the ongoing relationship between the franchisor and the franchisee after the franchise contract comes into effect is the Franchising Code of Conduct, which:

- requires the provision of a disclosure document upon renewal of a franchise agreement;
- prohibits franchisors from preventing franchisees from forming an association or associating with other franchisees;
- requires the franchisor to prepare and distribute an annual financial statement detailing all of the marketing fund's receipts and expenses for the financial year within four months of the end of the financial year and have that statement audited (unless 75 per cent of franchisees resolve otherwise within five months of the end of the financial year), and give a copy of the statement and the auditor's report to each franchisee within 30 days after preparing each;
- requires the franchisor to disclose changes in majority control or ownership and certain litigation and judgments within 14 days;
- requires the franchisor to give a franchisee a current disclosure document within 14 days of a request for same;
- prohibits the franchisor from unreasonably withholding consent to a transfer, sale or assignment of the franchised business;
- regulates what steps must be taken before a franchise agreement is terminated; and
- requires parties to participate in mediation if requested by either party.

25 Do other laws affect the franchise relationship?

The franchise relationship is also affected by laws in relation to corporations, intellectual property and other matters that relate to franchising contracts, business relationships and trade practices in general, such as:

- Corporations Act 2001 (Cth);
- Competition and Consumer Act 2010 (and regulations under this Act);
- Fair Trading Act 1999 (Vic) and applicable counterparts in each state;
- Income Tax Assessment Act 1936 (Cth);
- Income Tax Assessment Act 1997 (Cth);
- A New Tax System (Goods and Services Tax) Act 1999 (Cth);
- Occupation Health and Safety Act 1991 (Cth);
- Fair Work Act 2009 (Cth);
- Property Law Act 1958 (Vic) and applicable counterparts in each state;
- Retail Leases Act 2003 (Vic) and applicable counterparts in each state; and
- Estate Agents Act 1980 (Vic) and applicable counterparts in each state.

In addition, other acts that generally govern commercial and business matters, such as liquor licensing, may also apply, depending upon the particular franchise system.

26 Do other government or trade association policies affect the franchise relationship?

The Franchising Council of Australia (FCA) has endorsed the FCA Member Standards, which is a mandatory code of conduct for its members. This may affect the franchise relationship and the way that members are permitted to behave in a franchise relationship while being members of the FCA.

Membership of the FCA is voluntary and the FCA has no statutory authority or power. There is no precondition to becoming a member of the FCA. It is relatively easy to become a member upon paying the membership fee.

More information about the FCA can be found at its website www.franchise.org.au.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchisor may terminate a franchise relationship in the following circumstances:

- the franchisee breaches the franchise agreement and does not remedy that breach after being given reasonable notice by the franchisor:
  - that it proposes to terminate the franchise agreement because of the breach;
  - telling the franchisee what the franchisor requires to be done to remedy the breach; and
  - allowing the franchisee a reasonable time to remedy the breach (that is not required to be more than 30 days);

A franchisor may terminate a franchise relationship immediately if:

- the franchisee no longer holds a licence that it must hold to carry on the franchise business;
- the franchisee becomes bankrupt or insolvent under administration or an externally administered corporate body;
- the franchisee voluntarily abandons the franchised business or the franchise relationship;
- the franchisee is convicted of a serious offence;
- the franchisee operates the franchise business in a way that endangers public health or safety;
- the franchisee is fraudulent in connection with the operation of the franchised business; or
- the franchisee agrees to the termination of the franchise agreement.

Other matters may constitute a breach of the franchise agreement, which may allow the franchisor to terminate the franchise agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate the franchise relationship:

- within seven days of signing the franchise agreement or making a payment under the franchise agreement (the cooling-off period);

- with the consent of the franchisor;
- in accordance with any other rights under the particular franchise agreement; or
- in common law if:
  - the franchisor has repudiated the franchise agreement by indicating that it no longer wishes to be bound by its terms;
  - the franchisor breaches an essential term of the franchise agreement; or
  - the franchisee was induced to enter into the franchise agreement by a false representation or statement and has not, since becoming aware of the falsity of the representation or statement, elected to affirm the franchise agreement.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

There is no obligation to renew unless a contractual right is granted in the franchise agreement. A franchisor may refuse to renew the franchise agreement with a franchisee, provided circumstances exist that, under the terms of the expiring franchise agreement, entitle the franchisor to refuse to renew the franchise agreement.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

The Franchising Code of Conduct provides that the franchisor may not unreasonably withhold consent to a transfer. It further provides that it would be reasonable for the franchisor to withhold consent to a transfer in certain circumstances, including where:

- the proposed transferee is unlikely to be able to meet the financial obligations that the proposed transferee would have under the franchise agreement;
- the proposed transferee does not meet a reasonable requirement of the franchise agreement for the transfer of a franchise;
- the proposed transferee has not met the selection criteria of the franchisor;
- agreement to the transfer will have a significantly adverse affect on the franchise system;
- the proposed transferee does not agree in writing to comply with the obligations of the franchisee under the franchise agreement;
- the franchisee has not paid or made reasonable provision to pay an amount owing to the franchisor; or
- the franchisee has breached the franchise agreement and has not remedied that breach.

Further obligations may be imposed upon the transfer under the franchise agreement. A common obligation is the requirement that a transfer fee be paid. Transfers of ownership interest or change of control in a franchisee entity are often deemed to be an assignment or transfer by the franchisee and may thus trigger the transfer provisions.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Unless the interest clause constitutes a 'penalty clause' (that is, something that goes beyond what would be a genuine pre-estimate of the loss a franchisor would suffer by reason of a non-payment of money), then there are no restrictions on the amount of interest that can be charged on overdue payments. A rate of 3 per cent to 4 per cent above the overdraft rate charged to the franchisor by its bankers would be unlikely to constitute a penalty.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no such restrictions on a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency, other than compliance with the relevant withholding tax obligations referred to in question 5.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable provided they are drafted in sufficiently clear language.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

The law regarding good faith in Australia is developing. In the recent review of the Franchising Code of Conduct, a recommendation was made that the parties to a franchise agreement act in good faith. This has not as yet been adopted by the government, although the amendments to the Franchising Code of Conduct that took effect from 1 July 2010 confirm that nothing in the Code limits any obligation imposed by common law. Australia's highest appellate court, the High Court of Australia, is yet to hold that an obligation to act in good faith is a necessary legal incident of the franchise relationship. However many state courts have so ruled and the practice in Australia is for parties to assume that mutual obligations to act in good faith are implied into franchise agreements.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

From 1 January 2011 the Competition and Consumer Act imposes various consumer guarantees in respect of goods or services provided up to A$40,000 regardless of purpose or use. In other words franchisees may be treated and have the same protection as consumers in respect of supplies of goods or services by the Franchisor if the value of the transaction is less than A$40,000.
Consumer guarantees include (but are not limited to) in respect of goods, that they are:

- of an acceptable quality;
- reasonably fit for a represented or disclosed purpose; and
- free from undisclosed encumbrances.

Also, in respect of services (they include but are not limited to):

- that they will be rendered with due care and skill; and
- that they will be supplied within a reasonable time (when no time is set).

Further information is available from consumer/au.gov.au.

37 Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements must be written in English.

38 What restrictions are there on provisions in franchise contracts?

The Franchising Code of Conduct:

- prohibits provisions in franchise agreements requiring a franchisee to sign a general release of the franchisor from liability towards the franchisee and a general waiver of representations; and
- requires that the complaint handling and dispute resolution procedure specified therein be included in the franchise agreement.

Update and trends

There have been recent attempts to introduce state-based franchising laws In some states of Australia. State governments have conducted enquiries and have generally decided against such moves.

There is ongoing debate in various states, with the Franchise Council of Australia vigorously opposing any state-based legislation. For more information follow the links at www.franchise.org.au.

There are other restrictions on provisions in franchise contracts that apply at law and by virtue of statute. For example, the Competition and Consumer Act prohibits provisions that provide for certain anti-competitive conduct, such as price collusion, third line forcing, resale price maintenance and other forms of exclusive dealing.

A detailed explanation of these terms is beyond the scope of this chapter. Further information regarding the restrictions on the provisions in franchise contracts can be found on the ACCC website at www.accc.gov.au.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition law in Australia is contained in the Competition and Consumer Act. Relevant parts of the Competition and Consumer Act to franchising are:

- the requirement to comply with the Franchising Code;
- the prohibition of misleading and deceptive conduct;
- the prohibition of unconscionable conduct;
- the prohibition of price collusion between competitors and other forms of cartel conduct between competitors;
- the prohibition of resale price maintenance; and
- the prohibition of third line forcing or other forms of exclusive dealing.

In relation to the fourth, fifth and sixth items above, exemption from the prohibition may be sought from the ACCC through the process known as authorisation or notification or both.

Further information regarding the competition law that applies in Australia can be found on the ACCC website at www.accc.gov.au.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

There are state and federal courts in Australia. Federal court jurisdiction is limited to matters where a breach of federal laws is alleged (for example, the Franchising Code of Conduct and the Competition and Consumer Act). State courts can generally hear most matters, with the exception of certain claims under the Competition and Consumer Act and under the Corporations Act.

In most states, there are three levels of courts, with the lower two levels having monetary limits on their jurisdiction. The highest court in each state is called the Supreme Court. Each state Supreme Court and the Federal Court has appellate jurisdiction.

The highest appellate court in Australia is the High Court of Australia. This court hears constitutional matters and (subject to special leave to appeal being given) appeals from the state and federal appellate courts.

The most common form of dispute resolution process in franchising is mediation. The Franchising Code of Conduct requires dispute resolution provisions to be inserted Into all franchise agreements. It is common for franchise agreements to make mediation mandatory prior to litigation.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Adjudication of disputes via arbitration is not common in Australia, save where an international party is involved. This is because:

- civil litigation in Australia is adjudicated by judges only (not juries)
- the processes and cost of court proceedings are often more favourable than the arbitration process; and
- mediation tends to result in a high proportion of disputes being resolved.

In reality, there is no significant advantage for foreign franchisors in including arbitration clauses that require arbitration to be conducted in Australia in their franchise agreements. This is because:

- the arbitration process is not necessarily faster than court processes;
- the arbitration process is not necessarily more cost-effective than court processes;
- there is a higher risk of a decision not being strictly in accordance with law; and
- there are more limited rights of appeal against an arbitrator's award.

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Foreign franchisors may wish to include in their franchise agreements arbitration clauses that require arbitration to be conducted in their resident jurisdiction. Provided these clauses are properly drafted and proper disclosure is given to a franchisee, such clauses will be upheld by Australian courts, resulting in a permanent stay of any court proceeding commenced in breach of the arbitration clause.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

The amendments made to the Franchise Code of Conduct, effective 1 March 2008, now align the obligations of foreign franchisors to those of domestic franchisors to comply fully with the provisions of the Franchising Code of Conduct: that is, foreign franchisors are not treated differently from domestic franchisors.

Austria

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Franchisors are free to choose any form of business entity existing under Austrian law. The most common forms are:

- limited liability companies, such as a private liability company (GmbH) or public limited company (AG); and
- partnerships, such as a general commercial partnership (OG) or limited commercial partnership (KG).

The private limited liability company (GmbH) is typically used by franchisors as a business vehicle. Please see question 3 for further information.

An international franchisor located outside Austria is not required to form an Austrian entity for offering or selling franchises in Austria and is entitled to set up a branch office in Austria.

2 What laws and agencies govern the formation of business entities?

The Commercial Code (UGB) and Commercial Register Act are requisites for the formation of all business entities (especially the formation and legal framework governing partnerships) and their registration in the commercial register. The formation and legal framework governing private limited liability companies (GmbH) is set out in the Act on Limited Liability Companies and the formation and legal framework governing public limited liability companies (AG) is set out in the Stock Corporation Act.

All business entities must be registered with the commercial register of the respective commercial court at the seat of the business entity.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The requirements depend on the form of the business entity chosen.

Limited liability companies

Generally, the shareholders of limited liability companies are not personally liable for the company (except for the shareholders in a GmbH, where there is personal liability for the obligation to pay capital contributions, whereby a shareholder will be liable for the other shareholders in the case of refunding capital contributions or serious undercapitalisation and insolvency).

For a GmbH, the minimum share capital of the business entity is €35,000. At least half of it (namely, €17,500) has to be contributed in cash prior to the registration of the GmbH with the commercial register. The articles of association – or, if there is only one founding shareholder, the declaration of the foundation of the company – must be in the form of a notarised deed and must be filed with the commercial register. A notarised assignment deed is required for the assignment of shares. A GmbH is represented by one or more managing directors (CEOs), who are appointed by the shareholders. The managing director must act with diligence and care in business. Otherwise, he is personally liable for any damage caused. The election of the supervisory board is voluntary (except in some circumstances). A GmbH must publish its annual accounts in the commercial register.

Public limited liability company

The minimum stock capital of an AG is €70,000 and is split into shares. At least 25 per cent has to be paid prior to the registration of the AG with the commercial register. The articles of association state inter alia the names of the founders, the nominal value per share or the number of non-par value shares, the issue price, the number and types of shares subscribed by each shareholder and the subscription of all shares by the shareholders. The procedure for the formation of an AG is much more costly than the formation of a GmbH in terms of the time and money involved. The corporate bodies of an AG are the shareholders' meeting, the management board and the supervisory board.

Partnerships

An OG can be formed by two or more individuals or legal entities. Each partner is jointly and personally liable for the debts of the OG towards third parties. While not mandatory, the conclusion of articles of association is advisable (no specific form is required). A KG is generally subject to the same legal regime as an OG. Unlike an OG, a KG also has limited partners whose liability for the debts of the KG is limited to a certain amount. At least one partner of the KG has to be a partner with unlimited personal liability. In cases where this partner is a corporation, specific provisions apply.

Sole trader

In Austria, any person is free to engage in and carry out business as a single person. The UGB regulates this area.

Business licence

Anyone wishing to conduct business in Austria, whether a sole trader or large company, needs a business licence that governs the activities in which it will be engaged. According to the Austrian Trade Regulation Act, restrictions do exist, depending on the type of activity sought to be performed and the location of that specific business. 'Trade' is defined as any independent, continuous activity carried out for profit. Excluded from this definition are the exploitation of natural resources, artistic activities, liberal or freelance professions (for example, lawyers and physicians) and business activities governed by specific statutes (for example, banking and insurance). Notifiable trades constitute the vast majority of businesses and may be carried out subject to prior notification to the trade authority. They are subdivided into free trades and regulated trades. The free trades and regulated trades may be carried out if the businessman has not been disqualified from trade (namely, for committing cer-

tain criminal offences or bankruptcy). Furthermore, regulated trades require compliance with specific criteria (namely, age, qualification and experience). Regulated trades and free trades are registered in the trade register. Sensitive trades may only be carried out after a trade licence has been issued by the responsible public authority. Sensitive trades include master builders, wholesalers of pharmaceuticals, etc. Applicants for such a trade licence have to pass a mandatory reliability test.

Besides natural persons, legal entities such as corporations, partnerships and branches of foreign companies may carry out a trade, provided that they have appointed a business representative. The business representative, who can be a different person from the managing director but needs to be an employee of the company (with at least 50 per cent of normal working time, namely, 20 hours per week), is responsible for compliance with industrial trade law provisions.

4 What restrictions apply to foreign business entities and foreign investment?

There are no restrictions for shareholders of business entities in Austria and few restrictions for foreign investors (for example, special provisions regarding acquisitions of real estate by foreign investors from non-EU countries). Imports and exports, other than those within the EU member states, can be restricted by the Foreign Trade Act.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Capital transfer tax

Equity contributions to a corporation by its shareholders, by way of increase or otherwise, are subject to capital transfer tax at the rate of 1 per cent.

Corporate income tax

Corporations are considered as tax residents in Austria if they have their legal seat in Austria or if their effective management is carried out in Austria. Corporate profits are subject to Austrian corporate income tax at a flat tax rate of 25 per cent. However, there is a minimum annual corporate income tax amounting to €1,750 for GmbHs and €3,500 for AGs.

Municipal tax

Municipal tax is levied on all entrepreneurs who employ staff in Austria and amounts to 3 per cent of the gross wages paid.

Personal income tax

Individuals who are permanently domiciled or resident (staying for more than six months) in Austria are taxable on their worldwide income. Non-residents may also be subject to Austrian income tax to the extent of the income generated in Austria. Austria has entered into more than 80 double taxation treaties with countries to avoid double taxation of income. The rate of income tax is progressive and can rise to 50 per cent of annual gross income.

Real estate transfer tax

A real estate transfer tax is generally levied *inter vivos* on the transfer of real estate located in Austria and the amalgamation of a 100 per cent participation in a corporation holding properties with one person. It amounts to 3.5 per cent of the purchase price, or in the absence of consideration (for example, if real estate is transferred by way of a merger), the rate is based on a multiple of a specific tax value.

Stamp duties

The conclusion of certain agreements in writing, including lease agreements and loan agreements, triggers stamp duty at a certain percentage of the contract value.

Value added tax (VAT)

VAT is levied on the supply of goods and provisions of services for consideration carried out in Austria by an entrepreneur, own consumption and import from non-EU countries. The standard VAT rate is 20 per cent of the consideration; in some cases reduced rates of 10 per cent and 12 per cent apply.

Companies whose revenues are subject to VAT are entitled to deduct, as an input VAT, the VAT that other companies have invoiced.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

In Austria there is a risk that a franchisee could be treated as an employee or as a quasi-subordinate employee, with the result that all or significant obligations and duties of an employer apply to the franchisor (for example, competence of the labour court). The main distinction between an independent entrepreneur and an employee is that the employee, personally and economically, depends on the franchisor. Personal dependence can be in the form of being excessively bound to the employer's instructions and directives regarding:

- the subject matter;
- the work method; and
- working time and place.

However, an independent entrepreneur bears the entrepreneurial risk and is mainly free to determine his activities. The risk of being qualified as an employee may be excluded if the franchisee is organised in the form of a business entity (for example, GmbH).

7 How are trademarks and know-how protected?

In Austria trademark rights are protected by way of registration with the trademark register at the Austrian Patent Office. Legal names of persons, company or commercial firm names, trade names, placement and layout of fixtures, external design and appearance – even where not expressly covered by copyright – fall under the protection of the Austrian Unfair Competition Act and the Austrian Civil Code. Registration of words, pictures and letters ensures their protection under the Austrian Trademark Act. A registered trademark provides its holder with an exclusive right to use and transfer the trademark. Trademarks are protected for a renewable period of 10 years from the date of registration. In the event of an infringement, the trademark holder can claim damages and compensation for unjust enrichment, and can also request a preliminary injunction.

Alternatively, the franchisor can either register a trademark as a Community trademark, which has to be registered with the Office for Harmonisation in the Internal Market and which grants protection for all 27 EU countries, or apply for registration of an international trademark managed by the World Intellectual Property Organization in accordance with the Madrid arrangement for Austria that grants protection for approximately 80 countries worldwide.

There is no legal definition of know-how in Austrian law. The EC Block Exemption Regulation No. 2790/1999 (BER) defines 'know-how' as follows:

> *'Know-how' means a package of non-patented practical information, resulting from experience and testing by the supplier, which is secret, substantial and identified: in this context, 'secret' means that the know-how, as a body or in the precise configuration and assembly of its components, is not generally known or easily accessible; 'substantial' means that the know-how includes information which is indispensable to the buyer for the use, sale or resale of the contract goods or services; 'identified' means that the know-how must be described in a sufficiently comprehensive manner so as to make it possible to verify that it fulfils the criteria of secrecy and substantiality[.]*

The safeguarding of the franchisor's know-how is subject to protection under the Austrian Unfair Competition Act. Know-how, as an aspect of intellectual rights, is confidential information and, as such, its protection is secured by means of contractual obligation. Unauthorised use of business secrets can be punishable by criminal sanctions and according to the Unfair Trade Practices Act (civil liability).

Engaging in activities that contravene or give the appearance of contravening standards of public decency or moral turpitude or both (for example, unfair commercial practices and misleading general trade practices) constitutes, in general, a violation of the Unfair Competition Act. Actions that may constitute unfair trade and have an adverse effect on another business entity in the market give rise to injunctive relief and a claim for damages and are also governed by the Unfair Competition Act.

8 What are the relevant aspects of the real estate market and real estate law?

In Austria there are no special franchise-related regulations concerning the real estate market and real estate laws.

Sale or purchase of real estate

The general rules of the Austrian Civil Code apply. The assignment of ownership must be notarised and registered in the Austrian land register. Pursuant to legislation by the nine Austrian federal states concerning the acquisition of real estate by foreigners, EU or EEA citizens usually need 'negative confirmation'; otherwise acquisition proceedings must be notified or are subject to approval. The competent authorities in each federal state shall give their consent to the acquisition of a property by non-EU residents. In general, such approval is granted if the real estate acquirer is resident in Austria or has a resident permit. Please also see questions 4 and 5 for further information.

Commercial leases

Commercial leases are often subject to the Austrian Civil Code and the Tenancy Act. Under Austrian law, it is essential to determine under which regulatory tenancy scheme or regime a certain property falls: under the liberal regime of the Austrian Civil Code or – partly or fully – under the restrictive regimes of the Tenancy Act. As regards properties that are fully governed by the Tenancy Act, the tenant enjoys a high standard of protection, including protection against rent increases beyond a regulated level. For the franchisor it is possible to ensure that he or she can adopt the lease agreement related to the franchisee's business premises should the franchise agreement be terminated by stating such provision in the franchise agreement and by the landlord's acceptance being stated in the lease agreement. As mentioned in question 5, the conclusion of a written lease agreement triggers stamp duty.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no specific legal definition of a franchise and no specific franchise law in Austria. Thus, franchise agreements are subject to general contract law and the principle of freedom of contracts.

Please note that certain provisions of the Commercial Agents Act are applicable to franchise agreements (for example, compensation claims). There is also no specific definition of franchising in the BER as the BER is applicable to all vertical agreements. Nevertheless, according to the Guidelines on Vertical Restraints (2000/C 291/01) (the Guidelines) that do not constitute statutory law, franchising agreements are described as follows:

> *Franchise agreements contain licences of intellectual property rights relating in particular to trademarks or signs and know-how for the use and distribution of goods and services. In addition to intellectual property rights, the franchisor usually provides the franchisee during the life of the agreement with commercial and technical assistance. The licence and the assistance are integral components of the business method. Franchising may enable the franchisor to establish, with limited investments, a uniform network for the distribution of his products. In addition to the provision of the business method, franchise agreements usually contain a combination of different vertical restraints concerning the products being distributed, in particular, selective distribution and/or non-compete and/or exclusive distribution or weaker forms thereof.*

Please also see 'Update and trends'.

10 Which laws and government agencies regulate the offer and sale of franchises?

There are no specific laws or government agencies that regulate the offer and sale of a franchise in Austria. The principle of freedom of contracts applies.

For offers and sales of franchises, besides the general provisions of contract law of the Civil Code, the following Austrian laws must be taken into consideration: the Consumer Protection Act, the Unfair Trade Practices Act and the Antitrust Law.

Generally, according to the Austrian Civil Code, prior to the conclusion of a contract (pre-contractual negotiations) all potential contractual parties are obliged to ensure that the relevant facts have been clearly presented and all necessary and relevant information regarding the envisaged contract is disclosed. The content and scope of this duty depends on the individual case, taking into account the experience and the knowledge of the franchisee. The franchisor shall provide all relevant information about how the franchise system works and its sales forecast. Any lack of information or any misleading information may lead to liability on the basis of a breach of pre-contractual disclosure obligations.

The provisions of the Austrian Civil Code concerning general business terms are applicable. All standard form contracts are subject to a 'fair and reasonable' test. Of particular application are section 864a and section 879, paragraph 3 of the Austrian Civil Code. Section 864a applies to clauses which carry abnormally unusual content or matters which shock the party made subject to the terms; section 879, paragraph 3 addresses situations where one of the parties has received a 'raw deal', was discriminated against or was otherwise made subject to a bad deal. In these situations, regarding section 864a violations, the offending clause(s) lacks validity provided the affected party was not made aware of the content before becoming a signatory thereto. Regarding the violation of section 879, paragraph 3, such clauses are always invalid.

The franchise agreement also may not be *contra bonos mores* (against generally accepted standards of moral turpitude and public decency).

11 Describe the relevant requirements of these laws and agencies.

See question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

See question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

Under Austrian law, there are no specific laws or regulations regarding requirements to be met before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There are no pre-sale disclosure regulations regarding franchise contracts. However, the general rules of the Austrian Civil Code regarding pre-contractual negotiations apply. See question 10.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

In Austria there are no statutory provisions regarding a compliance procedure for making pre-contractual disclosure.

16 What information must the disclosure document contain?

There are no legal provisions or regulations.

The Österreichische Franchise Gesellschaft, a franchise association, follows the UNIDROIT Model Franchise Disclosure Law, which recommends that the franchisor should disclose to their potential franchisees the following information in writing:

- legal name, legal form and legal address of the franchisor;
- trademark, trade name and business name of the franchisor;
- description of the franchise concept;
- information regarding the franchisor's intellectual property to be licensed to the franchisee;
- existence of a pilot business;
- initial and ongoing support by the franchisor;
- required capital and manpower for the franchisee's business;
- rights and obligations of the franchisee;
- any criminal convictions or any finding of liability in a civil action or arbitration involving the franchise;
- any bankruptcy, insolvency or comparable proceeding involving the franchisor;
- information on the categories of goods and services that the franchisee is required to purchase or lease;
- a description of the general and local market of the products or services and the prospects for development of the market;
- accurate information on the profitability of the franchisee's business;
- actual number of franchisees; and
- pending lawsuits with an impact on the potential franchisee's business.

17 Is there any obligation for continuing disclosure?

There are no specific laws governing franchises or disclosure, nor regarding continuing disclosure. Prior to the conclusion of a contract all relevant information should have been presented, but there is no duty for ongoing or continuing disclosure by law. Any lack of information or any misleading information may lead to liability on the basis of a breach of pre-contractual disclosure obligations.

18 How do the relevant government agencies enforce the disclosure requirements?

Not applicable. See question 15.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

In principle, the general provisions of contract law of the Austrian Civil Code apply. In the case of a violation of the franchisor's duty to present the relevant facts, the franchisee has the right to claim damages (*culpa in contrahendo*). The franchisor has to put the franchisee in the position it would have been in if the franchisor had fulfilled its disclosure obligation. If the franchisee agreed to the franchise agreement without full disclosure it may rescind the franchise agreement. The franchisor, therefore, can be ordered to consent to the cancellation of the franchise contract, to pay all obtained franchise fees back to the franchisee and to reimburse the franchisee for all expenses incurred in connection with the franchised business. At the same time, income already earned from the franchise has to be deducted.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A sub-franchisor is solely liable for disclosure violations.

Directors, individual officers and employees of the franchisor are not the franchisees' contractual partners and are therefore not liable on the basis of the contract. Nevertheless, directors and employees can be held liable in case of a violation of their respective duties according to labour law.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See question 10.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There is no specific law governing disclosure in Austria. In general, according to the Austrian Civil Code, prior to the conclusion of a contract (pre-contractual negotiations), all potential contractual parties are obliged to ensure that the relevant facts have been clearly presented and all necessary and relevant information regarding the envisaged contract has been disclosed. The content and scope of this duty depends on the individual case, taking into account the experience and the knowledge of the franchisee. The franchisor shall provide all relevant information about how the franchise system works and also its sales forecast. Any lack of information or any misleading information may lead to liability on the basis of a breach of pre-contractual disclosure obligations.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See question 19.

Update and trends

One hot topic regarding the legal aspects of European franchising is a possible (goodwill) indemnity for franchisees by way of analogy to section 24 Austrian Commercial Agents Act.

Briefly, under certain circumstances a commercial agent shall be entitled to goodwill indemnification if the contract is terminated. The agent shall be entitled to an indemnity if he or she has brought new customers to the principal or significantly increased the volume of business with existing customers and the principal continues to derive substantial benefit from the business with such customers. The payment of this indemnity has to be equitable with regard to all the circumstances.

The German Federal Court took up the fundamental idea of the goodwill indemnity and applies section 89b German Commercial Code (HGB) by way of analogy. One main condition for such an analogy is the integration of the authorised dealers into the sales organisation of the principal in a manner similar to that of a commercial agent.

The Austrian Civil Supreme Court uses the same line of argument to affirm claims for indemnification of authorised distributors. The Court adopted the criteria and arguments developed by the German Civil Supreme Court almost word for word. The Austrian Civil Supreme Court has also cited the German Civil Supreme Court in a considerable number of court decisions.

There have been two rulings issued by the Austrian Civil Supreme Court in which the court held that a subordinate franchisee was entitled to goodwill indemnity under the same arguments as put forward for the indemnity of authorised distributors.

Although the German Civil Supreme Court was the first supreme court to apply the commercial agent's indemnity by analogy to authorised dealers, at present, Austria seems to be the only country within the EU whose supreme court decided on the analogous application of the commercial agent's indemnification for goodwill to franchisees. The Austrian Civil Supreme Court stated that the legal status of a franchisee is 'absolutely comparable' to that of the authorised dealer. Consequently, it applies the same arguments to franchisees that are used for authorised dealers both in German and in Austrian case law.

According to the Austrian Civil Supreme Court, the main criterion for justifying the analogy is an 'integration in the principal's distribution processes comparable to that of the commercial agent'.

The Austrian Civil Supreme Court developed a list of contract clauses that can indicate such an integration of the franchisee or distributor. This list only contains indications that do not have to appear cumulatively. The most decisive factor is a general perspective, whereas the Austrian Civil Supreme Court seems to apply stricter standards on some indications, such as the non-competition clause.

Even section 27, paragraph 1, Commercial Agents Act is applied by way of analogy. Thus, the analogous indemnity is also compulsory and cannot be derogated to the detriment of the franchisee before expiry of the franchising contract.

Basically, the calculation of the franchisee's indemnity in Austria is similar to that of the commercial agent. But before the franchisee's trade margin and the commercial agent's margin can be compared, the franchisee's trade commission has to be adjusted. One example of this adjustment would be that remuneration for administrative work must be deducted as it is usually not part of the commercial agent's activity or is at least not compensated by the principal.

If there is a high degree of brand awareness, the practice of the courts usually makes deductions for what is referred to as *Sogwirkung der Marke* (pull-effect of the brand) for reasons of equitableness. Such a deduction for an authorised car dealer, for example, would range between 10 per cent and 25 per cent. In contrast, there are no deductions if the franchise contract already takes into account the pull-effect of the brand by granting the franchisee a lower trade margin.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect. Generally, the principle of freedom of contracts applies.

25 Do other laws affect the franchise relationship?

Certain provisions of the Commercial Agents Act are applicable to franchise agreements (for example, compensation claims). By applying section 24 of the Commercial Agents Act by way of analogy, under certain circumstances a franchisee may be entitled to (goodwill) indemnification if the contract is terminated. The franchisee may be entitled to an indemnity if he or she has brought in new customers or has significantly increased the volume of business with existing customers and the franchisor continues to derive substantial benefit from the business with such customers. The payment of this indemnity has to be equitable having regard to all the circumstances. The amount of the indemnity may not exceed a figure equivalent to the franchisee's average annual revenue calculated on the basis of its income over the preceding five years.

The provisions of the Austrian Civil Code concerning standard form contracts may also be applicable. Besides the general provisions of contract law of the Austrian Civil Code, the following Austrian laws must be taken into consideration: the Consumer Protection Law, the Commercial Code, the Unfair Trade Practices Act, antitrust law, intellectual property regulations, tax law and the Data Protection Law.

In Austria the initial founder is protected by the Consumer Protection Law. Not all provisions of the Commercial Code may apply to the franchise contract with the initial founder.

26 Do other government or trade association policies affect the franchise relationship?

The Österreichische Franchise Gesellschaft was a pioneer in drafting a regulation regarding the standardisation of franchise systems. Another industry organisation, the Österreichische Franchise Verband, has adopted a code of ethics for franchising. This code of ethics is not legally binding. No other government or trade association policies affect franchise relationships in Austria.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Generally, the circumstances of termination are specified in the franchise agreement.

Franchise agreements under Austrian law generally end through lapse of time, notice or amicable termination. The agreement can be terminated without notice in the case of good cause, which exists if there is a serious infringement of contractual duties (for example, a repeated breach of important rules of the franchise system). Such termination has to take place within a reasonable time after said cause.

28 In what circumstances may a franchisee terminate a franchise relationship?

Both the franchisor and the franchisee may terminate the franchise relationship if there is good cause or any other cause as stipulated in the franchise agreement. See question 25.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The principle of freedom of contract prevails. The renewal of a franchise contract is exclusively subject to the agreement between the parties. Therefore, a franchisor may refuse to renew the franchise agreement without any justification for its decision. Nevertheless, under certain circumstances the franchisors' freedom of decision is limited concerning claims for damages (for example, preceding investments of franchisees).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Transfers of the franchise or restrictions of transfers of ownership interests in a franchise are subject to the principle of freedom of contract. A franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity in the franchise agreement. In particular, the transfer of the franchise is subject to the franchisor's prior written approval.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no specific laws or regulations affecting the nature, amount or payment of fees. These issues are subject to negotiation between the parties. In practice, the franchisee can expect an initial franchise fee (to be paid upon conclusion of the contract), a regular fee (principally depending on a percentage of the realised profits or turnover of the franchisee), a marketing fee, etc.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

For entrepreneurs, the rate of interest for overdue payments is 8 per cent above the base interest rate of the Austrian National bank unless otherwise agreed between the contractual parties.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no such regulations in Austria. The franchisor and franchisee are free to agree on any currency for making payments.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable in Austria. If a franchisee does not comply with its obligation to keep the know-how or business secrets confidential, the franchisor may request an injunction and claim damages from the franchisee.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

In Austria the principle of good faith regulates the enforcement of existing rights – or, in other words, it requires that rights are exercised in good faith. Any contractual party has an obligation to deal with the other party in good faith. A breach of this obligation may be taken into account by a judge with respect to the parties' liability.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In Austria the initial founders are protected by the Consumer Protection Law. Not all provisions of the Commercial Code may apply to the franchise contract.

37 Must disclosure documents and franchise agreements be in the language of your country?

Austrian law does not require the franchisor to provide disclosure documents and franchise agreements in German. But if the franchise agreement foresees Austrian jurisdiction, a certified translation of the agreement will have to be provided in court proceedings.

38 What restrictions are there on provisions in franchise contracts?

Restrictions on provisions in franchise contracts follow Austrian and European antitrust law and consumer protection law. See questions 9, 10 and 25.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Austrian competition law is line with European competition law. The latter is applicable as soon as trade between EU member states is affected.

All forms of competition restraints in distribution agreements, such as non-compete clauses, price-fixing and guaranteed exclusive areas, are in line with European antitrust law. It prohibits agreements between undertakings that may affect trade between member states and that have as their object or effect the prevention, restriction or distortion of competition within the common market. Except for hardcore restrictions such as price-fixing, under certain circumstances exemptions can be made on an individual basis or, if applicable, under a block exemption. Austrian law is in line with European antitrust laws, but Austrian antitrust law regarding misuse of dominant position is wider in scope because it permits the existence of a dominant position when one party has a severe business disadvantage coupled with a reliance on the imposing (and therefore 'dominant') party.

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Non-compete obligations often prohibit the franchisee, during the duration of the agreement, from running a competing business in the same market as the franchise. Such non-compete obligations are subject to competition law, as their effect is the restriction of the franchisee's freedom of business activities and the prevention of other franchisors from distributing their products or services through the franchisee involved. Provisions in franchise agreements essential to protect the franchisor do not constitute restrictions of competition for the purpose of article 101 of the Treaty on the Functioning of the European Union. If a non-compete clause is not essential for the protection of the franchisor, the BER can still apply. In such case non-compete clauses for the duration of the agreement must not exceed a period of five years or longer if the franchisor is the owner or lessor of the business premises. In contrast, non-compete clauses after the termination of an agreement may not exceed one year. These exemptions apply where the franchisor and the franchisee each have less than 30 per cent market share. If a franchise partner has a market share above 30 per cent, an individual self-assessment regarding whether such provision of the franchise agreement restricts competition on the respective market must be conducted.

According to the BER, post-term non-compete clauses are generally invalid. Non-compete clauses for one year are exempted if they apply to competing products or services only, are essential for the protection of know-how and are restricted to the franchisee's sites. It can always be agreed that the franchisee is not allowed to use the know-how provided by the franchisor after the term of the agreement, as long as the know-how is not publicly known.

There are no time restrictions for such clauses.

Every form of direct or indirect price-fixing is strictly prohibited by Austrian and European antitrust law. The franchisee must be free to determine the price of its products or services. Price-fixing clauses cannot be exempted by the BER. Nevertheless, the franchisor is allowed to set maximum retail prices and to issue non-binding price recommendations.

In general, a franchisor cannot be provided with an absolutely exclusive area. Nevertheless, franchisees may be prohibited from distributing actively outside of their exclusive areas. Active distribution consists of all forms of marketing where the franchisee is actively approaching potential customers. Passive distribution is all forms of marketing where the franchisee is not actively approaching potential customers. Passive distribution cannot be prohibited. Consequently, a franchisee is always allowed to deliver goods or render services at the request of a customer, even if this customer is located outside of its exclusive area. Sales over the internet are a form of passive distribution.

Also, according to the BER, restrictions of cross-supplies between distributors are not allowed within a selective distribution system. Consequently, franchisees cannot be prohibited from acquiring cross-supplies from other franchisees, should the franchise system be in the form of a selective distribution system.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The ordinary Austrian courts are district courts, courts of appeal and the supreme court. They have jurisdiction over all civil law matters unless there is a special court for a particular area (for example, the Commercial Court in Vienna for commercial disputes).

Procedural rules and regulations applicable to national and international arbitration are in the Austrian Civil Procedure Code.

Franchisors and franchisees are also entitled to submit all or certain disputes to arbitration.

The most popular arbitration institution is the International Arbitral Centre of the Austrian Federal Economic Chamber in Vienna.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Among the advantages of arbitration is the ability to maintain privacy during dispute resolution: the issue will not be a matter of public record. Negative publicity and media coverage can adversely affect a franchisor's name and may serve to negatively influence the chances of a foreign franchisor receiving a good reception in new markets. Disadvantages are, sometimes, expenses incurred and the fact that the forum for arbitration may not always be convenient for the foreign franchisee.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Generally, foreign franchisors are treated no differently from domestic franchisors. There are differences regarding the purchase of real estate (see question 8).

Belgium

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Belgian limited liability companies (SA and NV) with a minimum capital of €61,500 are relevant to typical franchisors.

2 What laws and agencies govern the formation of business entities?

The Belgian Companies Code.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The requirements are preparing the company statutes and a three-year financial plan together with an attorney's office and accounting expert, and having the statutes authenticated by a notary public. The statutes will be published in the Belgian Official Journal (Moniteur Belge or Belgische Staatsblad) and will be registered on the appropriate commercial register for the area where the business has its registered office. Accounts are to be deposited annually with the National Bank.

4 What restrictions apply to foreign business entities and foreign investment?

There are no restrictions on foreign business entities' participation or foreign investment in a Belgian SA or NV.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Franchises will be subject to the ordinary taxation of company profits.

The applicable corporate tax rates are:

Taxable revenue	Rate
From €1 to €25,000	24.98%
From €25,000 to €90,000	31.93%
From €90,000 to €322,500	35.54%
More than €322,500	33.99%

These tax rates may be reduced by a notional interest mechanism, according to which an amount equivalent to the notional interest on its capital may be deducted from the taxable base of the company. The percentage for the calculation of the deduction will be fixed each year by reference to the long-term interest rates on Belgian bonds, with a ceiling of 6.5 per cent.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The franchise contracts should be drafted and reviewed with the assistance of a lawyer to ensure that they are not assessed either as labour contracts for a salary, as agency contracts or as a contract for a concession (all of which are subject to specific legal rules). The risk that the status of the contract may be re-qualified in one of these ways exists if the contract is not carefully revised to ensure that the franchisee remains an independent contractor.

7 How are trademarks and know-how protected?

Trademarks have to be registered in order to be protected. Separate registration procedures are available for national, Benelux (Belgium, Netherlands, Luxembourg) and EU trademark registrations. The franchisor's needs have to be reviewed to decide which level of protection is most appropriate to its particular case. The franchise know-how can only be protected as such through the franchise contract itself.

8 What are the relevant aspects of the real estate market and real estate law?

Commercial leases and business premises are subject to specific rules. The laws in question apply to all business enterprises, irrespective of their form, and independently of whether or not they have adopted a franchise format. Estate agents and certain specialised consultants can assist the franchisor with such questions.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no definition of 'a franchise' in statute law. According to jurisprudence, a franchise involves the distribution of goods and services in any network using a common trademark, together with know-how transmitted to the franchisees while foreseeing that certain (technical) assistance will be given by the franchisor for the benefit of all the franchisees.

10 Which laws and government agencies regulate the offer and sale of franchises?

The most important statutes are the Law of 6 April 2010 Relating to Market Practices and Consumer Protection, and the Law on the Protection of Economic Competition consolidated on 15 September 2006 and modified by the provisions of the Law of 6 May 2009 making general amendments. These Laws transpose into Belgian statute the applicable EU legislation.

11 Describe the relevant requirements of these laws and agencies.

The Laws mentioned above seek to provide consumer protection, to guarantee fair dealing in commercial matters between competing companies and to ensure that the conditions of competition are effective and will not be compromised by unfair practices such as retail price maintenance or agreements between companies whose object or effect is to restrict competition.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There is no specific law on franchising as such. The (national and EU) rules on competition law must be respected.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The Law on Pre-Contractual Information regarding Agreements to Form a Commercial Business Relationship (the Law of 19 December 2005) regulates the pre-contractual information that must be provided by all franchisors to candidate franchisees at least one month before the signature of the contract.

The Law requires that a draft contract and a pre-contractual information document must be provided setting out certain information in accordance with a mandatory list. Failure to respect the requirements of the Law will entitle the franchisee to invoke nullity of the contract for a period of two years starting from the date of signature of the contract. There are no particular requirements concerning the franchisor company's own experience, either as regards a minimum number of company-owned operations or a minimum period for establishment of franchisor company-owned operations.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In accordance with the Law of 19 December 2005, required pre-contractual information must be given by the sub-franchisor to all proposed sub-franchisees. The contract between the sub-franchisor and the sub-franchisees does not have to be disclosed. The franchisor does not assume responsibilities with regard to the sub-franchisees. These responsibilities are assumed by the sub-franchisor alone. Nevertheless, if the franchisor has committed an actionable fault with respect to the sub-franchisee, the latter may bring an action directly against the franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The Law of 19 December 2005 sets out the information that must be given to the franchisee at least one month before the signature of the contract. This information is given in a pre-contractual information document prepared by the franchisor, which is valid for the duration of the contract. New disclosures must be made, in the required form, at least one month before the signature of any renewal of the contract.

16 What information must the disclosure document contain?

As well as the draft franchise contract itself, a separate document has to be provided that is divided into two sections:

(i) The important contractual provisions, in so far as they are to be included in the commercial relationship, namely:
- whether or not the franchise agreement is concluded intuitu personae (ie, in consideration of the active participation of particular natural person(s);
- the obligations (ie, the significant contractual terms);
- the consequences of a breach of the contractual terms (eg, failure to achieve a contractual commercial target);
- the manner of calculating the fee(s) owed by the franchisee, and how that calculation may be revised during the course of the contract and at its renewal;
- any non-compete clauses, their duration and conditions;
- the length of the franchise agreement and the conditions for its renewal;
- the conditions of notice and of termination of the franchise agreement, notably in relation to expenses incurred and investments made;
- the right of pre-emption or the purchase option of the party granting the franchise, and the rules for determining the value of the business at the time that this right or option is exercised; and
- the exclusive rights reserved by the franchisor.

(ii) Facts contributing to the correct understanding of the franchise agreement:
- the name or correct designation of the party conceding the franchise as well as its contact references;
- if the contract rights are being granted by a corporate person, the identity and the status of the physical person acting on its behalf;
- the nature of the activities of the party conceding the franchise;
- the intellectual property rights whose use is being granted;
- where available, the annual accounts of the last three accounting years of the party granting the franchise;
- the franchisor's experience of operating the franchise, and its experience of operating the commercial formula independently of any franchise agreement;
- the history, current status and future prospects of the relevant commercial market on which the activities are exercised, both from a general and local point of view;
- the history, current status and future prospects of the franchise network's market share, both from a general and local point of view;
- for each of the last three years, as the case may be, the number of franchises belonging to the Belgian and international network, as well as the expansion prospects for the network;
- for each of the last three years, as the case may be, the number of franchise agreements signed, the number of agreements terminated at the initiative of the franchisor, the number of agreements ended by franchisees, as well as the number of agreements that were not renewed at the end of their term; and
- the expenses that the franchisee agrees to incur and investments it agrees to make at the beginning and during the course of the agreement, detailing their amount, purpose and their depreciation term, the investment timetable and how these amounts will be treated at the end of the contract.

17 Is there any obligation for continuing disclosure?

No.

Update and trends

Jurisprudence is currently beginning to develop concerning the application of the Belgian Law of 19 December 2005 on Pre-contractual Information. We have been called on to advise about the annulment of franchise contracts where the legal requirements have not been respected; and on the calculation of damages and interest resulting from such annulments.

18 How do the relevant government agencies enforce the disclosure requirements?

Respect for the legal requirements is ensured by the courts having regard to the litigation that is brought before them. There are no other controls.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Franchisees may apply to the courts for an order in respect of any failure to respect the mandatory pre-contractual legal requirements. If such an order is made within a period of two years after the signature of the contract, the court must annul the contract if the franchisee so requests. The court will require the franchisor to repay to the franchisee all royalties received as well as paying damages in respect of any loss and damage suffered by the franchisee. The franchisee has to prove the existence of such loss and damage. The calculation of the amount of damages may be based on any appropriate legally admissible evidence, notably on the basis of accounting reports.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In principle, the responsibility of the franchisor cannot be invoked except if the franchisor has itself committed some breach with regard to a sub-franchisee. The officers, directors and employees are not liable except in the case of serious misconduct such as would render them liable for their actions through the application of the law generally applicable to companies.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The most important statutes are the Law of 6 April 2010 Relating to Market Practices and Consumer Protection and the Law on the Protection of Economic Competition consolidated on 15 September 2006 and modified by the provisions of the Law of 6 May 2009 making general amendments. These Laws transpose into Belgian statute the applicable EU legislation.

These Laws seek not only to protect consumers but also to guarantee honest conduct in commercial matters between competing companies and to ensure that conditions of free and effective competition are not compromised by prohibited practices such as retail price maintenance or agreements between companies that have as their object or effect the restriction of free competition.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

No.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Independently of the protection offered by the Law of 19 December 2005, customary law will apply to the franchisor; as such, the franchisee can require, as any citizen can, that such law shall be respected.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

No.

25 Do other laws affect the franchise relationship?

The Belgian Civil Code and the customary law of contract (what might be referred to as the 'common law') are the foundation of the relationship between the franchisor and franchisee after the franchise contract comes into effect.

26 Do other government or trade association policies affect the franchise relationship?

No.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

As the parties are free to decide on the terms of their contract, it is necessary to respect what the contract says. If the contract is silent on a particular point, the Civil Code will be the point of reference (for example, as regards annulment of contracts for failure to comply with commercial terms, provision of reasonable notice).

28 In what circumstances may a franchisee terminate a franchise relationship?

For a fixed-term contract, a franchise relationship may be terminated at the end of the term in accordance with the contract provisions. For a contract without a fixed term, a franchise relationship may be terminated at any time provided that reasonable notice is given or in accordance with the notice provisions in the contract. In either case, a franchise relationship may be terminated at any time if the franchisor fails to respect the terms of the contract.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The franchisor can refuse to renew a contract without giving reasons, unless the contract provides to the contrary.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, because the contract is normally one that has a personal character (intuitu personae); but it is always prudent to make express provision for this in the contract terms.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

No.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

No, provided that the interest clause is not abusive: in such a case, the courts may reduce any interest for late payment that is considered as excessive.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes. Non-respect of the requirements of good faith may lead to the annulment of the contract as against the party that fails to respect the requirements of good faith; see article 1134 of the Belgian Civil Code.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No.

37 Must disclosure documents and franchise agreements be in the language of your country?

No, but prudence would suggest that one of the official languages of the country should be used so that the franchisee cannot argue that it failed to understand the documents. Use of another language in commercial relations is not a basis for nullity, but it may permit the courts a margin of appreciation to decide whether a franchisee had properly understood the contract documents. In the case of litigation, the court can require a translation of the documents to be produced.

38 What restrictions are there on provisions in franchise contracts?

There are no restrictions except as regards:

- prices – it is not possible to impose resale prices for products or services that the franchisee shall charge to its customers;
- non-compete clauses – such clauses must be of limited temporal and geographic application, directed to the franchise business and intended to protect the franchisor's know-how;
- application of Belgian law – the pre-contractual phase of the franchise contract is a matter of Belgian law and is subject to the jurisdiction of the Belgian courts, provided that the franchisee carries out the activities that are the subject of a franchise contract principally in Belgium (article 9 of the Law of 19 December 2005); and
- application of Belgian and European competition law.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

- Prices – it is not possible to impose resale prices for products or services that the franchisee shall charge to its customers.
- Non-compete clauses – such clauses must be of limited temporal and geographic application, directed to the franchise business and intended to protect the franchisor's know-how.

The courts will verify compliance with these requirements in the case of litigation. Failure to comply may result in nullity of the contract.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

If there is an arbitration clause in the franchise contract, and if one of the parties so requests, the litigation will be submitted to either one arbitrator or three arbitrators. In the case of dispute, the arbitrator's or arbitrators' decision may be declared enforceable (in whole or in part) by the courts. Otherwise, it is the Commercial Tribunal that will have jurisdiction over disputes with the possibility of an appeal to the court of appeal and, on certain occasions, further appeal to the court of final jurisdiction – the Cassation Court. In certain litigation, questions may be referred by the Belgian court to the Court of Justice of the European Union (for authoritative interpretation of EU law).

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41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The advantage of arbitration lies in the special knowledge of the arbitrators, provided they are well chosen, and in the greater rapidity of the procedure. However, these are not guaranteed benefits. The disadvantages lie in the expense (arbitrators have to be paid, whereas the courts are free (with the exception of certain taxes, which are relatively minor)) and in the possibility to contest an arbitral decision before the courts if an error of procedure or of interpretation of the law has been made.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

There are no differences.

Canada

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Overview

1 What forms of business entities are relevant to the typical franchisor?

There are several different vehicles available to foreign franchisors who wish to carry on business in Canada, each with varying tax and corporate consequences.

The preferred choice of vehicle used for the expansion of a foreign franchise system into Canada is the incorporation of a Canadian subsidiary. By using a Canadian subsidiary, the franchisor has a local direct physical presence and indicates to the general public that it has made a commitment to Canada. Foreign franchisors may instead wish to enter the Canadian market by franchising directly from their country without the creation of a permanent establishment in Canada, thus avoiding being considered by Canadian tax authorities as carrying on business in Canada (see question 5).

2 What laws and agencies govern the formation of business entities?

The federal legislation under which a corporation may be incorporated is the Canada Business Corporations Act (CBCA). Provinces have also enacted similar statutes regulating the formation of corporate entities. The formation of partnerships and other non-corporate entities is governed solely by legislation that is specific to each province. Business entities must usually register with the relevant corporate or business registry of each province in which they wish to conduct business.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Registration mechanisms for forming and maintaining business entities in Canada are generally straightforward, requiring little more than the payment of prescribed fees and the filing of specific corporate or business registry forms that describe, inter alia, the nature of the business, its structure, the scope of its undertakings and basic information regarding its shareholders and directors. Annual filings are also typically required in each of the provinces in which a business entity carries on business and, in the case of corporations incorporated under the CBCA, at the federal level.

4 What restrictions apply to foreign business entities and foreign investment?

Pursuant to the Investment Canada Act, foreign business entities seeking to acquire or establish a Canadian business are required to notify Industry Canada no later than 30 days following such acquisition or establishment. An onerous and thorough review process applies to non-World Trade Organization investors where the asset value of the acquired Canadian business is at least C$5 million for direct acquisitions or C$50 million for indirect acquisitions. The same is true in the case of World Trade Organization investors acquiring control of a Canadian business, but only in cases of direct acquisitions where the asset value of the Canadian business is at least C$312 million. Most franchisors do not meet this threshold. Draft regulations that would gradually raise the threshold to an 'enterprise value' of C$1 billion are under consideration and not yet in force.

Furthermore, it is important to note that certain corporate statutes, such as the CBCA and the Ontario Business Corporations Act, set out requirements as to the residency of directors pursuant to which at least one director (or 25 per cent of the directors if there are more than four) must be a Canadian resident. The corporate statutes of other provinces, such as British Columbia and Quebec, do not impose similar residency requirements.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Generally, three business structures are available to a franchisor wishing to export its foreign franchise system into Canada.

- A foreign franchisor may choose to contract directly with its Canadian franchisees without carrying on business in Canada directly or through a permanent establishment in Canada. In such event, income earned in Canada by the franchisor through royalty payments and rent would be qualified as passive income and subject in Canada to a withholding tax only. The standard withholding tax rate of 25 per cent under Canadian income tax legislation is often reduced to 10 per cent by tax treaties entered into between Canada and other jurisdictions – these should be carefully reviewed and considered at the structural stage of planning any entry into the Canadian market.
- A franchisor may opt to carry on business in Canada using a Canadian branch or division. If the franchisor carries on business in Canada through a fixed place of business or permanent establishment, any income derived in respect thereof will generally qualify as 'business income' that is taxable in Canada on a net income basis. Furthermore, the income of a non-resident franchisor carrying on business through a Canadian branch will typically be subject to a 'branch tax' that is payable at the time the earnings of the subsidiary are accrued (and not at the time the income is paid to the foreign franchisor). In light of the foregoing, few franchisors choose to establish a branch office or division for the purpose of expanding into the Canadian market.
- A franchisor may choose to carry on business in Canada through a federally or provincially incorporated subsidiary. This is the most frequently used vehicle by non-resident franchisors wishing to export a franchise system into Canada. The incorporation of a subsidiary presents certain advantages, including the avoidance of Canadian withholding tax on passive income. Nonetheless, the subsidiary's income would be taxable in Canada on a net income basis and dividends paid to its parent would be subject

to a withholding tax of 25 per cent. This rate is often reduced to between 5 and 15 per cent by tax treaties entered into between Canada and other jurisdictions. The franchisor may also charge a reasonable fee for providing assistance to its Canadian subsidiary in the operation of its business activities with the expectation that a reasonable portion of such fee may then be deducted from the subsidiary's income for tax purposes. Normally, a fee negotiated between arm's-length parties would meet the reasonability test.

In conclusion, significant business and tax consequences arise from each of the above-mentioned structures – a thorough review of all relevant Canadian legislation pertaining to each structure and a careful evaluation of the impact of tax treaties ratified by Canada is highly advised.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Each Canadian province has enacted its own health and safety, employment standards and labour relations legislation. Accordingly, provincial laws and regulations govern most matters relating to labour law (for example, minimum wages, hours of work, overtime, leave, termination of employment, union certification and collective bargaining rights).

Each franchisee must operate as a truly independent and distinct entity from its franchisor so as to be considered a separate employer for labour union certification and collective bargaining purposes. Additionally, even if the franchisee is separately incorporated and operates independently, it is imperative to ensure that there exists no common control or direction emanating from the franchisor that is greater than that which typically characterises the franchisor–franchisee relationship. To do otherwise would be to run the risk of having a union certification or collective agreement with respect to one franchisee being extended to other franchised or corporate outlets. Furthermore, most provincial jurisdictions recognise successor liability following a transfer or sale of a business, such that the new employer is bound by the union certification and, in certain circumstances, by the collective bargaining agreement concluded with the union representing the employees of the sold business.

7 How are trademarks and know-how protected?

The Trade-Marks Act (Canada) defines a trademark as a 'mark that is used by a person for the purpose of distinguishing or so as to distinguish wares or services manufactured, sold, leased, hired or performed by him from those manufactured, sold, leased, hired or performed by others, a certification mark, a distinguishing guise or a proposed trade-mark'. As such, distinctiveness is central to the definition and a trademark need not be registered to be valid, or even licensed, in Canada. Nonetheless, registration with the Canadian Office of Intellectual Property has the advantage of providing nationwide protection of the registered trademark and, in the Province of Quebec, enables the use of any English-only terminology that is a registered trademark (provided no French version of the trademark has been registered) on catalogues, brochures, public signs, posters and other commercial advertising in circumstances where the same would, as a practical matter, be prohibited absent registration. An application for registration may be filed on several bases, namely on previous use or making known in Canada, proposed use in Canada or on foreign use and registration.

Remedies available following the breach of exclusive use clauses or the use of a confusing trademark range from injunctive remedies to passing-off actions that may be instituted before either the Federal Court of Canada or the provincial superior court with territorial jurisdiction.

There is no statutory protection of know-how in Canada. Parties must rely on common law tort and contractual undertakings to protect know-how from unauthorised disclosure or use. Accordingly, the nature of the confidential information that a franchisor wishes to protect, as well as the legal consequences arising as a result of its dissemination, should be clearly identified by the contracting parties in their franchise agreement.

8 What are the relevant aspects of the real estate market and real estate law?

With the exception of the Province of Quebec, all provincial property laws are based on the English common law system, pursuant to which real estate can either be held in fee simple or by way of a leasehold interest. Such interest is registered with the public land registry. Quebec's property laws are based on the French civil law system. They require the registration of ownership rights and permit the registration of lease rights in the public land registry.

No particular restrictions exist as to the nature of the arrangement to be concluded between the franchisor and the franchisee with regard to real (or, in civil law, immoveable) property. For instance, a franchisor may wish to enter into a head lease and sublease the premises to a franchisee. In such circumstances, cross-default provisions as between the sublease and the franchise agreement are advisable so that a right to terminate for breach of one gives rise to a right to terminate the other. In the absence of such provisions, the franchise agreement and the sublease will be construed as two independent contracts and breach of one may not have any bearing on the other. Moreover, it is advisable to include automatic termination provisions in a sublease and a franchisor's right to terminate in a franchise agreement in circumstances where the head lease is terminated.

Generally, foreign ownership of, or the transfer to non-residents of, real estate situated in Canada is not restricted, save for those instances where such real estate benefits from statutory protection given its cultural or historical significance.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The offer and sale of franchises in Canada is regulated by the provinces rather than by the federal government. Definitive franchise legislation is currently in force in only four Canadian provinces: Alberta, Ontario, New Brunswick (NB) and Prince Edward Island (PEI). The most recent of these provinces to have adopted franchise legislation is NB, whose legislation came into force on 1 February 2011. Franchise legislation has also been adopted in Manitoba (Manitoba Act), although the Manitoba Act is still waiting to be proclaimed into force by the government of Manitoba. In addition, the Civil Code of Quebec contains provisions applicable to all contracts governed by Quebec law, including franchise agreements.

The Arthur Wishart Act (Franchise Disclosure) in the Province of Ontario (Ontario Act), the Prince Edward Island Franchises Act (PEI Act), the New Brunswick Franchises Act (NB Act) and the Manitoba Act each generally define a 'franchise' as a right to engage in a business where the franchisee is required to make one or several payments to the franchisor in the course of operating the business or as a condition of acquiring the franchise or commencing operations, and in which the franchisee is granted either:

- the right to sell goods or services substantially associated with the franchisor's trademarks in circumstances where the franchisor or any of its associates has significant control over, or offers significant assistance in, the franchisee's method of operation; or
- representational or distribution rights to sell goods or services supplied by the franchisor or its designated supplier, and the franchisor (or any person it designates) provides location assistance to the franchisee.

The Ontario Act, the PEI Act and the NB Act apply to franchise agreements entered into on or after 1 July 2000, 1 July 2006 and 1 February 2011, respectively, and to renewals or extensions of franchise agreements, regardless of whether such franchise agreements were entered into before or after such date, provided that the business operated pursuant to such franchise agreements is to be operated partly or entirely in Ontario, PEI or NB, respectively. The Manitoba Act is conceptually the same and will apply to franchise agreements entered into, renewed or extended after the date of the coming into effect of such legislation. There is no residency requirement in respect of the franchisee with respect to whom the Ontario Act, the PEI Act, the NB Act or the Manitoba Act apply or will apply, as the case may be.

In Alberta's Franchises Act (Alberta Act), a 'franchise' is defined as a right to engage in a business:

- in which goods or services are sold under a marketing or business plan substantially prescribed by the franchisor or any of its associates and that is substantially associated with any of its trademarks, trade names or advertising; and
- that involves a continuing financial obligation of the franchisee to the franchisor or any of its associates and significant continuing operational controls by the latter on the operation of the franchised business, or the payment of any franchise fee (the latter fee being defined as any direct or indirect payment to purchase or to operate a franchise).

The Alberta Act applies to the sale of a franchise made on or after 1 November 1995 if the franchised business is to be operated partly or entirely in Alberta and if the purchaser of the franchise is an Alberta resident or has a permanent establishment in Alberta for the purposes of the Alberta Corporate Tax Act.

Given the breadth of these definitions, Canadian franchise legislation may cover a number of business agreements and traditional distribution or licensing networks that would not typically qualify as franchise agreements, as the term 'franchise agreement' may be understood in other jurisdictions.

10 Which laws and government agencies regulate the offer and sale of franchises?

Franchise legislation currently in force includes the Alberta Act, the Ontario Act, the PEI Act, the NB Act and the Manitoba Act (collectively, the Canadian Franchise Acts), although the Manitoba Act has not yet been proclaimed into effect, pending adoption of necessary regulations.

Based on a May 2008 report by the Manitoba Law Reform Commission that recommended that the Uniform Franchises Act adopted by the Uniform Law Conference of Canada be the model for Manitoba's franchise legislation with some modifications, the Manitoba Franchises Act was introduced into the Legislative Assembly on 6 April 2010 and was given royal assent on 17 June 2010. Regulations are being drafted and, while there is no formal indication as to when this legislation will come into force, it is expected that this will occur in 2011.

11 Describe the relevant requirements of these laws and agencies.

The Canadian Franchise Acts set forth a number of requirements governing the relationship between a franchisor and a franchisee, the principal ones being the duty of fair dealing imposed upon the parties in respect of their performance of the franchise agreement, the obligation of franchisors to disclose material and prescribed information to prospective franchisees in compliance with the relevant statutory and regulatory scheme, and the statutory right of franchisees to associate with each other and form an organisation.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Exemptions exist in each of the Canadian Franchise Acts as follows:

Full exemptions

The Ontario Act, the Manitoba Act, the NB Act and the PEI Act do not apply to the following commercial relationships:

- employer–employee relationships;
- partnerships;
- memberships in a cooperative association, as prescribed in the NB Act, the PEI Act or the regulations to the Ontario Act, as the case may be;
- arrangements for the use of a trademark, trade name or advertising to distinguish a paid-for evaluation, testing or certification service for goods, commodities or services;
- arrangements with a single licensee in respect of a specific trademark, trade name or advertising if it is the only one of its general nature and type to be granted in Canada;
- any lease, licence or similar agreement for space in the premises of another retailer where the lessee is not required or advised to buy the goods or services it sells from the retailer or any of its affiliates (Ontario Act only);
- oral relationships or arrangements without any writing evidencing any material term or aspect of the relationship or arrangement;
- a service contract or franchise-like arrangement with the Crown or an agent of the Crown (except the Manitoba Act); and
- an arrangement arising out of an agreement for the purchase and sale of a reasonable amount of goods at a reasonable wholesale price or for the purchase of a reasonable amount of services at a reasonable price (except the Ontario Act).

Partial exemptions – the obligation to disclose

The Ontario Act, the Manitoba Act, the NB Act and the PEI Act contain exemptions from disclosure requirements that include, for example, the sale of a franchise to a person to sell goods or services within a business in which that person has an interest, provided that the sales arising from those goods or services do not exceed 20 per cent of the total sales of the business. Exemptions are also set out in the Canadian Franchise Acts in connection with the granting of a franchise if the prospective franchisee is required to make a total annual investment to acquire and operate the franchise in an amount that does not exceed the amount prescribed under each of the Canadian Franchise Acts, currently C$5,000 (threshold not yet determined under the Manitoba Act).

The exemptions set out in each of the Canadian Franchise Acts, while substantively similar, are not identical. Under the Ontario Act, the sale of a franchise to a franchisee who invests more than a prescribed amount (currently C$5 million) in the acquisition and operation of the franchise over a prescribed period (currently one year) is exempted from the application of the disclosure requirements. One does not have to comply with the disclosure requirements under the Alberta Act when granting a licence to a person to sell goods or services within or adjacent to a retail establishment as a department or division of said establishment without requiring that the person purchase goods or services from the operator of the retail establishment.

In addition, each of the Canadian Franchise Acts affirms that a franchisor may apply for a ministerial exemption allowing it not to include its financial statements in a disclosure document.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

Except for compliance with applicable Canadian Franchise Acts and other legislation, there is no requirement – for example, that a franchisor be in business for a minimum period, that a franchisor has operated a minimum number of franchisor-owned operations, or that a franchisor has operated in Canada with franchisor-owned operations for a minimum period – that must be met before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Each of the Canadian Franchise Acts imposes the obligation to disclose upon 'franchisors', the definition of which includes a sub-franchisor with regard to its relationship with a sub-franchisee. Accordingly, pre-sale disclosures must be made to a sub-franchisee by the sub-franchisor in accordance with the same procedural and substantive requirements, and exemptions pertaining thereto, that apply to franchisors with regard to their relationships with their franchisees. Moreover, information regarding a sub-franchisor's relationship with the franchisor must be disclosed to a prospective sub-franchisee, but only to the extent that such information constitutes a material fact or is necessary for the sub-franchisor to properly acquit itself of its duty to furnish the information expressly prescribed by the relevant statutory and regulatory provisions governing disclosure.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

A franchisor governed by any of the Canadian Franchise Acts must furnish a prospective franchisee with a disclosure document not less than 14 days before the earlier of the signing by the prospective franchisee of the franchise agreement or any other agreement relating to the franchise, or the payment of any consideration by or on behalf of the prospective franchisee to the franchisor or any of its associates relating thereto.

The Alberta Act, the Manitoba Act, the NB Act, and the PEI Act, unlike the Ontario Act, exclude confidentiality and site selection agreements from the definition of franchise agreements for the application of the disclosure requirements. In addition, the Alberta Act exempts agreements that only contain terms and conditions relating to a fully refundable deposit (that is, a deposit that does not exceed 20 per cent of the initial franchise fee and is refundable without any deductions or any binding undertaking of the prospective franchisee to enter into any franchise agreement).

A franchisor must also furnish a prospective franchisee under each of the Canadian Franchise Acts with a description of any 'material change' as soon as practicable after the change has occurred and prior to the earlier of the signing of any agreement or the payment of any consideration by the prospective franchisee in relation to the franchise. A 'material change' is defined as a change (even if not yet implemented in certain cases) in the business, operations, capital or control of the franchisor or any of its associates, or in the franchise system, which change would reasonably be expected to have a significant adverse effect on the value or price of, or on the decision to acquire, the franchise.

16 What information must the disclosure document contain?

The regulations under each of the Canadian Franchise Acts (except for the Manitoba Act, which has no regulations as yet) require that general information concerning the franchisor be included in the relevant disclosure document. Such information includes the history of the franchisor, the business background of its directors, the general partners and the officers of the franchisor, and whether any of those persons has been subject to bankruptcy or insolvency proceedings or has been previously convicted of fraud or unfair or deceptive business practices. While substantively similar, the list of information that must be disclosed under each of the Canadian Franchise Acts is not identical.

Financial statements must be included in the disclosure document governed by the Canadian Franchise Acts, although the requirements set out in the regulations adopted under the Alberta Act (Alberta Regulations) differ substantially from the NB Regulations and those adopted under the Ontario Act (Ontario Regulations) and PEI Act (PEI Regulations). For instance, the Ontario, NB and PEI Regulations compel the inclusion in each disclosure document of statements regarding initial 'risk factors', as does the Manitoba Law Reform Commission report on franchise law, whereas those are not required under the Alberta Regulations.

The disclosure document must also include all 'material facts'. This encompasses any information about the business, operations, capital or control of the franchisor, its associates or the franchise system that would reasonably be expected to have a significant effect on the decision to acquire or the value of the franchise.

17 Is there any obligation for continuing disclosure?

None of the Canadian Franchise Acts require continuing disclosure beyond the signing of the franchise agreement or the payment of any consideration by the prospective franchisee to the franchisor with respect to the franchise, whichever occurs first. Before this point, any material change, defined as any change or prescribed change that could reasonably be expected to have a significant adverse effect on the value or the price of the franchise to be granted or on the decision to acquire the franchise, must be brought to the prospective franchisee's attention as soon as practicable.

Despite the lack of explicit continuing disclosure requirements, each of the Canadian Franchise Acts contains a broadly stated obligation of fair dealing. The possibility cannot yet be ruled out that Canadian courts might interpret fair dealing as requiring disclosure of certain material information under certain circumstances.

18 How do the relevant government agencies enforce the disclosure requirements?

Disclosure requirements are typically enforced by the affected parties rather than by government agencies as the interests are generally considered to be private rather than public.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Under each of the Canadian Franchise Acts, an action for damages or rescission may be instituted by the franchisee for non-compliance. The NB Act provides that a party to a franchise agreement may, in the event of a dispute with another party to such agreement, trigger a mandatory alternative dispute resolution mechanism (mediation). The foregoing does not, however, preclude any party to such franchise agreement from availing itself of other recourses available under contract or at law.

Rescission

Pursuant to the Ontario Act, the Manitoba Act, the NB Act and the PEI Act, a franchisee may rescind the franchise agreement without penalty or obligation: 'for late disclosure', no later than 60 days after

receiving the disclosure document if the franchisor failed to provide said document or a statement of material change within the prescribed time or if the contents of the disclosure document do not satisfy statutory requirements; or 'for absence of disclosure', no later than two years after entering into the franchise agreement. In either case, within 60 days of the effective date of rescission the franchisor must:

- purchase from the franchisee any remaining inventory, supplies and equipment purchased pursuant to the franchise agreement, at a price equal to the purchase price paid by the franchisee, and refund any other money paid by the franchisee; and
- compensate the franchisee for the difference between any losses incurred in acquiring, setting up and operating the franchise, and any amounts paid or refunded pursuant to the preceding paragraph.

Should a franchisor fail to provide the disclosure document as required under the Alberta Act, the prospective franchisee is entitled to rescind the franchise agreement by giving a cancellation notice to the franchisor or its associate, as the case may be, no later than the earlier of 60 days after receiving the disclosure document or two years after the grant of the franchise.

The franchisor does not have an obligation to purchase any of the franchisee's assets under the Alberta Act but must instead, within 30 days after receiving a cancellation notice, compensate the franchisee for any net losses incurred by the latter in acquiring, setting up and operating the franchised business.

Damages

Under the Ontario Act, the Manitoba Act, NB Act and the PEI Act, if a franchisee suffers a loss because of a misrepresentation contained in the disclosure document or in a statement of a material change or as a result of the franchisor's failure to comply with any disclosure requirements, the franchisee has a right of action for damages against the franchisor, the franchisor's broker (if any), the franchisor's associates, every person who signed the disclosure document or statement of material change and, under the Ontario Act, the franchisor's agent, all of whom are jointly and severally liable.

Under the Alberta Act, a franchisee who suffers a loss resulting from a misrepresentation contained in a disclosure document has a right of action for damages against the franchisor and every person who signed the disclosure document, on a joint and several basis.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Liability is imposed on franchisors and sub-franchisors for misrepresentations contained in a disclosure document, although the extent and scope of such liability is contingent upon the applicable franchise legislation. Where a franchisor and a sub-franchisor are found liable for misrepresentations contained in a disclosure document, their liability will be of a joint and several nature.

Generally, the officers, directors and employees of a company cannot be sued in their personal capacity for the debts and obligations of the company. Accordingly, a key advantage presented by the subsidiary structure is the creation of a generally effective shield for the foreign franchisor seeking to avoid exposure to liabilities arising in Canada. Nevertheless, liability will not be entirely absorbed by the corporate subsidiary in those cases where a separate entity furnished a guarantee under the franchise agreement or breached its legal or statutory obligations in regards to the same.

The Canadian Franchise Acts extend liability for misrepresentations contained in a disclosure document to a much broader class of persons than those who would otherwise be liable under Canadian common law. Under the Alberta Act, a franchisee has a right of action not only against the franchisor, but also against every person who signed the misrepresentative disclosure document. Similarly, the Ontario Act, the Manitoba Act, the NB Act and the PEI Act each provide that a franchisee may not only claim damages for misrepresentation from the franchisor, but also from the broker and associate of the franchisor as well as every person who signed the relevant disclosure document or statement of material change. In light of the very broad statutory construction given to the term 'franchisor's associate', the principal owner or controlling shareholders of a franchisor who are personally involved in the granting or marketing of the franchise may qualify as franchisor's associates. Similarly, parent companies of Canadian subsidiaries incorporated for the purpose of conducting franchise operations in Canada may also qualify as franchisor's associates where such parent companies participate in the review or approval of the granting of a franchise.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

General principles of law that may affect the offer and sale of franchises vary depending on the province in which a franchisor wishes to grant franchises.

In all provinces of Canada other than Quebec, general common-law principles regarding contract formation govern the offer and sale of franchises. In Quebec, franchise agreements are governed by the general principles of contract formation found in the Civil Code of Quebec and are generally regarded as contracts of adhesion. The Civil Code of Quebec, in an effort to correct a presumed economic imbalance between the parties, provides more favourable interpretation principles and a significantly broader margin of redress for the adhering party to a contract of adhesion than that which would be available absent a contract of adhesion. Furthermore, an abusive clause in a contract of adhesion will be considered null, or the obligation arising from it may be reduced by a court.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There is no such general obligation to disclose under the common law system in Canadian provinces. Nevertheless, the civil law applicable in the province of Quebec does contain general principles applicable to all contracts. Article 1375 of the Civil Code of Quebec establishes that the duty of the parties to conduct themselves in good faith also extends to pre-contractual negotiations and has generally been interpreted as imposing a positive obligation to inform the opposing party of any information which could affect its decision to enter into the contract. This diverges from the fair dealing provisions of the Canadian Franchise Acts that apply only in the 'performance and enforcement' of a franchise agreement.

The obligation to inform can be sanctioned in several ways depending on the situation. If the withheld information is sufficiently important that it would have caused the franchisee not to contract or to contract on different terms, the franchisee's consent is considered to have been vitiated, either due to error under article 1400 of the Civil Code of Quebec (if withheld inadvertently) or fraud under article 1401 (if withheld intentionally). In such cases, the franchisee can apply for annulment of the agreement and damages.

If the withheld information is not important enough to affect the validity of the contract, or if it is but the franchisee nevertheless prefers to maintain the agreement, the franchisee can simply claim damages or a reduction of its obligations set out in the franchise agreement equivalent to the damages to which it would otherwise be entitled.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

The rights conferred by each of the Canadian Franchise Acts are in addition to, and do not derogate from, any other right, remedy or recourse that a franchisee may have in law.

Judicial decisions emanating from the common law provinces reflect a general and growing affirmation of the common law duty of good faith in franchising, the substantive requirements of which will be conditioned by the specific set of circumstances surrounding the formation of the franchise agreement and the conduct of both parties. Where the courts find that there has been a breach of such duty of good faith, the franchisor may be found liable to the franchisee for its damages. Not every breach of such duty will constitute a fundamental breach of the franchise agreement, which fundamental breach would excuse the franchisee from future performance under the agreement.

In addition, pursuant to article 1401 of the Civil Code of Quebec, an error by a party induced by a fraud committed by the other party, or with its knowledge, will nullify consent whenever, but for the error, the misled party would not have contracted or would have contracted on different terms. It is important to note that in Quebec silence may amount to a misrepresentation. Such a fraud could be sanctioned with damages and annulment of the contract or, should the franchisee prefer to maintain the contract, a reduction of its obligations set out in the franchise agreement equivalent to the damages to which it would otherwise be entitled.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Other than the Canadian Franchise Acts, there are no specific statutes directly affecting the franchise relationship.

25 Do other laws affect the franchise relationship?

The ongoing franchise relationship is subject to generally applicable federal and provincial statutes and the principles of contractual law that emanate from the common law or, in Quebec, the civil law.

Canadian courts have been pragmatic in their approach to ongoing relational matters as they relate to franchising. The clear and express terms of a franchise agreement will be determinative of the issues arising in connection with same. If such agreements are unclear on a given point, courts will generally construct the litigious terms in a manner that provides for a 'sensible commercial result'. This has not, however, prevented courts from rendering judgments against franchisors that excessively and unlawfully interfere with the economic interest of their franchisees.

26 Do other government or trade association policies affect the franchise relationship?

No other government policies or requirements directly affect the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

There are no restrictions at law on the parties' rights to contractually establish termination rights and consequences arising upon such terminations. Nevertheless, courts may require that a material breach of the agreement be shown to permit its termination and will, from time to time, intervene to redress cases of abuse.

28 In what circumstances may a franchisee terminate a franchise relationship?

There are no rights at law that would specifically allow a franchisee to terminate the franchise relationship other than those applicable to all contracts under general principles of law and those expressly granted by the Canadian Franchise Acts. Similarly, there is no restriction precluding the parties from granting specific termination rights to a franchisee, although this is not often seen in typical franchise agreements used in Canada.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

In Canada, a franchisor may refuse to renew a franchise agreement with its franchisee unless such renewal is contractually required. The franchisor may contractually subject such renewal to the signature by the franchisee of a new franchise agreement and other conditions, including performance goals that the franchisee is required to achieve.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may contractually restrict a franchisee's ability to transfer its rights and interests under the franchise agreement, most notably by subjecting such transfer to the prior consent of the franchisor.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

No general restrictions apply to payment of initial fees. Where franchises are involved in the sale of liquor in certain provinces, however, a franchisor's ability to collect royalties on such sales may be restricted.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Franchise agreements frequently set out the rates of interest charged on overdue fees and royalty payments. Section 347 of the Criminal Code (Canada) provides that anyone who enters into an agreement to receive interest, or who receives a payment or partial payment of interest, at an effective annual rate of interest (broadly defined) in excess of 60 per cent on the credit advanced, commits an offence thereunder.

In addition, section 4 of the Interest Act (Canada) specifies that unless the contract expresses the applicable rate of interest on an annualised basis, interest will only be recoverable at a rate of 5 per cent per annum despite the terms of the contract.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

A franchisee may be required to make payments in a foreign franchisor's domestic currency. Nevertheless, the Currency Act (Canada) precludes a Canadian court from rendering a judgment in any currency other than Canadian currency.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are not only enforceable but highly advisable in light of the fact that recourse is only otherwise available under common law tort, as opposed to under any specific Canadian statute governing trade secrets or other confidential information. Unlike non-compete clauses, confidentiality clauses usually last for an unlimited period of time, particularly in respect of actual trade secrets.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

The Canadian Franchise Acts impose a general obligation of fair dealing upon the parties to a franchise relationship.

It is established law in Canada that the relationship between a franchisor and a franchisee is generally not a fiduciary one. Nevertheless, Canadian courts (even in provinces without franchise legislation) have generally begun to read into franchise agreements an implied duty of simple good faith (as opposed to 'utmost good faith'). Good faith is a legal requirement in all contractual matters governed by Quebec civil law. Accordingly, the courts have stated that where the franchisor retains sole discretion to authorise, prevent or proceed with a particular course of action, the franchisor will have to exercise its discretion reasonably. In addition, the duty to act in good faith requires a prompt response to another party's request and the making of a decision within a reasonable period of time thereafter. Moreover, parties under a duty of good faith must also pay any amounts that are clearly owed to another party in a timely manner.

The duty to act in good faith does not necessarily preclude a franchisor from competing with its franchisee (assuming, of course, the absence of contractual exclusivity in favour of the franchisee). A franchisor that opts to compete with its franchisee must ensure that it continues to perform its legal obligations towards the latter and that it acts in such a way that the franchisee may continue to enjoy the benefits of its franchise. The common-law principle of non-interference with the freedom of the parties to contract will often limit judicial interference in franchise agreements whose terms are found to accurately reflect the intent of the parties and are not patently inequitable. A determination as to whether a duty of good faith has been breached will be contingent upon all of the surrounding circumstances.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Consumer protection legislation in Canada has been enacted at the provincial level. The applicability of such legislation is generally restricted to transactions entered into for personal, family or household purposes and the legislation generally excludes from its ambit transactions entered into for business purposes. In a 2004 case before the Superior Court of Quebec, a franchisee sought to avail itself of protection under the Consumer Protection Act (Quebec) but was unsuccessful, the Court concluding that the tenor of the correspondence between the franchisee and the franchisor, as well as the nature of the franchise agreement, both clearly implied a commercial relationship falling outside of the scope of the legislation.

37 Must disclosure documents and franchise agreements be in the language of your country?

The Charter of the French Language (Quebec) compels businesses to prepare franchise agreements and disclosure documents in French for use in the Province of Quebec unless the parties have expressly agreed that another language may be used, which is not uncommon in circumstances where both parties are comfortable in such other language.

38 What restrictions are there on provisions in franchise contracts?

Franchise agreements often provide for exclusive territories and exclusive dealings with designated suppliers. These are not per se illegal, but are subject to competition law concerns relating to substantial lessening of competition and market barriers, including the exclusive dealings and abuse of dominance provisions of the Competition Act (Canada). Restrictions on the customers that the franchisee is entitled to serve may not be acceptable as they may be viewed as violating the market division prohibitions of the Competition Act or providing strong evidence of collusion pursuant to the same.

Resale price maintenance provisions set out in the Competition Act prohibit the franchisor from establishing a minimum price at which its products are sold. The mere suggestion of a minimum resale price by the manufacturer or the franchisor, other than on the labelling or packaging of the product, creates a presumption of violation of resale price maintenance provisions. All the same, franchisors may impose maximum prices as long as the latter are clearly referred to and defined in the franchise agreement and are not construed by courts as demonstrating an intent to establish an indirect minimum resale price. Accordingly, it is always prudent for franchisors to include disclaimers, whether in advertising or on packaging, to the effect that franchisees are at liberty to establish their own resale prices. Furthermore, it is preferable to contractually provide that prices are only suggested and that the failure of the franchisee to adhere to the suggested prices will not result in termination of the franchise agreement or detrimentally affect the relations between the parties.

Franchisors who are deemed to control a market are also subject to review by the Competition Bureau under the abuse of dominance provisions in the Competition Act. As of 2009, the criminal pricing provisions addressing price discrimination, predatory pricing, geographic price discrimination and promotional allowances have been repealed with a view to promoting innovative pricing programmes and increasing certainty for Canadian businesses. Nonetheless, such pricing policies may be reviewed under civil provisions of the Competition Act where there is evidence of a likely substantial anti-competitive effect.

Non-competition covenants are closely monitored by the courts. All restrictive covenants raise restraint of trade concerns and, accordingly, only reasonable restrictions as to scope of action (described with sufficient particulars), duration and geographical reach will be upheld by the courts. Canadian courts will generally not write down or reduce restrictive covenants determined to be unreasonable, but will uphold or strike down the covenant in its entirety.

Lastly, all Canadian provinces permit the selection of a foreign governing law as long as doing so is not considered to be in fraud of the domestic law. That said, Canada is party to numerous international treaties such as the Vienna Convention on the International Sale of Goods – where the selected or applicable law is that of Canada, the foregoing Convention finds automatic application unless expressly set aside by the parties in their contract.

Update and trends

Though franchise disputes may seem well suited for alternative means of dispute resolution, franchisees seem ever more likely to pursue class action proceedings against franchisors. In recent years, several class actions by franchisees have been certified by Canadian courts on issues including:

- franchisors' inadequate disclosure of, or failure to share, supplier rebates;
- whether wind-down agreements relating to automobile dealerships constitute franchise agreements;
- whether transfers of a franchise may be conditioned upon the granting by the transferor franchisee of a release of the franchisor; and
- the charging of exorbitant prices for food and other supplies, as well as other matters.

The clear trend in Canadian courts, as has already occurred in the United States, has been to lower the threshold for the certification of class actions based on their findings that there exists a significant impediment to access to justice by way of individual actions by franchisees, as evidenced by the power imbalance that the various Canadian Franchise Acts attempt to redress. In so doing, Canadian courts are demonstrating their view that judicial economy and access to justice is better attained through a reduction of the number of individual cases and the cost-sharing associated with a class action proceeding.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Competition Act sets forth penal and civil recourses with respect to various practices, including those identified as conspiracies and collusion, abuse of dominance, price maintenance, promotional allowances and price discrimination, misleading advertising, deceptive marketing and pyramid selling, refusal to deal, exclusive dealing, tied selling, as well as certain other vertical market restrictions.

While the penal provisions of the Competition Act impose a higher burden of proof, their violation grants injured parties the right to sue for damages caused by such practices; those damages are restricted to actual loss and costs. On the other hand, reviewable practices are civil in nature and are subject to the exclusive jurisdiction of the Competition Tribunal, upon the request of the commissioner of competition or, as of late, at the request of a private party with leave from the Competition Tribunal to that effect. In this latter case, it should be noted that private litigants may only seek redress through orders as monetary awards are not provided for.

The commissioner of competition heads the Competition Bureau and has broad powers of investigation and inquiry, such as search and seizure, examinations under oath, and ordering the production of physical evidence or records and wire tapping (in certain circumstances). Its enquiries are conducted under strict rules of confidentiality and its powers remain subject to the supervision of the courts. On the international level, the Competition Bureau has concluded numerous agreements of notification and mutual assistance with its international counterparts and is an active member of the International Competition Network.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Constitution Act, 1867 sets out the areas of law with respect to which the federal government has the power to legislate (for example, intellectual property, bankruptcy, trade and commerce) and the areas of law with respect to which each provincial government has the power to legislate within provincial borders (eg property and civil rights). Canada also has a dual court system. The Federal Court of Canada has jurisdiction over matters in respect of which jurisdiction as to subject matter is specifically conferred to it by statute, whereas the provincial courts have residual jurisdiction over remaining matters.

Choice of forum clauses are generally enforced by the Canadian courts, thus making it possible for the parties to choose that a non-Canadian court resolve any dispute or claim arising from any agreement. In addition, mediation and arbitration are viable and recognised mechanisms of dispute resolution across Canada. Furthermore, Canada is a signatory party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Both the federal and the provincial governments have also adopted substantially similar legislation to the UNCITRAL Arbitration Model Law. To date, three provinces (Ontario, British Columbia and Saskatchewan) have incorporated mandatory pre-trial mediation into their respective procedural statutes, and most provinces have enacted arbitration legislation.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The principal advantages and disadvantages of arbitration for foreign franchisors in Canada are essentially the same as for local franchisors.

Arbitration has the main advantage of being confidential. Disputes between franchisors and franchisees do not become a matter of public record as would be the case with litigation in the judicial system. In addition, arbitration gives the parties a level of control which they may not otherwise have over some aspects of the dispute, such as choice of venue and forum and the selection of an arbitrator with expertise in franchise issues or the relevant technical or specialised fields. Arbitration agreements are final, reliable and not open to appeal; Canadian courts have generally refrained from intervening in such decisions. Finally, arbitration tends to be faster and cheaper than litigation, at least in theory.

As for its disadvantages, arbitration, like litigation, can become bogged down procedurally, nullifying the cost and time savings which often motivate its use. The lack of ability to appeal heightens risk for the parties that have no recourse against a bad decision. Some also argue that arbitration clauses which preclude access to the judicial system will prevent the use of proceedings such as injunctive or other equitable relief that can be obtained quickly to effectively end a breach of contract.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

There is no legal discrimination or heightened level of legal requirements for foreign franchisors. Nevertheless, depending on the vehicle they choose through which to export their franchises to Canada, foreign franchisors may find themselves subject to a different taxation regime than would domestic franchisors, and subject to certain notice requirements under the Investment Canada Act. As a practical matter, franchisees may be more hesitant to enter into a franchise agreement, particularly one where the obligations of the franchisor (for example, training, advertising) are numerous, in circumstances where the franchisor has no domestic presence of note.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

A typical franchisor is in the form of a company. Administration of Commercial Franchise Operations regulations (promulgated by the State Council on 6 February 2007 and effective as of 1 May 2007) state that a franchisor must be in the form of an enterprise that owns a registered trademark, logo, patent, proprietary technology or other business resources. Organisations or individuals other than enterprises shall not engage in a franchise operation in the capacity of a franchisor.

In China, enterprises include companies, partnership enterprises, joint-stock cooperative enterprises, sole proprietorship enterprises, state-owned enterprises, collective-owned enterprises, Sino-foreign equity joint ventures (EJVs), Sino-foreign cooperative joint ventures (CJVs), wholly foreign-owned enterprises (WFOEs) and foreign-invested joint stock limited companies.

Under Chinese company law, a company is classified into limited liability companies (LLCs) and limited joint-stock companies. LLCs include two unique types of companies: wholly stated owned companies and one-person limited liability companies (one-person LLCs). If the owner of a one-person LLC fails to separate company assets from his own personal assets, he will be required to take joint responsibility for the company's liabilities.

To establish a partnership enterprise that can be either a normal partnership enterprise or a limited partnership enterprise, two or more individual persons shall enter into a partnership agreement, jointly make an equity contribution and complete the due process of registration. A partner in a normal partnership enterprise will assume unlimited liabilities for the enterprise's debts, whereas a partner in a limited partnership will only be responsible for the enterprise's debts up to the amount of equity that he or she contributed.

A joint-stock cooperative enterprise is a unique type of enterprise in China that is invested in mainly by its employees. The investors bear liabilities up to the amount of their investment.

A sole proprietorship enterprise is a business entity invested in and owned by a sole individual person. The investor assumes unlimited responsibility for the enterprise's liability based on his or her personal assets.

EJVs, CJVs, WFOEs and foreign-invested joint stock limited companies are the principal forms of foreign invested enterprises in China.

2 What laws and agencies govern the formation of business entities?

For Chinese domestic franchisors, different laws and regulations will apply depending on the nature of the enterprises of the franchisors. Specifically, if the franchisor is in the form of a company, the Company Law (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 January 2006) will apply and govern the formation of the entity; if the franchisor is a sole proprietorship enterprise, the Law of Sole Proprietorship Enterprises (promulgated by the Standing Committee of the National People's Congress and effective on 1 January 2000) will govern the formation of the enterprise; if the franchisor is a partnership enterprise, the formation of the enterprise must follow the rules set forth in the Law of Partnership Enterprises (promulgated by the Standing Committee of the National People's Congress with latest amendments effective on 1 June 2007); and if the franchisor is a joint-stock cooperative enterprise, as the lawmakers have not yet enacted an uniform law in this regard, the Guidance on the Development of Municipal Joint-Stock Cooperative Enterprises (promulgated by the National Development and Reform Commission and effective in June of 1997), along with the relevant local regulations, are treated as the major governing law and regulations.

Likewise, for foreign franchisors, based on their specific company nature, the Sino-Foreign Equity Joint Venture Law (promulgated by the National People's Congress with latest amendments effective on 15 March 2001), the Sino-Foreign Cooperative Joint Venture Law (promulgated by the National People's Congress with latest amendments effective on 31 October 2000), and the Law of Wholly Foreign Owned Enterprises (promulgated by the National People's Congress with latest amendments effective on 31 October 2000) will govern the formation of the entity. Administration of Foreign Investment in Commercial Sectors Procedures and its supplemental rules (promulgated by the Ministry of Commerce (MOFCOM) on 16 April 2004 and effective as of 1 June 2004) are also important.

The government agency in charge of establishing Chinese domestically invested companies, sole proprietorship enterprises, partnership enterprises and other types of enterprise is the State Administration for Industry and Commerce (SAIC). A foreign investment enterprise (FIE) is subject to the approval of MOFCOM or its local counterparts. If the FIE is engaged in a particular sector which is subject to special approval, the government agencies relevant to said approval will also be involved.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Except in sectors discouraged by central or local governments as provided in their investment policies, the statutory requirements to form a business entity in China are not generally stringent: as far as a company is concerned, the minimum initial registered capital that the shareholders shall contribute is 30,000 renminbi or 100,000 renminbi for a one-person LLC, while Chinese law does not prescribe a mimimum capital requirement for a partnership enterprise or a sole proprietorship enterprise.

For an entity to maintain its legality, it should comply with various applicable laws in respect of registration, taxation, labour, foreign exchange, customs, and so on, among which the Regulations of the People's Republic of China on Administration of Registration of Company promulgated by the State Council on 24 June 1994

with its latest amendment effective on 18 December 2005 ('Regulations of Company Registration') is worthy of special notice. In accordance with the Regulations of Company Registration, from 1 March to 30 June the registration office (normally SAIC's local counterparts) will conduct annual examinations of the companies registered with them. In order to pass the annual examination, companies shall submit an annual examination report, audited financial statements and other documents. If the company successfully passes the examination, the registration office will certify it on the company's business licence; if any significant violation is identified during the examination, the company's business licence could be revoked. Such violations include, but are not limited to, falsifying a capital injection report or other application documents in order to secure approval of establishment or pass the annual examination certification, failing to operate (without good cause) within six months of being granted a business licence, or voluntarily ceasing to operate for more than six months after establishment of the company.

4 What restrictions apply to foreign business entities and foreign investment?

The Chinese domestic market has not been entirely opened up for foreign investors, although a considerable amount of progress has been made since its entry into the World Trade Organisation. Foreign investment in China is classified into four categories based on the sectors concerned: encouraged, permitted, restricted and prohibited. Details can be found in the Industry Category Guide for Foreign Investors that is issued and updated by MOFCOM. Foreign franchisors must ensure that their investment does not fall into the 'prohibited' category.

Foreign investors are not allowed to set up partnership enterprises in China. In accordance with article 7 of administrative Measures for the Record Filing of Commercial Franchises, a foreign franchisor shall follow these measures when undertaking franchising activities in China. As such, it could be construed that a company outside China may make a filing as a franchisor with the Chinese government authority, although the Measures for Administration on Foreign Investment in Commercial Fields (Order of Ministry of Commerce [2004] No. 8) provide that foreign companies are forbidden to engage in franchise business directly by themselves, and that they must do it through a subsidiary established in China. The business licence of that subsidiary must specify that the subsidiary is intending to engage in commercial franchise activities.

Apart from the above, there are no restrictions that particularly apply to foreign franchisors.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

From the perspective of the Law of PRC on Enterprise Income Tax (adopted at the 5th Session of the 10th National People's Congress on 16 March 2007, promulgated by Order No. 63 of the President of the People's Republic of China and effective as of 1 January 2008), enterprises are classified as resident or non-resident enterprises. Resident enterprises are those that are set up under Chinese law or that are set up in accordance with the law of other jurisdictions and have their actual administration centre located in China. Non-resident enterprises are those that are set up in accordance with the law of foreign countries (regions) and have their actual administration centre outside of China but have establishment in China, or have income originating from China without establishment in the territory of China.

Franchisors who are considered as resident enterprises, regardless of the investor's nationality, are subject to income tax at a rate of 25 per cent on income originating from inside and outside of China. Non-resident franchisors must pay withholding income tax at a rate of 10 per cent pursuant to the Implementation Rules of Enterprise Income Tax for passive income originating from China (for example, franchise fees, royalties), unless provided otherwise in the tax treaty between China and the home country or region of the franchisor. Non-resident franchisors must also pay enterprise income tax on active income (for example, service fees) generated from China through its establishment. Depending upon the tax law of the home country or region of the franchisor, the withholding tax or enterprise income tax, or both, that is paid in China by the franchisor, may be creditable to the income tax payable in its home country.

In addition to the above-mentioned enterprise income tax, franchisors shall pay business tax at the rate of 5 per cent for the franchise fees (also known as 'service fees').

Article 8 of Enterprise Income Tax provides that de facto expenditure incurred in connection with operational activities is deductable to a reasonable extent when computing taxable income. According to interpretation by officials from the General Tax Bureau, such provision does not apply to non-resident franchisors' franchise fee income. Such interpretation has led to announcement of the abolishment of the Notice of General Tax Bureau and Financial Ministry regarding Enterprise Income Tax Levying on Foreign Enterprise after Receiving Franchise Fee and Paying off Business Tax (promulgated by the General Tax Bureau and Financial Ministry and effective as of 19 March 1998) that specifically allowed foreign enterprises to deduct business tax before paying enterprise income tax.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Franchise business owners must give special attention to the statutory requirement that employers shall pay social security for their regular employees (namely, pension, unemployment insurance, medical insurance and employment injury insurance). The enactment of the China Labour Contract Law (adopted at the 28th Session of the Standing Committee of the 10th National People's Congress on 29 June 2007 and effective as of 1 January 2008) has increased the overhead costs and legal risks for franchise business such as fast-food chain restaurants that engage a significant number of part-time employers or non-employee workers: the labour contract law provides that the daily working hours of a part-time employee cannot exceed four hours and the weekly working hours cannot exceed 24 hours. Non-employee workers will have to be dispatched from sourcing companies that legally are the employers of the dispatched employees. Otherwise, the non-employee workers will be deemed as regular employees of the franchise owners.

Although the risk that a franchisee or employees of a franchisee are deemed to be the franchisor's employees is not high in practice, it is advisable for the franchisor to set up a well-drafted relationship clause in the franchise contract to clarify the relationship between franchisor, franchisee and the franchisee's employees.

7 How are trademarks and know-how protected?

A trademark will be protected under Chinese law if it has been registered with the China Trademark Office. Know-how is protected in China as a trade secret if such know-how, that has not been in the public domain, may bring about economic benefits, has practical utility, and is protected by the owner under non-disclosure measures.

A franchisor can protect its trademarks and know-how by the following means:

- contractual protection, specifying each party's rights and obligations in respect of how the franchisee may use the franchisor's trademarks and know-how in the franchise agreement, specific trademark licence agreement or non-disclosure agreement;

- seeking protection from the administrative agency (State Administration for Industry and Commerce (SAIC)) and its local counterparts that may impose administrative sanctions on the infringer – in most cases warnings or monetary fines, or both. It may be quicker to seek protection from the administrative agencies than to litigate, especially if the trademark has been certified as a well-known trademark in China; and
- seeking protection through the courts.

8 What are the relevant aspects of the real estate market and real estate law?

Under Chinese real estate law, unlike domestic franchisors, a foreign franchisor is not allowed to directly purchase real estate property located in China unless it is for his or her own use. One solution is for the franchisor to set up a presence in China through which the purchase can be handled.

In addition, if a franchisor sets up certain standards for the properties to be used by a franchisee, or recommends a property to the franchisee, the franchisor should make sure the contract explicitly states that the franchisor is not responsible for any losses caused by fluctuations in the property market. Furthermore, as the overall Chinese economy is developing quickly and urban redevelopment is a prevalent trend, it is advisable for the franchise agreement to take into consideration a scenario in which the property used by the franchised business will be forcibly redeveloped and the franchisee will have to be relocated.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

As provided by Chinese law, a franchise refers to a business activity whereby the franchisor, by virtue of performance of contract, licenses the franchisee to use the operational resources inter alia, the registered trademark, enterprise logo, patent and know-how, and the franchisee undertakes business under the unified business format set up in the franchise agreement and pays franchise fees to the franchisor in return.

10 Which laws and government agencies regulate the offer and sale of franchises?

The provisions governing franchise activities can be found primarily in the following laws and regulations:

- Administration of Commercial Franchise Procedures (promulgated by the Ministry of Commerce on 30 December 2004 and effective as of 1 February 2005);
- Administration of Commercial Franchise Operations Regulations (promulgated by the State Council on 6 February 2007 and effective as of 1 May 2007);
- Administration of Commercial Franchise Operations Registration Procedures (promulgated by the Ministry of Commerce on 30 April 2007 and effective as of 1 May 2007);
- Administration of Information Disclosure for Commercial Franchise Operations Procedures (promulgated by the Ministry of Commerce on 30 April 2007 and effective as of 1 May 2007); and
- Administration of Foreign Investment in Commercial Sector Procedures (promulgated by the Ministry of Commerce on 16 April 2004 and effective as of 1 June 2004).

The government agency in charge of administration of franchises is MOFCOM and its local counterparts.

11 Describe the relevant requirements of these laws and agencies.

The principal requirements include the following:

- the franchisor shall have the necessary business resources (such as trademarks) that it will license to its franchisees in order for the franchisees to carry out the franchised business;
- the franchisor shall satisfy the '2+1' requirement, namely, the franchisor must already have at least two existing stores and must have been engaged in the franchised business for more than one year;
- the franchisor shall make registration with MOFCOM or its local counterpart (starting from 1 May 2009, foreign franchisors shall make registrations with MOFCOM, and Chinese franchisors (including FIEs) shall make registrations with MOFCOM's provincial-level counterpart in the province in which the franchisor is established). The franchisor shall also update MOFCOM on an annual basis regarding the number of franchise agreements that it signed or renewed or terminated with its Chinese franchisees during the previous year;
- the franchisor shall disclose information to its franchisees in accordance with Administration of Information Disclosure for Commercial Franchise Operations Procedures;
- the franchisor shall enter into the franchise agreement in writing with the franchisee, and the term of the franchise agreement shall be no less than three years (unless the franchisee agrees otherwise). Additionally, the franchisor shall give the franchisee a cooling-off period: that is, the franchisee has the right to unilaterally terminate the franchise agreement within a certain time frame as agreed by the franchisor and franchisee after the franchise agreement is signed; and
- the franchisor shall provide a manual, training and support to its franchisees in accordance with the agreement between the franchisor and the franchisee.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There is no exemption or exclusion under current Chinese franchise laws and regulations.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The franchisor must satisfy the '2 + 1' requirement, namely, the franchisor must already have at least two existing stores and must have been engaged in the franchised business for more than a year. The two existing stores can be anywhere in the world – they do not have to be in China. The franchisor must have the necessary business resources, such as a registered trademark, enterprise logo, patent or proprietary technology.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Under a sub-franchising structure, the sub-franchisor is obligated to disclose to the sub-franchisee that it is a sub-franchisor, that it has obtained the necessary operational resources (for example, trademarks) from the original franchisor, and that it has obtained (or will obtain) permission from the original franchisor to grant a sub-franchise to the sub-franchisee. In addition, it should disclose to the sub-franchisee all other information disclosed to it by the original franchisor. The sub-franchisee may also have to disclose certain information to the original franchisor where it is stipulated in the original franchise agreement or the original franchisor is directly involved: for instance, whether the original franchisor will provide training to the sub-franchisees, or whether the sub-franchisees must purchase certain goods or services from the suppliers designated by the original franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

In light of the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, the franchisor shall disclose in writing the information required by these regulations at least 30 days before the parties execute the franchise agreement. In addition, the franchisor shall provide a sample of the franchise agreement to the franchisees. If there is any material change to the information after the pre-contractual disclosure, the franchisor shall notify the franchisee of such in a timely fashion.

16 What information must the disclosure document contain?

According to the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, a franchisor shall disclose the following to its franchisees:

- Basic information about the franchisor and the franchising activities, such as:
  - name, correspondence address, contact information, legal representative, general manager, amount of registered capital and business scope of the franchisor, as well as the number, addresses and contact numbers of existing direct-owned stores;
  - an overview of the franchisor's commercial franchising activities;
  - basic information regarding the franchisor's franchise registration (with MOFCOM or its local counterpart);
  - basic information regarding the franchisor's affiliates shall be disclosed if such affiliates provide products or services to the franchisee; and
  - information on whether the franchisor or any of its affiliates has been declared bankrupt or has filed for bankruptcy during the past five years.
- Basic information on the business resources owned by the franchisor, such as:
  - a written indication to the franchisee regarding the available registered trademarks, corporate logo, patents, proprietary technologies, business model and other business resources that the franchisor can provide;
  - basic information regarding the franchisor's affiliates shall be disclosed if the business resources are owned by such affiliates, and the franchisor shall also explain how the franchise operations will be dealt with if the licence (regarding such business resources) from the franchisor's affiliates to the franchisor is terminated; and
  - information on whether the franchisor's (or any of its affiliates') registered trademarks, corporate logo, patents, proprietary technologies or any other business resources are involved in legal proceedings or arbitration.
- Basic information about franchise operations fees, such as:
  - the types, amounts, standards and payment method of fees charged by the franchisor and on behalf of third parties. Where the franchisor is unable to disclose such information, the reasons shall be given. Where there is no uniform fee standard, the highest and lowest standard shall be disclosed and the reasons shall be given;
  - collection of security deposits and the conditions, time and manner of the refund thereof; and
  - where the franchisee is required to make payment before entering into the franchise operations agreement, a written explanation of the usage of such fees and the conditions and manner of the refund thereof shall be given to the franchisee.
- Price and conditions for provision of products, services and equipment to the franchisee, such as:
  - whether the franchisee is required to purchase any product, service or equipment from the franchisor (or its connected company) and the related price and conditions thereof;
  - whether the franchisee is required to purchase any product, service or equipment from suppliers designated (or approved) by the franchisor; and
  - whether the franchisee is allowed to choose other suppliers, and the requirements for such alternative suppliers;
- continuous provision of services to the franchisee, such as:
  - exact contents, method of provision and implementation plan of training programme, including location, method and duration of training; and
  - exact contents of technical support, table of contents of the franchise operations manual and the relevant number of pages;
- method and content of guidance and supervision on the franchisee's business activities, such as:
  - the method and content of the franchisor's guidance and supervision on the franchisee's business activities, as well as the obligations of the franchisee and the consequences for failure to fulfil such obligations; and
  - whether the franchisor shall assume joint liability for consumer's complaint or claim, as well as the arrangements thereof;
- the investment budget status of franchise operations units:
  - the investment budget may include the following expenses: joining fee; training fee; property and renovation expenses; purchase fees of equipment, stationery and furniture; initial inventory; water, electricity and gas fees; fees required to obtain a licence and other government approvals; and initial working capital; and
  - the source of data and basis used in the estimation of the aforementioned expenses;
- information about franchisees in China, such as:
  - the number, geographical distribution, scope of authorisation and individually authorised district (if there is any, the estimated area should be described) of existing and expected franchisees; and
  - an evaluation of the operating performance of franchisees, including the actual or projected average sales volume, costs, gross profit and net profit, as well as the source of aforesaid data, period of data used, and the geographic distribution of franchised outlets shall be disclosed by the franchisor; in the case of estimated information, the basis used shall be explained and a statement that the estimate may differ from the actual operating performance of the franchisees shall be made;
- a summary of the past two years' financial and accounting reports and audit reports of the franchisor, audited by a firm of accountants or audit firm;
- material litigations or arbitrations of the franchisor related to the franchise operations in the past five years. Material litigations and arbitrations refer to those with a subject amount exceeding 500,000 renminbi. The basic circumstances, location of the proceedings and outcome of such litigation shall be disclosed;
- historical records of unlawful business operation conducted by the franchisor or the legal representative thereof, namely:
  - any fine of more than 300,000 renminbi but less than 500,000 renminbi imposed by a relevant administrative or law enforcement department; and
  - any criminal liability imposed;
- the franchise operations agreement, including:
  - a sample of the franchise operations agreement; and
  - a sample of other franchise-related agreements to be entered into between the franchisee and the franchisor (or its connected company) at the request of the franchisor.

17 Is there any obligation for continuing disclosure?

According to the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, in the case of any material change to the disclosed information, the franchisor shall notify the franchisees of such change in a timely manner.

18 How do the relevant government agencies enforce the disclosure requirements?

If a franchisor violates the disclosure requirements, its franchisee may report the violation to MOFCOM or its local counterpart. Upon verifying the violation, MOFCOM (or its local counterpart) will request that the franchisor remedies it and a monetary fine of between 10,000 and 50,000 renminbi will be imposed on the violating franchisor. In the case of a serious violation, a fine of between 50,000 and 100,000 renminbi will be imposed and MOFCOM will make a public announcement regarding the violation.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

A bona fide franchisee is entitled to rescind the franchise agreement if its franchisor has been found in violation of an information disclosure requirement: specifically, if the franchisor failed to disclose information that it should have disclosed or the franchisor provided false information to the franchisee.

Franchise-related laws and regulations do not specifically provide for how the parties can dispose of a franchise agreement in the event that the franchisee rescinds the franchise agreement in such a way as that mentioned above. Nevertheless, the parties may follow the rules and principles of contract law and the Civil Code. Principally, the franchisor and franchisee will not perform the outstanding part of the franchise agreement that has not yet been performed, while the franchisee may request to return to status quo for the part of the franchise agreement that has been performed. As a critical part of so doing, the franchisee will return the franchisor's manual and other materials, stop using the franchisor's business resources, and seek indemnification from the franchisor to cover the franchisee's necessary expenses for entering into the franchise agreement, performing the franchise agreement and returning to status quo.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The sub-franchisor is legally obligated to disclose the required information to the sub-franchisee. There is no statutory requirement for the original franchisor to disclose any information to the sub-franchisee, nor will the original franchisor be held jointly and severally liable for the sub-franchisor's default on its disclosure obligation. Nonetheless, if a judge or arbitrator ultimately determines that the sub-franchisor's default is partially caused by the original franchisor, the original franchisor will undertake the liabilities commensurate with its mistake at the discretion of the adjudicator.

In light of current Chinese franchise-related laws and regulations, the individual officers, directors and employees of a franchisor or sub-franchisor will not usually be held personally responsible for civil liability as a result of disclosure violation, unless the related individual is found to have engaged in any fraudulent or deceptive practices which could be construed as a crime under criminal law.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

As a written franchise agreement must be signed, the PRC Contract Law (promulgated by the National People's Congress and effective as of 1 October 1999) and relevant judicial interpretations will apply to formation, interpretation, performance and liabilities related to the franchise agreement.

In addition, as mentioned in question 19, the PRC Civil Code (adopted at the Fourth Session of the Sixth National People's Congress, promulgated by Order No. 37 of the President of the People's Republic of China on 12 April 1986, and effective as of 1 January 1987) is another critical source of law: adjudicators frequently refer to its doctrines and principles when the specific franchise statutory provision is in absence.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Apart from the information that the franchisor is mandatorily required to disclose under the Administration of Information Disclosure for Commercial Franchise Operations Procedures and Administration of Commercial Franchise Operations Regulations, the franchisor generally does not have to disclose any other information. Nevertheless, in compliance with the rules and doctrines under the Civil Code and the Contract Law, a franchisor should answer the questions of a prospective franchisee in good faith.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In accordance with Administration of Commercial Franchise Operations Regulations, the franchisor shall not include any fraudulent, deceptive or misleading information in its promotional or marketing activities. In particular, its advertisement cannot contain any propaganda regarding franchisees' earnings. Violating this requirement will lead to a fine of 30,000 to 300,000 renminbi.

Furthermore, if a franchisor committed fraudulent or deceptive practices in the course of the offer and sale of franchises, the franchisee as a bona fide victim may pursue the dispute resolution provided in the franchise agreement and seek the relief available under contract law and the Civil Code. Specifically, the franchisee may request that the franchise agreement is modified or nullified. If the franchise agreement is nullified, it will become retroactively invalid from its very beginning, meaning that to some extent, the parties shall return to status quo. All costs and losses incurred by the franchisee in so doing shall be compensated by the franchisor. A one-year statute of limitation applies: in other words, the franchisee must file the case within a year of the time at which it knew or should have known of the fraud or deception.

If the fraud or deception is very serious in terms of the amount of damages, the magnitude of the negligence or the effect of such fraud or deception on the public and society, it will fall under the Criminal Law. In that case, the franchisor or its directors, officers or employees, as the case may be, will be prosecuted for committing a crime.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Administration of Commercial Franchise Operations Regulations (Administration) is a major regulation that governs the relationship between franchisor and franchisee once the contract has come into effect. It deals with major obligations between the parties, quality control of the franchised business, assignment of contracts, and so on. For instance, in accordance with the Administration, a franchisor shall provide an operating manual, continuing operational guidance, technical support, business training and other services to the franchisee pursuant to the franchise contract. Furthermore, where a franchisor collects advertising and promotion fees from a franchisee, it shall use the collected monies pursuant to contractual stipulations. The usage of advertising and promotion fees shall be disclosed to the franchisee promptly. In addition to the foregoing, the Administration also provides that a franchisee shall not transfer the rights of its franchise operation to others, nor shall he or she divulge or allow others to use the commercial secrets of the franchisor to which the franchisee has access.

25 Do other laws affect the franchise relationship?

In addition to the Contract Law and the Civil Code that govern the validity, interpretation, performance and other areas of a franchise agreement, the franchisor and franchisee shall also comply with several other laws, including advertisement law (in respect of advertising), trademark law (in respect of trademark protection and licensing), and some regulatory requirements, such as Regulations on Prohibition of Pyramid Selling.

26 Do other government or trade association policies affect the franchise relationship?

MOFCOM and its local counterparts are the governmental authority in charge of approval, filing and administration of franchise activities. The other government agencies that regulate different perspectives of business activities do not have the authority per se to act on the franchise relationship between the parties. For example, the police or SAIC and its local branches will be involved if there is found to be fraud or deception relating to the sale of franchised business. Neither does any trade association have such authority per se.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchisor may terminate a franchise relationship pursuant to the franchise contract's provisions regarding the early termination of the contract. In absence of such express contractual provisions, the franchisor may terminate the franchise relationship in accordance with Contract Law in the following circumstances:

- the purpose of the franchise contract is not able to be realised due to force majeure;
- the franchisee explicitly expresses or indicates through its acts that it will not perform its principal debt obligations;
- the franchisee delays performing its principal debt obligations and still fails to perform them within a reasonable timeframe of being urged to do so; or
- the purpose of the franchise contract cannot be realised because the franchisee delays performing its debt obligations or commits some other act in breach of the contract.

28 In what circumstances may a franchisee terminate a franchise relationship?

According to Chinese law and regulation, a franchisee may terminate a franchise relationship under the following circumstances:

- based upon the contractual stipulations in the franchise agreement or under the provisions of the PRC Contract Law;
- during the cooling-off period as mutually agreed by the franchisor and the franchisee in the franchise contract; or
- if the franchisor violates its disclosure obligation.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

It is not mandatory for the franchisor to renew the franchise agreement. The franchisor has sole discretion over whether or not to renew, unless the initial franchise agreement contains any provisions to the contrary.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

In accordance with Administration of Commercial Franchise Operations Regulations, a franchisee must obtain the franchisor's prior consent before assigning the franchise agreement. One point to note is that, from the perspective of Chinese law, transfer of ownership interests will not be deemed as assignment of a franchise agreement. The franchisor must expressly stipulate in the franchise agreement if he wishes to have the power to prevent the franchisee transferring its ownership interests in a franchisee entity.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

In light of Administration of Commercial Franchise Operations Regulations, if the franchisor requests that the franchisee pay initial franchise fees before the execution of a franchise agreement, the franchisor must explain to the franchisee in writing the purpose of the payment, as well as the conditions and manners of refund. With regard to the funds paid by the franchisee pursuant to the franchise agreement for the advertisement and promotion of the franchise business, the franchisor shall ensure that the fund is spent for the exact purpose agreed in the franchise agreement and update the franchisee on the status of the same.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The franchisor is entitled to interest for overdue payments which, however, should not be excessively higher than the actual damage suffered by the franchisor. To this end, the adjudicator may adjust the interest rate provided in the franchise agreement.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

China adopts a foreign exchange control system according to which all outbound payment, except for settlement with Hong Kong, Macao and ASEAN (Association of Southeast Asian Nations) countries which could be denominated in renminbi, shall be in foreign currency against various supporting documents. Accordingly, a franchisee must present the agreements (franchise agreement, licence agreement, etc) which have been filed with MOFCOM's local counterpart, the tax certificate evidencing that the franchisee has fulfilled its obligation in respect of withholding tax (if any) and other documents which might be required by the payer bank in accordance with foreign exchange control regulations.

34 Are confidentiality covenants in franchise agreements enforceable?

It is enforceable in general. Nevertheless, the owner of the proprietary information must be able to prove that the information in discussion:

- has never been in the public domain;
- may bring about economic benefits;
- has practical utility; and
- is protected by the owner under non-disclosure measures.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, both the PRC Civil Code and the PRC Contract Law provide that commercial transactions should be conducted in good faith, and this is also applicable to franchise contracts. Notwithstanding the disclosure requirements underneath Administration of Commercial Franchise Operations Regulations and Regulations Administration of Information Disclosure for Commercial Franchise Operations Procedures, if the information disclosed by the franchisor is not in good faith, it could still be misleading or unreliable. For example, the aforementioned regulations require that the franchisor provides its record and speculation about existing and potential franchisees and assesses the operation status of the franchisee. As the franchisor is legally obliged to provide this information in good faith, it must be reasonably diligent and careful in the course of its calculations; thus, the credibility of the provided information will be significantly increased.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. As provided by the laws and regulations in respect of consumer protection, 'consumers' in China usually means people who purchase materials or services for their own consumption. With regard to consumer protection, a franchisee, who provides materials or services to its end-user consumers is not a consumer.

37 Must disclosure documents and franchise agreements be in the language of your country?

Chinese law does not specifically require that franchise agreements and disclosure documents be made in Chinese. For the convenience of making registration with government agencies and in order to avoid potential disputes with local Chinese-speaking franchisees, in practice bilingual versions of the documents are recommended.

Update and trends

The Ministry of Commerce solicited public comments for its draft amendments that were publicised in May 2011, respectively to the Administration of Commercial Franchise Operations Registration Procedures and the Administration of Information Disclosure for Commercial Franchise Operations Procedures. In the said draft amendments, the provisions regarding disclosure and registration have become more specific.

38 What restrictions are there on provisions in franchise contracts?

As provided by Administration of Commercial Franchise Operations Regulations, the term of a franchise contract shall not be less than three years. In the case of a foreign franchisor, according to the Measures for The Administration on Foreign Investment in Commercial Fields (promulgated by the Ministry of Commerce and effective as of 1 June 2004), the term of operation of a foreign-funded commercial enterprise shall not exceed 30 years in general, and the term of operation of a foreign-funded commercial enterprise that is established in the middle and western areas shall not exceed 40 years in general. Although for the time being there is no specific statutory restriction on franchise contracts providing exclusive territory, designated suppliers for franchised business, conditional sales or tied sales, in accordance with the Anti-Unfair Competition Law (promulgated by the Standing Committee of the National People's Congress and effective as of 1 December 1993) and the Anti-Monopoly Law (promulgated by the National People's Congress and effective as of 1 August 2008), these provisions shall not be involved with abuse of market position, impairment to the public interest, or interference in a franchisee's lawful business activities. The motive of these clauses is to protect the goodwill, quality and safety of the franchised business.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Anti-Unfair Competition Law (promulgated by the Standing Committee of the National People's Congress and effective as of 1 December 1993) and the Anti-Monopoly Law (promulgated by the National People's Congress and effective as of 1 August 2008) are two major statutes governing competition activities in China, according to which the following will be prohibited in business activities: a monopoly agreement which fixes prices for resale, restricts the lowest price for resale, limits the output or sales of the products, allocates the sales markets or the raw material purchasing markets, or limits the purchase of new technology or new facilities or the development of new products or new technology.

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In order to ensure the franchisees carry on a franchised business in an uniform business format, the franchisor must set forth a lot of standards in the franchise contract that appear to fall into the above-mentioned prohibited areas, such as fixed prices for franchised services or products, designated raw material suppliers and conditional sales. Nevertheless, franchising will not be considered to be in violation of the above competition regulations as long as there is no abuse of market position, no impairment to the public interest and no interference in the franchisee's lawful business activities (for example,, if the purpose of the conditional sale is to protect the quality and then the goodwill of the franchised business, or the conditional sale is the only way for the franchisor to safeguard his know-how, proprietary technology or other commercial confidential information). On the other hand, if the conditional sale's purpose is to create market barriers, sell unmarketable goods or other unreasonable intentions, such a conditional sale will be construed as a violation of unfair competition law and shall be punished.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The court system in China consists of four levels of court: the basic people's court; the intermediate people's court; the high court (which is the highest court in each province, autonomous region and municipality under direct administration of the central government); and the Supreme People's Court (which is the highest court in China). The judgment of the court of the second instance is usually final, and only in rare cases (such as new evidence being found which leads to the judgment being overruled) can the parties bring the case to a retrial.

China is not a case law country, so case precedents are not one of the legal resources used. Nevertheless, in practice, previous judgments on similar cases can be used as reference, especially if the judgments were made by a superior court.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

It is always recommended for foreign franchisors to select arbitration as a mechanism to solve their dispute and to choose a reputable arbitration centre for the arbitration tribunal. The core advantage is that a foreign franchisor may nominate its own arbitrator from the arbitration centre's arbitrators list and does not need to be concerned about local protectionism or the bias which is still fairly rampant in local courts. Nevertheless, if the arbitration centre selected by the parties is located outside China, it is likely to become very cumbersome to serve notice to the Chinese party if said party refuses to sign to accept the notice. In addition, in comparison with the procedures of the Chinese court system, the proceedings needed for an arbitration heard in a foreign arbitration centre could be much more time-consuming and expensive; and even if the foreign franchisor receives a favourable award from the foreign arbitration centre, the local court will be called upon to enforce it.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

From both a Chinese law and a practical perspective, in general a foreign franchisor is treated similarly to a domestic franchisor. In other words, no particular discriminatory treatment is applied to foreign franchisors.

Czech Republic

Barbara Kusak and Halka Pavlíková

Noerr sro

Overview

1 What forms of business entities are relevant to the typical franchisor?

A franchisor usually does business as a sole proprietor or via a limited liability company (sro). Limited liability companies are the most frequently used type of corporate entity in the Czech Republic. The advantages of an sro include the liability that is limited to the company, the relatively low minimum capital required for establishment (200,000 korunas) and the limited administrative burden.

Other than an sro, the Czech law recognises other entities that may also be used to conduct business, including franchises in the Czech Republic, as follows:

- joint-stock company (as);
- European join stock company (SE);
- general partnership (vos); and
- limited partnership (ks)

2 What laws and agencies govern the formation of business entities?

The formation and establishment of business entities is regulated by Act No. 513/1991.

The European join stock company is regulated by Act No. 627/2004 on the European Company.

All companies, as well as their branches, need to be registered in the Commercial Register kept by the applicable register court. The jurisdiction of the register court depends on the registered office of the company; namely, the register court in whose district the company has its registered office has local jurisdiction.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Czech law requires two basic steps for the establishment of a company. The first step is the execution of foundation documentation (a foundation deed or a memorandum of association) in the form of a notarial record. The foundation deed must contain a certain amount of minimum information: for example, the company's name, the amount of registered share capital, the number and identification of shareholders or members, the field of business etc. The second step is the registration of the newly created company in the relevant Commercial Register. This registration must take place within 90 days of the execution of foundation documentation. The company is able to commence business on its registration, although some preliminary transactions can be carried out beforehand. Within 30 days after the registration in the Commercial Register, the company must also be registered as a taxpayer with the Financial Authority.

In the process of registration certain documents are required by the registration court. Other than the foundation document, confirmation from a bank is required that the registered capital has been paid in the amount set out by law or the foundation deed. Furthermore, an extract from the Trade Licensing Office (or another state authority) will be needed that shows that the company has the relevant licences in order undertake business. The Commercial Code also requires affidavits from future members of the company's statutory operations demonstrating that they fulfil conditions set out by law and also documents concerning the identification of the shareholders.

The running of the company principally requires preparation of annual financial statements and an annual general meeting of shareholders (by which the financial statement is approved). In some cases auditors need to be appointed. Annual financial statements must be filed with the Commercial Register.

4 What restrictions apply to foreign business entities and foreign investment?

In principle, foreign persons or entities may carry out entrepreneurial activities in the territory of the Czech Republic on the same conditions and to the same extent as Czech persons or entities. There are certain limitations imposed by law for some specific types of activities, such as operating a lottery or trading in military materials. A foreign entity carries out its business in the Czech Republic through its branch or enterprise located in the territory of the Czech Republic. The foreign entity's ability to carry out business in the Czech Republic is authorised in the same manner as the authorisation of a Czech entity – by registering the foreign entity, or its branch or enterprise, in the Commercial Register.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The Czech Republic is a member state of the EU and important features of the Czech tax system have, therefore, been harmonised with EC tax law, including direct taxes, VAT, excise duties, mutual assistance and administrative cooperation.

Income taxation

A business enterprise is a tax resident if it has a registered office or place of management in the Czech Republic. Subject to an applicable double taxation treaty, a tax resident business enterprise is subject to Czech taxation on its worldwide income.

Corporations (such as an sro and an as) are taxed at the regular, corporate income tax rate of 19 per cent.

Tax losses can be carried forward for five years. The use of losses is limited if a substantial change in the direct shareholding of the company occurs, unless the company passes the 'income structure test', namely, at least 80 per cent of the income has been generated by the same activities as the activities performed in the year the loss accrued.

Non-tax resident businesses are subject to limited tax liability on their Czech source income. Income received through a Czech permanent establishment is regarded as Czech source income and, therefore, subject to income tax at the general rate. Other types of Czech source income include, for example, income from the collection of receivables purchased from third parties and fees for certain services. If income from a permanent establishment is paid to non-EU or EEA residents, a tax security advance must be withheld from the income at the rate of 10 per cent (1 per cent for collection of receivables).

Royalties paid to non-tax residents are generally subject to a 15 per cent withholding tax. The withholding tax can be reduced or eliminated under the rules resulting from the EU Interest-Royalties Directive or under an applicable double tax treaty. Residents of other EU and EEA countries can file a tax return for interest under the same rules as described above.

Other taxes

Supplies of goods and services in the Czech Republic by an entrepreneur are generally subject to value added tax. The standard rate is 20 per cent. Some supplied goods are taxed at the reduced rate of 10 per cent (for example, food and special health care products) and some supplies are tax exempt (for example, financial services). Taxation of imports and exports depends on whether the goods are supplied within the EU or outside.

Real estate transfer tax at the rate of 3 per cent is levied on the transfer of real estate. For more details, see question 8.

The ownership of real estate situated in the Czech Republic is subject to real estate tax.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The franchisor and franchisee are considered as separate and independent. No employment relationship between the franchisor and franchisee, or the franchisee's employees, is permitted. With a view to the definition of business activities pursuant to section 3 of the Commercial Code, this means that in order for franchisees not be considered as employees, they have to carry out their activities aimed at generating income on a continuous basis, on their own behalf and as their own responsibility. A franchisee organised in the form of a corporate entity will not run the risk of being qualified as an employee under any circumstances.

7 How are trademarks and know-how protected?

In the Czech Republic, protection is granted to national trademarks under Act No. 441/2003 Coll. the Trademarks Act, community trademarks are pursuant to Council Regulation (EC) No. 207/2009 on the Community Trademark, international trademarks under the Madrid Agreement on the Madrid system for the international registration of trade marks and to 'trade marks generally known' in the Czech Republic within the meaning of the Paris Convention for the Protection of Intellectual Property of 20 March 1883.

The Industrial Property Office (Office) keeps a trademarks register (www.upv.cz). The filing of an application to register a trademark in the trademarks register kept by the Office establishes the applicant's right of priority over any person who files an application for registration of a trademark that is similar or likely to cause confusion for the same or similar products or services. On the basis of the registration, the trademark owner acquires the exclusive right to mark its products or services using the registered trademark and to use the trademark in connection with its products and services. The registration of a trademark is valid for 10 years and may be renewed. Protection against unjustified interference is granted by Act No. 221/2006 on the enforcement of industrial property rights.

Know-how does not enjoy any special protection, but may be protected as a trade secret, subject to its compliance with the conceptual features of a trade secret, or within the scope of punishment of unfair competition. Both of these events are regulated by Act No. 513/1991 the Commercial Code.

The following possibilities of protection against unfair competition, breach of a trade secret, or against unauthorised interference with trademark rights are available under the law: a court may be requested to order the breaching party to refrain from such unauthorised action to resolve the defective situation and, further, if a claim exists, that it be paid in cash to a reasonable amount and to order compensation for damage and surrender of unjust profit.

Certain elements of know-how may also be protected by intellectual property legislation, namely by Act No. 121/2000 the Copyright Act.

8 What are the relevant aspects of the real estate market and real estate law?

Due to the current economic situation, at the present time it is not difficult for a franchisee to find non-residential premises in the Czech Republic at a reasonable price that are suitable to operate and develop its business.

From the legal point of view, it is necessary to mention that the ownership title and other rights in rem to real estate are subject to registration in the Cadastral Register. If a transaction is carried out on the basis of a real estate transfer agreement, such agreement must be in writing and must contain the expression of the parties' will on the same instrument.

Leases and subleases of non-residential premises are subject to Act No. 116/1990 Coll. on the lease and sublease of non-residential premises, but it should be mentioned that the parties have a contractual freedom to agree on their arrangements. It is mandatory for both the lease and sublease agreement to require a written form.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no legal definition of franchising in Czech law. The Czech Franchise Association adopted the definition from the European Code of Ethics For Franchising, according to which, franchising is a system of marketing goods, services or technology that is based upon a close ongoing collaboration between legally and financially separate and independent undertakings, namely, the franchisor and its individual franchisees, whereby the franchisor grants its individual franchisee the right, and imposes obligations, to conduct a business in accordance with the franchisor's concept.

In a previous decision, the Higher Court in Prague defined franchising as a:

> […] *vertical long-term relationship between independent entrepreneurs who carry out their business on their own responsibility and risk, in which the rights and duties of the partners correlate. A granted licence authorises the licensee to operate its own business; while the licensor is entitled to a one-off fee for granting the licence, and a continuous franchise fee set out as an amount in per cent of the turnover or profits.*

10 Which laws and government agencies regulate the offer and sale of franchises?

Franchise agreements, as such, are not specifically regulated under Czech law. Rather, they constitute an 'unspecified type of contract' according to section 269 (2) of the Czech Commercial Code that can contain elements of different types of contract, especially of a licence agreement, an agreement for the transfer of know-how, a rental or leasing contract, a commercial agency agreement, a contract

of sale (where goods are supplied) or a contract for the provision of services.

There are no government agencies regulating the offer and sale of franchises in the Czech republic.

11 Describe the relevant requirements of these laws and agencies.

Given the lack of any specific statutory provisions, no special requirements are set out. Compliance with the general prerequisites for entering into an 'unspecified type of contract' is required, such as sufficient specification of the subject matter of the obligation and with other business-related legislation (the Trades Licensing Act, Commercial Code, etc).

There is no specific franchisors' register in the Czech Republic in which franchisors have to register. If a franchisor (or a franchisee) is a legal entity – a company organised under Czech law – it is subject to registration in the Commercial Register kept by the applicable Regional Court. Individuals, namely entrepreneurs, who fulfil certain conditions regarding the amount of their turnover, must also register. If a franchisor (or a franchisee) is a sole trader, that is, carries out a trade under the Czech Trades Licensing Act, it is necessary to register with the Trades Licensing Authority and obtain a relevant trade licence (authorisation) to perform the activities and to declare the location of the establishment where such activities will be performed.

12 What are the exemptions and exclusions from any franchise laws and regulations?

As there is no special regulation of franchise agreements under Czech law there are no exceptions.

All the same, it is worth pointing out that not all business relationships in which one contracting party provides the other with know-how are considered as regulated by a franchise agreement. For instance, the mere provision of a licence for manufacturing activities, transfer of technology, consent to the use of a logo or of a commercial brand is not a franchise agreement.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is currently no law in the territory of the Czech Republic, that regulates requirements to be fulfilled by a franchisor before it starts offering its franchise on the market, a franchisor's duty to inform the franchisee or to register with the franchise association. According to general legislation, a franchisor's proposal to enter into a franchise agreement should be sufficiently specific, namely, it should clearly state who is making the proposal, what the subject is (the franchising concept detailed as much as possible) and should indicate the franchisor's will to be bound by such an agreement if the proposal is accepted.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

As Czech law does not regulate a franchise agreement as a special type of contract, it does not contain any express specification of rights and obligations between a master franchisor, master franchisee (sub-franchisor) and a sub-franchisee. As a result, Czech law does not expressly regulate the pre-contractual phase of entering into the franchise agreement, including any franchisor's duty to provide information (the same applies to sub-franchising contracts between sub-franchisor and sub-franchisee). Naturally, the general statutory requirements as to the specifics of all legal acts apply here as well (see also question 13).

In view of the requirements of the legal acts, the master franchisee (sub-franchisor) must disclose to sub-franchisees basic information not only about itself and the subject matter of agreement, but also basic data regarding the franchisor's identity, including evidence of its existence (for instance, by submitting an applicable extract from the Commercial Register), and proof should be submitted to sub-franchisees that the master franchisee has the requisite permits and licences for sub-franchising.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Please see question 14.

16 What information must the disclosure document contain?

This issue is not expressly regulated by Czech law.

In general terms, the information provided by the franchisor to the franchisee before entering into the agreement should be sufficiently specific to give the franchisee the option to freely decide whether or not it wants to enter into the agreement. Before the execution of the agreement, the franchisor may not deceive the franchisee, namely, by providing it with deceitful or misleading information.

The specific extent of disclosure documents therefore depends on the agreement between the parties.

17 Is there any obligation for continuing disclosure?

As stated above, Czech law does not contain any express regulation of franchise agreements as a type of contract and thus does not expressly regulate a franchisor's obligation for continuing disclosure. Determining the obligations for cooperation is at the franchisor's and franchisee's discretion.

As a rule, a franchisor's obligations to provide advice and information relating to system development, information about market development in the applicable region and updated information about the sales and marketing strategy are incorporated in the contents of the franchise agreement.

18 How do the relevant government agencies enforce the disclosure requirements?

Czech law does not require the franchisor to disclose information relating to the franchise after the execution of the agreement. If such an obligation is included in the franchise agreement by agreement between both contracting parties but the franchisor fails to discharge it, the franchisee may request the remedy before a court (there are no state agencies that would enforce the fulfilment of such an obligation), namely, sue for performance of a contractual obligation. A franchisee may also claim damages caused by a franchisor's failure to comply with its contractual obligation of continuing disclosure.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

As stated above, Czech law does not contain any express regulation of disclosure requirements or violations of disclosure requirements.

Generally, the issue of compensation for damage between a franchisor and franchisee as two independent businesses would be governed by the applicable provisions of the Commercial Code (Act No. 513/1991 Coll.) regarding compensation for damage (section 373 to section 386). If a franchisor breaches its obligation under a contractual relationship, it must compensate damage caused by it to a franchisee.

A precondition for compensation for damage is a breach of a legal obligation (either statutory or contractual), damage incurred and their causation. Such damage is objective, namely, regardless of fault. The breaching contracting party is always liable for damage, unless it proves that the breach of obligation was caused by circumstances excluding liability. The damaged party must prove the quantum of damage; no rules are set for its calculation. A franchisee (or franchisor, if it is the franchisee which breaches the obligations) would file an action for compensation for damage with a general civil law court. The local jurisdiction of the court depends on the registered office or residential address of the defendant.

Generally, if a franchisee cancels a franchise contract, it will not be entitled to damages unless the termination is due to a previous breach by the franchisor. As a result of a breach of a franchisor's disclosure obligation, a franchisee may rescind an agreement provided that the franchise agreement sets out or provides that such a breach by the franchisor constitutes a material breach of its contractual duties (a material breach is a breach when the breaching party knew, or could have presumed given the purpose of the agreement, at the time of executing the agreement that the other party would not be interested in performing the agreement in the event of such a breach). Notice of rescission must be given to the other contracting party without undue delay after the entitled party learns of the breach of obligation. If the franchisee or franchisor rescinds the agreement, the contracting parties have to return any partial consideration to one another. If the consideration is returned by the contracting party who rescinded the agreement, it is entitled to reimbursement of costs connected with rescission.

A franchisor and franchisee may also agree on the possibility of terminating the agreement on the basis of the payment of a certain amount of compensation.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In principle, the breaching party is liable for such a breach. Only the sub-franchisor is liable under the contractual relationship with the franchisee. This means that the sub-franchisor is primarily responsible for a failure to comply with an obligation in relation to the franchisee. In certain conditions, a sub-franchisor may have the right to recourse for damages from the franchisor.

If several parties are liable for damages, the Czech Commercial Code sets out that such persons are obliged to compensate the damage jointly and severally and then settle the amount among themselves according to the extent of each person's liability.

Members of statutory organs, CEOs or employees of the franchisor or sub-franchisee have no personal liability (either in commercial law or civil law) for a breach of obligations undertaken by a franchisor or sub-franchisor, even if such an obligation has been breached as a result of their act or omission. All the same, with certain conditions, the franchisor or sub-franchisee may have the right of recourse in relation to all of these persons.

Another issue is that of criminal law. Legal entities in the Czech Republic have no criminal liability. Only the individual who committed the criminal act may be criminally liable. This means that if acts by members or employees of the statutory body resulted in a criminal act, they may be individually criminally liable.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Entering into a franchise agreement is governed by general civil law and commercial law rules for entry into contracts. The general private law principles which also apply to a franchise agreement primarily include the principles of contractual freedom, bona fides and fair business conduct. The process of entry into a franchise agreement should be consistent with the European Code of Ethics for Franchising, which, however, has only an advisory nature (in other words, it is not binding, just recommended).

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There are no general rules on pre-sale disclosure under Czech law. All the same, the statutory requirements as to the specifics of all legal acts (that implicitly include all necessary information the franchise agreement must contain in order to be specific enough) and basic legal principles as ethical and fair business conduct apply.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If a franchisee suspects, or if it has been proved, that a franchisor has engaged in fraudulent or deceptive practices that relate to the offer or sale of a franchise, it is obliged to file a criminal complaint. If the suspicions prove to be true, the franchisor may be indicted for, and later charged by the prosecutor with, the crime of fraud, breach of laws on the rules of economic competition, and misrepresentation of data on economic results and business assets, infringement of trademark and other brand rights.

On the level of civil law, claims may be raised in the event of a franchisor's acts constituting unfair competition. In this case, a franchisee may request reasonable satisfaction, compensation for damage and surrender of unjust enrichment.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

As stated above, a franchise agreement is an 'unspecified type of contract' under Czech law that is, in general, regulated by Act No. 513/1991 the Commercial Code. There is no special Czech legislation that would regulate the relationship between the franchisor and franchisee after the franchise agreement comes into effect. All the same, every relationship must always comply with the general provisions and basic principles of Czech law. Two of the leading principles on which commercial law is based are ethical behaviour and fair business conduct. See also questions 10 and 35.

25 Do other laws affect the franchise relationship?

The most significant legislation in force in the Czech Republic that regulates the legal relationship between a franchisor and franchisee after the effective date of a franchise agreement, is as follows:

- Commission Regulation (EU) No. 330/2010, on the application of article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices;
- Act No. 513/1991 the Commercial Code;
- Act No. 40/1964 the Civil Code;
- Act No. 143/2001 on the Protection of Economic Competition;
- Act No. 441/2003 the Trademarks Act;
- Act No. 207/2000 on the Protection of Industrial Designs;
- Act No. 527/1990 on Inventions, Industrial Designs and Rationalisation Proposals;
- Act No. 455/1991 the Trades Licensing Act;
- Act No. 586/1992 the Income Taxes Act;
- Act No. 235/2004 the Value Added Tax Act;
- Act No. 216/1994 on Arbitration Proceedings and Enforcement or Arbitral Awards; and
- Act No. 99/1963 the Civil Procedure Code.

A redraft of the Civil and Commercial Codes is currently under way in the Czech Republic that should introduce a number of innovations that will be effective from 1 January 2013.

26 Do other government or trade association policies affect the franchise relationship?

The Czech Franchising Association (Česká asociace franchisingu (ČAF)) is a non-profit, professional organisation, operating at the national level, franchising providers, namely, franchisors and specialists dealing with franchising. ČAF is a member of the European Franchise Federation. ČAF is focused on supporting the development of current franchise systems and creating better conditions for the growth of this type of business. Any opinions given by ČAF have an advisory nature only.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchise agreement may be entered into for a specific or unspecified period of time. A franchise agreement that has been entered into for a specific period of time terminates upon the expiry of the agreed term.

A franchise agreement with an unspecified duration may be terminated by either party, as specified in the franchise agreement. If the parties do not agree on terminating the agreement by notice, any franchise agreement of an unspecified duration may be terminated without providing reasons on three months' notice, ending at the end of a calendar quarter.

A franchisor and franchisee may also rescind an agreement, provided that the franchise agreement allows this or if any of the contracting parties has breached its obligations in a material manner. A material breach of an agreement is a breach where the breaching party knew or could have presumed at the time of executing the agreement that given the purpose of the agreement stemming from the contents of the agreement or circumstance of its execution, that the other party would not be interested in performing the agreement in the event of such a breach.

28 In what circumstances may a franchisee terminate a franchise relationship?

Please see question 27.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

If the contracting parties have entered into a franchise agreement for a specific period, the extension of an agreement is at the sole discretion of the contracting parties. If either of the contracting parties (for example, the franchisor) is not interested in an extension, the franchise agreement terminates upon its expiration.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, provided that the franchisor has agreed to such provisions with the franchisee in the agreement. All the same, no right exists to prevent a franchisee from transferring its corporate entity anchored in law. A franchisor and franchisee may agree on a franchisor's preemptive right if the franchisee decides to sell its corporate entity.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Czech law does not regulate the fees connected with a franchise agreement and leaves their structure, amount or distribution schedule to the will of the contracting parties. Similarly, due dates for fees are, as a rule, set out in the agreement. Only general principles apply, according to which fees should correspond to market conditions and follow the rule that the relationship between a franchisor and franchisee is that of two independent entrepreneurs.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Yes, the default interest rate is limited by the principles of ethics or fair business conduct. All the same, neither the minimum nor the maximum amounts of default interest are expressly set. In the absence of the parties' agreement on the amount of default interest, it is governed by the provisions of section 369, section 1 of the Commercial Code, which refers to civil law regulations, namely Government Decree No. 142/1994 Coll. that states that the amount of default interest is based on the repo rate plus seven percentage points of the Czech National Bank (ČNB) declared as of the last day of the calendar half-year that precedes the half-year in which the defendant's default occurred for the first time.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no restrictions on payments by a franchisee made in a foreign franchisor's currency.

34 Are confidentiality covenants in franchise agreements enforceable?

When granting a franchise, a franchisor discloses its know-how, so the execution of a confidentiality agreement is recommended. If the disclosed information has the nature of a trade secret within the meaning of the Commercial Code, then it enjoys legal protection under section 20 of the Commercial Code, against a breach or threat of breach as unfair competition.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, the principles of bona fides and fair business conduct constitute significant legal principles and apply to the pre-contractual phase, during the entire term of the franchise agreement and after its termination. According to the provisions of section 265 of the Commercial Code, any legal act that contradicts the principles of fair business conduct does not enjoy legal protection.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. Pursuant to Czech law (Act No. 634/1992 on Consumer Protection), a consumer is only an individual who does not act within the scope of their business activities or independent performance of their profession.

37 Must disclosure documents and franchise agreements be in the language of your country?

Czech law does not require the execution of the franchise agreement in the Czech language. All the same, for avoidance of all doubt concerning the good faith and certainty of the drafted documents, it is generally advisable to additionally provide a version in Czech. Also, in the case of any disputes held before a Czech court, such a translation would be necessary.

38 What restrictions are there on provisions in franchise contracts?

The following principles primarily apply when entering into a franchise agreement: contractual freedom, fair business conduct and good faith.

Certain limitations are imposed by competition legislation, such as a ban on determining sale prices for which the franchisees supply goods and services to their customers. There are also certain limitations for negotiating a non-competition clause in the event of a termination of a franchise agreement. A franchisee may be prevented from manufacturing, purchasing, selling or reselling goods or services for only one year after the expiration of a franchise agreement, provided that such an obligation relates to goods or services that compete with the contractual goods or services of the franchisor, that it is limited to the premises in which a franchisee has operated during the contractual term and that it is necessary for the protection of know-how delivered to a franchisee by a franchisor. Certain limitations are also imposed by competition law on the mandatory purchase of goods by the franchisee from the franchisor.

As far as territorial exclusivity is concerned, a franchisor may agree with a franchisee on a specific area in which no other franchisee or franchisor may do business. Other franchisees may only be prevented from 'active' sales in the exclusive territory (namely, direct active approach to customers, offering goods or establishing branches or warehouses) and not from passive sales (namely, reacting to a customer's demand).

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition law plays an important role also in the area of franchise agreements.

Following the Czech Republic's accession to the European Union on 1 May 2004, EU competition law has direct effect. Franchise agreements that interfere with or breach economic competition are prohibited by virtue of article 101 (1) of the Treaty of the European Union. In the franchise sector, the Commission Regulation (EU) No. 330/2010, on block exemptions for vertical agreements and on concerted practices is of importance.

In terms of Czech antitrust legislation, the negotiation of franchise agreements is mainly governed by the Act on the Protection of Economic Competition ('Czech Competition Act', No. 143/2001 Coll.) in which section 3 prohibits all agreements that interfere with competition unless their influence on the market is negligible. Under section 4 of the Czech Competition Act, the ban under section 3 of the Act does not apply to those agreements that may not have any influence on trading among EU member states, but which meet the other conditions set out in the EC block exemption (such as Regulation No. 330/2010).

The conditions for awarding a statutory exception from the general ban on agreements interfering with competition are regulated in section 3 (4) of the Czech Competition Act. According to that provision, agreements which serve to improve the manufacturing or distribution of goods, or which further support technical or economic development, are exempt from the ban, providing that consumers can adequately profit from these benefits and providing the agreements only contain restraints on competition that are essential for achieving the above objectives. Agreements that do not allow competitors to impede competition within a core segment of the market for goods, the supply or purchase of which constitutes the subject-matter of the relevant agreement, are, additionally, not covered by the ban.

Compliance with antitrust provisions is monitored by the Office for the Protection of Economic Competition, that is located in Brno, and by the EU Commission. The parties must verify and decide whether the requirements for a statutory or community exemption have been met.

From the point of view of competition law and also the regulation of unfair competition conduct, the points contained in the Commercial Code are important for franchise agreements.

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40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Proceedings on disputes arising from business relationships fall within the jurisdiction of a court in accordance with Act No. 99/1963 the Civil Procedure Code (CPC).

Within the Czech judicial system there are three courts. In a majority of cases, the court with jurisdiction for dispute resolution in the first instance is the District Court. All the same, the law may set exceptions to that rule (see section 9, sections 2, 3 and 4 of the CPC) and determine that the court with jurisdiction is the Regional Court (in Prague called the Municipal Court). The territorial jurisdiction of the court stems from the provisions of section 84 et seq, of the CPC. If no exception applies, the court with territorial jurisdiction is, as a rule, the court in whose district the defendant has their registered office or residential address. A review of a decision of a first-instance court is an appeal that is heard at a Regional or Higher Court (if, in the first instance, the matter was resolved by a Regional or Municipal Court, respectively). The court with exclusive jurisdiction over an extraordinary remedy, being an extraordinary appeal, is the Supreme Court.

Before the proceedings are initiated, or during their course, a preliminary injunction may be ordered if it is necessary to ensure that the relationship between the participants is regulated on a temporary basis. Court proceedings in the Czech Republic are very formal. Disputes from franchise agreements would be the subject of contentious litigation where, in order to be successful in the case, the plaintiff has to bear its burden of evidence in respect of the facts alleged by it. This means that the parties to the dispute are obliged to actively search for and propose evidence in support of their allegations. The average duration of first-instance court proceedings is approximately one to two years.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The main advantages of arbitration proceedings are their speed, lower costs, informal nature and privacy (namely, they may not be attended by the public). Another significant advantage is the wide enforceability of arbitral awards according to the New York Convention of 1958. Arbitration proceedings may also be more just, since they may be decided according to equity principles.

The most important disadvantage of arbitration proceedings lies in the disunity in the decision-making by arbitrators as a result of the absence of any more independent, higher organisation that would unify the decision-making system. Another problem is a narrower jurisdiction during the taking of evidence, as arbitrators cannot enforce a procedural obligation against third parties (witnesses and experts), who may only be heard if they appear voluntarily. Arbitrators may not issue preliminary injunctions.

Arbitration proceedings are single-instance proceedings, which may bring both advantages and disadvantages. An arbitral award is final and no appeal against it may be filed, except in extraordinary situations concerning the procedural errors.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not treated any differently from domestic franchisors.

Denmark

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The franchisor can choose between many different types of business entities when establishing a franchise business in Denmark. These include sole tradership, partnership, branch, private limited company (anpartsselskab – ApS) or public limited company (aktieselskab – A/S). Typically, the franchisor chooses between a private or public limited company because of the limited liability.

2 What laws and agencies govern the formation of business entities?

The formation of a public or private limited company is governed by the Danish Companies Act 2010. The Danish Business Authority is the authority responsible for the administration of this Act and both public and private limited companies must be registered with the Danish Business Authority.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Forming a business entity

The initiative to form a limited company is taken by one or more founders. The share capital for a private limited company must be a minimum of 80,000 Danish krone (approximately €10,700) or a minimum of 500,000 Danish krone (approximately €67,100) for a public limited company. Registration is contingent on 25 per cent of the contributed capital, subject to a minimum of 80,000 Danish krone, being subscribed with binding effect and paid up. However, where all or part of the share capital is paid up by way of non-cash contributions, the entire share capital must be paid up.

In order to form a private or public limited company, the founders are obliged to sign a memorandum of association including articles of association.

The articles of association must contain provisions on the object of the company, the amount of share capital, the company's management structure and the shareholders' voting rights. Besides these requirements the formal requirements in relation to the articles of association of a private limited company are few, and the shareholders in a private limited company can more or less freely decide how to organise the company's affairs. For a public limited company, the formal requirements are more detailed and the organisation of the company's affairs by the shareholders is more regulated than for a private limited company.

All physical and legal persons with the necessary legal capacity can be founders of a private or public limited company regardless of the founder's nationality or place of residence. The following information is required if the founders are foreign individuals: their names, residential addresses and copies of passports, or if the founder is a foreign company: the name, address, registration number and documentation of the company's existence, eg, a transcript from the relevant company register.

A limited company will not become a legal entity until it has been registered with the Danish Business Authority, and until it is registered, the persons acting on behalf of the company are personally liable for all obligations undertaken by the unregistered company. Upon registration, the limited liability company acquires the rights and obligations conferred on the company after the signing of the memorandum of association.

Management

A limited liability company may choose from two different types of management structures:

- a management structure where the company is managed by a board of directors responsible for the overall and strategic management and an executive board responsible for the day-to-day management consisting of one or more persons appointed by the board of directors. In public limited companies the board's chairman and vice chairman as well as the majority of the board members may not be members of the executive board; or
- a management structure where the company is managed solely by an executive board appointed by a supervisory board. The supervisory board oversees the executive board, and thus the supervisory board has no responsibility for the overall and strategic management. No member of the executive board may also be a member of the supervisory board.

The board of directors or the supervisory board of a public limited company must have at least three members.

Private limited liability companies may choose among the two mentioned management structures, however, a private limited liability company has the further option to be managed solely by an executive board.

Maintaining a business entity

When the public or private limited company has been registered, any changes, for example in the company's management, amendments to the articles of association or similar, must be registered with the Danish Business Authority.

A private or public limited company must prepare an annual report for each financial year. The company's auditor or auditors must be registered with the Danish Business Authority and at least one auditor is required to be a state-authorised public accountant or a registered public accountant. A limited company must submit the annual report to the Danish Business Authority no later than five months following the expiry of the company's financial year.

4 What restrictions apply to foreign business entities and foreign investment?

As a member of the EU, Denmark is committed to observe the principle of free movement of capital, goods, services, labour and non-discrimination against entities and persons from other member states. There are no restrictions as to the nationality or place of residence

of the members of the board of directors, supervisory board or the management board of a Danish limited company. The same applies to entities and persons from countries outside the EU.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The Danish tax system has no specific regulations with respect to franchising. The Danish tax system distinguishes between individuals and companies considered resident in Denmark and individuals and companies considered non-resident in Denmark.

Individuals and companies resident in Denmark are subject to unlimited tax liability, i.e., liable to pay tax on all income, whether it derives from Denmark or abroad. Individuals and companies non-resident in Denmark are subject to limited tax liability, i.e., only liable to pay tax on income earned in Denmark.

Foreign individuals and companies are often also subject to tax liability in another jurisdiction, which means that income earned in Denmark is also subject to taxation in that other jurisdiction. In order to avoid double taxation, Denmark has entered into double taxation relief agreements with various countries around the world.

Company tax

A company is considered resident in Denmark, and thereby subject to unlimited tax liability in Denmark, if the company is registered with the Danish Business Authority, or if the management of the company has its place in Denmark.

The corporate income tax rate is 25 per cent (2011). Corporate income tax is imposed on the company's profit which consists of all types of income. In general, all expenses incurred when obtaining, ensuring or maintaining the taxable income of the company are deductible in the taxable income. Companies are also allowed to depreciate their assets.

With respect to royalty payments from franchises in Denmark, a final withholding tax of 25 per cent (2011) applies as a main rule for payments to non-resident companies. Furthermore, as a main rule, a final withholding tax also applies with respect to interest payments (25 per cent (2011)) and dividend payments (27 per cent (2011)) to non-residents.

Individuals

Individuals are considered resident for Danish tax purposes when the individual is domiciled in Denmark or the individual has been staying in Denmark for a continued period of at least six months (including short stays abroad as vacation, etc).

For individuals, the taxable income consists of personal income (i.e., business income and employment income), capital income and assessment deductions. Besides the taxable income, individuals are subject to taxation on share income (dividends and gains/losses on shares).

Danish residents are subject to tax on employment income at progressive income rates up to a maximum of approximately 51.5 per cent (2011). The maximum capital income rate is 47.5 per cent (2011) whereas the maximum rate on share income is 42 per cent (2011).

With respect to royalty payments from franchises in Denmark, a final withholding tax of 25 per cent (2011) applies as a main rule for payments to non-resident individuals. Furthermore, as a main rule, a final withholding tax also applies with respect to interest payments (25 per cent (2011)) to non-residents.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

There are no relevant labour or employment considerations for a typical franchisor. However, the franchisor may not give instructions to the franchise regarding recruitment of employees which can be classified as discriminations, such as to gender, ethnicity, age or religion.

Regarding the risk of the franchisee to be deemed an employee of the franchisor, it is important that it is specified in the franchise agreement that the franchisee is an independent contractor acting in the franchisee's own name and at the franchisee's own expense and risk with respect to establishing and operating the business and when employing a suitable workforce.

7 How are trademarks and know-how protected?

Trademarks can be protected in accordance with the Danish Trademark Act in two different ways, either by registration of a trademark with the Danish Patent and Trademark Office, or by commencement of use of a trademark. If the trademark does not have the required distinctive character at the commencement of use, the right is established if and when a distinctive character is created by the use of the mark.

Know-how is not defined by statute, but can be protected by the provisions of the Danish Marketing Act. When drafting a franchise agreement, the franchisor's know-how is usually protected by detailed provisions of confidentiality, both during the term of the agreement, but also after the agreement has expired.

8 What are the relevant aspects of the real estate market and real estate law?

Establishing the franchise business at the proper location is of great importance for the success of the business.

There are different options how a franchise business may be established in the right location. The franchisor or the franchisee may establish the premises in a real property owned by one of the parties. This option may be a significant investment for the party that owns the premises. Another option is that the franchisor enters into a commercial lease agreement with a third party and subsequently sublets the premises to the franchisee. A third option is that the franchisee enters into a lease agreement with a third party with a right for the franchisor to enter into the agreement if the franchise relationship ceases to exist. The franchisor or the parties may decide which option is suitable for the specific type of franchise business.

Real property

In Denmark, the right to acquire real property is unlimited. Although if the buyer (both individual persons and business entities) is not a resident of Denmark, or if the buyer has not previously been a resident of Denmark for a total period of five years, permission from the Danish Ministry of Justice is required. Citizens of and companies domiciled in the EU and in the European Economic Area (EEA) may acquire real property in Denmark without permission from the Ministry of Justice, apart from holiday homes. This follows from Denmark's obligations under the EC Treaty.

All information, including mortgage rights, ownership and other rights and obligations regarding the real property can be registered in the Danish Land Register. The rules on registration are contained in the Danish Registration of Property Act.

Leasehold

If the franchisor or the franchisee chooses to establish the franchise business from leased premises, a lease agreement may be concluded. The lessor and the lessee have as a main principle the freedom of

contract to conclude any lease agreement. The lease relationship, however, is regulated by the Danish Commercial Leasing Act, which provides certain mandatory rules that cannot be deviated from to the detriment of the lessee. For example, regardless of what is agreed, the lessor may only terminate a lease agreement in certain cases, and only if a notice for a specific period has been given.

The Commercial Leasing Act also regulates the lessor's and the lessee's rights and obligations regarding rent increase, notice of terminations, defects, etc.

Under the Commercial Leasing Act the lessee also has a right to assign or sublet the lease to another lessee under certain conditions.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no official or statutory definition of a franchise. However, the Danish Franchise Association defines franchise in its Code of Ethics for Franchising as:

> *Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor grants its individual franchisee the right, and imposes the obligation, to conduct a business in accordance with the franchisor's concept.*

The definition is a translation of the definition of franchising made in the European Code of Ethics for Franchising.

10 Which laws and government agencies regulate the offer and sale of franchises?

No government agencies regulate the offer and sale of franchises, and there is no specific legislation regulating this area.

The overall principle in Danish contract law is the principle of freedom of contract. However, the drafting of a franchise agreement may be restricted by various mandatory rules. In particular, the rules in certain statutory regulations such as the Competition Act, the Marketing Practices Act, the Commercial Leasing Act and others may restrict the terms of a franchise agreements.

Furthermore, the Danish Franchise Association provides certain ethical standards in its Code of Ethics for Franchising, which are binding for its members.

11 Describe the relevant requirements of these laws and agencies.

The Danish Act on Contracts provides provisions within some of the main areas of drafting, such as the formation and invalidity of agreements.

The Act specifies certain elements which may invalidate the whole agreement or certain clauses, if for example fraud or coercion has been used during the formation of the agreement. Furthermore, clauses in an agreement can be invalid if the clauses are found to be contrary to good faith or honest conduct. The content and scope of the legal standards are set out by the Danish courts.

As a general principle, the franchisor has a duty to disclose any and all information and matters that may have importance or may affect the potential franchisee's decision to accept entering into the franchise agreement. The scope of this duty depends on the circumstances as well as the franchisor's and franchisee's knowledge and experience at that specific time.

For the requirements in the Competition Act, see question 39.

12 What are the exemptions and exclusions from any franchise laws and regulations?

See question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There are no laws or regulations on this matter. The Danish Franchise Association has set out some ethical standards in its Code of Ethics for Franchising, which only bind its members. According to these standards the franchisor shall have operated a business concept with success for a reasonable time and at least one unit before establishing a franchise system. Furthermore, it is required that the franchisor is the legal owner of its trademarks.

See also question 11 regarding the franchisor's contractual duty to inform the franchisee before entering into an agreement.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There is no legislation regarding disclosure prior to entering into a franchise or sub-franchise agreement in Denmark. However, it is possible that the outcome of a dispute between a franchisee and a franchisor (a sub-franchisor and sub-franchisee) regarding interpretation of the franchise agreement will be affected by which party had access to the relevant information before the agreement was entered into.

If it is found that the franchisor (or the sub-franchisor) has not supplied the franchisee (or the sub-franchisee) with relevant and adequate information before entering into the agreement, this will probably have a negative affect on the outcome of the dispute for the franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

See questions 13 and 14.

16 What information must the disclosure document contain?

See questions 13 and 14.

The information to be disclosed before entering into a franchise agreement depends on what is found adequate and relevant in the specific situation according to the principles of good faith or honest conduct.

17 Is there any obligation for continuing disclosure?

See questions 13 and 14.

18 How do the relevant government agencies enforce the disclosure requirements?

See questions 13 and 14.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

See questions 13 and 14.

If the franchisor has failed to perform his contractual obligation to inform the franchisee, the franchisee is entitled to various

remedies, in particular a right to demand performance, immediately terminate the agreement or claim financial compensation. The parties may agree what remedies are available, but if the parties have not agreed, the franchisee can bring the dispute to the relevant court.

It is not possible for a franchisee to withdraw from its obligations under a franchisee agreement unless the franchisor's breach is material. If the franchisor's breach is found to be material, the franchisee is entitled both to terminate the agreement and to claim damages.

The franchisee can only recover damages from the franchisor if the franchisee has suffered a loss and such loss may be attributed to the franchisor's breach.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

See questions 13 and 14.

The sub-franchisor is obligated to provide his franchisees with relevant and adequate information in case of sub-franchising. If the franchisor has provided the sub-franchisor with misleading or false information which leads to consequences for the sub-franchisor in the relationship with his franchisees, the sub-franchisor may have recourse to the franchisor in regard to any claims of damages.

The individual officers, directors and employees of the franchisor or sub-franchisor are not exposed to liability, as the franchisor/sub-franchisor according to the principle of vicarious liability is liable for damages for the negligent acts or omissions committed by his employees in the course of their employment, unless they have acted with gross negligent or intentional behaviour.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The parties are free to decide the contents of their agreement but also which contracts they will make and who they choose as contract partners. There are no specific laws or governmental agencies in this matter. See also question 10.

The Danish Franchise Association has set out some ethical standards in its Code of Ethics for Franchising which are binding only for its members.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 11, 13 and 14.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See questions 13 and 14.

If the franchisor has engaged in fraudulent or deceptive practices, the franchisee can contact the criminal authorities who may start an investigation of the franchisor. This investigation may lead to the franchisor being convicted of a felony which may result in fines or imprisonment. Both in criminal and civil proceedings the franchisee can claim damages due to such fraudulent or deceptive practices from the franchisor.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws regulating the relationship between franchisor and franchisee after the franchise agreement comes into effect. However, the general principles of Danish contract law will apply.

Often the parties have only addressed material issues in the agreement, and therefore not taken all matters into consideration. Most statutory rules relating to agreements are non-mandatory, which means that the parties are free to determine the content of their agreement themselves. When a court or arbitration tribunal is presented with a situation in which the wording of the agreement gives no clue as to how a dispute is to be solved, they will decide how the agreement is to be interpreted and/or how its gaps must be filled.

If attempts are made to interpret the agreement, this is sought via application of the agreement's individual elements to determine the intended content of the particular agreement. The most important sources for interpretation include the wording of the agreement, the negotiations preceding the making of the agreement, or a potential common understanding of the agreement between the parties. An important principle for interpretation is the so-called ambiguity rule upon which an ambiguity is interpreted against the party who has drafted the agreement.

Only when no more progress can be made by interpretation will gap-filling be resorted to – which means that the agreement is supplemented by the rules of law, customs or principles applying to agreements of the particular type.

25 Do other laws affect the franchise relationship?

Various laws affect directly or indirectly the relationship between the franchisor and the franchisee. Laws such as the Commercial Lease Act, Competition Act, Marketing Practices Act, Product Liability Act, Personal Data Act and the Taxation Acts shall all be continuously adhered to by the parties.

26 Do other government or trade association policies affect the franchise relationship?

Trade organisations such as the International Chamber of Commerce (ICC) manifest certain international customs of relevance or usages between contract parties also in Denmark. Furthermore, the Danish Franchise Association sets out certain ethical standards for its members.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

When an agreement is validly entered into, the parties are bound by its terms. Often, the agreement contains a provision on termination with an agreed notice period. If no notice period has been agreed, the agreement can be terminated with a reasonable notice period, depending on how long the agreement has been in force and on the particular agreement in question. If a party is in breach of any of its obligations under the agreement, the agreement can be terminated by the other party without any notice period, if the breach is found to be material.

Due to the principle of freedom of contract, the parties can agree which circumstances may lead to the franchisor's termination of the agreement. It may be agreed that the franchisor can terminate the agreement if the franchisee is not loyal to the franchise network or has acted in a way which violates the franchisor's interests.

The franchisee's insolvency, reconstruction, bankruptcy or the franchisee's non-payment of any amount due under the agreement may also be agreed to allow the franchisor to terminate the agreement. However, according to Danish mandatory rules, the franchisee's reconstruction or bankruptcy does not automatically gives a right to terminate the agreement, even if it is allowed under the agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

The same contractual principles as specified in question 27 will apply to the franchisee.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

There are no legal obligations for the franchisor to renew the franchise agreement. As the principle of freedom of contract applies, it is up to the parties to agree under what circumstances the franchisee may require that the agreement is renewed.

The ethical standards in the Code of Ethics for Franchising issued by the Danish Franchise Association only state that it shall be clear in the franchise agreement which terms and conditions the franchisee shall fulfil to be given the right to renew the agreement.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

The principle of freedom of contract applies, so it is possible for the franchisor to restrict the franchisee's ability to transfer the franchisee or the ownership interests in a franchisee entity in the franchise agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations that affect the nature, amount or payment of franchise fees or royalties. However, if the contractual terms relating to the franchise fees or royalties are found to be too unreasonable, they may be set aside or adjusted by the Danish courts.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The parties can agree the amount of interest that may be charged on overdue payments. If nothing has been agreed, it follows from the Danish Act on Interest that the interest after the due date is fixed at an annual rate of interest equivalent to the fixed reference rate plus 7 per cent. The reference rate is the official lending rate fixed by the Danish Central Bank.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no restrictions on the franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable in Denmark. However, the enforceability depends on how the covenants in the agreement are drafted. If the covenants are found to be too extensive, they may be set aside or adjusted by the Danish courts. Penalty clauses in case of breach of the covenants are recommended.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

In the context of general Danish contract law it is a principle that the parties to an agreement shall deal with each other in good faith and with honest conduct. The ethical standards of the Danish Franchise Association also obligate its members to exercise fairness in the dealings with a franchisee/franchisor. How good faith is defined in the specific relationship depends on the circumstances and the actual relationship between the parties.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

When entering into a franchise relationship the franchisee is considered to act in the course of trade, and the franchisee is therefore not protected by any of the Danish laws concerning protection of consumers.

37 Must disclosure documents and franchise agreements be in the language of your country?

See questions 13 and 14.

The parties can themselves agree in what language the agreement shall be made, and it may be in any language that both the franchisee and franchisor understand.

38 What restrictions are there on provisions in franchise contracts?

As stated in question 10, the overall principle in Danish contract law is the principle of freedom of contract. The parties may agree upon what rights and obligations, the parties shall have according to the agreement.

However, certain provisions of an agreement may be set aside or modified in whole or in part if it would be unreasonable or at variance with the principles of good faith to enforce it. This follows from the general clause in the Danish Acts on Contracts section 36. This section will sanction invalidation of a promise both on account of circumstances at its making, on account of its terms, or on account of special factors concerning the promisor's person. Section 36 also provides the Danish courts with a statutory provision to set aside a promise wholly or partly with reference to a change in circumstances after its making, and therefore gives access to the possibility of taking subsequent events into account.

With regard to restrictions that follow from competition law, see question 39.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Danish Competition Act applies to competition law matters in Denmark. The Danish Competition Act is similar to EU competition law in all material aspects. Furthermore, as Denmark is a member of the EU, EU legislation is also directly applicable in Denmark.

Franchise agreements may fall within the Danish Competition Act if they are found to have an appreciable detrimental effect on competition in Denmark. There are no de minimis rules defining 'appreciability' similar to the Commission's de minimis notice.

In so far as the agreement is capable of having an appreciable effect, the agreement may nonetheless be exempted and thus allowed in so far as the following thresholds are not exceeded:

- the parties to the agreement achieve an aggregate annual turnover of less than 1 billion Danish krone and an aggregate market share of less than 10 per cent of the product or service market concerned, or
- the parties to the agreement achieve an aggregate annual turnover of less than 150 million Danish krone.

Update and trends

There are no emerging trends or hot topics in the Danish regulation regarding franchise.

Regarding rules of disclosure, several countries have chosen to introduce rules on disclosure which have an effect on formation of a franchise agreement – including Denmark's neighbour, Sweden. It will be interesting to see if the Danish legislator will choose to follow this tendency.

The UN Convention on Contracts for the International Sale of Goods (CISG) may have a larger role regarding the formation of contracts as the Danish legislator has recently decided that the Danish reservation to CISG part II shall be repealed. However, the relevant law has not yet entered into force. Thereby, in the future CISG part II will apply to the formation of contracts between a Danish party and a foreign party – unless the parties in advance agree that CISG shall not apply to the agreement.

However, this does not apply if the agreement contains 'hardcore' restrictions.

Block exemptions

Pursuant to EU competition law, block exemptions have been adopted, which provides for a general exemption of a certain type of agreements, such as the EC Block Exemption Regulation for Vertical Agreements, which is also incorporated into Danish law. The Block Exemption provides a safe harbour for certain agreements even though they may contain vertical restraints.

Provided that the market share held by the supplier does not exceed 30 per cent of the relevant market on which it sells the contract goods or services, and the market share held by the buyer does not exceed 30 per cent of the relevant market on which it purchases the contracted goods or services, vertical agreements fall within the scope of the Block Exemption and are thus allowed.

The Block Exemption does not regulate the permitted duration of a franchise agreement, but non-compete obligations that are indefinite or exceed five years (at a time) are not exempted by the Block Exemption. However, as franchise agreements, due to their particular nature, differ from other distribution agreements, the Commission has in its case law developed the principle that non-compete obligations on goods or services purchased by the franchisee for the duration of the franchise agreement will fall outside the scope of EU competition law, in so far as the obligation is necessary to maintain the common identity and the reputation of the franchise network.

The Danish Competition Council may also grant an individual exemption of the agreement from the prohibitions in the Danish Competition Act.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

It is recommended that the parties to a franchise agreement agree on a venue clause in the agreement, either arbitration or stating that a dispute shall be referred to a specific court.

The Danish courts are composed of the Supreme Court, two High Courts, the Maritime and Commercial Court and 24 district courts. Almost all legal proceedings must initially be filed at the district courts. However, if the dispute concerns a principal matter, the district court may choose to refer the dispute to the High Court.

The Danish Maritime and Commercial Court settles disputes concerning international commercial disputes, intellectual property disputes, competition law disputes, disputes where the Danish Consumer Ombudsman is a party relating to the Danish Marketing Practices Act or the Payment Services Act, as well as disputes concerning EU trademarks and EU designs.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The main advantage of arbitration in Denmark is that the arbitration will follow the normal rules, standards and procedures for arbitration in other similar Western countries. Denmark has acceded to a number of international conventions including the New York Convention of 10 June 1958 on Recognition and Enforcement of Foreign Arbitral Awards and the Geneva Convention of 21 April 1961 on international commercial arbitration. Therefore, arbitration in Denmark will not be unfamiliar for most foreign franchisors. In comparison to the Danish courts, arbitration is not public and the arbitral decision may be made in secrecy if the parties choose so.

The main disadvantage of arbitration is that it will include a high cost as the parties must pay the costs for the arbitration tribunal. However, the costs are not high compared to international arbitration under the ICC arbitration rules and similar.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not and may not be treated differently from domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The most common forms of business entity are:

- incorporating a local corporation through a stock company;
- incorporating a limited liability company or partnership; and
- obtaining authorisation from the government to incorporate a foreign company through a branch office.

Some franchisors do not incorporate local entities; they choose to stay as non-domiciled entities, subject to the tax treatment that such choice involves.

2 What laws and agencies govern the formation of business entities?

The law that governs the formation of business entities is the Code of Commerce and the agency responsible for authorising their incorporation is the Registry of Commerce. The Superintendency of Mercantile Obligations is responsible for supervising the compliance of mercantile obligations by all existing companies.

The Ministry of Economy is responsible for authorising the incorporation of branch offices.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The most commonly used legal entity is the stock company. Its legal formation requirements are:

- type of corporation (a stock company with variable capital) – the variable capital regime allows the shareholders to increase or decrease the capital stock without having to publish the minutes of the board of directors in the Official Gazette and in two newspapers of national circulation, and without amending the by-laws of the company;
- commercial name – the corporation will have the name of preference (any language is allowed), followed by *sociedad anónima de capital variable* or its abbreviation 'SA de CV'. A prior search must be conducted at the Registry of Commerce to confirm whether the name is available or not, or if there are any conflicting names that might prevent the use of the selected name;
- nationality – according to Salvadorean laws, the Corporation will be of Salvadorean nationality irrespective of its number of foreign shareholders. This means that after its incorporation at the Registry of Commerce it will be subject to Salvadorean laws;
- domicile – the domicile of the corporation will be the one where it will be established within El Salvador. However, the company may open branches abroad;
- term – the law requires the fixing of a term or duration of the corporation;
- capital stock – the minimum capital stock should be US$2,000. According to the applicable law, at the time of incorporation at least 5 per cent of the subscribed capital stock must be paid. The outstanding 95 per cent must be completely paid within one year. The value of each share of the capital stock can be US$1 or multiples of one;
- shares and shareholders – the law requires a minimum of two shareholders to constitute a corporation. If a shareholder is a foreign corporation, power of attorney must be granted to a person that resides in El Salvador or to a foreigner that comes to El Salvador in order to represent it at the execution of the deed of incorporation. The power of attorney must be legalised by apostille if the country where the documents come from is a member of the Hague Convention of 1961, or legalised up at the nearest Salvadorean consulate if the country is not a member of the Hague Convention of 1961; and
- administration – the administration of the corporation shall be given either to a board of directors or a sole administrator. The former must be composed of at least two directors and their corresponding alternates. The common practice is to appoint a board of directors of three or five members and their alternates: namely president, secretary and first, second and third directors. Constitution of a board of directors is recommended, as is the inclusion in the board of a person residing in El Salvador who shall have the legal capacity to sign documents and petitions on behalf of the corporation and act as its legal representative. By law, the legal representation of the corporation belongs to the president and the secretary of the board acting jointly or separately, unless otherwise provided in the by-laws of the corporation (that is, it can be delegated to the president and the local director). Another option is to grant power of attorney to a person residing in El Salvador who shall have the legal capacity to sign documents and petitions on behalf of the corporation and act as its representative.

In order for a business entity to legally operate it is necessary to obtain other licences and registrations. This includes:

- obtaining from the Ministry of Treasury an income tax identification number (NIT) and a value-added tax number (IVA). The NIT is required for the shareholders and for the newly established subsidiary and its legal representative. The IVA is only needed for the newly established subsidiary;
- obtaining a merchant licence and registering the initial balance sheet at the Registry of Commerce; registering as an employer before the Salvadorean Social Security Institute, the Social Housing Fund and the Ministry of Labour; registration before City Hall; among others;
- obtaining authorisation for the accounting books, the accounting catalogue and the corporate books, which include shareholders' meetings minutes, board of directors' minutes and shareholders' registration; and

- the merchant licence at the Registry of Commerce must be requested and paid.

4 What restrictions apply to foreign business entities and foreign investment?

Foreign investors and the commercial companies in which they participate shall enjoy the same rights and be bound by the same responsibilities as local investors and partnerships, with no exceptions other than those established below. No unjustified or discriminatory measures that may hinder the establishment, administration, use, usufruct, extension, sale and liquidation of their investments shall be applied to them, so they may not be subjected to discrimination or differentiation due to their nationality, residence, race, sex or religion.

According to the Political Constitution and auxiliary laws, investments shall be limited in the following activities and conditions:

- small-scale trade, industry and provision of services, in particular coastal fishing as established by law, are the exclusive right of Salvadoreans by birth and Central American nationals;
- the subsoil belongs to the state, which may grant concessions for its exploitation;
- foreign nationals whose country of origin does not grant the same rights to Salvadoreans shall not be allowed to acquire rural property, except in those cases when the land shall be used for industrial plants;
- no individual or legal entity shall own rural property in excess of 245 hectares. This limitation shall not be applicable to cooperative associations or peasant community associations, which are subject to a special regime;
- the state is entitled to regulate and oversee public services provided by private companies, as well as to approve their rates, except those established in accordance with international treaties or agreements;
- state concessions shall be required for the exploitation of piers, railways, channels and other public infrastructure, under the terms and conditions stipulated by law; and
- investments in the stock of banks, financial institutions and foreign exchange institutions shall be bound by the limitations stated in the laws governing those institutions.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Tax-resident business entities pay income tax on Salvadorean source income at a rate of 25 per cent on net income. VAT at 13 per cent applies to the transfer of moveable goods and the provision of services. Dividends paid to a parent company are not taxable if the subsidiary has paid income tax in El Salvador.

Non-resident companies obtaining income (such as royalties) in El Salvador are subject to withholding taxes of:

- 20 per cent on all taxable income; and
- 13 per cent on all VAT-taxable payments.

In addition, each municipality has its own local taxes.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The Labour Code of 1972 regulates employment relationships between employers and employees. The Ministry of Labour has administrative jurisdiction over inspections and conciliation hearings. Labour courts have judicial jurisdiction over labour disputes, which are further reviewed by labour appeal courts and the Supreme Court of Justice, if the case merits it. The Labour Code applies to all foreign and domestic employees working in El Salvador, regardless of the employer's nationality. All labour law is mandatory and cannot be contracted out of the employment agreement.

A written employment agreement is required under the Labour Code. In the absence of an employment agreement, witnesses can be used to prove the employment relationship.

For companies with 10 or more employees, an internal labour regulations document comprising disciplinary regulations and procedures must be adopted and filed with the Labour Ministry.

Employees are not entitled to management representation or to be consulted in relation to corporate transactions.

An employee can be dismissed with or without just cause (under the Labour Code). If an employee is dismissed without just cause, he or she is entitled to a severance payment of one month's salary per year of work, plus proportional vacation and year-end bonus payments. This is limited to a maximum of four times the statutory minimum salary multiplied by the number of years at work, unless the company's custom is to compute severance pay based on current salary on dismissal.

Foreign employees require a work permit (a temporary residence visa). This can be obtained from the Salvadorean consulate in their country of origin, but the most common way to obtain it is to enter the country as a tourist and then apply for temporary residence. The process takes about three to five months.

If the franchise agreement clearly states that there is no employer–employee relationship between the franchisor and franchisee's employees, any risks can be diminished.

7 How are trademarks and know-how protected?

Trademarks and service marks are protected through registration at the Registry of Intellectual Property. El Salvador follows the Nice Agreement, which adopts the international classification of goods and services. Trade dress is also protectable. Both foreign and domestic franchisors can license the use of their trademarks and service marks through licensing agreements.

Know-how is protected through confidentiality agreements that prevent the receiving party from using the know-how received for purposes other than the franchise relationship.

8 What are the relevant aspects of the real estate market and real estate law?

It is customary that real estate will be sold by setting a price to the duration of the lease and a price to the construction, if any. It is always advisable to do a property title due diligence prior to making an offer. Promise to purchase and sell agreements can be entered into to reserve a property for a certain time by making an advance payment prior to acquiring it, and setting a date or conditions to be met by either party. The acquisition and transfer of real estate property has many formalities to observe, one of which being that the documents must be granted through a public deed before a notary public and registered at the respective real estate registry. Such documents would be granted in Spanish. If one or more of the grantors does not speak or understand Spanish, the notary public must appoint an interpreter who will prepare a translation of the documents in the language of the grantors.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

A franchise is not a regulated contract in El Salvador, hence there is no legal definition provided by law; however, it is permitted based on the freedom to contract provided in the Political Constitution, which is the highest-ranking law of the nation.

Update and trends

Small and medium-sized local businesses are starting to operate under franchise schemes.

10 Which laws and government agencies regulate the offer and sale of franchises?

No specific laws or government agencies regulate the offer and sale of franchises.

11 Describe the relevant requirements of these laws and agencies.

See question 10. From experience, any potential franchisee would expect to know the general terms of the franchise (term, territory, price, royalties) and the general contractual conditions.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Not applicable.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

No law or regulation creates a requirement that must be met before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

It would be expected that the sub-franchisor makes any relevant disclosure to sub-franchisees. There are no specific items required; however, experience indicates that any potential sub-franchisee would expect certainty as to the rights of the sub-franchisor to sub-franchise the franchise. In some cases, potential sub-franchisees ask for certification or written evidence.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Normally, foreign franchisors would follow a protocol that requires the potential franchisee to sign a non-disclosure or confidentiality document prior to disclosing the general franchise terms and general contractual conditions. There are no regulations on how often disclosures are updated.

16 What information must the disclosure document contain?

Information to be included in disclosure documents is not regulated. The extent of disclosure depends on the ability of the potential franchisee to inquire as to the business to be franchised.

17 Is there any obligation for continuing disclosure?

Continuing disclosure is not regulated. Accordingly, any such disclosure to current franchisees should be governed by the franchise agreement.

18 How do the relevant government agencies enforce the disclosure requirements?

Disclosure requirements are not regulated.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Disclosure is not regulated.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Disclosure is not regulated.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Civil law provides for the general principle that all entities are responsible for damages caused by their tortious intent or negligence. Following case law, clauses limiting such responsibility are considered to be unconstitutional.

According to the Code of Commerce, it is presumed that dealings among merchants are done in good faith.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Pre-sale disclosure is not regulated.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Fraudulent or deceptive practices by a franchisor or by any other merchant in a commercial dealing could constitute a felony that can be criminally prosecuted.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect.

25 Do other laws affect the franchise relationship?

Yes, there are laws that regulate the different legal provisions contained in a franchising agreement.

The Mediation, Conciliation and Arbitration Law sets out the principles and guidelines for the establishment of mediation, conciliation and arbitration panels; the maximum time frame for the processes; types of arbitration proceedings, including ad hoc arbitration and arbitration conducted in a foreign language selected by the parties; and other topics. The Law applies to parties arbitrating in El Salvador who have specifically chosen the parameters of this Law, as applicable.

The Monetary Integration Law establishes the US dollar as legal tender. It applies to all foreigners and nationals living or conducting business in El Salvador.

The Investment Law provides equal legal treatment for foreign and national investors; provides a series of rights, including repatriation of capital and goods, subject to registration of the investment done in El Salvador; and applies to foreign investors doing business in El Salvador. It affects franchising in cases when a franchisor invests locally in the franchised business: that is, when a franchisor buys property and builds its own premises to enter into future franchising, or when a franchisor sets up a local training centre, distribution centre or similar.

The Civil Code provides the general rules for civil contracting. It regulates obligations, contracts, ways of terminating a contract, conditional contracts, contractual objects, etc, and applies in the territory of El Salvador.

The Commercial Code provides the general applicable rules for contracting between merchants and general behaviour rules for commercial activity, unfair competition, corporations, etc. It applies to merchants conducting business activities within the territory of El Salvador.

The Law for Promoting and Protecting Intellectual Property regulates trade secrets – when these are protected – and liability that arises from infringement, among many other intellectual property issues. It applies to creators of artistic, literary and artistic works, inventors, holders of confidential information and persons or companies for the protection of their copyrights, invention patents, utility models, industrial designs and trade secrets.

The Law Against Money and Asset Laundering defines what is understood by money and asset laundering; creates felonies; delegates the prosecution authority; and provides particular obligations to banks when opening accounts for clients (namely, banks shall report to the attorney general all transactions exceeding US$57,142.86 and those that are unusual when considering the client's record).

The Consumer Protection Law protects consumers against unfair dealings by merchants, non-compliance of offers, abusive contractual clauses and misleading advertisement, among others.

26 Do other government or trade association policies affect the franchise relationship?

There are no other government or trade association policies affecting the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Since there are no laws regulating franchises, the parties can freely negotiate the circumstances of termination. There are no specific legal restrictions on a franchisor's ability to terminate a franchise relationship but it is advisable to always agree to prior written notice, rather than to automatic termination circumstances without notice, as such latter option can represent multiple problems.

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate a franchise relationship under the circumstances determined and mutually negotiated in the franchise agreement, which normally includes non-compliance clauses, a procedure to cure and termination possibilities if the curing actions are not taken.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Yes, a franchisor can refuse to renew the franchise agreement with a franchisee if the franchise contract provides conditions that must be met for renewal to occur and the franchisee does not meet these conditions. Again, it is the franchise contract that mandates the circumstances.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, a franchisor can restrict a franchisee's ability to transfer its franchise agreement. Any restrictions on the transfer of ownership interest in a franchise entity are null and void: that is, in the case of stock companies, the Code of Commerce provides that any restriction on the transfer of fully paid shares of stock would be null and void, and accordingly any such restriction would not be enforceable.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

No. This is mutually agreed by the parties.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

No. In the absence of agreement between the parties on this topic, the Code of Commerce provides for 12 per cent interest.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No. The Investment Law provides a series of rights to the foreign investor (franchisor), including the repatriation of its investment, when the franchise agreement is registered (as explained under question 25, paragraph 4).

In El Salvador, the US dollar has been legal tender since January 2001. Consequently, foreign exchange controls have been abolished and the conversion of funds into US dollars is no longer an issue. The parties are able to choose a currency other than the US dollar. However, formalities provided by the Law Against Money and Asset Laundering shall be observed in all transactions exceeding US$57,142.86 and in all those that the franchisor or franchisee's local bank considers to be unlike the client's normal transactions.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes. The law provides for civil and criminal actions in this regard. A civil action could be pursued to collect damages and a criminal action would punish a felony committed upon violating a confidentiality covenant.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes. Good faith is presumed in dealings among merchants (Code of Commerce) and provisions reinforcing dealings in good faith are acceptable. Accordingly, it is presumed that parties entering into a franchise agreement do so in good faith.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Yes. In general, the Consumer Protection Law provides that a consumer (franchisee) to whom an offer was made (franchise conditions) can take action against a supplier (franchisor) if the conditions are not complied with. In addition, since franchising is dealing between merchants, the Code of Commerce allows legal action to be taken regarding a breach of contractual obligations to perform or not to perform certain duties during commercial dealing.

37 Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements are not required to be in Spanish, the official language of El Salvador.

From experience it seems most members of the business community are fluent at least in English, and that the majority of franchise agreements have been executed in English. However, a potential franchisee could require a translated version of the agreement and any disclosure documents.

It is important to note that any judicial claim derived from the franchise agreement would require that the franchise agreement be submitted to any court in Spanish. If the documents are written in any other language, they must be translated into Spanish following the local legal requirements, under which a notary public would delegate a trusted interpreter to write the translation.

It is advisable that the final franchise agreement executed between the parties should be duly notarised if it is executed in El Salvador. If it is executed abroad, it is required that the document is notarised and legalised by apostille or alternatively by the nearest consulate of El Salvador in order for it to be valid in El Salvador.

38 What restrictions are there on provisions in franchise contracts?

There are no statutory restrictions; hence, provisions in franchise contracts can be negotiated between the parties. Contractually, the parties are free to enter into restrictions, provided these do not contradict public policy, general business principles or the applicable laws. Different conditions can be negotiated with different franchisees within the local legal framework.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition is regulated under the Competition Law, the provisions of which are overseen by the Competition Superintendency. The Competition Law requires selective approval of mergers and acquisitions to ensure antitrust provisions are met. So far, such law is not relevant to franchisors, unless they are engaging in a deal that would disrupt a particular market or that would imply the exercising of a dominant position.

Covenants not to compete, which were formerly permitted, have been abolished by the Competition Law.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The court system is headed by the Supreme Court of Justice. It is organised by subject jurisdiction – namely, civil and mercantile courts, criminal courts, labour courts, family courts, minor claims courts, peace courts, etc – which are normally present in each major city and territorial jurisdiction. In the inner cities, courts are competent over several subjects. As of July 2010, a new Civil and Mercantile Process Code changed the way civil and commercial judicial trials are conducted. Now all cases are resolved in one audience and the most complex ones in two audiences, which must be attended by all parties. Allegations are now verbal and presented before the judge. All evidence must be presented upfront. This change has been positive and has made justice faster and better. The system allows first instance and second instance (appeal) procedures. If the case has sufficient merits, an appeal ruling can be further challenged before the Supreme Court of Justice through a cassation procedure. Constitutional *amparo* processes are available when a court ruling violates a constitutional right.

Disputes derived from franchise agreements would normally be ruled by a civil and mercantile court in the judicial district of San Salvador or, in other cities, by a mixed court competent in civil and commercial matters. Alongside judicial resolution of disputes, parties in a franchise agreement could resolve their disputes through mediation, conciliation or arbitration.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

There are three main advantages for conducting arbitration proceedings in El Salvador: arbitration proceedings can be conducted in any language chosen by the parties; the proceedings last a maximum of 90 days; and any decision can be enforced promptly against the local franchisee in the country where it is likely to hold its assets.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

According to the Political Constitution, there shall be no discrimination between foreign or domestic persons in the application of the law. The same applies to foreign and domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The franchisor will probably choose business entities that allow it to limit its liability. These include a corporation that in Finland is simply a limited liability company (whether private or public); a partnership, subject to it being owned by a limited liability company; and a foundation. The typical franchisor is likely to choose the private limited liability company (the limited company) because of the simplicity of incorporation, low capital requirements, and well-regulated administration as well as the fact that shares are easily transferable. With this in mind, this work focuses on the limited company.

2 What laws and agencies govern the formation of business entities?

The formation of a limited company is governed by the Companies Act 2006. The Trade Register Act and the respective decrees also apply. The company acquires legal capacity once registered with the Companies Register.

3 Provide an overview of the requirements for forming and maintaining a business entity.

For forming a business entity

Execution of the memorandum of association, incorporating by reference the articles of association (by-laws), must be enacted. The by-laws need not contain more than the trade name, the municipality in Finland where the company is to have its registered office and the industry. The memorandum outlines the board members (namely, the directors), the auditor and the subscription of shares. If no directors are resident in Finland, another individual must be resident to receive service of process. At least one director has to be resident within the European Economic Area (EEA) unless an exemption is granted. This also applies to the managing director (CEO). The auditor should be a resident authorised or approved public accountant.

Forwarding the subscription price, whether in cash or kind, is a prerequisite for registration. This shall be documented by means of receipt and certificate issued by both the directors and the auditor.

The completion, execution and filing of the start-up notice also serves the purpose of notifying the tax authorities of the existence of the new taxpayer. Processing for registration with the Companies Register does not generally take long, provided the name and business proposed is distinguishable from and not found to be confusingly similar to names already registered.

For maintaining

Whether the company is doing business or is dormant, the directors shall be responsible, for example, for maintenance of the accounting records in accordance with the Companies and Accounting Acts, keeping a register of all shareholders and shares issued and filing the annual report and auditor's report with the Companies Register, which will thereby be subject to public scrutiny.

In addition, for the purposes of VAT, the tax authorities shall expect the company to submit monthly tax return filings and make tax account payments as well as filing annual tax returns. Employers also have to pay payroll taxes.

A business entity does not require the owner's physical presence; the incorporation in itself constitutes a permanent establishment for the purpose of any tax treaty. However, if the employer wishes to employ staff, it is a requirement to take out policies for the purposes of old age pensions, unemployment, injury and sickness insurance. Payment of dividends must also be notified.

4 What restrictions apply to foreign business entities and foreign investment?

Finland is committed to non-discrimination and subscribes to the principle of free movement of capital, goods, services and labour. The facilities and incentives available to local enterprises are available to foreign entrepreneurs on equal terms. There are no restrictions on ownership unless an acquisition is perceived to put at risk an important national security interest, in which case formal approval must be given, pursuant to the Monitoring Act.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

There is no specific taxation applicable to franchisors.

Corporate income tax

This tax is assessed on the worldwide income attributable to the business, bearing in mind the arm's-length principle. Thus, service fees, interest, royalties, capital gains and dividends are included, but costs, expenses and losses attributable to the business are deductible. The corporate tax rate is 26 per cent. (This is expected to fall to 22 per cent in the next few years.) Since there are currently no thin capitalisation restrictions, a business can be financed from abroad.

Foreign businesses

According to the main rules, foreign businesses are taxed only on income sourced in Finland. Real estate tax is assessed on the taxable value of the property, whether land or buildings. However, should the foreign business have a permanent establishment (PE) in Finland, it will be liable to tax on all income attributable to the PE. Thus, as a main rule, dividends, interests, royalties and capital gains are included, but costs and expenses attributable to the business are deducted. If a PE's business operation results in loss, such a loss will be deductible during the subsequent ten tax years, applying the same loss-carry forward rules that are applied in respect of Finnish business entities. However, these rules will not apply should more than half the ownership of the foreign company change hands.

Foreign individuals

Non-Finnish residents are taxed in Finland on their income sourced in the country, subject to any applicable treaties for avoidance of double taxation. On certain conditions and subject to the approval of an application, salary earners with special expertise may – for a maximum period of four years – be entitled to participate in a regime permitting the employer to withhold, in lieu of income and municipality tax, 35 per cent of salary earned. Otherwise, alien employees will be liable for progressive tax on their salary or wages should they stay in Finland for longer than six months, regardless of citizenship. At the same time, where their stay lasts no longer than six months, the Finnish employer will collect 35 per cent tax at source on the pay, as well as withholding social security payments unless the pay is effectuated by and encumbers a foreign company. Royalties paid to holders of intellectual property rights who are not Finnish residents are subject to a 28 per cent tax at source.

Tax treaties

Double tax treaties, some of which are multilateral, have been concluded with almost 80 countries. The most frequent method for eliminating double taxation is the ordinary credit method. If Finland has no double tax treaty with the domicile state of the foreign tax payer, the country's tax rights will be determined by national tax laws.

VAT

In general, goods and services supplied in Finland in the course of business are subject to VAT. The general rate of VAT is currently 23 per cent, although the rate for food and restaurant and catering services is 13 per cent and the rate for categories such as books, medicines, passenger transport and accommodation is 9 per cent. Thus, all franchising fees, including – among others – downpayments, royalties and marketing fees, are subject to VAT.

Transfer tax

Transfer of title to shares of a private limited liability company is generally subject to a transfer tax of 1.6 per cent of the price agreed. On real estate, the tax rate is 4 per cent.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The crucial question is twofold: whether the franchisee is put under the direction and supervision of the franchisor and whether he or she lacks responsibility for financial risk. If the answers are affirmative, the franchisee is considered more an employee of the franchisor than an entrepreneur. On the other hand, depending on the industry, the franchisor may find it justified to dictate far-reaching requirements regarding recruitment, education, conduct and continuing training of employees, etc. But equilibrium must be maintained so as not to deprive the franchisee of the independence that is a prerequisite for an entrepreneur.

7 How are trademarks and know-how protected?

Trademarks can be protected by active surveillance and immediate decisive action against infringements. In order to be capable of enforcing trademark rights, the first step is to ensure that the trademark is registered, rather than relying on the mere establishment of the mark, symbol or brand. It is risky attempting to make it evident that the mark is generally well-known in the appropriate Finnish business or consumer circles and requires a lot of effort; while this effort is being undertaken, a competitor could be exploiting the trademark.

8 What are the relevant aspects of the real estate market and real estate law?

Since freeholds generally require significant capital investment, transferable and, most often, renewable tenancies are exploited by franchisors with a need for space (whether foreign or domestic), such as restaurants, hotels, retail stores, vehicle rental businesses, and gas stations. Offered mainly by municipalities for periods varying between 30 and 100 years, in many ways tenancies resemble freeholds: the tenant is expected to erect and maintain the buildings and they are subject to real estate tax of 0.6 to 1.35 per cent of the taxable value of property, depending on the municipality.

Franchisors who do not require an entire building generally lease the business premises, for example, a flat or the entire ground floor of a building, thereby assuming the financial and commercial risks. The most common lease term is five to six years, with options of renewal for periods of about three years each. Rents are expressed on a monthly basis computed per utilised square metre, which is frequently pegged to some index or – as in the case of many shopping malls – divided into the capital rent (percentage rent), the maintenance rent and the marketing fee; all utilities such as gas, water and electricity, however, have to be paid as an extra cost. Landlords frequently require a guarantee, which is generally the equivalent of three months' rent and is a bank-held security or collateral.

Where the franchisee is the lessee and it is worthwhile to ensure that a competitor cannot take over the location should the franchise agreement cease, the franchisor may wish to ensure that it is entitled either to take over the lease itself or to replace the franchisee. This may entail a conditional lease assignment between the landlord and the franchisee, or some similar arrangement.

While the relationship between the landlord and the lessee or assignee is regulated by the Act on Lease of Business Premises and the mandatory rules of that Act must be complied with, case law suggests that where the premises are sublet as part of a franchise agreement that is considered to be mingled and complex, the Act on Lease of Business Premises cannot be applied.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no statutory definition for a franchise. The Finnish Franchising Association (FFA) defines a franchise arrangement as a right conveyed by one undertaking to another. While, generally, product distribution and trade name franchise arrangements are not regarded as franchising, on the one hand the main feature of the business format franchise is the licence extended to the franchisee by means of a written standard contract against the payment of an upfront fee or running royalties or both, submission to continuing supervision and reporting and undertaking not to transfer the franchise to any third person to use, within a certain exclusive territory, the franchisor's business format, this being characterised by the trademark, brands, commercial signs, business features of the network and the know-how contained in the manual of the franchisor, and on the other hand, initial and continuing training as well as the technical and commercial back-up services of the franchisor. From the viewpoint of the method of franchising, whether international or domestic, the general notion encompasses the master franchise agreement, the unit franchise agreement and the (master) development agreement.

10 Which laws and government agencies regulate the offer and sale of franchises?

There is no special legislation in this field, but there are a number of statutory regulations that must be heeded. The most important of these are the Contracts Act, the Unfair Business Practices Act, the Trademarks Act and the Competition Restrictions Act.

No government agency regulates the offering or sale of franchises, nor is there any regime for registering or recording franchise contracts. It is advisable to have a trademark licence recorded.

11 Describe the relevant requirements of these laws and agencies.

From the Contracts Act it may be inferred that there is a legal doctrine imposing on contractual parties a mutual duty of loyalty. This is widely acknowledged in case law. Accordingly, there is a kind of general contractual good faith and fair dealing requirement to avoid misrepresentations inducing the opposite party to enter into a contract. In some circumstances, silence may amount to a misrepresentation. Accordingly, the franchisor should, as a general rule, endeavour to disclose any and all matters that may affect the potential franchisee's decision to accept the franchise. The content and scope of this duty depends on the merits of the case, bearing in mind the potential franchisee's knowledge and experience. On the other hand, the franchisee is also generally under a duty of care, prompting him or her to obtain (through his or her own initiative) information available to him or her, such as information on general market conditions and their impact on the business being contemplated.

The Unfair Business Practices Act prohibits any conduct violating good business practice. In particular, it prohibits the use of untrue or misleading representations regarding a business, whether one's own or another that are apt to either affect the demand for or supply of a product or to cause harm to somebody else's business. The Trademarks Act covers the national trademark law and the Competition Restrictions Act sets boundaries regarding actions considered to restrict competition.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Please see question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

No, there is no law or regulation on this matter. Nevertheless, pursuant to the FFA's Code of Ethics, prior to setting up a franchise network the franchisor should have used the business concept successfully and for a reasonable time and in at least one unit.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The sub-franchisor (the master franchisee) is responsible for making disclosures. See question 11 regarding the contents.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Further to question 11, the compliance procedure founded on the principle of good faith and fair dealing requires full and accurate written disclosure of all information material relating to the franchise relationship within a reasonable time prior to the execution of those documents. As the above principle is continuous by nature, disclosures need to be updated whenever circumstances change.

16 What information must the disclosure document contain?

The sale of a franchise requires full and accurate written disclosure of all information material, including the draft franchise agreement. Despite the lack of any express statutory duties regarding the agreement's essential minimum terms, it should contain the terms and conditions set forth in section 5.4 of the Code of Ethics of the European Franchise Federation (EFF; see www.efffranchise.com/IMG/article_PDF/article_a13.pdf).

17 Is there any obligation for continuing disclosure?

Since the principle of good faith and fair dealing is continuous by nature, disclosures need to be updated whenever circumstances change.

18 How do the relevant government agencies enforce the disclosure requirements?

No government agency enforces disclosure requirements. In practice, it is up to the franchisee to ensure that his or her rights will not be encroached. See question 10.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

An action due to violation of the requirements to provide true and sufficient information may be brought before the Market Court if it is founded on a charge of unfair business practice. This court may, however, merely prohibit the franchisor's action and reinforce its judgment by means of a conditional fine. Any claim for damages – whether contractual, such as based on breach of contract, or in tort, such as infringement of the disclosure requirements – has to be instituted by an action before the competent ordinary court. Cease and desist orders, sequestration and a variety of precautionary remedies are also available. In case of tort the main rule is negligence; in case of contracts the liability is strict and is vicarious in respect of lack of care of employees, agents and sub-contractors. The starting point is the principle of full compensation: namely, the franchisee has to be put in the position in which he or she would have been, had the franchisor fulfilled his duties. In the event of the franchisee being entitled to rescind the franchise contract, it is likely that the not-yet-amortised expenditure will be recoverable on the one hand, as well as the estimated loss of future profits from the unit on the other. But where termination would have been permitted, the damages are likely to be restricted to the loss of profits merely for the length of the period of notice.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Although the sub-franchisor is responsible for disclosure with respect to his or her franchisees, the sub-franchisor may have recourse to the franchisor for untrue or misleading information furnished by the franchisor. As far as acting within the powers of the entity, individual officers, directors and employees are not exposed to liability, except where a director can be held liable for negligence on company legal grounds.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Finnish contract law exhibits important principles, such as freedom of contract, freedom of form and the principle that a contract based on the consent of the parties to it is binding (pacta sunt servanda) and must be both negotiated and executed in good faith. Accordingly, the principle of culpa in contrahendo (obligations in negotiation) is emphasised. The guiding force is loyalty between the parties: each party ought to deal loyally with the other, paying attention to the other party's advantage as well. The main thrust of the general rule admitting the competent court to adjust the contract is that, should the court deem a contract term unfair or should the application of such term lead to an unfair result, the term may be adjusted or set aside.

The networks that are members of the FFA have established a certain self-regulation by their commitment to comply with the FFA Code of Ethics, which constitutes a set of standards similar to those of the EFF and, accordingly, deals to a considerable extent with matters relating to the offer and sale of franchises. The member networks have undertaken to furnish the potential franchisee, well in advance of the signature of a binding agreement, with 'any written information capable of being furnished on the franchising relationship between the parties'. The standards on recruitment and advertising are similar to those of the EFF. The same is true where a franchisor imposes a pre-contract on a potential franchisee.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 11 and 21.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

The franchisee may request a pre-trial investigation as to whether the franchisor has committed fraudulent practices, merely a marketing offence or unfair competition offence. A conviction may result in a fine or imprisonment. Damages, including reimbursement for expenditure, may be recovered at criminal or civil proceedings.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no franchise-specific law, but there is court practice and related specific legislation that must be heeded during the length of the relationship. These include the Sale of Goods Act on the supply of commodities and rights – which is analogously considered as applicable to services – and the statutes mentioned in question 10.

25 Do other laws affect the franchise relationship?

Yes – whether directly or indirectly, a number of other statutes affect the franchise relationship. These include the Consumer Protection Act, the Employment Contracts Act, the Damages Act, the Product Liability Act and, should parties seeking settlement of a dispute have elected for arbitration in lieu of ordinary court procedures, the Arbitration Act.

26 Do other government or trade association policies affect the franchise relationship?

There are currently no government initiatives that significantly affect franchising relationships, except for plans to, within a few years, streamline corporate taxation, lower the corporate income tax rate and increase the tax on dividends where they are not tax-exempt.

Regarding trade association policies, the importance of the FFA's board of ethics is expected to grow as an authority capable of formulating good franchising practice in the future.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Where the franchise agreement is for a fixed period, there ought to be very good cause for the franchisor to terminate the agreement and, in particular, for terminating it without notice. Whether or not the agreement is for a fixed period, much will depend on the contents of the contract and the justified expectations of both parties. If the franchisee proves not to be loyal to the network, this is a good cause for termination. This would also be the case if the franchisee, at the conclusion of the agreement, has deceived the franchisor regarding any essential issue, such as his skills, education, personal qualities or financial resources, has breached material contract provisions constantly or repeatedly or has severely violated the interests of the franchisor resulting in a justified loss of trust. If the franchisee either becomes unable to perform the expected duties or is seriously hampered in performing them due to any other specified circumstance, this will also be seen as a good cause.

Franchise agreements frequently contain elaborate grounds for termination, such as non-payment of licence fees, royalties and other monies due to the franchisor, in order to enable the franchisor to rescind the agreement if need be. It is, however, important to note the franchisee's right to challenge the fairness of the provisions, even late in the day. If the franchisee becomes bankrupt, the general rule is that the principle of continuation of agreements precludes discontinuation of the contract.

28 In what circumstances may a franchisee terminate a franchise relationship?

Unless there is a good cause, the right to terminate without notice will not be deemed justified. The threshold for terminating an agreement for a fixed period is much higher. This said, termination with notice is likely to be regarded as justified if the franchisor has neglected core duties, such as guidance, training, the duty of supply of commodities the franchisee may be bound to acquire for his business, the duty of updating the operating manual or similar instructions or is favouring or siding with fellow franchisees at the terminating franchisee's expense. Termination without notice is normally seen as justified if the franchisor:

- at the conclusion of the agreement has deceived the franchisor regarding any essential issue, such as the alleged success of any pilot unit or his or her capabilities for guidance or training;
- has breached material contract provisions constantly or repeatedly; or
- has severely violated the interests of the franchisee, resulting in a justified loss of trust.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The franchisor can refuse to renew the agreement if it was made for a fixed term and there is no provision to the effect that the franchisee has an option to renew it. Where there is an option clause, it is frequently contingent on the franchisee meeting certain conditions; if these are not met, the franchisor may refuse to renew the agreement.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

It is acceptable to contractually restrict a franchisee's ability to transfer its franchise and such a restriction is, in general, enforceable. The same is true of restrictions of transfers of ownership interests in the franchisee's entity. However, a severely strict or long-lasting prohibition may be considered unreasonable.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Should a franchisee (or sub-franchisor), exceptionally, be deemed an associated enterprise in the sense of the transfer pricing regime in order to avoid tax consequences, the arm's length principle and documentation regime must be complied with.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The transfer pricing standards referred to in questions 5 and 31 also apply to interest. There is no restriction on the amount of interest that may be charged unless it is deemed to be unreasonable or to amount to usury. Nevertheless, any provision related to the amount of interest is deemed a term of the contract and, therefore, the rules of the Contracts Act regarding adjustment may be applicable.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No. With regard to money exchange and exchange rates, please see the Bank of Finland's webpage: www.bof.fi/en/suomen_pankki/faq/valuutanvaihto.htm

34 Are confidentiality covenants in franchise agreements enforceable?

Yes, they are enforceable, though the risk of court-ordered adjustment or setting aside exists, such as if the covenant is made more extensive than need be so as to prove unreasonable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, dealing in good faith has a central position in law, though not necessarily in practice. See questions 11, 15, 17 and 21.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. Consumer protection protects consumers only where goods or services are acquired primarily for a purpose other than business or trade.

37 Must disclosure documents and franchise agreements be in the language of your country?

No, they can be in any language understood by the parties, unless the network is bound by the EFF Code of Ethics: in this case the documents may be in either Finnish or Swedish, both of which are official domestic languages.

38 What restrictions are there on provisions in franchise contracts?

Duration

In practice, there are no restrictions.

Exclusive territories

Exclusivity can be provided by means of restricting active – but not passive – sales outside the contract territory.

Restrictions on sources from whom a franchisee may purchase or lease products

From a competition law viewpoint, the franchisor is free to impose on its franchisee an obligation to purchase the contracted products exclusively from the franchisor or from other entrepreneurs designated by the franchisor, provided that such obligation does not exceed five years in length.

Restrictions on customers the franchisee may serve

Generally, the franchisor is free to impose on the franchisee an obligation not to sell contract products to resellers outside the network, subject to the condition that the franchisee is free to effectuate cross-supplies to or from other members of the network at any level and the franchisee is not prohibited from active sales to end users wherever they are located.

Prices franchisees charge their customers

Antitrust law prohibits price fixing, whether direct or indirect. All horizontal agreements on prices and on other trading conditions are prohibited.

Non-competition restrictions

According to the main rule, provisions that are essential in order to protect the franchisor do not constitute restrictions of competition. The more important the transfer of know-how, the more likely it is that the restraints create efficiencies or are indispensable to protect the know-how, and that the vertical restraints fulfil the conditions of the EC Treaty. A non-compete obligation on products purchased by the franchisee falls outside the scope of the prohibition where the obligation is necessary in order to maintain the common identity and reputation of the franchised network. In such cases, the duration of the non-compete obligation is irrelevant, as long as it does not exceed the duration of the franchise agreement itself. All the same, to be effective after the expiration of the contract, the non-compete obligation must be related to the contract products and must not only be indispensable to protect know-how transferred by the franchisor, but must also be limited to both a duration of not more than one year and to the premises or land from which the franchisee has operated during the contract period. In any case, in order not to forfeit the benefit of the block exemption, the 30 per cent market share threshold must not be exceeded. Nevertheless, under the Contracts Act, a non-compete clause may be considered to be either too restrictive or to unreasonably limit the freedom of the franchisee and, therefore, be regarded as non-binding. Accordingly, there is good reason to give much thought to whether a non-compete clause is required and, if so, to its scope and duration.

Governing law

Generally, a franchise agreement can be subject, in part or in whole, to the law of a foreign country. Nevertheless, the choice of foreign law – whether or not it is accompanied by the choice of a foreign tribunal – does not necessarily prejudice the application of domestic mandatory rules from which no derogation can be made.

Dispute resolution

Finnish law acknowledges contracts on jurisdiction unless there is exclusive jurisdiction. By means of a jurisdiction clause, parties may elect to have any, all, or just certain disputes resolved, whether exclusively or not, in some other jurisdiction or by a certain court, whether in Finland or abroad. Nevertheless, one should bear in mind the fact that with the exception of jurisdictions covered by the Brussels and Lugano Conventions and EU Regulation 44/2001, the recognition and enforcement of foreign judgments does meet obstacles. Therefore, commercial arbitration is much in favour. See question 41.

Court's power to adjust contract terms

Always bear in mind the overarching stipulation that any contract term that is held to be unfair, or the application of which is deemed to lead to an unfair result, may be adjusted or set aside. Further, pursuant to the Act on Regulating Contracts Terms between Entrepreneurs, the Market Court may adjudicate a prohibition and a conditional fine should a franchise contract be deemed unfair to the franchisee.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition rules on vertical restraints and in particular on selective distribution may be of some concern to the typical franchisor. The National Competition Restrictions Act prohibits and exempts agreements, decisions or practices by means of similar wording to the Treaty on the Functioning of the European Union. The guidelines of the European Commission are applied in respect of the interpretation of vertical restraints, whether challenged on the basis of the national statute or the basis of the EU block exemption regulation. Where competition restrictions affect trade between the EU member states, EU antitrust law is directly applied. The agency responsible for enforcement is the Finnish Competition Authority (FCA; www.kilpailuvirasto.fi/cgi-bin/english.cgi?luku=about-us&sivu=about-us). Abuse of the antitrust rules may, unless deemed minor or unjustified in respect to safeguarding competition, lead to the Market Court (on proposal by the FCA) imposing a competition infringement. In addition, the abuser may be liable for damages, whether through tort or contract.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The competent courts in civil and commercial matters are, ordinarily, the civil courts that are the courts of first instance (namely, the district and circuit courts), the courts of appeal and – as a last resort – the Supreme Court. Leave to the Supreme Court is granted only rarely. Consequently, the number of cases actually handled by the Supreme Court is low and the number of Supreme Court precedents containing the word franchise can be counted on the fingers of one hand.

However, the Market Court – being a special court assigned competence regarding, for example, disputes on restrictions of competition, unfair competition, public procurement, disputes brought forward by the ombudsman for consumers, certain disputes between traders, etc – plays an increasingly important role. Alternatively, franchisors and franchisees can agree to submit all or certain disputes to arbitration.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The main advantages are the finality and enforcement of the award, whether Finnish or foreign (subject to the provisions of the New York Convention, 1958); confidentiality, in contrast to the publicity involved in court procedures; flexibility as to the procedures (however, this is subject to agreement); and the fact that arbitrators deal in terms of 'market economy': namely, they have to work at their highest level in order to ensure they gain future cases. All the same, such elaborate rules on procedural matters in connection with litigation could be perceived as a disadvantage: the lengthy hearings; the difficulty in appointing the right individuals for the tribunal; the fact that the outcome cannot be appealed against; and, finally, the cost: the arbitrators' expenses must be covered by the interested parties and not by the taxpayer, as is generally the case in litigation.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Legally, there is no difference. In practice, foreign franchisors are probably treated better, not least because of the respect gained by a concept that has been successful in foreign markets.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Business entities that are most commonly adopted by franchisors are those that allow them to limit their liability and thus to control the risk they are ready to assume when launching a franchise.

Three main forms of limited liability companies may be used:

- the *société anonyme* (SA), which requires a minimum capital of €37,000 and a minimum of seven shareholders. This company may be governed by a dualistic structure (a directory board manages the SA under the constant supervision and control of a supervisory board) or a simple structure (the SA is managed by a board of directors that entrusts a general manager with the day-to-day management of the company). The appointment of a statutory auditor is mandatory. Among those three main forms of companies, the SA is also the only entity that can be listed on a public stock exchange.
- the *société à responsabilité limitée* (SARL/EURL), which can be incorporated by a sole shareholder without minimum capital, and does not need an auditor to be appointed unless some thresholds (turnover, total assets and number of employees) are reached.
- the *société par actions simplifiée* (SAS/SASU), which can also be incorporated by a sole shareholder without minimum capital. The appointment of a statutory auditor is mandatory only if certain thresholds (turnover, total assets, and number of employees) are reached (and provided that the company is not affiliated to a group or controls one or several other companies). This entity offers a greater flexibility and freedom of organisation as compared with the SARL and SA. The SAS is easily customised, whereas the two other entities must comply with a rigid legal framework.

The choice of one of these corporate entities will depend on the size of the concerned business and its short-term plans (for example, IPO), the resources available to the franchisor or tax considerations. At the same time, as a general comment, it should be noted that a change of corporate form is always possible between these three entities.

2 What laws and agencies govern the formation of business entities?

All the laws and regulations governing the formation and incorporation of limited liability companies have been collected within the French Commercial Code and, to a lesser extent, the French Civil Code.

Business entities must be registered with the Trade and Companies Registry of the commercial court with jurisdiction over the company's seat.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The formation of a business entity requires the signature of the articles of association of the company by the shareholders. The articles of association must contain all the means of identification of the company (amount of the capital, registered seat, first managers, corporate purpose, etc) and the capital has to be paid up to 50 per cent for an SA and an SAS and up to 20 per cent for a SARL (please also refer to question 1). The articles of association must then be registered with the Trade and Companies Registry. Upon registration, the company acquires legal capacity.

In order to maintain a business entity, a shareholders' meeting must be held every year to approve the annual accounts, which must be registered with the Trade and Companies Registry.

4 What restrictions apply to foreign business entities and foreign investment?

Generally, no restrictions apply to foreign entities wishing to develop their business in France, or to foreign investments. Except in restricted areas, for which prior authorisation from the French administration is required (for example, the defence sector), foreign investors are free to invest in France, subject only to a prior statistical declaration (this declaration must also be submitted when incorporating a company in France). At the same time, if a foreigner who is not a citizen of a country of the European Economic Area or of Switzerland is appointed as legal representative of a French company, some formalities – declarations to the prefectural authorities or obtaining a resident permit, depending on whether the person resides in France – must be fulfilled prior to the registration of the company.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

No specific taxation applies to franchisors. They are thus subject to the following main categories of taxes:

- income taxes: taxes on the profits generated by the activity of the franchisor. If the franchisor is a company, it will be taxed at a 33.33 per cent flat rate (with some minor exceptions). If the franchisor is an individual, he or she will be subject to a progressive tax up to a maximum amount of 40 per cent of his or her income; and
- value added tax: a flat rate of 19.6 (and, in certain cases, of 5.5) per cent applies on all sales of goods or services in France. The fees paid to the franchisor are subject to VAT.

Pursuant to the treaties for the avoidance of double taxation entered into with most countries, foreign business entities are generally not subject to taxation in France but in light of the specifics of each given situation, this is a matter that calls for personalised advice.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

In principle, a typical franchise agreement would be entered into between the franchisor and the franchisee as independent parties. Hence, franchisees (or their employees) should not be deemed employees of the franchisor.

Nevertheless, whatever the terms of the franchise agreement, if, as a matter of fact, a franchisee is placed under the close control of, and takes instructions from, the franchisor (a 'subordination link'), it is likely that this could be construed as an employment relationship under the law.

This could be the case, in particular, where the franchisee's duty merely consists of selling goods that are exclusively (or almost exclusively) supplied by the franchisor, at conditions and prices fixed by the franchisor, in premises owned or rented by the franchisor, or where the elements entering into the franchisee's remuneration mainly depend on the conditions imposed by the franchisor, or both.

It must be noted that under certain circumstances, certain provisions of the French Labour Code may apply to franchisees who are economically dependent on the franchisor without it being necessary to establish a subordination link (articles L7321-1 and seq of the French Labour Code).

In order to limit that risk, a franchisor must be careful not to impose a direct subordination link on franchisees or conditions that would make them economically dependent.

The franchisee is the employer of its own employees. Nevertheless, if there is a direct subordination link between the franchisor and the franchisee's employees, there is a risk that the franchisor would be deemed to be their employer, or at least their co-employer, which could entail criminal sanctions under certain circumstances. In order to avoid that risk, it is important to ensure that the franchisee is the sole decision-maker in hiring, providing work instructions, supervising, sanctioning and terminating employment contracts of the franchisee's employees.

7 How are trademarks and know-how protected?

Trademarks are protected in France by way of registration with the French Industrial Property Institute. European trademarks (registered with the Office for Harmonisation in the Internal Market) also enjoy legal protection in France, as do international trademarks (registered with the World Intellectual Property Organisation) provided that they designate France.

Trademarks are regulated by the Intellectual Property Code, enacted by Law No. 92-597 of 1 July 1992.

A duly registered trademark confers exclusive rights on its holder for a period of 10 years, which is renewable indefinitely. These rights notably enable their holder to act against any unauthorised use of the trademark.

Signs can be protected by way of registration with the Registry of Commerce and Companies. Nevertheless, such protection is granted under the condition that the signs are effectively and continuously exploited on the national territory.

Know-how and trade secrets are not subject to any form of registration but can be enforced as long as they are original, secret or economically valuable, and protected from any form of involuntary disclosure. In order to enforce their protection, one should act on the grounds of unfair competition. Particular care must be taken with respect to confidentiality obligations when disclosing the know-how, particularly at the pre-contractual stage.

8 What are the relevant aspects of the real estate market and real estate law?

In France, the purchase of real estate is governed by the Civil Code. Sales contracts must be signed before a notary public and registered with the land registry. Urban planning has been subject to extensive legislation in order to preserve architecture and environment and to create a framework for the development of urban and rural areas. Domestic and foreign purchasers of real estate are not treated differently.

Franchisors usually rent the premises in which they conduct business under a commercial lease. Commercial leases are regulated by mandatory rules set out in the French Commercial Code. The lessee must be registered with the Registry of Commerce and Companies. A foreign lessee has similar rights to a domestic lessee. These include, under specific conditions, the right to renew the lease and to obtain compensation should the lessor decide to terminate the lease.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Although this is a widely used model for developing business, in particular in the distribution sector, there is no legal definition of a franchise in French law. Nevertheless, franchising is viewed, generally speaking, as the 'reiteration of a commercial success'.

According to case law and to various legal commentators, a franchise may be defined as an agreement by which two independent companies or persons proceed to cooperate, in such a way that one of them (the franchisor) provides the other (the franchisee) with its distinctive signs (trademark, commercial sign), original and permanently improved know-how and ongoing commercial and technical assistance. As considerations, in addition to paying fees (and sometimes a lump sum when joining the franchise network), the franchisee is notably committed to using the know-how and distinctive signs in a uniform, commercial manner.

Franchising was previously described, in a 29 November 1973 administrative order, as 'an agreement by which one entity, in exchange for fees, grants to other independent entities the right to use its commercial sign and its trademark in order to sell products and services. This agreement generally includes technical assistance'. This definition was considered partial and is no longer in force.

After having elaborated its own definition of franchise in 1987, the French Franchise Federation now refers to the European Code of Ethics for Franchising, which defines franchising as:

> *A system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the franchisor and its individual franchisees, whereby the franchisor grants its individual franchisees the right, and imposes the obligation, to conduct a business in accordance with the franchisor's concept. The right entitles and compels the individual franchisee, in exchange for a direct or indirect financial consideration, to use the franchisor's trade name, and/or trademark and/or service mark, know-how, business and technical methods, procedural system, and other industrial and/or intellectual property rights, supported by continuing provision of commercial and technical assistance, within the framework and for the term of a written franchise agreement, concluded between parties for this purpose.*

Such a definition may be taken into consideration by French courts.

10 Which laws and government agencies regulate the offer and sale of franchises?

As there is no codified mention of franchise agreements in French law, there are no specific legal provisions applicable to franchises.

General contractual aspects are governed by the Civil Code and commercial aspects are governed by the Commercial Code. In particular, it is worth mentioning articles L330-1 and L330-3 of the Commercial Code that apply to exclusivity or quasi-exclusivity undertakings and often impact on franchises (see question 11).

There are no government agencies specifically dedicated to the regulation of the offer and sale of franchises. Nevertheless, competition law aspects of distribution (including franchises) fall under the respective authority of the General Directorate for Competition Policy, Consumer Affairs and Fraud Control, an administrative body within the Ministry of Economy, and of the Competition Authority, an independent authority.

11 Describe the relevant requirements of these laws and agencies.

Article L330-3 of the Commercial Code provides for pre-contractual disclosure obligations. It is applicable to all agreements by which one person grants to another a trade name, a trademark or sign, and requires an exclusivity or quasi-exclusivity undertaking for the exercise of such other person's activity.

The pre-contractual information must be disclosed in a document (the content of which is described in question 16), which must be remitted at least 20 days prior to the signature of the franchise agreement. Such document must contain truthful information allowing the franchisee to commit to the contract with full knowledge of the facts.

Pursuant to article L330-1 of the Commercial Code, the duration of exclusive supply obligations may not exceed 10 years. It is nevertheless possible for the parties to enter into another agreement at the end of this 10-year period.

12 What are the exemptions and exclusions from any franchise laws and regulations?

As French law does not provide for any specific franchise law or regulations, no exemptions or exclusions are applicable.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no such legal or regulatory requirement under French law. Nevertheless, since a franchise is described by case law as the 'reiteration of a commercial success', the franchisor must be in a position to prove, prior to offering a franchise, that it has operated at least one similar commercial business in a manner and, for the time necessary to consider such business, as a success.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There are no specific provisions regarding sub-franchising structures in French law. Nevertheless, article L330-3 of the Commercial Code is applicable to 'any person who provides to another person a corporate name, trademark or trade name'. Hence, it is up to the sub-franchisor, as the contracting party, to disclose the pre-contractual information. This would apply even more so where the sub-franchisor has altered the franchise concept in order to customise it to the geographical area granted to it by the franchisor.

The pre-contractual document mentioned in article R330-1 of the Commercial Code does not specifically require that a sub-franchisor disclose information concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor. Nevertheless, since article L330-3 of the Commercial Code requires the disclosure of truthful information allowing the franchisee to commit to the contract with full knowledge of the facts, the sub-franchisor is under the obligation to disclose all relevant information, which may also relate to the franchisor. Such information may consist notably in the franchisor's name, its location, registration number, professional references, the identity of the managers, or the date of the company's creation.

In the event that there are direct contractual obligations between the franchisor and the sub-franchisee, the pre-sale disclosure might also be made by the franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The pre-contractual disclosure must be made in writing at least 20 days prior to the occurrence of the first of the two following events:

- signature of the franchise agreement; or
- payment by the future franchisee of a sum prior to the signature of the agreement, notably in order to obtain the booking of a geographic area.

According to case law, the disclosure has to be made at each renewal of the agreement, even tacit ones. The general principle of 'good faith' in contractual relationships may also require that the franchisor deliver any necessary piece of information during the course of the contractual relationships.

16 What information must the disclosure document contain?

Articles L330-3 and R330-1 of the Commercial Code provide for a very precise list of information that must be disclosed to the franchisee.

The disclosure document must contain, notably, the following information:

- on the franchisor: company name, location, description of its activity, capital, registration number, bank accounts (this may be limited to the five main bank accounts), identity of the entrepreneur or of the managers, all indications regarding their professional references, date of the company's creation, principal stages of its evolution over the past five years, annual financial statements of the two last financial years or the annual reports for the past two years, if the company's securities are publicly traded;
- on the licensed trademark: registration, registration number, date of acquisition of the trademark or date and duration of the licence of the trademark, if applicable;
- on the state and prospects of the market (general and local);
- on the network: list of the member companies with indication of the operating mode, list of the companies (maximum 50) located in France with which the franchisor concluded the same agreement and the date of conclusion or renewal, or both, of such agreements, indication of the number of companies which have left the network during the previous year and of the reason why they left the network (termination, expiration, etc), indication of the presence within the business area of the franchisee of any commercial premises where the products or services concerned are sold; and
- on the contract: the term and conditions of renewal, cancellation and assignment of the contract and the scope of the exclusive rights.

The document must also mention the nature and amount of the expenses and investments related to the commercial name, sign or trademark that the franchisee must pay out before exploiting those IP or commercial rights (see also question 21).

17 Is there any obligation for continuing disclosure?

As explained above (see questions 10 and 14), there are no specific legal provisions applicable to franchises. Nevertheless, franchise agreements are characterised by the transfer of the franchisor's know-how to the franchisee. The European Code of Ethics for Franchising states that the franchisor shall inform and provide training to the franchisee in order to pass down its know-how; this transfer of know-how and training implies ongoing disclosure of the necessary information related thereto.

Moreover, franchise agreements must comply with general principles of contracts and the franchisor is under a general obligation to contract in good faith (see question 21). As a consequence of this good faith obligation, the franchisor must provide to the franchisee, after the execution of the agreement, all information that may have an effect on the franchise or the franchisee or both. In particular, according to case law, the franchisor should inform the franchisee of any significant change in its situation (for example, the franchisor must immediately inform the franchisee if it goes into receivership).

18 How do the relevant government agencies enforce the disclosure requirements?

There is no specific government agency involved in the enforcement of disclosure requirements. Any violation would be assessed by the courts that have material (typically, the tribunal de commerce) and territorial jurisdiction.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

The franchisee may bring an action before the commercial courts in order to be granted damages and to obtain proportionate reimbursement of the fees paid to the franchisor and the investments made by the franchisee.

It may also ask for the rescission of the contract in the case of an error (article 1110 of the Civil Code) or a fraudulent misrepresentation (article 1116 of the Civil Code), provided that it proves it would not have entered into the contract had the franchisor met the disclosure requirements. Where the contract is rescinded, the franchisee may be entitled to reimbursement of the franchise fees, as well as to compensation for losses suffered during the exploitation of the franchise.

Damages generally amount to the gross margin that the franchisee would have realised if the information had been correctly disclosed. It must be noted that, in assessing damages, courts generally take into account the professional experience of the franchisee itself.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There are no provisions under French law regulating any sharing of liability between the franchisor and sub-franchisor. Nevertheless, even though the sub-franchisor is directly exposed to liability, the franchisor may also be held liable if it has disclosed any erroneous information to the sub-franchisor or directly to the franchisee. As far as civil liability is concerned, individuals are, in principle, not exposed to personal liability unless they have not acted on behalf of a company.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

It may not be sufficient to comply with the disclosure requirements of article L330-3 of the Commercial Code. According to the principle of good faith set forth in article 1134 of the Civil Code, the franchisor may have to disclose other significant information (for example, the fact that a previous franchisee in the same area declared bankruptcy two years ago. Article R330-1 of the Commercial Code requires that such information be given only for the previous year).

The French Franchise Federation issued a Code of Ethics which has been substituted by the one put out by the European Franchise Federation. It must be noted that membership of the French Franchise Federation is not mandatory. Therefore, the Code of Ethics may not be enforceable against any franchisor or franchisee, even though it may be viewed by French courts as a guide to what is commonly promoted.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Other than the pre-contractual disclosure obligation set forth in article L330-3 of the French Commercial Code, the general principle of 'good faith' in a contractual relationship (article 1134 of the Civil Code) applies to franchisors. This means that the franchisor must act dutifully and in cooperation with the prospective franchisee (or the sub franchisor with the sub franchisee). This implies disclosing clear and accurate information that would be of significance to the future franchisor, even if such information is not covered by the pre-contractual disclosure obligation package of article L330.3 (see questions 10, 11, 14, 15, 16 and 21).

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

A franchisor may be prosecuted in specific cases of fraud (for example, use of a false identity or occupation) or misleading advertising.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific French laws that govern the entire franchisor–franchisee relationship in ongoing franchise contracts. Nevertheless, it should be noted that general contract rules apply, as well as certain specific rules relating to distinct contractual obligations within the framework of the franchise relationship (for example, licences of intellectual property rights).

25 Do other laws affect the franchise relationship?

Where a franchisor exercises an excessive amount of control over the franchisee, the latter could be qualified as an employee, which will lead to the applicability of labour law (see question 6).

The provisions of French and EC competition laws are also applicable to certain obligations provided for in franchise contracts.

26 Do other government or trade association policies affect the franchise relationship?

As a member of the European Franchise Federation, the French Franchise Federation ensures that its members comply with the European Code of Ethics for Franchising.

In addition, the French Association for Standardisation has issued a standard known as AFNOR Standard (NF Z 20-000), which contains non-binding rules related to the content and termination of franchise agreements.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Where a franchise agreement is concluded for an indefinite term, it may be terminated by the franchisor at any time by it giving a written notice of termination, provided that a reasonable notice period is respected.

It should be noted that pursuant to article L442-6 of the Commercial Code, a party to a commercial agreement may be held liable in case of an abrupt termination of an established commercial relationship.

Where a franchise agreement is concluded for a fixed term, it may be cancelled in the case of serious and repeated breaches by the franchisee of its main contractual obligations (for example, failure to comply with network standards, breach of an exclusive supply clause, breach of loyalty).

As a general rule, cancellation for breach of contract has to be decided by a court. Nevertheless, there are precedents for the unilateral termination of franchise contracts (without recourse to courts) in the case of gross misconduct by one of the parties.

A franchisor may also unilaterally terminate a franchise agreement for breach if the agreement contains an automatic cancellation clause.

On the other hand, a provision in a commercial agreement whereby it may be terminated upon the bankruptcy of one party is unenforceable as a matter of law.

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate a franchise agreement under the same conditions as those described in question 27.

As far as cancellation for breach of contract is concerned, according to case law, it may be justified in the case of breach of the franchisor's obligation to provide the franchisee with an original and specific trademark, distinctive sign or know-how, or with the assistance necessary to carry out the contemplated activity.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

A franchisor is not required to renew a franchise agreement upon the expiration of its term. The franchisor is neither required to indemnify the franchisee, nor to justify its decision not to renew the agreement.

However, the franchisor's right not to renew an agreement must not be abused (for example, by leading the franchisee to believe that the agreement would be renewed under certain conditions, but refusing to do so).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Franchise agreements are considered to be concluded on the basis of the contractors' identities (*intuitus personae*). Consequently, the franchise agreement's terms may require the franchisor's consent prior to any transfer of the franchise or change of control of the franchisee entity, or may alternatively prohibit such transfers.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Article L330-3 of the Commercial Code may apply to initial franchise fees if, under the terms of a franchise agreement, a licence to use a trade name, a trademark or a logo is granted subject to a commitment of exclusivity. Pursuant to article L330-3, if payment of any monies is requested prior to the execution of such an agreement, the disclosure document mentioned in question 15 must contain information concerning 'the undertakings made in consideration of such payment' and the 'reciprocal obligations of the parties in case of forfeiture'. This information must be provided to the franchisee 20 days prior to the payment of the monies.

The amount and nature of fees are not affected by any statutory provisions applicable specifically to franchise fees and royalties. They are of course subject to applicable taxes.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

As a general principle, the amount of interest that can be charged on overdue payments is determined by the parties. Nevertheless, article L441-6 of the Commercial Code stipulates a minimum rate of three times the legal interest rate. If no rate is provided by the agreement, the rate applied amounts to 10 per cent over the official interest applied by the European Central Bank to its most recent financing operation.

There is no specific provision for a maximum interest rate. Nevertheless, the imposition of unreasonably high rates, in particular with regard to commercial practices, may be considered as manifestly abusive and thus prohibited by article L442-6 of the Commercial Code.

The creditor may also claim damages for any harm he or she may have suffered as a result of late payments.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Case law consistently holds that clauses relating to payment in a foreign currency are valid in international contracts.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants are upheld insofar as they tend to protect the franchisor's know-how or the common identity and reputation of the franchise network, or both.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Pursuant to article 1134 of the Civil Code, agreements must be performed in good faith. This general contract rule fully applies to franchise agreements. It implies in particular an obligation of loyalty and cooperation at all stages of the dealings.

Update and trends

The French Competition Authority (ADLC) recently expressed concern about the very high degree of concentration and the lack of competition in the food retail sector in France (ADLC's notices of 7 December 2010). In France, this sector is operated by cooperatives, integrated groups or through franchising.

The ADLC first pointed out the existence of significant barriers to entry for new franchisors, either French or foreign, mainly owing to restrictive planning regulations concerning retail spaces and to the behaviour of retail brands. The ADLC found that, most of the time, these brands impose non-compete obligations on buyers of their commercial land or premises and impose rights of first refusal to future sales of such property. Thanks to these mechanisms, a retail brand can anticipate and impede the arrival of a competing brand.

Secondly, the ADLC noted that independent stores, including franchisees, are captives of the network, as they are subject to multiple obligations that restrain their mobility, and often render a change of brand practically impossible. These constraints are chiefly imposed on franchisees by means of overlapping agreements with differing maturities, making it difficult for the franchisee to exit or to terminate, or through post-contractual non-compete and non-reaffiliation obligations.

In an attempt to revitalise competition in this sector, the ADLC recommends, in particular:

- imposing a single affiliation agreement (could be a framework agreement with application contracts such as commercial leases or supply contracts);
- strengthening the content of the pre-contractual disclosure obligation (together with a longer disclosure deadline);
- limiting the duration of affiliation agreements to five years;
- prohibiting non-compete clauses and priority rights in commercial land purchase agreements;
- limiting post-contractual non-compete obligations;
- forbidding rights of first refusal to the benefit of the retail brands in affiliation agreements, and
- limiting the right of retail brands to hold an equity or voting stake in their independent retailers or franchisors granting them a blocking minority.

On 1 June 2011, the government submitted a bill with the purpose of introducing these reforms. It is therefore likely that relationships between franchisors and franchisees will be affected by new legislation within the next few months.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The notion of a consumer is somewhat disputed under case law. At the same time, it may be noted that for the purpose of the main consumer-related legal provisions, and according to recent case law, only natural persons may be treated as consumers. In the few remaining instances where a legal person may be considered as a consumer, it is usually required that it act as a non-professional. As franchisees generally act as professionals, they are unlikely to be treated as consumers, even if they happen to be natural persons.

37 Must disclosure documents and franchise agreements be in the language of your country?

There are no statutory rules imposing the mandatory use of the French language in disclosure documents and franchise agreements. Nevertheless, the disclosing party must make sure that the disclosure document is understandable to the future franchisee.

For the sake of completeness, it should be noted that the non-binding AFNOR standard mentioned in question 26 requires that the franchise agreement be written in the language of the franchise's place of exploitation.

38 What restrictions are there on provisions in franchise contracts?

Concerns related to the anti-competitive effects of these provisions are mentioned in question 39.

If the franchise agreement contains an exclusivity clause, the duration of the exclusivity is limited to a maximum of 10 years pursuant to article L330-1 of the Commercial Code.

Restrictions on sources from which the franchisee may purchase goods or lease services are valid provided that their duration is limited to 10 years and that they do not restrict competition (see question 39).

According to case law, a non-competition clause applicable after the termination of the agreement is valid only if it is necessary in order to protect, in a proportionate manner, the legitimate interests of the beneficiary, and the time and place of its performance is limited.

Parties acting as traders enjoy great liberty in choosing jurisdiction or governing law, or both. In particular, they may elect to submit a dispute to a court that would not normally have territorial jurisdiction over it, or to arbitration. Parties to an international contract may also freely choose the governing law of the contract.

However, a French court may refuse to apply any provision of the governing law that it considers to be manifestly incompatible with French public policy.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition issues are governed by French and EC competition rules. In particular, European Commission (EC) Regulation 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices is applicable to franchise agreements (insofar as they may affect trade between EU member states) and may be enforced by French competition authorities and courts.

The fixing of minimum prices by the franchisor for the resale of goods is prohibited pursuant to articles L420-1 and L442-5 of the Commercial Code. Nevertheless, price guidelines or maximum prices are allowed provided that they do not have the effect of creating pressure on franchisees that effectively leads to the fixing of prices or to a uniform price applied by the whole network.

Exclusive agreements leading to absolute territorial protection are prohibited. As regards restrictions on customers that the franchisee may serve, one must distinguish between restrictions of active sales and restrictions of passive sales to customers reserved to the franchisor or allocated by it to other franchisees. In general, active sales may be restricted (provided that this restriction does not limit sales by the customers of the franchisee), but there can be no restriction on passive sales.

As far as restrictions on the source from which a franchisee may purchase goods or lease services are concerned, according to the European Commission's Guidelines on Vertical Restraints, they are not deemed to restrict competition if they are necessary to maintain the common identity and reputation of the franchised network.

Under French law, non-compete obligations must be reasonable as regards their duration, their geographical applicability, and the scope of activities covered. French law does not provide for a strict limitation in time. Nevertheless, French competition authorities refer to EC Regulation 330/2010 of 20 April 2010, which provides for a one-year limitation on post-contractual obligations and a five-year limitation on non-compete obligations applicable during the contract term.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

In the French court system, disputes are brought before specialised courts, depending on the matter at stake.

A typical franchise dispute would be brought before relevant commercial courts – usually those of the jurisdiction where the defendant is located. Appeals may be brought before the relevant court of appeal, whose decision may be appealed to the Supreme Court, which will review questions of law only.

Labour law matters must be brought before specific labour jurisdictions. Matters concerning trademarks must be brought before the ordinary civil courts. These cases may subsequently be taken up by a court of appeal and the Supreme Court.

Arbitration is possible between professionals under the French Civil Procedure Code. The case may be brought before various relevant internal or international organisations (French Arbitration Association, French Arbitration Committee, ICC, etc).

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The main advantages of arbitration for a franchisor are the discretion, confidentiality and flexibility of the procedure. The fact that the parties can choose arbitrators who are specialists in the matter at hand and who are not attached to the national legal system of one of the parties can also be an advantage. Furthermore, as an arbitration award may be final and binding upon the parties, the arbitration procedure can be faster and more efficient than a standard procedure before the courts.

However, the fact that the enforcement of an arbitration award requires a judgement of a civil court (Tribunal de Grande Instance) may be a disadvantage in case of emergency. Besides, arbitration can be expensive and the costs of the procedure can dissuade the parties from choosing arbitration or, where arbitration is already provided in the franchise contract, from bringing an action before the arbitration panel.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not, in practice or legally, treated differently from domestic franchisors.

Investments made in France by foreign companies are only submitted to statistical declarations. This may be of concern to foreign franchisors if they intend to invest directly in France (see question 4).

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Franchisors wishing to set up business in Germany have a variety of legal forms (partnerships and limited liability companies) from which to choose. Nevertheless, the most common form of corporate vehicle to be established by a typical franchisor in Germany is a private limited liability company (GmbH). This corporate form requires a minimum amount of capital investment (at least €25,000) and offers limited liability, so only the company's assets are liable to the company's creditors. Furthermore, the GmbH offers a great deal of flexibility as regards internal structures and procedures. Others forms of corporations are the public limited company (AG) that requires a share capital of at least €50,000, and the recently introduced Unternehmergesellschaft (haftungsbeschränkt). The latter is a version of the GmbH and to some extent resembles a private company limited by shares (Ltd) under common law – mostly through the abandonment of a minimum capital requirement.

2 What laws and agencies govern the formation of business entities?

If the business entity is to be classified as a partnership, its formation is governed by the German Civil Code (BGB) and the German Commercial Code (HGB). The incorporation of a private limited liability company is subject to the Limited Liability Company Act (GmbHG), and the formation of a public limited company is regulated by the Stock Corporation Act (AktG). Limited liability companies must be registered in the commercial register that is maintained by the local courts.

3 Provide an overview of the requirements for forming and maintaining a business entity.

A GmbH is incorporated by a shareholder agreement that has to be certified by a notary and registered with the commercial register. The agreement and therefore the registration has to declare the name and registered office of the company, corporate objects, the amount of share capital and individual contributions of the shareholders.

4 What restrictions apply to foreign business entities and foreign investment?

There are no restrictions on foreign business entities and foreign investment in Germany.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

A business entity that has its registered office or place of management in Germany is considered tax-resident in Germany. Unless otherwise provided for in an applicable double tax treaty, a tax-resident entity is subject to unlimited tax liability in Germany on its worldwide income.

Corporate income tax is payable at a rate of 15 per cent (plus solidarity surcharge of 5.5 per cent of the corporate income tax). Individuals who conduct business in Germany or are partners in a partnership in Germany are subject to progressive German income tax rates of up to 45 per cent (plus a solidarity surcharge of 5.5 per cent of income tax), depending on the amount of their income.

Trade tax is a municipal tax and varies between approximately 12 per cent and 18 per cent. The trade tax base is the taxable profit for income tax or corporate income tax purposes, modified by some add-backs and deductions. To mitigate the double burden of income tax and trade tax, income tax on business income is to a certain extent reduced by trade tax (trade tax rate relief allowance). Trade tax cannot, however, be deducted from corporate income tax.

Non tax-resident business entities or entrepreneurs are subject to limited tax liability on their domestic-sourced income. Income received from a permanent German establishment is regarded as domestic-sourced income and is therefore subject to income tax (for individuals not tax-resident in Germany) or corporate income tax (for companies not tax-resident in Germany), as well as trade tax at the normal rate.

Income tax on domestic taxable income from the licensing of know-how or rights of use of non tax-resident business entities or entrepreneurs not having a permanent establishment in Germany is levied at source by way of a withholding tax, unless otherwise provided for in an applicable double tax treaty. The withholding tax is normally paid by the debtor (the franchisee) on account of the creditor (the franchisor). The tax rate is 15 per cent. The solidarity surcharge amounts to 5.5 per cent of the income tax or the corporate income tax.

Deliveries and services supplied in Germany against consideration by an entrepreneur are generally subject to German value added tax (VAT). Services relating to licensing of rights or the provision of know-how supplied by an entrepreneur are generally subject to VAT, if the recipient of these services is situated in Germany. Deliveries of goods from abroad are either subject to German VAT on intra-Community acquisition of goods or to German import VAT. The standard rate is 19 per cent; however, some deliveries are taxed at the rate of 7 per cent and some supplies are tax exempt (for example, financial services).

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Depending on the nature of the relationship between a franchisor and a franchisee, there may be a risk that the franchisee may be treated as an employee or a quasi-employee of the franchisor, with the result that employer obligations and employee rights apply. Whether a franchisee will be classified as an independent businessman or as an employee (or quasi-employee) depends on the scope of the control exercised by the franchisor and on the extent of the entrepreneurial risk assumed by the franchisee.

In this respect, the courts rely on the criteria of personal dependency (employees) or economic dependency (quasi-employees). Dependency exists if the franchisee is excessively bound to the franchisor's instructions regarding the subject matter, conduct, time, length and place of his activity. Self-employment exists where the franchisee is mainly free to determine its activity and bears the entrepreneurial risk. A franchisee organised in the form of a company limited by shares (for example, a limited liability company or a stock corporation) will not run the risk of being qualified as an employee.

7 How are trademarks and know-how protected?

Apart from well-known or famous brands, trademark protection in Germany requires registration either with the Deutsches Patent- und Markenamt, or a designation of international trademarks (IR-trademark) for Germany, or registration as a Community trademark. Trademarks such as words, pictures and letters are protected by the Trade Mark Act.

Although know-how is part of a franchisor's intellectual property rights, the protection of know-how is not subject to specific statutes such as the Trade Mark Act or the Copyright Act. Even so, franchisors' know-how is confidential information under the franchise agreement or other confidentiality agreements. Breach of business confidentiality constitutes a breach of those agreements and, moreover, is punishable under the Act Against Unfair Competition.

8 What are the relevant aspects of the real estate market and real estate law?

German law does not provide for any special franchise-related regulations concerning the real estate market or real estate law. Thus, the general rules of the German Civil Code apply. Commercial leases and subleases may be freely concluded between lessor and lessee. Any assignment of ownership must be notarised and registered in the land register.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no statutory definition of 'franchising' in Germany. According to the definition of the German Franchise Association that is partly recognised by the courts, franchising is a sales and distribution system by means of which goods, services or technologies are marketed. It is based on close and ongoing cooperation between legally and financially independent and self-employed companies, the franchisor and the franchisees. The franchisor grants its franchisees the right, at the same time as imposing the obligation on them, to run a business according to its concept. This right entitles and obliges the franchisee, in return for direct or indirect remuneration, within the framework and for the duration of a contract signed between the parties, to utilise, under ongoing technical and economical support by the franchisor, the system's name, the trademark, the logo or other intellectual property or protection rights, as well as know-how, economic and technical methods and the business system of the franchisor.

10 Which laws and government agencies regulate the offer and sale of franchises?

There are no specific laws or government agencies that regulate the offer and sale of franchises. Therefore, the offer and sale of franchises is only governed by the general provisions of contract law (the German Civil Code), consumer law, commercial law (the German Commercial Code) and unfair trade and antitrust law. According to the law, the franchisor must disclose all necessary information to the franchisee (see question 14). In particular, the provisions of the German Civil Code concerning standard terms can be applied where the franchisee has signed on a take-it-or-leave-it basis and where no negotiations of the contract can be ascertained (section 307 of the German Civil Code). According to German consumer credit law, a franchisee is entitled to revoke the contract if it is, on entering into the contract, establishing an independent business enterprise, and the contract contains an obligation to repeatedly take supplies of goods. But such right of revocation does not exist if the total value of goods to be purchased repeatedly exceeds an amount of €75,000.

11 Describe the relevant requirements of these laws and agencies.

Please see question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Please see question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

German statutory law does not provide for special requirements that a franchisor must meet prior to offering franchises. Nevertheless, the German Franchise Association (www.franchiseverband.com) lists numerous guiding principles in its Code of Ethics:

- the franchisor must have successfully run a business concept for an appropriate period of time and with at least one pilot project before founding his franchise network;
- the franchisor must be the owner or legitimate user of the company name, trademark or any other special labelling of his network; and
- the franchisor must carry out initial training of the individual franchisee and must assure ongoing commercial or technical support or both to the franchisee during the entire term of the contract.

Observance of the stated principles is obligatory in order to become and remain a member of the Franchise Association, and to demonstrate fair business practices.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Under German law, pre-contractual disclosure in connection with franchise contracts is not regulated by special statute or monitored by a specific agency. Only the general provisions regarding the opening of contractual negotiations apply. Therefore, prior to the conclusion of the franchise contract, the franchisor or sub-franchisor must ensure that all the relevant facts have been clearly presented to the potential franchisee. In the case of a violation of the franchisor's duty to present the relevant facts, the franchisee has the right to claim damages. The content and the scope of the duty depend on the individual case, taking the experience and knowledge of the franchisee into account. The courts have stressed that, as a general rule, the franchisee is obliged to obtain information at the franchisee's own initiative about the general market conditions and the impact of those conditions on the prospective franchise business. Nevertheless, an exception to that rule applies if there are particular circumstances of which only the franchisor is aware and which are recognisably of importance to the other party's decision as to whether to enter the franchise contract or not.

Thus, the scope of disclosure requirements depends on the franchisee's need for information and on the existing possibilities for the franchisee to obtain information. As a result, the franchisor must provide information about the way the franchise system works and its prospects of success. It follows from the court decision that the franchisor must refrain from providing misleading information on the franchise system and must disclose all relevant information about it in order to avoid subsequent damage claims. Any lack of information or any misleading information may lead to liability on the basis of a breach of pre-contractual disclosure obligations. A non-binding guideline for franchisors about disclosure in Germany is the German Franchise Association's code of ethics for franchising that is available on the above-mentioned website.

The sub-franchisor must, at least, offer information about the master-franchise and the allocation of tasks between franchisor and sub-franchisor. He or she must show the extent of the derivation of rights from the franchisor (particularly as to trademarks and know-how).

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Unlike common-law countries, and contrary to the legal situation in France, Italy and Spain, there is no specific compliance procedure under German law or under German franchise practice. A written standard compliance procedure does not exist. Nevertheless, it would be advisable for franchisors to expressly disclose to their potential partners in writing all information that is deemed necessary according to German case law and to the German Franchise Association code of ethics for franchising (reflecting the actual constitution of the franchise system). German franchise lawyers have developed checklists to ensure such proper disclosure (see also question 14).

16 What information must the disclosure document contain?

There is no statutory requirement for specific items for pre-contractual disclosure. Even so, it may be derived from German case law and from the German Franchise Association's code of ethics that at least the following items should be disclosed (see also question 14):

- description of the franchise concept;
- initial and ongoing support by the franchisor;
- date of beginning of the franchise system;
- existence of a pilot business;
- required capital and manpower for the franchisee's business;
- accurate information on the profitability of the franchisee's business;
- actual number of franchisees; and
- pending lawsuits with an impact on the potential franchisee's business.

17 Is there any obligation for continuing disclosure?

An obligation for continuing disclosure can follow from the principle of good faith that is a basic principle of German law (see question 35). By invoking good faith, a court may establish collateral obligations owed between contracting parties. This may include protective obligations, such as information (disclosure) about developments having an impact on the franchisee's business or on the franchise system in general (for example, the franchisor's trademark being challenged by a third party).

18 How do the relevant government agencies enforce the disclosure requirements?

This is not relevant for German jurisdiction (see question 14).

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

If the franchisor infringes its duty regarding disclosure, the franchisee is entitled to claim damages. The franchisor has to put the franchisee in the position it would have been in if the franchisor had fulfilled its disclosure obligation. As the franchisee may have not agreed to the franchise agreement under full disclosure, it may rescind the franchise agreement. The franchisor, therefore, can be ordered to consent to the cancellation of the franchise contract, to pay all obtained franchise fees back to the franchisee and to reimburse the franchisee for all expenses incurred in connection with the franchised business. But income earned from the exercise of the franchise has to be deducted.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In principle, a sub-franchisor is solely responsible for fulfilling its disclosure obligations with regard to franchisees. Nevertheless, the sub-franchisor may have recourse against the franchisor if the sub-franchisor has used and relied on the franchisor's disclosure material containing misleading information. Normally, individual officers, directors and employees of the franchisor are not exposed to liability because they are not supposed to become franchisees' contractual partners. That said, in exceptional cases, those intermediaries or third parties might be held liable for violations of pre-contractual disclosure because the German Civil Code provides for the responsibility of third parties when the third party claims reliance for itself to a special extent (inducing special trustworthiness) and thereby substantially influences the contractual negotiations or the conclusion of the contract.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See question 10.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 14 and 16.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See question 19. The franchisee may file a complaint with the competent public prosecutor's office for fraudulent practices of the franchisor. A conviction for fraud may lead to imprisonment or a fine.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

As well as the offer and sale of franchises, the ongoing relationship between franchisor and franchisee is only governed by the general provisions of the German Civil Code, the German Commercial Code, and competition and antitrust law (see question 10). In practice, the laws of the German Civil Code concerning standard business conditions play an important role for the enforcement of standardised business conditions; for example, regarding franchisees' obligation to effect changes to the franchise system that are introduced by the franchisor during the term of the agreement. This law (in particular, section 307 of the German Civil Code) provides that standard terms are null and void if they unduly prejudice the other party contrary to the requirements of good faith. In other words, the standard terms law addresses unfair contract terms which operate unreasonably to the detriment of the other party.

25 Do other laws affect the franchise relationship?

Besides the general provisions of contract law, commercial law, competition and antitrust law, the franchise relationship can be affected in particular by laws regarding the protection of intellectual property, such as trademark law and the laws regarding patents.

26 Do other government or trade association policies affect the franchise relationship?

Although the German Franchise Association (the Association) is a non-governmental body and membership is not compulsory, the guiding principles contained in the Association's code of ethics influence franchise relationships at least to some extent. This is mainly due to the fact that the Association represents a quality association of the franchise business by determining the binding guidelines for member companies, by verifying these before admission into the Association and by checking whether the strict admittance requirements for membership of the Association have been met. Given that membership of the Association is regarded as an indication of quality for a reputable franchise business, many franchisors adhere to the guidelines in order to become (and remain) members of the Association.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Generally, franchise agreements end as a result of lapse of time, termination with notice or the conclusion of an agreement to annul the franchise relationship. That said, there may be circumstances that lead to sudden friction in the relationship between the franchisor and the franchisee and, as a consequence, one party might wish to terminate the franchise agreement even without notice. Under German law, a termination without notice can only be performed if a good cause exists and the franchisee (or the franchisor) has been formally issued with a warning letter beforehand. Only major infringements of the duties of the franchise agreement constitute good cause for a termination without notice.

Good cause that enables the termination of the agreement without notice is established when serious infringements of the contractual duties occur: for example, refusal to pay the franchise fees or the repeated breach of important rules of the franchise system (such as the prohibition to cooperate with competitors). Assessment of whether an action represents good cause requires an overall assessment of the circumstances of each individual case and a weighing of the interests of the franchisor and the franchisee. The termination has to take place within a reasonable time of the occurrence of the activity that led to the friction in the relationship. Finally, it must be noted that, pursuant to German law on standard business conditions, neither the necessity nor the requirements for 'good cause' can be waived in a standard franchise agreement. The same applies to the necessity for a formal reminder before termination without notice.

Upon termination of the franchise agreement, the franchisee might be entitled to claim compensation for loss of income that might otherwise have been earned from further business. If so, the compensation can be as high as the average annual income that is averaged on the basis of the past five years. Compensation will not be paid if the contract was terminated by the franchisee, or in case of termination without notice because of misbehaviour by the franchisee.

28 In what circumstances may a franchisee terminate a franchise relationship?

The franchisee may also terminate the franchise relationship if good cause arises. For example, good cause has been affirmed by German courts where a franchisor undertakes the contractual obligation to include the franchisee in purchase benefits (such as rebates) that the franchisor receives from its suppliers, but then conceals that it has actually received such benefits.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

According to German law, the renewal of a franchise contract is exclusively subject to agreement between the parties. Therefore, a franchisor may refuse to renew the franchise agreement without having to give reasons for his or her decision. Nevertheless, it should be noted that franchisors' freedom of decision is limited in terms of claims for damages. For example, where a franchisor has announced his or her intention to renew the franchise contract and in this connection encouraged the franchisee to invest in the (expensive) refurbishment of business premises on the verge of contract expiry, the refusal to renew the franchise contract without good reason may entitle the franchisee to claim damages.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Under German law, it is possible to regulate such restrictions within the franchise contract. Normally, the transfer of the franchise is subject to the franchisor's prior written approval in order to protect the know-how and integrity of the franchise system and to prevent entry of the franchisor's competitors. Likewise, it is possible (and enforceable) to make the franchisee's transfer of ownership (including assignment or pledge) in the franchisee entity subject to the prior approval of the franchisor.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no specific laws or regulations affecting the nature, amount or payment of fees. These issues are subject to negotiation between the parties. Nevertheless, the amount of fees should reflect the quality and value of the franchise system and franchisor's services, given that fees that are conspicuously disproportionate to the franchisor's performance are considered immoral and are therefore void (section 138 of the German Civil Code).

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

According to German law, the rate of interest for demands for payment is 8 per cent above the base interest rate (currently 0.37 per cent, according to the European Central Bank) for merchants (businesses). Although this provision is not mandatory and therefore can be waived, it should be noted that agreements that deviate as to the amount of interest are scrutinised by the courts, given that an amount of interest exceeding the amount regulated by law (which is regarded as rather adequate) must reflect the loss that the franchisor could usually be expected to incur.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No such laws or regulations exist in Germany.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes, confidentiality covenants are enforceable. If a franchisee does not comply with its obligation to keep know-how or business secrets confidential, the franchisor may apply for an injunction and claim damages from the franchisee.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

German law stipulates that the parties to a contract effect performance in the manner required by good faith (section 242 of the German Civil Code). This is a basic principle of German law and a 'general provision', enabling a court to 'tailor' its decision to the circumstances of the particular case (section 307 of the German Civil Code regarding the assessment of standardised terms is one particular instance of the basic principle of good faith). The principle of good faith limits the enforcement of existing rights; or, in other words, requires that rights are exercised in a manner consistent with good faith. Although the application of the good faith principle depends on the facts of the individual case, it can be said that, in most cases, the courts make restrained use of this principle and refrain from simply introducing new terms that might be regarded as more appropriate.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

As a general rule, franchisees are not treated as consumers under German statutory law or jurisdiction. In that respect, the Federal Supreme Court decided on 24 February 2005 that potential franchisees are not to be treated like consumers in connection with the setting-up of the business. Nevertheless, even if a franchisee is not considered as a consumer he might be a 'business founder' who is also entitled to revoke the contract according to section 512 of the German Civil Code if he is obliged to purchase goods on a recurrent basis (see question 10).

37 Must disclosure documents and franchise agreements be in the language of your country?

German law does not require an international franchisor to provide the franchisee with pre-contractual information or a franchise agreement drafted in the German language. Nevertheless, in order to avoid misunderstandings and future disputes, it is advisable that the franchisee is at least provided with a translation of the franchise agreement for convenience, as long as it cannot be excluded that the franchisee might have difficulties with the interpretation of the franchise agreement. Moreover, if the franchise agreement provides for the jurisdiction of a German court, a translation of the agreement will become necessary if it is brought before a court, given that the language in court needs to be German (this applies to all documents involved).

38 What restrictions are there on provisions in franchise contracts?

German law is characterised by the principle of contractual freedom that allows the parties to agree on the provisions of a contract at their discretion. Therefore, restrictions on provisions in franchise contracts are an exemption and mainly follow from antitrust law and the laws regarding conditions in standardised contracts (in particular section 307 of the German Civil Code: see questions 10, 24 and 35).

The law regarding conditions in standardised contracts specifies the principle of good faith and bans standardised provisions that unreasonably disadvantage the franchisee in a manner contrary to the requirements of good faith. For example, a provision stipulating that the duration of the franchise agreement shall be 30 years would presumably be considered void, given that it unreasonably restricts a franchisee's entrepreneurial freedom. On the other hand, a duration that is too short (for example, one year) could also be regarded as unreasonable, as it would be practically impossible for the franchisee to recover the costs of its investment in setting up the franchise business within the agreed term.

The second source for legal restrictions on provisions in franchise contracts is antitrust (competition) law. In 2005, German antitrust law was completely harmonised with European antitrust law. All forms of competition restraints contained in distribution agreements, such as non-compete clauses, price-fixing and guaranteed exclusive areas, are now treated in full compliance with European antitrust law. European antitrust law (article 101(1) of the Treaty on the Functioning of the European Union (TFEU)) prohibits agreements between undertakings that may affect trade between member states and that have as their object or effect the prevention, restriction or distortion of competition within the common market. Exemptions are made either on an individual basis or, if applicable, under a block exemption. Vertical restraints such as those typically encountered in franchise agreements can be, to some extent, exempted under the EC Block Exemption Regulation No. 330/2010 (BER).

Non-compete clauses

Franchise agreements often provide for non-compete obligations prohibiting the franchisee, during the term of the agreement, from carrying on competing business in the market to which the franchise agreement applies. Such non-compete obligations are generally subject to competition law, as their effect is to restrict the franchisee's freedom of business activities and to prevent other franchisors from distributing their products or services through the franchisee involved. Provisions in franchise agreements that are essential in order to protect the franchisor do not constitute restrictions of competition for the purpose of article 101(1) TFEU (European Court of Justice, judgment of 28 January 1986, case 161/84, ECR 1986, 353, *Pronuptia*). If a non-compete clause is not essential for the protection of the franchisor, the BER can still apply. According to the BER, non-compete clauses during the term of the agreement must not be agreed for more than five years, while non-compete clauses after the termination of an agreement may not last for more than one year. These exemptions are only available to franchisors and franchisees with a market share of less than 30 per cent. If the market share is higher, the block exemption does not apply and the clause is invalid.

According to the BER, post-term non-compete clauses are generally invalid. Nevertheless, there are several exemptions: according to the BER, non-compete clauses can be agreed for one year if they only apply to competing products or services, are essential for the protection of know-how and are restricted to sites from which the franchisee was doing business during the term of the agreement. It can always be agreed that the franchisee is not allowed to use the know-how that was provided by the franchisor after the term of the agreement, provided that the know-how is not publicly known. There are no time restrictions for such clauses.

Update and trends

For some time now, there has been a lively discussion on whether the franchisor is statutorily obliged to pass on purchasing benefits such as cash-backs, quantity discounts or differential discounts to the franchisee. With its judgment of 11 November 2008, the German Federal Court of Justice (File KVR 17/08) brought some clarity into this discussion and held that franchisors are only obliged to pass on these benefits if an agreed contractual obligation in this respect is in place. Otherwise, there is no statutory obligation to do so (Praktiker – Decision). This judgment was prompted by a decision of the Federal Cartel Office of 8 May 2006 (File B 9 – 149/04). In its decision, the Federal Cartel Office held that a refusal to pass on purchasing benefits proportionately to the franchisees, linked to an obligation of the franchisee to source 100 per cent of the goods for the franchise system from specified suppliers, constitutes an inequitable practice and therefore prohibited unfair hindrance of dependent companies according to section 20(1) of the Act against Restraints of Competition (GWB). The Federal Cartel Office thereby introduced the legal right of franchisees to share in purchasing benefits. This decision, however, has now been set aside by the decision of the German Federal Court of Justice.

Another very significant practical franchise question is whether after expiration of the contract the franchisee has a compensation claim against the franchisor for loss of clientele on the basis of commercial agency principles by analogous application of section 89b, Commercial Code (HGB). According to the judgments of the higher regional courts, a franchisee is entitled to such compensation if, firstly, the franchisee is integrated as a commercial agent into the organisation of the franchisor and, secondly, the franchisee has a contractual obligation to transfer its customer base to the franchisor when the contract ends. Nevertheless, it has never been clear under what circumstances the franchisee is seen as being integrated in the franchisor's organisation. The German Federal Court of Justice has potentially shed some light on this issue with its judgment of 29 April 2010 in the case *JOOP!* (File I ZR 3/09). Although the judgment only deals with a claim for compensation after the ending of a trademark licensing agreement, the German Federal Court of Justice also considered comparability to franchises in the grounds of its judgment. The court held that the interests under a trademark licensing agreement are not comparable to the interests under a commercial agent's agreement if the owner of the trademark and the licensor is not itself active in the area of the goods sold by the licensee. The same assessment applies to franchises. A compensation claim analogous to that in section 89b, Commercial Code (HGB) does not arise if the franchisee does not sell goods of the franchisor but is only permitted to use trademark rights, business concepts or other know-how. Consequently, a compensation claim of the franchisee is, in most cases, ruled out.

Price fixing

Basically, every form of direct or indirect price fixing is prohibited by German and European antitrust law. The franchisee must be free to determine at what price he wants to sell his products or render his services. The exemptions of the BER do not apply to agreements with price-fixing clauses. The franchisor is only entitled to set a maximum for the prices at which the product or service of the franchise system are to be sold. Additionally, the franchisor is entitled to issue non-binding price recommendations. Nevertheless, fixed resale prices may be permissible to organise a coordinated short-term low-price campaign in a franchise system (two to six weeks in most cases).

Guaranteed exclusive area

Under European and German antitrust law, a franchisor cannot be provided with a completely exclusive area. Nevertheless, there is a large array of exemptions to that rule. Exclusivity can be provided in the sense that the franchisees can be forbidden to actively distribute outside their exclusive areas: active distribution is defined as all forms of marketing where the franchisee actively approaches potential customers. Passive distribution cannot be prohibited: passive distribution is all forms of marketing where the franchisee does not actively approach potential customers. Therefore, the franchisee cannot be forbidden to deliver goods or render services at the request of his customer even if this customer is located outside of its exclusive area. The establishment of an internet homepage is expressly deemed by the European Commission to be passive distribution. The franchisee cannot therefore be deprived of the right to present itself on the internet.

Restrictions of cross-supplies

It is often agreed in franchise agreements that the franchisee is only allowed to acquire goods from the franchisor and not from other sources, including other franchisees. This is considered a restraint of competition that can have negative effects on price competition. The BER prohibits restriction of cross-supplies between distributors within a selective distribution system. Under European and German antitrust law, most franchise systems have to be considered as selective distribution systems. Therefore, franchisees have to be allowed to acquire cross-supplies from other franchisees.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

See question 38.

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40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Civil and commercial matters are dealt with by the civil courts. Unlike countries in which parallel court systems exist on both the federal and state levels, only one uniform court system is in place in Germany (consisting of the local courts, the regional courts, the higher regional courts and the Federal Supreme Court). Unless there is exclusive jurisdiction (such as for disputes relating to real property or antitrust law), German law acknowledges agreements on jurisdiction between the parties as to international and local jurisdiction. Franchisors and franchisees are also entitled to submit all or certain disputes to arbitration. Therefore, each of the parties may challenge the court's jurisdiction by reference to a valid arbitration agreement. Mediation is also increasingly recognised as a form of joint dispute resolution. Nevertheless, given that mediation does not end with an enforceable judgment for one of the parties, franchisors and franchisees usually agree on mediation proceedings as only the first stage of dispute resolution.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration in Germany offers a number of advantages, such as significant flexibility (for example, number of arbitrators, place and language of the arbitration proceedings), potential cost and time efficiencies, greater confidentiality and a binding, enforceable and non-appealable resolution of the dispute. But arbitration proceedings may be more expensive than court proceedings, particularly if the matter in dispute is of relatively low value. In those cases, additionally, the parties may find it difficult to appoint their favoured (namely, highly specialised) arbitrators, given the relatively low arbitrators' fees following on from the low value of the dispute.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Under German law there is no difference between franchisors from EU and non-EU member states.

Guatemala

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Guatemalan commercial code establishes five types of business entities that could be relevant to the typical franchisor. These are: corporations, limited liability companies, general partnerships, limited partnerships and special limited partnerships. The most common form of business is a corporation. In a corporation, the equity is divided into shares that have to be listed: since 29 June 2011, bearer shares were no longer permitted in the Guatemalan jurisdiction after the Decree of Congress 55-2010, named the Extinction Property Law, came into force. This law introduces amendments to the Commercial Code, establishing a unique type of shares that companies have to issue. These are called *acciones nominativas* and are shares regsitered to a particular person. All companies that conformed before the Decree of Congress 55-2010 came into force have the obligation to substitute bearer shares with *acciones nominativas* within a period of two years from 29 June 2011. If companies do not comply with this law, sanctions will be applied.

2 What laws and agencies govern the formation of business entities?

The Commerce Code (Decree of Congress 2-70) and its amendments, introduced by Decree of Congress 55-2010, is the principal law that governs the formation of business entities in Guatemala. The General Mercantile Registry governs the formation of such entities.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Mercantile companies are organised by means of a public deed. This public deed is registered before the General Mercantile Registry. For this purpose the following documents must be submitted:

- an official transcript of the articles of incorporation of the company in public deed;
- a form requesting registration of the entity; and
- evidence of payment of the registration fee according to the Mercantile Registry rate sheet – this payment is calculated taking as its base the authorised capital or equity of the company, of which the minimum is the equivalent in quetzals of US$700.

Once registration of a company is requested and the deed meets all the legal requirements, the registrar will make a provisional registration and will make this known to the public on behalf of the interested party in the Official Gazette. If no objection has been raised eight days after the publication, the registrar will make a definitive registration, the effects of which will be backdated to the date of provisional registration, and will return to the interested person the official transcript, duly annotated.

There is no annual fee for maintaining a business entity in Guatemala. All companies have the obligation to hold a general shareholders' meeting at least once a year within the first four months of the year. Companies must also comply with tax laws.

4 What restrictions apply to foreign business entities and foreign investment?

Permanent operations

Corporations that have been legally established abroad and wish to establish themselves or operate in any form in Guatemala, or that wish to establish a local office or agency, are subject to the Commercial Code and the laws of Guatemala.

The Commercial Code demands from them a series of requirements that establish the security of those entering into any local relationships. These requirements are:

- proof that the corporation has been duly established under the laws of its country of origin;
- submission of a certified copy of the articles of incorporation, as well as any possible amendments to the same;
- proof that the competent authority of the corporation has adopted a pertinent resolution as to its purpose;
- provision of the name of a representative in Guatemala who possesses ample and sufficient attributes to perform all the responsibilities within its economic ambit and to legally represent the corporation in judicial or extra-judicial matters;
- establishment of a capital stock exclusively assigned to operations in Guatemala and a surety bond in favour of third parties for an amount that the General Mercantile Registry will set that is no less than the equivalent in quetzals of US$50,000 and that must remain in force during the time that the corporation operates in the country;
- to respond before liabilities with the company assets located in Guatemala and abroad;
- to submit to the courts and laws of Guatemala for all acts and businesses entered in Guatemala, and to render an affidavit that neither the corporation nor its representatives or workers may invoke foreign rights;
- a declaration that before leaving the country, it has to fulfil all its legal requirements; and
- presentation of a certified copy of its last general balance sheet and profit and loss statement.

Once these requirements are fulfilled, the Mercantile Registry will grant the corporation authorisation to start activities.

Temporary operations

Foreign corporations that pursue temporary operations in Guatemala for a term of less than two years must obtain special authorisation from the Mercantile Registry.

The requirements that must be fulfilled in order to obtain this special authorisation are:

- proof that the corporation is duly established under the laws of its country of origin;
- provision of the name of a representative in Guatemala who has ample and sufficient attributes to perform all the responsibilities within its economic ambit and legally represent the corporation in judicial or extra-judicial matters while the company is in existence; and
- rendering of a surety bond in favour of Guatemala for an amount set by the Mercantile Registry, which may be no less than the equivalent in quetzals of US$50,000.

Once these requirements are fulfilled, the Mercantile Registry will grant the corporation authorisation to start activities. All documents should carry a tax stamp of 0.10 quetzals per sheet as the sole tax.

Operations requiring no registration or authorisation

Foreign corporations do not require registration or approval in Guatemala to engage in the following activities:

- selling to or purchasing from independent commercial agents legally established in the Republic of Guatemala;
- seeking orders through agents legally established in Guatemala, provided that such orders are subject to confirmation abroad;
- opening or maintaining accounts in authorised banks in Guatemala;
- acquiring real estate or other property, with the exception of land near international borders and waterfront properties, except where this is not the principal activity of the company;
- granting loans to businesses established in Guatemala;
- drawing, endorsing or protesting credit instruments in Guatemala; or
- participation in any legal action or proceeding before a Guatemalan court or public office. It is sufficient to grant power of attorney to an accredited Guatemalan attorney who has sufficient qualifications to act in judicial and extrajudicial affairs.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The income tax regime applicable to franchisors for individual or juridical persons not domiciled in Guatemala is the following:

- 10 per cent on interest or dividends, profits, revenues and other benefits paid or credited by companies or establishments domiciled in the country; also daily stipends, commissions, bonuses and other encumbered wages, including salaries, and the income paid to sportsmen and to visual artists. Dividends, profits, revenues and other benefits are exempted when it can be proved that the taxpayers have wholly and effectively paid a corresponding tax;
- 31 per cent on fees, royalties and other recompenses corresponding to the use of patents and industrial brands, as well as the fees for scientific, economical, technical or financial consulting services paid to enterprises or to juridical persons; and
- 31 per cent on any other income of Guatemalan source not provided for in the previous sections.

Exceptions to the 10 per cent tax mentioned in the first point are payments or credits to interest accounts for loans granted by prime banking and financial institutions duly registered in their country of origin and by multilateral ones, in both cases domiciled abroad. Such loans must, however, be destined to produce taxed income and the foreign currency coming from such loans must be or have been directly negotiated with the Bank of Guatemala or through banks and other commercial companies hired and entitled to operate exchanges, according to the exchange regime in effect.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The Guatemalan Constitution and the Labour Code govern all rights and obligations of employers and employees. Labour law in Guatemala protects employees, granting them preferential juridical protection to compensate for their economic inequality with employers. It constitutes a minimum of social guarantees that protect employees and cannot be forfeited by them.

There are no relevant labour and employment considerations for typical franchisors. There is some minimal risk that a franchisee or employee of the franchisee could be deemed an employee of the franchisor; in order to reduce this risk, the franchise agreement must clearly state that any relationship between franchisor, franchisee and the employees of the franchisee should not constitute a labour relationship of any kind.

7 How are trademarks and know-how protected?

Obtaining rights over a trademark in Guatemala is achieved only through registration and depends on the date and time of filing the application; mere use does not grant any rights. The applicant for registration of a trademark may invoke priority based on a previous application for registration in a state that is part of a treaty or agreement to which Guatemala is bound. The priority right lasts for six months starting from the day following the presentation of the priority application. Multiple or partial priorities may be invoked.

Know-how is protected according to the agreement signed between franchisor and franchisee. The protection will be based on what is agreed in the contract. Usually, protection of know-how is linked to a non-disclosure agreement regarding such know-how.

8 What are the relevant aspects of the real estate market and real estate law?

There are no limitations on the real estate market and real estate law that could affect franchisors, whether foreign or domestic. In general, the only limitation concerning foreign entities and individuals is that regarding the acquisition of property near international borders and waterfront properties without government authorisation.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The Guatemalan law does not establish a legal definition of a franchise. Where no definition is stated, Guatemalan law states that the definition used will be that established by the Royal Spanish Academy Dictionary that defines a franchise as, 'Concession for the rights of exploiting a product, activity or trade name granted by an enterprise to one or various persons in a determined zone.'

10 Which laws and government agencies regulate the offer and sale of franchises?

There is no specific law or government agency in Guatemala that regulates the offer and sale of franchises. Any offer and sale is subject to general commercial laws and practices.

11 Describe the relevant requirements of these laws and agencies.

There are no relevant requirements regarding franchises in Guatemalan law.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Guatemalan law does not provide any exemptions or exclusions regarding franchises. Franchisor and franchisee establish the provisions of their relationship in the franchise agreement and this agreement becomes 'law' between the parties.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no law or regulation in Guatemala that creates a requirement that must be met before a franchisor may offer franchises. The franchise is only subject to the general principles applicable to all contracts and agreements, commercial practices and uses.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The franchise agreement must establish the authorisation or prohibition on the franchisee to give sub-franchises. In such an agreement, the franchisor reserves the right to establish the provisions of the sub-franchise.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

There is no established compliance procedure for making pre-contractual disclosure in Guatemala. Commercial practice and uses make it common for a confidentiality agreement to be signed between the parties in order to disclose information prior to the signing of a final agreement, and also to have a memorandum of understanding (where certain specific terms of the business are disclosed).

16 What information must the disclosure document contain?

Such a disclosure document shall contain only such information that both the franchisor and the franchisee consider necessary. It is most common that a disclosure document, drawn up prior to a franchise agreement, discloses only the terms of the proposed franchise relationship contained in the form of a memorandum of understanding.

17 Is there any obligation for continuing disclosure?

Only if the disclosure document establishes it. The parties may contractually agree that confidentiality will be maintained for the term deemed convenient by both parties. This term may be months or years. Moreover, confidentiality may be established for the duration of the franchise relationship or for an indefinite term if the parties expressly provide for it.

18 How do the relevant government agencies enforce the disclosure requirements?

There are no government agencies that enforce disclosure requirements in Guatemala. Both parties, by mutual consent, decide which documents should be disclosed. If a franchisor or franchisee decides not to disclose a document that it is required to disclose in the agreement, such disclosure can be forced by means of a court order.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

There are no precedents in Guatemalan law that allow franchisees to obtain relief for violations of disclosure requirements. If the franchise agreement does not establish a specific pre-arranged amount of damages in the case of violation of disclosure requirements, such a valuation must be determined by the civil and mercantile courts following a summary procedure. Having determined the exact amount of damages and losses caused, such an amount will be duly executable. Damages and losses can be calculated by any of the parties or by an expert in such proceedings. Some franchise agreements include a pre-arranged damages clause in the contract, which is duly enforceable.

The franchisee is entitled to reimbursement or damages only if this entitlement is included in the franchise agreement.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In the case of sub-franchising, liability for disclosure violations that could be shared by the franchisor and sub-franchisor should be limited in both the franchise and sub-franchise agreements. There is no exposure to liability for individual officers, directors and employees of the franchisor or the sub-franchisor, except with regard to those acts that could be interpreted as criminal behaviour on the part of those officers, directors and employees of the franchisor or sub-franchisor.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Any offer and sale of franchises is subject to general commercial law and practices. If an offer is made by the franchisor, such an offer has to be accepted by the franchisee in order to finalise an agreement. Guatemalan commercial law states that a signed document is not a requirement to have a commercial relationship of any kind. The agreement, in these cases, will be determined by the practices of such a commercial relationship. It is important to note that a franchise contract is necessary in order to determine the rights and obligations of both parties. In the case of selling a franchise, there has to be an agreement between the parties.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There is no specific law or government agency in Guatemala that regulates the offer and sale of franchises. Therefore, obligations are regulated by the contractual documents executed by the parties. A letter of intent for a franchise agreement establishing and formalising the subject matter of the future business relationship and its governing terms would be useful to rule what pre-sale information could be disclosed.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In the case of fraudulent practices in connection with the offer and sale of franchises and since there is no specific law that enforces franchises, general civil and mercantile actions and criminal law actions may be referred to against the franchisor. If the franchise agreement states an obligation on behalf of the franchisor or franchisee that has not been complied with, a civil action may be engaged in order to force compliance of such an obligation.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no specific law in Guatemala regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect. The relationship is regulated by the agreement signed by both parties.

25 Do other laws affect the franchise relationship?

Commercial laws regulate the franchise relationship in Guatemala but are only supplementary to what is agreed in the franchise contract.

26 Do other government or trade association policies affect the franchise relationship?

There are no other government or trade association policies that affect franchise relationships in Guatemala.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Since the franchise relationship is not regulated by Guatemalan law, the franchisor may only terminate a franchise relationship in the circumstances stated in the franchise agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

Since the franchise relationship is not regulated by Guatemalan law, the franchisee may only terminate a franchise relationship in the circumstances stated in the franchise agreement.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The relationship between franchisor and franchisee is governed by the franchise agreement signed between them. The franchisor has the obligation to renew the franchise agreement only if the obligation to do so was included in the agreement. If not, the franchisor may refuse to renew.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

The franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchise entity. This restriction must be provided for in the franchise agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations in Guatemala that affect the nature, amount or payment of fees in a franchise relationship.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no restrictions on the amount of interest that can be charged on overdue payments. Such an interest rate must be established in the franchise contract.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

According to Decree No. 94-2000 enacted by the Congress of Guatemala (the Law of Free Negotiation of Foreign Currency), the disposition, holding, contracting, remittance, transference, purchase, sale, collection and payment in foreign currency is allowed in Guatemala, but the risks derived from such operations correspond to each individual or juridical person, either national or foreign, involved in them.

The Guatemalan quetzal is used as account currency and as a means of payment in every negotiation of monetary content in Guatemala and has a debt-releasing power. Nevertheless, the parties may conventionally and expressly agree that the obligations assumed in Guatemala be paid in foreign currency.

In any case, the judicial courts and the administrative organs must respect and enforce the fulfilment of the parties' agreements, so that the currency agreed in their contract is applied to their obligations.

With the purpose of granting juridical certainty to operations accomplished in foreign currency within the country, the external free convertibility of the national currency is guaranteed, as well as the mobility of capital.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are fully enforceable according to Guatemalan law. Franchisor and franchisee may choose between enforcing the obligations contained in the franchise agreement in the civil and mercantile courts of Guatemala or submitting to arbitration or to an alternative mechanism for resolving conflict, either in Guatemala or abroad.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Although the Guatemalan commercial law principle of good faith governs all commercial relationships, the principle is only supplementary to the provisions stated in the franchise contract, so this generally accepted principle does not affect any franchise relationship.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

There is no definite reference in the consumer protection laws in Guatemala regarding treatment of franchisees as consumers. Nevertheless, the Consumer Protection Law, Decree 6-2003 of the Congress, defines consumers as any person or legal entity, whether public or private, domestic or foreign, that by virtue of any legal act, acquires, uses or enjoys goods or services of any kind. With this in mind, both franchisees and franchisors can be considered consumers by means of the consumer protection legislation in Guatemala.

37 Must disclosure documents and franchise agreements be in the language of your country?

There is no obligation for disclosure documents and franchise agreements to be in Spanish, the official language of Guatemala. It is generally accepted that if the franchisor is foreign, disclosure documents and franchise agreements will be in English.

38 What restrictions are there on provisions in franchise contracts?

Guatemalan law recognises that the power of will prevails in commercial relationships (in this particular case, franchises). There are no restrictions on the provisions contained in franchise contracts, as long as both franchisor and franchisee accept such provisions.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Guatemala currently does not have a competition law or agency that enforces infringements in this matter. There are preliminary amendments of this law, but they are in final draft awaiting the approval of Congress.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The court system in Guatemala is divided into specialised courts (civil and mercantile, criminal, labour and family courts) and courts of first instance, appeals courts and the Supreme Court of Justice (in the case of some procedures that can be revised by the Supreme Court).

The dispute resolution procedures that are relevant to franchising are the summary procedure (applicable to all disputes that derive from commercial relationships), execution procedures (applicable for all debts with a duly executable document) and arbitration (when both franchisor and franchisee submit all disputes to arbitration).

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration today is commonly accepted as an important alternative means for dispute resolution and offers the advantages of expeditiousness, fairness, specialisation, confidentiality and, in certain situations, saving money for the parties involved in the dispute in comparison with judicial proceedings. Having arbitration centres ensures a range of administrative services guaranteeing the smooth flow of the arbitration process: receiving the claim, giving notice of hearings, demanding that the parties fulfil terms, giving notice of the award, etc.

To ensure arbitration is possible, it is necessary to record in writing an 'arbitration clause or agreement' stating the parties' desire to submit matters to arbitration and the conditions thereof (language, venue, applicable law, etc).

A disadvantage that may be presented by arbitration in Guatemala is that some parties use the constitutional remedy known as amparo (appeal for relief) to delay proceedings. The abuse of this remedy is a concern: it has been used in malicious litigation during arbitral proceedings. Abuse of power by arbitrators has also been detected.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign and domestic franchisors are treated equally in Guatemalan law.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Pursuant to Hungarian law, there is no restriction on the forms of business entities that may be franchisors. In practice, the following forms of business entities are mostly relevant to the typical franchisor under Hungarian law: private limited liability companies, private limited companies or public limited companies.

2 What laws and agencies govern the formation of business entities?

The most prominent laws are Act IV of 2006 on Business Associations and Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The specific requirements depend on the type of business entity, but it can be generally stated that a memorandum of association, which contains the main provisions in relation to the structure and operation of the business entity, shall be accepted. Every foundation of a business entity has to be notified to and subsequently incorporated by the Company Court of Registration.

4 What restrictions apply to foreign business entities and foreign investment?

There are no specific restrictions to foreign business entities and foreign investment. The Foreign Investment Act (Act XXIV of 1988) provides a liberalised regime. Accordingly, a franchisor may also be a foreign entity.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Due to a recent amendment of the Hungarian Corporate Tax Act (effective as of 1 January 2011), foreign businesses entitled to royalties from Hungarian companies or individuals or both were taken out of the scope of the Act. In respect of a franchise relationship this means that no corporate tax shall be deducted upon the payment of the royalty to the franchisor. This is an important amendment, since, under the previous regime, if there was no treaty on the avoidance of double taxation between Hungary and the country of domicile of the franchisor, then corporate tax had to be deducted from the royalty and be paid to the Hungarian tax authority.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The relevant consideration is that the franchisor's employees shall not be employees of the franchisee since the franchisee shall be independent from the franchisor. From a practical perspective, the relevant risks are generally not likely to be significant.

7 How are trademarks and know-how protected?

Trademarks are protected in Hungary in three ways:

- as a national trademark (registered by the Hungarian Patent Office);
- as an international trademark (which has the same effect as a national trademark if it is extended to Hungary under the Madrid System); or
- as a Community trademark (the trademark automatically extends to all member states of the EU).

Know-how is protected under articles 86(3) and (4) of the Hungarian Civil Code as follows:

> *(3) Intellectual products that are not regulated in other legislation but which can be used by the general public and have not yet become part of the public domain shall also be protected by law;*
>
> *(4) Persons shall also be entitled to protection with respect to their economic, technical, and organisational knowledge and experience that has pecuniary value.*

Know-how protection lasts until the knowledge, experience or information becomes part of the public domain.

8 What are the relevant aspects of the real estate market and real estate law?

Hungarian real estate law provides that the most important rights (ownership, mortgage rights, etc) pertaining to real estate are established once these rights are registered by the competent land registry on the basis of the relevant documents, in particular contracts. Hungarian law provides for specific rules on the lease of premises (Civil Code and Act LXXVIII of 1993).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no legal definition of a franchise under the currently effective Hungarian law. Franchise contracts are not specifically codified in Hungarian law as a type of contract. The most extensive legal regulation in relation to franchise contracts is actually provided for by competition law, but competition law regulation does not provide for a legal definition either. In practice, the definition provided for by article 1 of the European Franchise Code of Ethics is accepted, but this is not legal definition.

10 Which laws and government agencies regulate the offer and sale of franchises?

The Civil Code of the Republic of Hungary (Act IV of 1959), and in particular its chapter on the general rules of contract law, applies to all contracts, including the offer and sale of franchises.

11 Describe the relevant requirements of these laws and agencies.

The rules extend to, among others, the conclusion of the contract, rights and obligations, performance and termination. At the same time, it must be emphasised that this is not specific legislation.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Not applicable.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There are no such requirements pursuant to Hungarian law.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There is no specific mandatory legal regulation pursuant to Hungarian law.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

There is no specific mandatory legal regulation pursuant to Hungarian law. Nevertheless, the general principles of cooperation and good faith apply also to the pre-contractual stage pursuant to article 205(3) of the Civil Code as follows:

> *Parties shall cooperate during the conclusion of a contract, and they shall respect each other's rightful interests. Parties shall inform each other regarding all essential circumstances in relation to the proposed contract before the contract is concluded.*

Directive 2002/1 (IX.18) of the Hungarian Franchise Association on pre-contractual disclosure obligations is applied in practice, but the directive is not law. This directive recommends that a franchisor prepares an information brochure regarding its system and provides this to the potential franchisee. According to the directive, disclosure may be made either in one step or in several steps.

16 What information must the disclosure document contain?

There is no specific mandatory legal regulation pursuant to Hungarian law.

Directive 2002/1 (IX.18) of the Hungarian Franchise Association on pre-contractual disclosure obligations is applied in practice, but the directive is not law. The directive recommends that the franchisor hands over the draft franchise agreement to the potential franchisee at least 14 days before the conclusion of the contract. Furthermore, the directive recommends that the franchisor prepares an information sheet in relation to the system, which contains the following in particular:

- a short description of the system;
- an introduction of the franchisor;
- the number of franchisees in the system;
- intellectual property rights; and
- a list of goods or services, financial obligations and confidentiality obligations.

17 Is there any obligation for continuing disclosure?

There is no specific mandatory legal regulation pursuant to Hungarian law. There is no specific relevant directive of the Hungarian Franchise Association either.

18 How do the relevant government agencies enforce the disclosure requirements?

Not applicable.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

There is no specific mandatory legal regulation pursuant to Hungarian law, but the general civil law provisions may apply.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There is no specific mandatory legal regulation pursuant to Hungarian law.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The European Franchising Code of Ethics of 1991 was adopted by the Hungarian Franchise Association and may affect the offer and sale of franchises. Directive 2002/1 (IX.18) of the Hungarian Franchise Association may affect pre-contractual disclosure obligations.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There is no specific mandatory legal regulation pursuant to Hungarian law, but general civil law provisions, such as the general principles of cooperation and good faith, may apply. Furthermore, the

Hungarian Franchise Association's code of ethics and directive 2002/1 (IX.18) of the Hungarian Franchise Association on pre-contractual disclosure obligations may affect pre-sale disclosure obligations (see questions 15 and 16).

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In the case that the franchisor engages in fraudulent or deceptive practices, the franchisee may rely on the general contract law regulation of the Civil Code (article 210), which allows the aggrieved party to claim avoidance of the contract on the basis of deception, duress or mistake as follows:

- *a person acting under a misapprehension regarding any essential circumstance at the time a contract is concluded shall be entitled to contest his contract statement if his mistake had been caused or could have been recognised by the other party;*
- *a contract statement may be contested on the grounds of misapprehension of a legal issue if such misapprehension is deemed significant and if the advice of legal counsel, acting within the scope of his competence, to the parties affected has been patently erroneous in terms of the contents of legal regulations;*
- *if the parties had the same mistaken assumption at the time the contract was concluded, either of them may contest the contract; or*
- *a person who has been persuaded to conclude a contract by deception or duress by the other party shall be entitled to contest the contract statement. This provision shall also apply if deception or duress was committed by a third person and the other party had or should have had knowledge of such conduct.*

The avoidance shall be claimed within one year. The time limit for avoidance shall commence upon recognition of the mistake or deception or, in the case of unlawful menace, upon the cessation of duress.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Franchise contracts are not specifically codified in Hungarian law as a type of contract; however, the general contract law provisions of the Civil Code of the Republic of Hungary do apply to franchise contracts.

Due to the lack of specific comprehensive legal regulation of franchise contracts, franchise relationships are primarily governed by the franchise agreements between the parties; therefore, franchise contracts must be drafted very carefully.

25 Do other laws affect the franchise relationship?

Antitrust laws do affect the franchise relationship: primarily, the Hungarian Act LVII of 1996 on the Prohibition of Unfair and Restrictive Market Practices. Government Decree 55/2002 (III.26) on the exemption of certain vertical restraints provides for exemptions from restrictive market practices in relation to franchise agreements. Government Decree 55/2002 (III.26) basically corresponds to Commission Regulation (EC) 2790/1999 of 22 December 1999 on the application of article 81(3) of the Treaty to categories of vertical agreements and concerted practices. Intellectual property laws also affect the franchise relationship: primarily, Act XI of 1997 on Trademarks and Geographical Product Markings and Council Regulation (EC) 207/2009 of 2 February 2009 on the Community trademark.

26 Do other government or trade association policies affect the franchise relationship?

The Hungarian Franchise Association adopted the European Franchising Code of Ethics of 1991. Membership of the Hungarian Franchise Association is only possible if the candidate company's franchise contract corresponds to the provisions of the European Franchising Code of Ethics. Furthermore, the Hungarian Franchise Association has issued two directives: namely, Directive 2000/1 (IX.15) on the concept of independence and Directive 2002/1 (IX.18) on the pre-contractual disclosure obligations.

The directives of the National Tax and Customs Authority are also relevant in relation to the interpretation and application of Hungarian tax legislation, such as directive 1994/322 on franchise contracts, among others.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The franchisor may terminate a franchise relationship if the law or the contract itself enables the franchisor to terminate the contract. In the latter case, termination may be claimed pursuant to the provisions of the contract. In practice, the right of unilateral termination is provided to the franchisor in case of material breach of the contract by the franchisee. Material breach could be but is not limited to the failure of the franchisee to pay the franchise fees or violation of the provisions on confidentiality, non-competition or supply.

If Hungarian law is applicable to the franchise contract and the parties have stipulated so, the contract may be terminated in accordance with the general provisions of the Civil Code: primarily the provisions on default, which is relevant in relation to late payment of franchise fees.

Article 298 of the Civil Code provides:

An obligor shall be in default:

(a) if the time of performance, as stipulated in the contract or as can be inferred beyond doubt from the intended purpose of the service, has elapsed without any result;

(b) in other cases, if he does not perform his obligation in spite being requested to do so by the obligee.

Article 300 of the Civil Code provides:

(1) An obligee shall be entitled to demand performance, or, if performance no longer serves his interest, he shall be entitled to rescind from the contract irrespective of whether or not the obligor has offered an excuse for his default.

(2) It shall not be necessary to prove the cessation of an interest in performance if, according to the agreement of the parties or due to the imminent purpose of the service, the contract had to be performed at a definite time and none other, or if the obligee has stipulated a reasonable deadline for subsequent performance and this period too elapsed without result.

28 In what circumstances may a franchisee terminate a franchise relationship?

The franchisee may terminate a franchise relationship if the law or the contract itself enables the franchisee to terminate the contract. In the latter case, termination may be claimed pursuant to the provisions of the contract. In practice, the right of unilateral termination is rarely provided to the franchisee, but is primarily used if the franchisor breaches its obligations of exclusive supply.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Yes, a franchisor may refuse to renew the franchise agreement with the franchisee unless the parties have agreed on mandatory renewal in the franchise contract or unless the parties have concluded a preliminary contract to renew the franchise contract.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, a franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity provided that such restrictions are provided for in the franchise agreement or the franchisor does not consent to the franchisee's proposal to transfer its franchise.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Article 201(2) of the Hungarian Civil Code provides that the fees shall be proportionate to the services offered by the other party. If the fees are not proportionate, the aggrieved party may claim avoidance of the contract within a one-year term.

Article 201(2) of the Civil Code provides:

If at the time of the conclusion of the contract the difference between the value of a service and the consideration due, without either party having the intention of bestowing a gift, is grossly unfair the injured party shall be allowed to contest the contract.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Pursuant to article 301(4) of the Civil Code, the court shall be entitled to reduce the rate of the default interest if the interest fixed by parties is excessive.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Generally there are no regulations restricting a Hungarian franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency (Act CXIII of 2001).

34 Are confidentiality covenants in franchise agreements enforceable?

Yes. Hungarian law provides for the protection of business secrets. It is advisable to put explicit confidentiality covenants into the franchise agreements. If the confidential obligation is explicitly put down in the franchise agreement and a party breaches this obligation, damages and other potential consequences established in the contract (eg a penalty) may be enforced.

Article 81(2) of the Civil Code defines business secrets as follows:

Business secrets shall comprise all of the facts, information, conclusions or data pertaining to economic activities that, if published or released to or used by unauthorised persons, are likely to imperil the rightful financial, economic or market interest of the owner of such secrets, provided the owner has taken all of the necessary steps to keep such information confidential.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, under Hungarian law the parties shall deal with each other in good faith, with mutual respect and in cooperation (article 4(1) of the Civil Code). Pursuant to Hungarian law, the principle of good faith and cooperation primarily means that the parties shall notify each other of important circumstances and shall act in a manner that helps the other party to perform its obligations arising from the agreement.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No. Pursuant to Hungarian law, 'consumer' shall mean any person who is a party to a contract concluded for reasons other than economic or professional activities (article 685(d) of the Civil Code).

37 Must disclosure documents and franchise agreements be in the language of your country?

No. The parties may agree that the disclosure documents are provided to the franchisee in a language other than Hungarian and may also agree that the franchise agreement is drawn up in a language other than Hungarian. It is suggested that such an agreement should be put into writing by the parties. Agreement on the language may also constitute part of the franchise contract.

38 What restrictions are there on provisions in franchise contracts?

Regulation 2790/1999/EC (for agreements having a Community dimension) and Government Decree 55/2002 (III.26) (for agreements having a national dimension) contain the main restrictions and conditions in relation to exclusive territories, customers, prices, etc. Please see question 39.

Pursuant to the Hungarian Private International Law Act (Act 13 of 1979), the parties are free to choose the governing law for their franchise contract, provided that there is an international element in their relationship. In other words, a Hungarian franchisor and a Hungarian franchisee shall not agree on the application of a foreign law for their franchise contract, but if the franchisor is not a Hungarian entity, then the parties may freely decide which law governs their franchise contract. The choice of law shall be made in writing and in a explicit manner. It shall be noted that for contracts entered into after 17 December 2009, Regulation 538/2008/EC will be applicable.

Pursuant to the Hungarian Private International Law Act (Act 13 of 1979), the parties may stipulate the jurisdiction of a certain domestic or foreign court (regular court or arbitration court) for potential disputes arising from their franchise contract.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition law is highly relevant for franchise contracts – in particular, but not limited to, the issues of exclusive territories, customers, prices and non-compete obligations. Government Decree 55/2002 contains essentially the same obligations as Regulation 2790/1999, as follows:

Article 2

(1) The exemption provided for in Article 1 shall apply on condition that the market share held by the supplier does not exceed 30 per cent of the relevant market on which it sells the contract goods or services.

(2) In the case of vertical agreements containing exclusive supply obligations, the exemption provided for in Article 1 shall apply on condition that the market share held by the buyer does not exceed 30 per cent of the relevant market on which it purchases the contract goods or services.

Article 3

The exemption provided for in Article 1 shall not apply to vertical agreements which, directly or indirectly, in isolation or in combination with other factors under the control of the parties, have as their object:

(a) the restriction of the buyer's ability to determine its sale price, without prejudice to the possibility of the supplier's imposing a maximum sale price or recommending a sale price, provided that they do not amount to a fixed or minimum sale price as a result of pressure from, or incentives offered by, any of the parties;

(b) the restriction of the territory into which, or of the customers to whom, the buyer may sell the contract goods or services, except:

- *the restriction of active sales into the exclusive territory or to an exclusive customer group reserved to the supplier or allocated by the supplier to another buyer, where such a restriction does not limit sales by the customers of the buyer,*
- *the restriction of sales to end users by a buyer operating at the wholesale level of trade,*
- *the restriction of sales to unauthorised distributors by the members of a selective distribution system, and*
- *the restriction of the buyer's ability to sell components, supplied for the purposes of incorporation, to customers who would use them to manufacture the same type of goods as those produced by the supplier.*

Article 4

The exemption provided for in Article 1 shall not apply to any of the following obligations contained in vertical agreements:

(a) any direct or indirect non-compete obligation, the duration of which is indefinite or exceeds five years. A non-compete obligation which is tacitly renewable beyond a period of five years is to be deemed to have been concluded for an indefinite duration. However, the time limitation of five years shall not apply where the contract goods or services are sold by the buyer from premises and land owned by the supplier or leased by the supplier from third parties not connected with the buyer, provided that the duration of the non-compete obligation does not exceed the period of occupancy of the premises and land by the buyer;

(b) any direct or indirect obligation causing the buyer, after termination of the agreement, not to manufacture, purchase, sell or resell goods or services, unless such obligation:

- *relates to goods or services which compete with the contract goods or services, and*
- *is limited to the premises and land from which the buyer has operated during the contract period, and*
- *is indispensable to protect know-how transferred by the supplier to the buyer,*

and provided that the duration of such non-compete obligation is limited to a period of one year after termination of the agreement; this obligation is without prejudice to the possibility of imposing a restriction which is unlimited in time on the use and disclosure of know-how which has not entered the public domain.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Regular courts

According to the general rules for civil and commercial disputes, where the case value is below 5 million forints, the lower courts have competence in the first instance and the county courts and the Metropolitan Court are the second instance courts. Where the case value is above this threshold, the county courts and the Metropolitan Court are the first instance courts, while the regional Court of Appeal is the second instance forum.

Arbitration

The parties may stipulate the jurisdiction of a Hungarian or foreign arbitration court in their franchise contract. The most common arbitration forum in Hungary is the Arbitration Court attached to the Hungarian Chamber of Commerce and Industry. Pursuant to article 46(3) of the Act LXXI of 1994 on Arbitration, in the case of international arbitration, the Arbitration Court attached to the Hungarian Chamber of Commerce and Industry is the permanent arbitration court.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Under Hungarian law and legal practice, the principal advantages of arbitration are that the procedure is in general significantly quicker than the procedure before the regular courts, and that the proceeding judges or arbitrators may be chosen by the parties and generally have more expertise and specific knowledge in business issues. As a further advantage, it is to be noted that oral hearings are not open to the public (while publicity is a basic principle in regular court cases).

Relatively higher costs can be a potential disadvantage of arbitration. Furthermore, arbitration judgments may not be appealed (however, under certain circumstances invalidation of the judgment may be requested before regular courts).

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors may be treated differently from a tax law perspective. Generally, there are not likely to be significant differences in the treatment of foreign and domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The typical franchisor would usually take the form of a limited liability company whose capital is divided into shares.

2 What laws and agencies govern the formation of business entities?

The formation of limited liability companies in Indonesia is governed by the Companies Law (Law No. 40 of 2007) and administered by the Ministry of Law and Human Rights (MOLHR).

3 Provide an overview of the requirements for forming and maintaining a business entity.

In general, a limited liability company must be formed by at least two parties by executing a deed of incorporation and articles of association before a notary public. The notary then files the deed of incorporation and articles of association with the MOLHR for its approval. Upon obtaining MOLHR approval, the company attains legal status and the shareholders' liability will be determined by the amount of issued shares to which they subscribed.

Thereafter, the company must be registered in the Companies Registry that is maintained by the local office of the Ministry of Trade (MOT). The MOT will issue a company registration certificate valid for five years (renewable). Another division of the MOT will issue an operating business licence that is valid for as long as the company is in operation. Any changes to the company's shareholders, board of directors, commissioners (supervisory board), domicile, etc, must be reported to the MOLHR and the MOT. The company must convene annual general meetings of shareholders to discuss and approve, among other things, the annual report and financial statements prepared by the board of directors. Extraordinary general meetings of shareholders may also be held when required.

4 What restrictions apply to foreign business entities and foreign investment?

Foreign business entities may conduct business in Indonesia through direct investment, the capital markets, a joint operation or other forms of joint venture, through a representative office, or by appointing an Indonesian agent or distributor. Activities in certain business sectors cannot be undertaken by foreign entities. Foreign business entities may establish a foreign investment company in Indonesia to undertake business activities that are open to foreign investment. Foreign investment companies fall under the auspices of the Indonesian Capital Investment Coordinating Board. To undertake certain business activities (such as mining), foreign investors require a recommendation or approval from the relevant technical agency or agencies. Foreign entities may not carry out retail businesses, except if conducted on a large scale. Foreign investment in the financial sector is regulated by the Ministry of Finance. There is no foreign exchange control. However, any movement of foreign currency worth US$10,000 or more must be reported to the Indonesian Central Bank by the facilitating bank in Indonesia. In addition, the bank must obtain the following documents from its customer or the foreign party if they wish to purchase foreign currency against Indonesian rupiah and the total amount will exceed US$100,000 (or its equivalent in other currencies) per month per customer, including purchases of foreign currencies for derivative transactions:

- a copy of the underlying document;
- a copy of the relevant Tax Registration Number (only applicable to Indonesian parties); and
- a statement from the bank's customer or the foreign party that the underlying document is a valid document and that the foreign currency will only be used to settle payment obligations connected with the underlying documents.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Foreign businesses and individual residents of Indonesia will be subject to income tax. Some tax matters that should be considered include value added tax (VAT), withholding tax and permanent establishment.

VAT is levied on supplies of goods and services within the customs area of Indonesia and those imported into the customs area. VAT also applies to services performed abroad but enjoyed in Indonesia. Therefore, VAT is payable on the provision of services by the franchisor to the franchisee, regardless of the place of performance.

The general rate of VAT is 10 per cent. VAT on luxury goods is 10 to 200 per cent.

Withholding tax

Tax on the importation of goods and the use of foreign services is paid by the importer or user. Under Indonesian tax law, a foreign franchisor, as a non-resident taxpayer, does not have the obligation to withhold taxes.

Permanent establishment

Foreign companies with no permanent establishment in Indonesia are subject only to a final withholding tax on certain types of income derived from Indonesian sources. A permanent establishment of a foreign corporation is liable for regular Indonesian corporate tax on profits directly or indirectly attributable to its permanent establishment in Indonesia. In addition, a 20 per cent 'branch profit' tax (reduced by tax treaty; 10 per cent in the case of the United States) is imposed. With respect to services and contracts to be performed in

Indonesia, a foreign corporation from a tax treaty country (such as the United States) is considered to have a permanent establishment should its employees be present in Indonesia for business purposes for more than 60 days in a 12-month period (in some cases a 90-day or 120-day limit applies, depending on the tax treaty of the relevant country). If the franchisor plans to send any staff to Indonesia, it should seek tax advice in relation to this issue. If no staff are to be sent to Indonesia, the franchisor and its affiliates should ensure that their franchise arrangement is not viewed as permanent establishment.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

In general, labour law would not apply to franchisors, unless franchisors employ Indonesian nationals or expatriates to work in Indonesia. To minimise the risk of a franchisee's employee being deemed an employee of the franchisor, the franchisor must ensure that the relationship with the franchisee is that of an independent contractor and expressly provide for this in the franchise agreement. If the franchisee requires assistance from the franchisor's employees on a more permanent basis, the employees should be employed by the franchisee.

7 How are trademarks and know-how protected?

Foreign and domestic franchisors may protect their trademarks and know-how in accordance with the prevailing intellectual property rights laws. Trademarks are registered with the Indonesian Trademark Office of the Directorate General of Intellectual Property Rights, and know-how may be protected under patent or relevant IPR laws (industrial design, copyrights, trade secrets). There is no obligation to register a copyright, but it is recommended.

Trade secrets are also protected under the Indonesian Trade Secret Law (Law No. 30 of 2000) and the Anti-Monopoly and Unfair Competition Law. Under the Trade Secret Law, an agreement containing the granting of rights to use trade secrets must be registered with the Directorate General of Intellectual Property Rights (Directorate). The agreement will further be published in the Official News of Trade Secrets. One consequence of not registering the agreement is that it will not bind third parties. According to the Trade Secret Law, the procedures for registration will be regulated by the government; although said government regulation does not yet exist. Given this fact, the Directorate is not able to formally process any registration of such an agreement. As registration of agreements is nonetheless important, it is advisable to submit the agreement even though the Directorate cannot process it and the submission would not be considered a valid registration. The fee for registering this agreement is 150,000 rupiah per application for a small scale business or 250,000 rupiah per application for a large scale business.

Please also see question 37 regarding the use of the Indonesian language in agreements that involve an Indonesian party.

8 What are the relevant aspects of the real estate market and real estate law?

The franchisee will have to purchase or lease the real estate for its shop from the property owner. Under the Indonesian Civil Code (ICC), the lessee will have the right to enjoy the leased property until expiry of the lease term. If the property is transferred to a third party, the new owner cannot terminate the lease without the consent of the lessee. Care should be taken that the property is located in an area designated for commercial purposes (as opposed to residential purposes). In general, non-resident foreign franchisors will not be able to purchase real estate. Resident foreigners may purchase property under a specific right – namely the right to use title – and under certain conditions: namely, that their presence must be 'of benefit to national development' and their ownership is limited to one property.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

A franchise is described as a special right that is owned by an individual or an entity over the unique characteristics of a business system that has been successful in the promotion of goods or services, and can be used by another party pursuant to a franchise agreement.

10 Which laws and government agencies regulate the offer and sale of franchises?

Law No. 42 of 2007 dated 23 July 2007 on Franchising (Regulation No. 42) and its implementing regulation, Regulation of the Minister of Trade No. 31/M-DAG/PER/8/2008 dated 21 August 2008 on Implementation of Franchising (Regulation No. 31), and Decree of the Director General of Domestic Trade No. 138/PDN/KEP/10/2008 dated 31 October 2008 on the Technical Guidelines for the Implementation of Franchising (Decree No. 138).

11 Describe the relevant requirements of these laws and agencies.

A franchise must fulfil the following criteria:

- have a specific business characteristic;
- be a proven successful business, which refers to the franchisor having business experience of approximately five years;
- have a written standard operating procedure to enable the franchisee to conduct its business in accordance with the franchisor's business system;
- be easy to learn and apply;
- provide continuous support to the franchisee; and
- have a registered intellectual property right.

Prior to entering into a franchise agreement, a franchisor must provide a prospectus disclosing its business data or information to a franchisee at least two weeks before the execution of the franchise agreement.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There are no exemptions.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The Franchise Law stipulates that the franchisor must have been in business for five years. Its franchise business must still be in operation and must be profitable.

A franchisee that has been granted the right to sub-franchise must have at least one company-owned operation.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The law does not explicitly regulate this. A master franchisee will act as a franchisor in a sub-franchising arrangement, therefore the provisions applicable to a franchisor will also apply to a master franchisee. The sub-franchisor must provide disclosure of its proposed sub-franchising. The scope of disclosure will be similar to that which must be disclosed by the franchisor. See questions 15 and 16.

In addition, in a sub-franchising arrangement, the master franchisee is required to own and manage by itself at least one of the businesses that it is permitted to sub-franchise.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The franchisor must provide the disclosure document at least two weeks before execution of the franchise agreement. Although the law does not impose an obligation to update the disclosure, it is advisable to do so. The disclosure document must be registered with the MOT (for franchises originating from outside Indonesia) or the governor or regent (for domestic franchises), following which the franchisor or sub-franchisor will receive a franchise registration certificate (the franchisor certificate). An application form must be submitted with a copy of the prospectus and details of the franchisor's business legality.

Regulation No. 31 requires that for the prospectus to be registered with the MOT it must be legalised by a notary public, with an attached statement or reference letter issued by the relevant trade attaché or Indonesian consulate in the home country of the franchisor. The information provided in the application for a franchisor certificate includes, among other things, the franchisor's name, country of origin, franchised products or services, types of intellectual property rights and the name of the person responsible for the franchisor and his or her contact details. The franchisor certificate is valid for five years and may be renewed every five years for the same term.

16 What information must the disclosure document contain?

As a minimum, the following information must be included in the disclosure document:

- the identity of the franchisor, covering information provided in the identity cards or passports of shareholders, commissioners and board of directors (if the franchisor is a business entity);
- the business legality of the franchisor, covering information on the franchisor's business licence;
- the business history of the franchisor, covering information regarding the establishment of the franchisor, business activities and the development of the franchisor's business;
- the organisational structure of the franchisor, covering the management hierarchy, from commissioners, shareholders and board of directors to the organisational structure of the operating division and its franchisees;
- the balance sheet for the past two years;
- the number of franchise businesses, covering the number of outlets owned by the franchisor;
- the list of franchisees; and
- the rights and obligations of:
  - the franchisor, such as the right to receive royalties and the obligation to provide continuous assistance to the franchisee; and
  - the franchisee, such as the right to use the franchisor's intellectual property rights or business characteristics and the obligation to keep confidential the intellectual property rights and business characteristics.

17 Is there any obligation for continuing disclosure?

As advised above, the law does not impose an obligation to update disclosure. However, we understand that in practice, it is advisable to continuously update disclosure to the current franchisees and the MOT.

18 How do the relevant government agencies enforce the disclosure requirements?

There are no regulations regarding enforcement of the disclosure requirements, except the enforcement of the disclosure registration itself. An administrative sanction in the form of a written warning will be imposed on the franchisor or franchisee, or both, that does not comply with the prospectus and franchise agreement registration requirements. The written warning will be served a maximum of three times: each warning will be served two weeks after the date of the previous warning letter.

A fine of up to 100 million rupiah will be charged if the franchisor or franchisee, or both, fail to respond to the registration requirements within two weeks of the third warning letter's expiry date.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Franchise law provides no remedy for the franchisee. Any remedy it wishes to have should be provided in the franchise agreement. Article 1338 of the ICC allows parties to a commercial contract to contract freely as long as the contract is made in good faith and satisfies the requirements of article 1320 of the ICC. Therefore, the parties can fashion their own remedies in the contract, subject to limitations in the law.

In the absence of contractual provisions to the contrary, general remedies available to a contracting party in the event of a breach of contract can arise from claims based on articles 1236, 1243 and 1267 of the ICC.

Article 1236 stipulates that the obligor is obliged to reimburse costs, losses and interest to the creditor if it has put itself in a situation whereby it is unable to deliver the goods or if it is unable to properly maintain the goods.

Article 1243 stipulates that compensation for costs, losses and interest due to non-performance of an agreement is only imposed if the obligor, after being declared in default, continues to fail to perform, or if it has to deliver or make the goods and such delivery or performance is performed beyond the agreed period.

Article 1267 states that the party against whom an agreement is breached can choose whether to force the defaulting party to fulfil its obligations (if this is still possible) or to request a termination of the agreement, accompanied by compensation of costs, losses and interest.

To avoid difficulties in calculating or proving damage, the franchise agreement may provide a certain amount of money to be paid to the non-defaulting party (article 1249 of the ICC). This means that the amount of compensation is agreed upon before actual losses are incurred. The consequence of such an agreement is that the agreed amount must be paid in the event of non-performance, regardless of the actual losses: in fact, no evidence is required to prove the losses. Under article 1249, the creditor can claim for performance of the obligation or for compensation, but not for both.

However, under article 1309 of the ICC, judges may reduce the agreed compensation if the contract has been partially fulfilled. Jurisprudence shows that judges have reduced the agreed compensation (even when there is no performance at all) on the basis of decency and good faith.

The law provides limitations as to what can be claimed as compensation. Compensation for default or non-performance is limited to losses that can be predicted and that are directly caused by the default or non-performance (articles 1247 and 1248). Another limitation is with regard to moratorium interest. Moratorium interest is interest that must be paid (as a punishment) because the obligor is in default. Article 1250 of the ICC states that in agreements that solely relate to payment of money, the compensation of costs, losses and interest caused merely by a delay in payment shall only consist of payment of interest as determined by law, without prejudice to any specific regulation. Furthermore, article 1250 stipulates that compensation of costs, losses and interest shall only be paid from the day the claim is filed to the court to the day of payment thereof, unless otherwise determined by law.

Remedies specified in the contract are not the sole and exclusive remedies to which a party is entitled in the event of a breach. There are also provisions in the ICC that allow a party to claim for losses suffered outside any contractual relationship, namely, article 1365 of the ICC on negligence.

To our knowledge, few cases brought under article 1365 have been successful. In most cases, the court either rejects or partially accepts the claim: it agrees there is a tort but the amount of compensation cannot be fully justified. Also, claims under article 1365 cannot be combined with remedy under the contract or under article 1365.

Statutory liability for negligence is recognised in Indonesia. This concept is contained in both the Criminal Code and the ICC. The Indonesian Criminal Code separates crimes resulting from an intended action and those resulting from negligence. Article 1366 of the ICC states that any person will be liable, not only for any losses caused by his or her actions, but also for any losses caused by his or her negligence or carelessness.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

There is no regulation on the sharing of liability. This should be agreed between the franchisor and the sub-franchisor. Individual officers, directors and employees of the franchisor or the sub-franchisor should not be exposed to liability unless there is negligence or fault on their part. However, in legal proceedings, they will usually be named as co-defendants.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The Indonesian Supervisory Commission on Business Competition (KPPU) Regulation No. 6 of 2009 on Guidelines for Exemptions from the Implementation of the Anti-monopoly Practices and Unfair Business Competition Law for Agreements Related to Franchises and the ICC. Also, see question 25.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There are no other general rules on pre-sale disclosure other than the franchise-specific rules on what disclosure franchisors should make to potential franchisees. As advised above, a franchisor must provide a prospectus disclosing its business data or information to a franchisee at least two weeks before the execution of the franchise agreement. We believe that the disclosure should cover franchise transactions. Please see question 16 for the minimum information that must be included in the disclosure document.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See question 19.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Franchise law stipulates that the franchisor must provide assistance and guidance in the form of education and training on the management of the franchise, routine guidance in the operation of the franchise, assistance in developing the franchisee's market through promotion (advertising, catalogue, etc), and market and product research and development.

25 Do other laws affect the franchise relationship?

Franchises are exempt from the provisions of Indonesia's Antitrust and Unfair Business Competition Law (article 50B of Law No. 5 of 1999 on the Prohibition against Monopolistic Practices and Unfair Business Competition). The Indonesian Supervisory Commission on Business Competition (the Commission) has formulated franchise guidelines (Regulation No. 6 of 2009 on Guidelines for Exemptions from the Implementation of the Anti-Monopoly Practices and Unfair Business Competition Law for Agreements Related to Franchises (Guidelines)). The Guidelines serve as a clarification of article 50B that deals with matters relating to agreements for intellectual property such as franchising, licensing, patent, trademark, copyright, industrial designs, integrated circuits and trade secrets. Franchise agreements must not contain provisions that may result in monopolistic and unfair business practices. Other laws may affect the franchise relationship. If the franchise involves the importing of goods, import and export regulations are relevant. Trademark laws and other intellectual property laws may affect the franchise relationship.

Other specific laws that may affect the franchise relationship may include regulations on food registration and 'halal' certificates, regulations on modern markets (applicable to mini-markets, supermarket franchisees, hypermarkets and traditional markets), regulations on advertising, and Indonesian consumer law. The ICC will apply regarding the parties' general contractual obligations or when said obligations are not specifically regulated in the franchise agreement.

26 Do other government or trade association policies affect the franchise relationship?

The Indonesian Supervisory Commission on Business Competition affects the franchise relationship. Indonesian domestic franchisors are consulted by or otherwise submit their views to the MOT on regulatory and policy matters concerning franchise.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

In general, the parties should provide in the franchise agreement the circumstances that may give rise to termination of the franchise relationship. Under the ICC, a party may not unilaterally terminate an agreement without the consent of the competent court. Consequently, the franchise agreement should provide a clause allowing unilateral termination, by reason of breach, default or any other reason. The franchise agreement may also be terminated with the consent of both parties.

28 In what circumstances may a franchisee terminate a franchise relationship?

See question 27.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

As with termination, renewal rights and their terms and conditions should be provided in the franchise agreement. It would be prudent to provide in the agreement that the agreement expires on a certain date; then either party may request a renewal of the agreement by written notification to the other party three or six months prior to the expiry of the agreement. Automatic renewal is not recommended as it would be easy to miss the expiry date of the current term, which may mean that the agreement will continue under the same terms and conditions. The franchisor should provide that it may, at its sole discretion, refuse to renew. In the event of renewal, the parties will execute a renewal agreement based on terms and conditions agreed between them. Notwithstanding the foregoing, it is recommended that the discontinuation of the franchise relationship (either by termination or non-renewal, or otherwise) be made amicably with the aim of securing a clean break agreement or letter from the franchisee. This will pave the way for the franchisor to appoint a new franchisee, if required.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, these rights should be specifically provided in the franchise agreement. Usually, these rights belong to the franchisor. The franchise agreement would normally provide that the franchisee may only transfer its franchise or undertake a transfer of ownership with the prior written approval of the franchisor. The aim is to ensure continuation of the franchise operation despite the transfer of the franchise or transfer of ownership in the franchisee entity.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no specific laws or regulations affecting the nature, amount or payment of fees.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The parties may provide in the agreement the amount of interest charged on overdue payments. The underlying principle is the good faith of the parties. It is possible for an aggrieved party to seek a reduction of interest if it believes the amount is not reasonable. The interest rate provided in a contractual agreement may exceed the interest rate provided by law (6 per cent according to Staatsblad Nederlandsh – Indie 1848-22) to the extent that it is not in violation of the prevailing laws, regulations and public policy. There are no clear guidelines under Indonesian laws and regulations regarding the concept of public policy and, as explained above, Indonesian courts have interpreted the term public policy very broadly. Furthermore, it should be noted that:

- Staatsblad Nederlandsh – Indie, which was published in 1938 (prior to the independence of the Republic of Indonesia), regulates matters related to usury. We understand that the Indonesian courts still recognise the applicability of this law, but we are not aware of any case law in the Republic of Indonesia where the judges explicitly referred to this law as the basis for their decisions; and
- There is conflicting case law in the Republic of Indonesia regarding the high interest rates provided in contractual agreements. Some Indonesian court decisions have held that high interest rates must be reduced because, among other things, the rates stood against justice and humanity. Other court decisions have held that the high interest rates that have been agreed by the parties in a contractual agreement must be honoured by the parties.

It is worth noting that the Republic of Indonesia adopts a civil law system. Unlike the common law system, there is no necessity for a court to follow precedent. Each case is decided according to the presiding court's interpretation of the law and determination of the facts. It will be difficult to predict what interpretation the judges may take with regard to a specific matter such as this.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No, there is no law or regulation restricting the franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency. Nevertheless, please note the requirements related to the purchase of foreign currency against Indonesian rupiah discussed in question 4.

Even though this may not be relevant to the question, it is still worth noting that Law No. 7 of 2011 regarding Currency (enacted on 28 June 2011) provides that Indonesian rupiah must be used for any payments, financial transactions or for the settlement of obligations in the territory of the Republic of Indonesia, except for:

- certain transactions for the implementation of the State budget;
- grants from or to Indonesia;
- international trade transactions;
- deposits in foreign currencies with Indonesian banks; or
- international financing.

Given this, the requirement to use Indonesian rupiah should apply to a sub-franchisee's payments to the master franchisee or sub-franchisor which we understand means payment that will take place in the Republic of Indonesia. Any violation of this requirement is subject to imprisonment for up to one year and a fine of up to 200 million rupiah. In addition, any recipient who refuses to accept payment in Indonesian rupiah for the settlement of financial transactions in Indonesia will be liable to up to one year in prison and a fine of up to 200 million rupiah, unless:

- they are in doubt about the genuineness of the money they have received;
- they have agreed in writing with the other parties to the agreement that the payment will be in foreign currency; or
- the payment is for one of the transactions in items bullet-pointed in the previous paragraph.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes, they are generally enforceable. The franchise agreement should provide that the franchisor will be entitled to certain damages or sanctions caused by violation of these confidentiality covenants.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, the ICC provides that all agreements must be made in good faith. Article 1338 of the ICC states that '[…] all agreements validly entered into shall serve as law to the parties thereto. Such agreements cannot be withdrawn except by a mutual agreement of the parties, or by reasons determined by law. Such agreements shall be implemented in good faith'.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Several laws contain provisions protecting consumers' interests, such as the Law on Hygiene, the Law on Goods, the Law on the Principles of Local Government, the Regulation of the Ministry of Trade on Direct Selling, Trading, etc, but consumers are not specifically defined.

Update and trends

Other than Law No. 7 of 2011 regarding Currency that stipulates that, in the territory of the Republic of Indonesia, rupiah must be used for any payments and financial transactions or for the settlement of obligations that include payment under any domestic franchise or sub-franchise arrangement, there are no new developments in franchise regulations. In addition, foreign franchisors should continue to note that the awaited implementing regulation for Law No. 24 of 2009 on the National Flag, Language, Emblem and Anthem may provide certain restrictions on the use of foreign languages in agreements that would also affect franchise agreements.

The Law on Consumer Protection (Law No. 8 of 1999) defines consumers as users of goods and services for use by self, family, other persons or other living creatures that are not to be traded. The law further elucidates that consumers are end-users of the products and services. As franchisees are business agents and not end-users, they are not treated as consumers for the purposes of consumer protection.

37 Must disclosure documents and franchise agreements be in the language of your country?

The disclosure document and the franchise agreement may be in English. If a prospectus is made in a foreign language, an Indonesian version of the same must be prepared, because the Indonesian version of the prospectus must be registered with the MOT. As advised by officials at the MOT, it is recommended to have the prospectus translated into the Indonesian language by a sworn translator in Indonesia. Regulation No. 42 and Regulation No. 31 state that if a franchise agreement is drawn up in a foreign language, an Indonesian version must be prepared – a sworn translated document is recommended. Both the foreign and the Indonesian versions must be signed by the franchisor and franchisee.

Other than the language requirements under Regulation No. 42, Regulation No. 31 and Decree No. 138, it should be noted that Law No. 24 of 2009 on the National Flag, Language, Emblem, and Anthem enacted on 9 July 2009 (Law No. 24 of 2009) stipulates that the Indonesian language must be used in, among other things, agreements entered into by Indonesian parties. If the agreement involves foreign parties (such as a foreign franchisor and an Indonesian franchisee), the agreement can be executed in dual language (namely, using the Indonesian language and the language of the relevant foreign party or the English language). Further, Law No. 24 of 2009 provides that if a contract entered into by foreign and Indonesian parties is executed in dual language, all versions are the same as the original. Note that Law No. 24 of 2009 does not provide any sanctions for violations of the obligation to use the Indonesian language as described above or any further explanations of what is meant by all versions being the same as the original (given a dual language agreement).

The implementing regulation of Law No. 24 of 2009 (in the form of a Presidential Regulation) is to be introduced within two years of the enactment of Law No. 24 of 2009, that is, by 9 July 2011. This implementing regulation may or may not provide sanctions for failure to fulfil the obligations imposed under Law No. 24 of 2009. Pending further clarification of Law No. 24 of 2009 in the Presidential Regulation, it appears that a number of leading commercial lawyers are of the view that unless required by law, the agreement may be in a language other than Indonesian (usually English). Therefore, it should soon be possible for contracting parties to agree that the English version of the agreement will prevail in the event of a dispute, particularly if it is the version negotiated by the parties. Given this, it is advisable that a clause clearly confirming the parties' agreement on this matter be inserted. With respect to franchise agreements, by policy of the competent government agency (namely, the Department of Trade), parties may register their franchise agreement executed in a foreign language. However, a translation of the agreement prepared by a sworn translator must also be submitted.

38 What restrictions are there on provisions in franchise contracts?

Term of the agreement

Prior to the issuance of Regulation No. 42 and Regulation No. 31, the terms of a franchise agreement were provided in Regulation No. 12 (the implementing regulation of the Franchise Law of 1997 that is no longer valid) as follows:

- a franchise agreement between a franchisor and a master franchisee must be valid for at least 10 years; and
- a franchise agreement between a master franchisee and a sub-franchisee must be valid for at least five years.

The terms of a franchise agreement are not provided in either Regulation No. 42 or Regulation No. 31. However, as advised by the officials at the MOT, the minimum term of a franchise agreement as previously provided in Regulation No. 12 is still used as a reference. Early termination of the franchise agreement by the franchisor or master franchisee will not automatically enable the franchisor to appoint a new franchisee. Under Regulation No. 31, a franchise certificate for the new franchisee will only be issued by the MOT if the franchisor has settled all outstanding issues resulting from the early termination of the franchise agreement by the franchisor as evidenced in a written agreement (clean break agreement). However, the MOT may issue a franchise certificate to the new franchisee if the franchisor and franchisee fail to settle their issues within six months of the termination of the franchise agreement.

Governing law

Regulation No. 42 no longer requires a franchise agreement to be governed by Indonesian law, but it must observe Indonesian law. However, Regulation No. 31 clearly states that a franchise agreement must be governed by Indonesian law.

Local content

It is a requirement that all parties give priority to the maximum use of domestic products or services, provided that quality standards are met. It is unclear to what extent or in which way this may be imposed on a franchise arrangement other than by the authorities reviewing the franchise agreement.

SME priority

It is required that the franchisor prioritises small and medium-scale enterprises as its franchisees or sub-franchisees and, in certain cases, as its suppliers.

Business areas

Except for provincial capitals, a franchise business may not be conducted unless the city or area has been 'opened' specifically for franchise activities by the Ministry. Again, this is to protect smaller enterprises. The precise location of franchise activities (whether in a traditional market or in a modern shopping mall) is also regulated, as is the ability to appoint franchisees for the same products or services on adjacent sites at a particular location.

Franchised products

It appears that uniquely Indonesian products or services, including traditional food and drinks, may only be franchised in Indonesia by or with the participation of small or medium-scale enterprises.

Training programmes

Regulation No. 42 requires a franchisor to provide training programmes in the form of operational management assistance, marketing, research and sustainable development to the franchisee. The following are types of training programmes that should be provided by the franchisor to the franchisee under Regulation No. 31:

- an education and training programme regarding the franchise management system, in order to help the franchisee to operate the franchise in good order and to make a profit;
- routine operational management assistance, so any operational errors can be fixed immediately;
- market development assistance through promotions using advertisements, leaflets, catalogues, brochures or participating in exhibitions; and

- market research and development of products to be promoted, so the products meet the market's needs and are well accepted by the market.

The authorised agency will revoke the franchisor's certificate if the franchisor fails to carry out these obligations after receiving three consecutive warning letters.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Indonesian competition law is not applicable to franchise relationships. However, the Indonesian Supervisory Commission on Business Competition has issued a guideline on franchising. See question 25.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The 1945 Constitution and relevant laws governing Indonesia's judicial system (for example, Law No. 4 of 2004 on the Competency of the Courts of Justice) have been designed so that the competency of the judicature is performed by the Supreme Court and judiciary authority lies under its supervision as well as the Constitutional Court. The judicature authority under the Supreme Court comprises the general courts, religious courts, military courts and the State Administrative Court. Unlike other courts, the Constitutional Court is not supervised by the Supreme Court.

In addition, Indonesia also recognises several specialised courts that operate under the auspices of the general courts – namely the Commercial Court, which adjudicates bankruptcy petitions and trademark infringements; the Children's Court; the Industrial Relations Court; and the Tax Court.

Commonly, a lawsuit is initiated by a plaintiff filing a complaint to the chairman of the district court located in the defendant's domicile. The plaintiff is then required to register the lawsuit with the deputy registrar of the appropriate district court. The losing party at the district court level is entitled to appeal to the High Court. It may take a year or more for the High Court's judgment to be rendered. A party that has lost a High Court decision may appeal to the Supreme Court. In these cases it can take three years or more for a final decision to be issued. Unless otherwise expressed in the relevant law, a panel of judges consisting of at least three judges, of which one is a presiding judge, will examine any lawsuit. The judgment must be delivered in open public court.

As well as settlement of disputes through the courts, the parties may also settle their disputes by means of arbitration or alternative dispute resolution if they agree to it. The law defines alternative dispute resolution as an institution for settlement of disputes or divergent views through an out-of-court procedure agreed upon by parties, namely by means of consultation, negotiation, mediation, conciliation or evaluation experts. Foreign arbitral awards may also be enforced in Indonesia. The enforcement of an arbitral award, whether domestic or foreign, will require an execution order from the relevant court.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Theoretically, the principal advantages of arbitration for foreign franchisors are as follows:

- the confidentiality of disputes between the parties is guaranteed;
- procedural and administrative delays can be avoided;
- the parties can appoint an arbitrator who in their view has proper knowledge, experience and background in the disputed matters;
- the parties can determine the choice of law for dispute settlement, as well as the process and venue of arbitration; and
- the decision resulting from arbitration can be executed through a supposedly simple procedure.

However, there are certain disadvantages to arbitration over normal litigation: for example, while Indonesian arbitration law attempts to reduce the potential for delays in the enforcement of arbitral awards, there is a distinct danger that the tight procedural timeframe for courts to hear appeals or for the disputing parties to prepare and make filings may result in hasty decisions and rushed drafting. Some uncertainty is also caused by some of the provisions of arbitration law, eg the requirement for the parties to try to resolve disputes within 14 days prior to proceeding to alternative dispute resolution, although there is no further provision regarding when the 14-day period commences or whether it can be extended.

Another example is where a party wants urgent injunctive relief in the event of default by the defaulting party. In some contracts it is stated that one or both parties can go to the courts for such urgent relief. This has the obvious disadvantage that once a matter is before the court it is very difficult to cease the action and the party bringing the action will have to face counterclaims etc. Finally, as a matter of practice, we have to point out that it is often difficult to stop another party taking a dispute to the courts even though the parties have chosen arbitration as the exclusive dispute resolution mechanism.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Indonesian franchise law applies equally to foreign and domestic franchisors. Administrative requirements may differ, but in general, foreign and Indonesian franchisors are not treated differently.

The author wishes to thank Patron Mohammad Hara for conducting the necessary research.

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Japan

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The most typical franchisors are organised in the form of a joint-stock company.

2 What laws and agencies govern the formation of business entities?

The formation of joint-stock companies in Japan is governed by the Companies Act (Act No. 86, 2005) and administered by the Ministry of Justice.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The formation of a joint-stock company requires articles of incorporation and other incorporation documents to be prepared and registered at a competent legal affairs bureau. After incorporation, it is necessary to prepare financial statements etc, and to hold a shareholders' meeting each year.

4 What restrictions apply to foreign business entities and foreign investment?

Foreign business entities must register their representatives in Japan in order to conduct business continuously in the country. Once registered, they can carry out business in the same way as domestic entities. In addition, foreign investment is regulated by the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949 – FEFTA); industry-specific laws may also apply, depending on the business sector of the foreign entities.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Franchisors in the form of joint-stock companies need to pay corporate tax, corporate enterprise tax, corporate inhabitant tax and consumption tax. Depending on the nature of the assets held by a franchisor, property tax and automobile tax may also be payable. Foreign businesses' and individuals' income sourced in Japan is generally subject to Japanese taxation.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Labour regulations generally apply to franchisors, especially with regard to the relationship between franchisors and their respective employees. Nevertheless, in a typical franchise arrangement, a franchisee or the employees of a franchisee are not considered to be employees of the franchisor. To avoid the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor, a franchisor needs to structure the franchise relationship so that the franchisee is an independent entity, and needs to clearly explain the independent nature of the franchise relationship with the franchisee. In addition, if a franchisor is involved in the hiring process of employees of the franchisee, it should explain its position well and make it clear to the prospective employees that the employer will be the franchisee, not the franchisor. Breach of labour regulations may result in penalties including imprisonment.

7 How are trademarks and know-how protected?

Franchisors can register trademarks to protect such marks from infringing use. Nevertheless, there is no registration system per se for know-how. Know-how that falls within the scope of registrable types of intellectual property, such as patents, designs or copyrights, may be registered accordingly. In addition, if the know-how falls within the scope of a 'trade secret' under the Unfair Competition Prevention Act (Act No. 47 of 1993), it will be protected against any acts constituting unfair competition.

8 What are the relevant aspects of the real estate market and real estate law?

In general, a franchisee leases real estate for its operations directly from a property owner. Disputes may arise when the lessor tries to increase the rent or to terminate or refuse to renew the lease agreement. In such situations, protection would be available to the franchisee under the Land Lease and Building Lease Act (Act No. 90, 1991) and the doctrine of the destruction of a relationship of mutual trust (see question 27).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no uniform definition of a franchise in Japan. Nevertheless, there are three relevant definitions with regard to franchise businesses. Firstly, the Medium and Small Retail Commerce Promotion Act (Law No. 110 of 1973 – MSRCPA) defines a 'chain business' as a business that, pursuant to an agreement with uniform terms and conditions, continuously sells or acts as an agent for sales of products and provides guidance regarding management, and primarily targets medium and small retailers. In addition, a 'specified chain business' is defined as 'any chain business the agreement for which includes clauses which permit its members to use certain trademarks, trade names or any other signs, and collects joining fees, deposits or any other money from the member when becoming a member'. If a franchise business falls under this definition, the regulations of the MSRCPA apply.

Secondly, the Guidelines Concerning the Franchise System (Franchise Guidelines) under the Act on Prohibition of Private Monopolisation and Maintenance of Fair Trade (Act No. 54 of 1947 – Antimonopoly Act) provide the following:

> *The franchise system is defined in many ways. However, the franchise system is generally considered to be a form of business in which the head office provides the member with the right to use a specific trademark and trade name, and provides coordinated control, guidance, and supports for the member's business and its management. The head office may provide support in relation to the selling of commodities and the provision of services. In return, the member pays the head office.*

Thirdly, the Japan Franchise Association (JFA) defines a franchise as:

> *A continuing relationship between one business concern (called a Franchisor) and another business concern (called a Franchisee) where a Franchisor and a Franchisee enter into a contractual agreement, the Franchisor granting the Franchisee the right to use the signs representing the Franchisor's business, which signs include the Franchisor's logo, service mark, trade name and others as well as the Franchisor's management know-how, and to conduct the product sales and other businesses which bear the same image as the Franchisor's; the Franchisee paying the consideration to the Franchisor in return, providing the fund required for the business, and operating the business under the Franchisor's guidance and assistance.*

10 Which laws and government agencies regulate the offer and sale of franchises?

If the franchise business falls within the scope of a specified chain business, the MSRCPA regulates the disclosure obligations related to the offer and sale of franchises. The Ministry of Economy, Trade and Industry, as well as other Ministries, depending on the products sold by the franchise business, have overall responsibility in this regard.

From the perspective of competition law, the Franchise Guidelines regulate the offer and sale of franchises in connection with the Antimonopoly Act, and the Fair Trade Commission has overall responsibility in this regard.

The JFA has also implemented voluntary rules, such as the Japan Franchise Association Code of Ethics and the Voluntary Standard Regarding Disclosure and Explanation of Information to Prospective Franchisees.

11 Describe the relevant requirements of these laws and agencies.

Under the MSRCPA, franchisors whose businesses fall under the definition of specified chain businesses are required to provide a written document that describes prescribed items and to explain the contents of the written documents prior to executing a franchise agreement with prospective franchisees.

The Franchise Guidelines require franchisors to disclose sufficient and accurate information to prospective franchisees.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There are no exemptions under the MSRCPA or the Franchise Guidelines. Nevertheless, if a franchisor's business does not fall within the definition of a franchise under such law or regulation, that law or regulation will not apply.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no such requirement in general, except for those provided in the MSRCPA and the Franchise Guidelines. If the industry of the franchise is regulated by industry-specific laws, it is necessary to check those regulations.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In the case of a sub-franchise, the relationship between the sub-franchisor and the franchisee needs to be analysed; if it falls within the definition of a specified chain business under the MSRCPA, the sub-franchisor owes a disclosure obligation. In such a case, the information relating to the sub-franchisor must be disclosed. The relationship between the franchisor and the sub-franchisor must also be analysed; if it too falls within the definition of a franchise, the franchisor has a disclosure obligation as well.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Under the MSRCPA, when a franchisor intends to negotiate a franchise agreement with a prospective franchisee, the franchisor must provide written documents describing the prescribed items and explain the contents of the written documents to prospective franchisees. There are no regulations regarding the frequency of updating disclosures.

16 What information must the disclosure document contain?

Under the MSRCPA, the following information is required to be disclosed by the franchisor to the franchisee (MSRCPA article 11, Enforcement Regulation (ER), articles 10 and 11):

- Information regarding the franchisor, including:
  - the name and address of the franchisor, number of full-time employees and, if the franchisor is a company, the title and names of officers;
  - the amount of capital, names of the principal shareholders (those holding more than 10 per cent of the shares directly or indirectly) and, if the franchisor is conducting another business, the type of business;
  - the name of any entity of which the franchisor holds a majority of the voting shares;
  - the balance sheet and profit and loss statement, or other documents equivalent to these with regard to the past three business years of the franchisor's business;
  - the date on which the franchisor began its specified chain business;
  - the number of litigation cases in which the franchisor is the plaintiff and a franchisee or ex-franchisee is the defendant with regard to the franchise agreement and vice versa during the past five business years;
  - business hours, business days and regular or irregular closing days of franchisees' stores;
  - if there is a provision stipulating whether the franchisor will engage in or allow other franchisees to engage in business operations conducting the same or similar retail business near the shops of the franchisee and, if there is such a provision, the contents of the provision;
  - whether there is a provision that prohibits or restricts the ability of franchisees to conduct businesses, such as prohibiting them from joining other specified chain businesses or from being employed with similar businesses, either during or after termination or expiration of the agreement, and, if there is such a provision, the contents of the provision;
  - whether there is a provision that prohibits or restricts disclosure of information that the franchisee may know regarding the specified chain business during or after termination or expiration of the agreement, and, if there is such a provision, the contents of such provision;

  - if the franchisees need to remit all or part of the sale proceeds periodically, the timing and method thereof;
  - if the franchisor lends or arranges to lend money to franchisees, the interest rate or the method of calculating the rate and any other conditions of the lending or arranging of lending;
  - if the franchisor adds interest to all or part of the remaining amount after setting off the rights and obligations which accrue in connection with a transaction with the franchisor during a certain period, the interest rate or the method of calculating the rate and any other conditions;
  - if the franchisor imposes on franchisees a special obligation regarding the structure or interior or exterior of stores of franchisees, the contents of the obligation; and
  - the amount of money or the method of calculating the amount of money that accrues when the franchisor or a franchisee violates the agreement;
- information with regard to the initial fee, deposit or any other money that the franchisor will collect at the time when the prospective franchisee becomes a franchisee. Such information must specify:
  - the amount of money to be paid or the method of calculating the amount;
  - the nature of the money to be collected, such as whether it is an initial fee, deposit, equipment fee, etc;
  - the timing of payment;
  - the method of collection; and
  - whether the money will be refunded or not, and the conditions applicable to such refund;
- information with regard to the type of products that are sold or arranged to be sold to the franchisees and the method of payment for such products;
- information with regard to management instruction, specifying whether there will be training or a seminar when joining, the content thereof, and the method of continuous management instruction to franchisees and how many times such instruction will be conducted;
- information with regard to the trademark, trade name, and any other matters regarding the indication of the business name that will be permitted to be used. In addition, if there are any terms and conditions with regard to the use of the indication of the business name, the content thereof must be provided;
- information with regard to the duration of the agreement and renewal and termination of the agreement, specifying:
  - the duration of the agreement;
  - the conditions and procedure to renew the agreement;
  - the requirements and procedures to terminate the agreement; and
  - the amount of compensatory damages that will accrue on termination of the agreement or the methods to calculate the amount, and the content of any other obligation;
- information with regard to changes in the number of franchisees' stores during the most recent three business years, specifying:
  - the number of franchisees' stores as at the last day of each business year;
  - the number of franchisees' stores that newly started operations during each business year;
  - the number of franchisees' stores whose franchise agreements have been terminated during each business year; and
  - the number of franchisees' stores whose franchise agreements were renewed during each business year and the number of franchisees' stores whose franchise agreements were not renewed during each year;
- information with regard to any periodic payments, specifying:
  - the amount of money to be paid periodically or the method of calculating the amount of money to be paid periodically;
  - the nature of the payment, such as whether it is a royalty for the use of the business name, a consulting fee, etc;
  - the timing of payment; and
  - the method of collection of the payment.

17 Is there any obligation for continuing disclosure?

The MSRCPA and the Franchise Guidelines do not provide any continuing disclosure obligation on current franchisees.

18 How do the relevant government agencies enforce the disclosure requirements?

The Ministry of Economy, Trade and Industry and the relevant ministry which administers the distribution of the specific products sold by the franchise business have the authority to enforce the disclosure obligation under the MSRCPA. They may issue a recommendation to comply to a franchisor that does not comply with disclosure obligations under the MSRCPA (paragraph 1, article 12), and if the franchisor does not follow the recommendation, the minister may disclose such fact to the public (paragraph 2, article 12).

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

No special remedy exists for franchisees under the MSRCPA. Therefore, unless otherwise provided in the franchise agreement, franchisees need to base any claims for damages on the general principles of contract under the Civil Code (Act No. 89, 1896). In the event of fraudulent disclosure of information, franchisees can rescind the franchise agreement (Civil Code, article 96). If there is a material misunderstanding about the franchise agreement, the franchisee can claim that the franchise agreement is void (Civil Code, article 95).

If damage has been caused by the violation of the disclosure requirement, franchisees may bring a claim for damages based on contract theory or tort theory (Civil Code, articles 415 and 709). A violation of the disclosure requirement under the MSRCPA can establish the element of illegality required to bring a tort claim. There is no formula to calculate damages, but damages are recognised provided the violations are an actual and proximate cause of the damages.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

As discussed in question 14, a franchisor or a sub-franchisor whose business falls within the definition of a specified chain business will owe disclosure obligations, and any party who owes such obligations shall be responsible for any breach thereof. Generally, individual officers, directors and employees of the franchisor or the sub-franchisor are not exposed to liability. Nevertheless, if there are breaches of duty of care or faults on the part of these individuals, they may face liability accordingly. In addition, there is a risk that a franchisee will name these individuals as defendants in a suit against the franchisor or the sub-franchisor to seek recovery of damages from them.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See question 19.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There are no such general obligations, except for those provided in the MSRCPA and the Franchise Guidelines. If the relevant industry pertaining to the business undertaken by the franchise is regulated by industry-specific laws, it is necessary to check such regulations, and if a party is a listed company, timely disclosure obligations and other disclosure obligations under the securities regulations would apply.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

See question 19. In addition, franchisees may also claim that a franchisor is violating the Franchise Guidelines, thereby violating the Antimonopoly Act.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws regulating the ongoing relationship between franchisors and franchisees.

25 Do other laws affect the franchise relationship?

Various laws affect the franchise relationship. From a competition law aspect, the Antimonopoly Act is relevant. The Franchise Guidelines and the Guidelines Concerning Distribution Systems and Business Practices under the Antimonopoly Act (11 July 1991, the Distribution Guidelines) specify what kinds of activities are problematic under the Antimonopoly Act. The Trademark Act (Act No. 127 of 1959), the Unfair Competition Prevention Act (Act No. 47 of 1933), the Act on Specified Commercial Transactions (Act No. 57 of 1976) and other laws are relevant in the areas of intellectual property, know-how and advertisement. As described in questions 19 and 35, the general obligations under the Civil Code often affect the franchise relationship, especially when there is neither a specific law nor a clause in the agreement addressing a particular issue.

26 Do other government or trade association policies affect the franchise relationship?

There are voluntary rules, such as the Code of Ethics, prepared by the JFA. If a franchisor is a member of the JFA, its voluntary rules are an important consideration in the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Usually, the franchise agreement lists the circumstances in which the franchisor may terminate a franchise relationship. In addition, if the franchisor and the franchisee mutually agree, the franchisor may also terminate a franchise relationship .

If there is no clause in the franchise agreement regarding the termination, the franchisor may terminate the franchise agreement prior to the expiration of the term of the agreement if the franchisee violates the franchise agreement (Civil Code, articles 541 to 543). Nevertheless, because franchise agreements are usually continuous agreements, it can be expected that courts will be more reluctant to terminate such agreements, compared with normal agreements. On this point, it may be useful to refer to the doctrine of the destruction of a mutual trust relationship; this has been established in the area of lease agreements that are also generally considered as continuous agreements. With regard to lease agreements, a lessor's ability to terminate a lease agreement is limited to the case that the mutual trust relationship is destroyed because of the lessee's violation of the agreement (Supreme Court, 28 July 1964, 21 April 1966). This means that a lessor may not terminate a lease agreement even if the lessee is violating it, provided that the violation is not sufficiently material to destroy the mutual trust relationship. In many cases, this doctrine is applied or considered by the court to restrict a franchisor's ability to terminate a franchise relationship.

28 In what circumstances may a franchisee terminate a franchise relationship?

Usually, the franchise agreement regulates the circumstances in which a franchisee may terminate a franchise relationship. In addition, the franchisee may terminate a franchise relationship due to mutual agreement with the franchisor. In cases where there is no clause in the franchise agreement, the same considerations apply as those relating to termination by the franchisor.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Provisions in the franchise agreement generally determine whether a franchisor may refuse to renew the franchise agreement with the franchisee. In cases where the franchise agreement states that it will not be renewed unless otherwise agreed to between the parties, the franchisor may generally refuse to renew. On the other hand, in cases where the franchise agreement states that it will be renewed automatically unless either party notifies otherwise, it is unclear in which circumstances the franchisor may refuse to renew. On this point, there is a case in which a court required 'compelling circumstances which make it difficult to continue the agreement' for a franchisor to be able to refuse to renew a continuous agreement (*Hokka Hokka Tei* case, Nagoya District Court, 31 August 1998).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

By so stipulating in a franchise agreement, a franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity. As to the transfer of a franchise, a franchise agreement usually requires the franchisor's consent for the franchisee to transfer its franchise under the agreement. It is also generally understood that when a party to an agreement is going to transfer its status or obligations under the agreement, the other party's consent is necessary; therefore, even if there is no clause in the franchise agreement requiring consent for transfer, the franchisor's consent will be required.

As to the transfer of ownership interest in a franchisee entity, the owner of the ownership interest in a franchisee entity is generally free to transfer its ownership interest. The franchise agreement may require the franchisor's consent for the transfer of ownership interest in a franchisee entity. Such covenants will be only contractually enforceable against the franchisee and not against the owner of the ownership interest in a franchisee entity, unless the owner of the ownership interest in the franchisee is also a party to the franchise agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There is no specific limitation on the amount or payment of fees. But if such fees are unreasonably high, the obligation to pay such fees may be deemed void because it may be construed as an abuse of dominant bargaining position (Designation of Unfair Trade Practice (Designation of UTP), item 14, Antimonopoly Act, article 19) or as against good public order and customs (Civil Code, article 90).

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

For interest on loans from a franchisor to a franchisee, the restriction on interest under the Interest Rate Limitation Act (Act No. 100 of 1954) applies. But if the overdue payment is not in connection with a loan, there is no specific restriction on the amount of interest. If the interest charged is unreasonably high, however, it can be held to be void for the reasons stated in question 31.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no restrictions on currency.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants are generally enforceable. If a franchisee breaches confidentiality covenants, a franchisor may ask for compensation for the damages caused by such violation or ask for a preliminary injunction to avoid any damages in advance.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Under the Civil Code, there is a general duty to act in good faith (article 1). In addition, if an agreement is unreasonably advantageous to one party, it can be deemed void because it is against good public policy (Civil Code, article 90). These clauses affect franchise relationships in various ways. One area where the duty to act in good faith under article 1 of the Civil Code plays an important role is with regard to the franchisor's obligation to disclose information. A court has construed that a franchisor has an obligation to provide prospective franchisees with accurate and adequate information so that they can make decisions (Fukuoka High Court, 31 January 2006, *Shin Shin Do* case, Kyoto District Court, 1 October 1991). In addition, courts use article 90 to limit liquidated damages.

Update and trends

Many franchisors and franchisees in Japan suffered damages as a result of the earthquake and tsunami on 11 March 2011. The electricity shortage due to the nuclear energy issue is also a burden on the operation of businesses. Needless to say, how we can cope with these difficulties is the most important issue. Various discussions seem to be ongoing between franchisors and franchisees, especially regarding the reduction of royalties, compensation of damages, and how to save electricity necessary for operations. Franchisors, especially in the area of retail, are also trying to fulfil their corporate social responsibility by flexibly answering the needs of afflicted people. They also plan to increase the number of stores in the Tohoku area so as to meet the continuous needs of consumers in that area.

For example, in the *Honke Kamadoya* case (Kobe District Court, 20 July 1992), a court stated that liquidated damages of an amount equal to 60 months' loyalty payment were significantly out of balance with the expected amount of damages; consequently the liquidated damages were void to the extent that they went beyond a reasonable amount of damages because such amount was against good public policy (Civil Code, article 90).

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, a franchisee would not be protected as a consumer for the purpose of consumer protection laws because the franchisee is doing business. For example, the Consumer Contract Act (Act No. 61 of 2000) defines a 'consumer' as any natural person excluding a natural person who becomes a party to a commercial contract to engage in commercial endeavours. Nevertheless, as demonstrated by the courts' inclination to protect franchisees (see question 27), depending on the case, franchisees could be protected by interpretation of the Civil Code or other consumer protection laws.

37 Must disclosure documents and franchise agreements be in the language of your country?

There is no clear requirement that disclosure documents need to be in Japanese, but since the disclosure obligation is imposed so that prospective franchisees have sufficient information and understand the franchise well, it is prudent to prepare such documents in Japanese. There is no requirement that franchise agreements should be in Japanese.

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38 What restrictions are there on provisions in franchise contracts?

The most important restrictions on provisions in franchise agreements are the restrictions imposed by the Antimonopoly Act. Under the Distribution Guidelines, a provision that assigns a specific area to each distributor and restricts the distributor from selling outside each area (exclusive territory) may be illegal, depending on how powerful the franchisor is in the relevant market. In addition, any other restriction on territory or customers may be problematic under the Antimonopoly Act (see question 39). The Franchise Guidelines also specify restrictions which could be problematic, including restrictions on suppliers or bargain sales and restrictions on trade after termination of an agreement.

As stated above, the restriction on liquidated damages may be void or reduced if it is construed as against good public policy and customs (Civil Code, article 90).

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

As stated in the answer to question 38, the Antimonopoly Act is relevant to the typical franchise agreement. The Franchise Guidelines and the Distribution Guidelines describe what kind of activities or restrictions are problematic under the Antimonopoly Act. First of all, the Franchise Guidelines require franchisors to disclose sufficient and accurate information when they are soliciting prospective franchisees, otherwise their actions can be deemed to be deceptive customer inducement that is illegal as it falls into the category of unfair trade practice (Designation of UTP, item 8). In addition, the Franchise Guidelines regulate transactions between franchisors and franchisees. They state that it could be an abuse of a dominant bargaining position (Antimonopoly Act, article 2, paragraph 9, item 5) to limit parties with whom franchisees can make transactions, to compel franchisees to buy a designated amount of goods, to restrict the ability of the franchisees to offer discounts to their customers or to restrict competitive activities after the termination of a franchise agreement. It also states what kind of items should be considered in connection with tie-in sales (Designation of UTP, item 10), dealing on restrictive terms (Designation of UTP, item 13), and resale price restriction (Antimonopoly Act, article 2, paragraph 9, item 4).

If the restrictions on unfair trade practices under the Antimonopoly Act are violated, the Fair Trade Commission can order the breaching party to cease and desist from the activity, to delete the clauses concerned from the agreement and to take any other measures necessary to eliminate such activities (Antimonopoly Act, article 20). Some of the categories, such as abuse of dominant bargaining position and resale price restrictions, could be subject to surcharges (Antimonopoly Act, article 20-5).

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

A dispute regarding a franchise relationship will be brought to one of the district courts. In every prefecture, one or more district courts exist. Decisions by district courts may be appealed to a competent High Court, then to the Supreme Court. In addition to litigation in a courtroom, arbitration is possible if the parties agree.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Foreign franchisors' principal advantage in choosing arbitration is that the proceedings can be conducted in English or any other language as agreed in the franchise agreement. In addition, considering that international franchise agreements tend to be governed by laws other than the laws of Japan, arbitrators may be more familiar with such governing law than Japanese judges. The principal disadvantage of arbitration is the generally higher costs due to fees for the arbitrators, and the fact that the number of arbitrators who are familiar with franchise laws in countries other than Japan and who know the business practices of franchises may be limited.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Because of certain restrictions on foreign business entities and foreign investment (see question 4), foreign franchisors could face different regulations. For example, certain technical licences could be subject to a regulatory filing under the FEFTA, depending on the contents of the licence. In addition, if the industry of the franchise is regulated by specific laws, such laws may treat foreign franchisors differently.

Korea

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Lee & Ko

Overview

1 What forms of business entities are relevant to the typical franchisor?

The stock company and the limited liability company are the business forms in South Korea that would be relevant to the typical franchisor. About 90 per cent of Korean companies are stock companies, which are similar to US stock companies. Only this legal entity, plus occasionally the limited liability company, is recommended for foreign investors and businesses.

2 What laws and agencies govern the formation of business entities?

Primarily, the Korean Civil Act and Korean Commercial Code govern the formation of business entities. In addition, the Foreign Investment Promotion Act relates to the formation of business entities from foreign investment.

The Korean Court Commercial Registrar, National Tax Service and Ministry of Knowledge Economy are the main agencies that have authority relating to the formation of business entities.

3 Provide an overview of the requirements for forming and maintaining a business entity.

There is no minimum paid-in capital for a stock company. However, the minimum paid-in capital is 10 million won for a limited liability company. Registration is with the Court Commercial Registrar and National Tax Service. In the case of foreign business entities' or foreigners' investment, they must report to the Ministry of Knowledge and Economy (in practice, the function of receiving reports is delegated to designated foreign exchange banks or the Korea Trade Investment Promotion Agency).

4 What restrictions apply to foreign business entities and foreign investment?

A foreigner may freely carry on foreign investment activities in Korea without being subject to any restrictions unless otherwise specifically restricted by the Foreign Investment Promotion Act or other laws and regulations. Specifically, a foreigner is not to be restricted from foreign investment other than in the following cases:

- where it interferes with the safety of the nation or maintenance of public order;
- where it causes harm to the health and safety of nationals or is markedly contrary to public morals and decency; or
- where it violates Korean laws and regulations.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The principal taxes affecting business enterprises in Korea include corporate tax, individual income tax, value-added tax, customs duties, and inhabitant tax levied on corporate tax, income tax and other taxes.

The franchisor has a duty to pay taxes (corporate tax or individual income tax) on royalty incomes. However, the tax rates are limited to the rate stipulated in the tax treaty between Korea and the state in which the franchisor resides. In this regard, the franchisee has a duty to withhold such taxes from the royalties it pays to the franchisor.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Under the Korean Civil Code, an employer is liable for a tort committed against a third party by an employee who is under the employer's actual direction or supervision, in relation to the performance of a work that is directed or supervised by the employer. Therefore, if a franchisee or a franchisee's employee is deemed an employee of the franchisor, the franchisor may be held liable for damages to a third party caused by the franchisee or the franchisee's employee during the performance of his or her work.

To reduce the risk of such liability, it is advisable for the franchisor not to be involved with the specifics of the franchisee's management and to specify in the franchise agreement that the franchise will be operated by the franchisee as an entity independent from the franchisor. However, since a franchisor and a franchisee are generally independent entities and, therefore, the franchisee is not subject to the direction or supervision of the franchisor, we think that the above liability will rarely occur.

7 How are trademarks and know-how protected?

Korea is a 'first-to-file' jurisdiction. To obtain reliable protection of trademark rights in Korea, the owner of the trademark should register it with the Korean Intellectual Property Office pursuant to the Trademark Act. During the application period, no protection is provided. However, while the application is pending, the applicant may send a warning letter to a person who uses an identical or similar mark on goods that are identical or similar to the goods for which the application has been filed. If the trademark application subsequently becomes registered, the applicant (now the registrant) may bring a claim against such person for losses accrued from the date the written warning was received by such person up to the registration date of the trademark.

Once the registration is granted, the owner may seek to enforce the trademark rights against third-party infringements by seeking injunctive relief against further infringement or damages (or both), or by an order for the destruction of infringing goods.

In addition to the Trademark Act, the Unfair Competition Prevention and Trade Secret Protection Act is available to protect well-known unregistered trademarks, trade secrets and know-how.

8 What are the relevant aspects of the real estate market and real estate law?

Ownership of Korean real estate by foreigners was previously regulated in two ways: restrictions on title to land under the Alien Land Acquisition Act, and restrictions against leasing real estate (land or building) under the Foreign Investment and Foreign Capital Inducement Act. However, the Alien Land Acquisition Act was substantially amended, effective 25 June 1998, permitting a foreigner to purchase real property located in Korea with a simple report of the acquisition of title to the relevant local government office. In addition, through amendments to the Foreign Investment and Foreign Capital Inducement Act on 1 April and 1 July 1998, foreign investment in the business of leasing real estate was fully liberalised (the name of this Act was changed to the Foreign Investment Promotion Act from 17 November 1998).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Under the Fairness in Franchise Transactions in Franchise Business Act (Franchise Act), a 'franchise' is defined as:

> *[…] a continuous business relationship in which the franchisor allows the franchisee to sell goods (including raw and auxiliary materials) or services under certain quality standards and business method using its trademarks, service marks, trade name, signs and other business marks (collectively, 'Business Marks'), and supports, educates and controls the franchisee with regard to relevant management and operating activities, and in which the franchisee pays franchise fees to the franchisor in return for the use of the Business Marks and the support and education concerning the management and operating activities.*

10 Which laws and government agencies regulate the offer and sale of franchises?

The Franchise Act that was enacted on 1 November 2002 and most recently amended on 22 March 2010, and its Presidential Decree, are the primary statutes applicable to the franchisor-franchisee relationship. Additionally, the Monopoly Regulation and Fair Trade Act (MRFTA) and regulations promulgated by the Korea Fair Trade Commission (KFTC) are generally applicable to the relationship.

The KFTC regulates franchises in Korea. The KFTC has a franchise-related department and has the authority to impose administrative measures against those who engage in unfair activities. In this regard, the KFTC has the discretion to determine the unfairness or reasonableness of the activities of the franchisor and to levy penalties and issue corrective orders against those violators depending on the unfair nature of the activity. However, the violator may seek a district court's judicial review of the KFTC's findings.

11 Describe the relevant requirements of these laws and agencies.

The Franchise Act is based on the principle of good faith and fair dealing and tries to provide a framework for building a fair and equal business relationship between the parties involved in franchising. The Franchise Act delegates the task of overseeing the franchise industry to the KFTC, and the KFTC in turn provides necessary guidance and order by monitoring the industry through corrective measures and penalties for those who violate the Franchise Act.

The Franchise Act is divided into six main chapters. Chapter I sets the stage by providing the purpose of the Act and the definitions of various terms used throughout the Act. Chapter II deals with the basic principles that govern the franchise transactions, and chapter III has to do with fairness in franchise transactions, which, among other requirements, places a disclosure requirement on the franchisor. Chapter III also provides a list of basic provisions that need to be included in a franchise agreement. Chapter IV provides for a nine-member dispute mediation committee regulated by the KFTC and details the qualifications and the roles of the committee. Chapter IV also defines the roles and responsibilities of a 'franchise consultant'.

Chapter V deals with the disposition of cases under the KFTC and contains details of the corrective measures that can be instituted, including a provision on an administrative fine imposed on a franchisor that violates certain provisions of the Franchise Act. Furthermore, because this chapter also makes references to provisions of the MRFTA, a franchisor must also be concerned with the application of the MRFTA. Chapter VI imposes administrative and criminal liabilities on the people who violate the Act, and depending on the type and degree of violation, the person may be subject to a maximum prison sentence of up to five years or a penalty of not more than 150 million won.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Article 3 of the Franchise Act provides that the Act will not be applicable, for example, to the delivery of a disclosure document to a prospective franchisee, if the total franchise fee paid by the franchisee to the franchisor for a six-month period beginning from the date of initial payment of the franchise fee does not exceed an amount of 1 million won or if the franchisor's annual sales amount is less than 50 million won. The 1 million won and 50 million won are prescribed by the Presidential Decree of the Franchise Act.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

Although the disclosure requirement under the Franchise Act requires a franchisor to disclose information if the franchisor operated or is operating a franchise, there is no law or regulation that mandates that the requirements must be satisfied before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

A master franchisor need not provide a disclosure document to a sub-franchisee if the master franchisor is not in a contractual relationship with the sub-franchisee: that is, a master franchisor has no obligation to provide a disclosure document if it is not a party to the franchise or any other agreements with a sub-franchisee.

Disclosure documents must contain a description of the general status of the franchisor (see question 16 for a list of information to be disclosed). Although neither the Franchise Act nor its Presidential Decree specifically requires that the information concerning the master franchisor and the contractual or other relationship between the master franchisor and the sub-franchisor be included in the disclosure documents, as the information relates to the 'description of general status of the franchisor', it would be appropriate to include a rough summary of such information.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Under the old Franchise Act (prior to the 2007 revision), franchisors were excused from the obligation to make disclosure to prospective franchisees unless the prospective franchisee had specifically requested delivery of the disclosure document in writing.

However, under the new revision of the Franchise Act, the above disclosure procedure has been amended drastically, mainly as follows:

- a franchisor must provide a disclosure document to the prospective franchisee even if the franchisee does not specifically request it in writing;
- in providing the disclosure document to a prospective franchisee, the franchisor must register the disclosure document with the KTFC first and then provide the registered disclosure document to the prospective franchisee; and
- acceptance of a franchise fee or execution of a franchise agreement is prohibited unless the franchisor provides the registered disclosure document and 14 days have elapsed from the date of provision of the registered disclosure document.

The disclosure document may be furnished to a prospective franchisee by:

- providing the disclosure document (hard copy) directly or sending it by mail to the prospective franchisee;
- providing the disclosure document in an electronic file on a disc (or other similar medium that may be recorded, kept and printed from);
- providing the disclosure document via access to the internet; or
- sending the disclosure document in a soft file to the prospective franchisee's e-mail address.

With regard to the update of the disclosures, a franchisor must register (or report) any changes in the disclosure documents with the KFTC. Depending on the importance of the information that has been changed, deadlines for filing the report thereto range from 'within 30 days from the occurrence of the cause of the change' and 'within 30 days from the expiration of the quarter in which the cause of the change has occurred' to 'within 120 days from the expiration of each fiscal year'.

16 What information must the disclosure document contain?

The following broad categories of information are required to be contained in the disclosure document:

- information regarding the general status of the franchisor;
- information regarding the current status of the franchisor's franchise;
- information regarding any legal violation by the franchisor and its executive;
- information regarding the obligations of the franchisee;
- information regarding conditions of and restrictions on business activities;
- information regarding detailed procedures and the period required in respect of the commencement of franchise business; and
- information regarding education and training programmes (it must be specified if there is no plan for education and training).

17 Is there any obligation for continuing disclosure?

According to the Franchise Act, if disclosures have been made in accordance with the Franchise Act, under article 5-3(1) of the Enforcement Decree, franchisors are required to prepare and register (or report) with the KFTC an amendment to the disclosure document within:

- 30 days from the date the changes occurred (if the changes pertain to the general status of the franchisor);
- 30 days from the end of the quarter in which the change occurred (if the changes pertain to obligations of the franchisee, or conditions of and restrictions on business activities); or
- 120 days from the end of the fiscal year in which the change occurred (if the changes pertain to the current status of the franchisor's franchise).

18 How do the relevant government agencies enforce the disclosure requirements?

Where franchisers have violated their duties to provide a disclosure document or have provided false or exaggerated information, the KFTC may require the franchisor to provide or amend the disclosure document; report on necessary plans or actions taken or any other measures necessary for correction of such violations (corrective measures); or it may arrange a plan for correction and recommend that a franchisor follow such a plan (recommendation of corrective measure). With respect to such violations, the KFTC may impose an administrative fine of an amount not exceeding 2 per cent of the franchisor's total sales.

Furthermore, in the event that a franchisor violates certain provisions of the Franchise Act relating to disclosure requirements (for example, where a franchise fee has been accepted or a franchising agreement has been executed before providing the disclosure document, or where a franchisor has provided false or exaggerated information or omitted important information), the KFTC may file a criminal complaint with the attorney general. It is worth noting that a complaint from the KFTC is required for a public criminal action to be instituted for violation of the Franchise Act.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

See question 17 for legal remedies and assessing damages for violating the disclosure requirements.

In the case of violation of disclosure requirements, the franchisee may report such violation to the KFTC. Furthermore, the franchise may bring a lawsuit for damages and cancel or rescind the franchise contract under general principles of tort or contract law in accordance with the Korean Civil Code. If there remain damages that are not recovered by cancelling and rescinding the contract, the franchisee may additionally be entitled to such damages, apart from such cancellation or rescission.

Violations of the Franchise Act may be introduced in a lawsuit for damages as evidence of a party's pattern of conduct or culpability for conduct but, in general, such violations do not have any bearing on the calculation of damages in a civil context. Damages are calculated by the general principles of tort and contract law (proximate causation theory) and there is no specific law and regulation applied to the franchise transaction.

In connection with the criminal penalties, the Franchise Act does not create any private rights of action. The franchisee can only report the franchisor's violations to the KFTC. A complaint from the KFTC is required to institute a public criminal proceeding against violators of the Franchise Act. If receiving a report from the franchisee or investigating on its own initiative, the KFTC may decide to institute a public criminal proceeding depending upon the 'seriousness' and 'clarity' of the violation of the franchisor. In addition, the attorney general may, on its own initiative, request the KFTC to file a complaint, and in such a case, the KFTC must comply with the request. Once a public criminal indictment has commenced the KFTC cannot withdraw the complaint.

In theory, the criminal penalties under the Franchise Act for disclosure violations are among the most severe in the sphere of Korean business.

The harshest penalty is reserved for fraud; provision of false or exaggerated information or omission of important items from disclosures required under the Franchise Act carries a penalty of up to five years' imprisonment or a fine of not more than 150 million won under article 41, paragraph 1 of the Franchise Act. Failure to provide a disclosure document, or execution of a franchise

agreement or acceptance of a franchise fee within the 14 days prior to the provision of the disclosure document, is subject to a possible term of imprisonment of up to two years or a fine of up to 50 million won under article 41, paragraph 3 of the Franchise Act.

Refusal to comply with the KFTC's orders to provide disclosure, if such orders are given, is also potentially subject to a serious penalty. Where disclosure is not provided, or where the disclosure is later reviewed by the KFTC upon the franchisee's request and found to be incorrect (but not fraudulent), the agency may demand that the franchisor provide proper disclosure materials. Failure to do so in the face of the KFTC's 'corrective order' may be subject to up to three years' imprisonment or a fine of up to 100 million won under article 41, paragraph 2 of the Franchise Act.

In addition, in certain cases of disclosure failures, the KFTC may order the return of the franchise fee.

The KFTC generally prefers to apply pressure to a party – usually the franchisor, given the objective of the statute – to correct its behaviour in order to avoid the application of criminal sanctions.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

A master franchisor has no duty to provide a disclosure document if it is not a party to the franchise or any other agreements with a sub-franchisee. In such a case, liability for disclosure violations is solely attributable to the sub-franchisor.

If individual officers, directors and employees of the franchisor engage in a disclosure violation, they are exposed to liabilities similar to those of the franchisor. They may be subject to damage claims filed by the franchisee or criminal penalties.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The general fair trade principles under the MRFTA may affect the offer and sale of franchises (see question 10). No other regulation, government agency or industry code, besides the KFTC, may affect the offer and sale of franchises.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

No.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Fraudulent or deceptive practices by a franchisor may constitute fraud as stipulated by the Korean Criminal Code. In the case of a disclosure violation, the franchisee can only report such violation to the KFTC who will then determine whether to file a criminal proceeding. In the case of fraudulent or deceptive practices constituting criminal fraud, a franchisee may directly file a criminal complaint with the public prosecutor. In addition, a franchisee may file a lawsuit for damages against the franchisor with or without cancelling or rescinding the franchise contract.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchise Act regulates the ongoing relationship between the franchisor and franchisee after the franchise contract comes into effect.

25 Do other laws affect the franchise relationship?

General fair trade principles under the MRFTA may affect the offer and sale of franchises (see question 10).

26 Do other government or trade association policies affect the franchise relationship?

The guidelines provided by the KFTC may affect the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The Franchise Act does not specify grounds for termination of the franchise agreement; it merely provides the procedure to be observed when terminating the franchise relationship.

Under the previous Franchise Act, when a first notice of breach from the franchisor (which stated the grounds of breach and a request to cure such breach, and stated that failure to cure would result in termination of the agreement) was received by the franchisee, the two-month cure period 'clock' began to run (and the franchisee's obligation to cure arose at this point). During this cure period, the franchisor could send two additional notices of the same breach, which worked as a reminder for the cure. If the franchisee failed to 'cure' the breach during this period, the relationship could be terminated.

Under the new Franchise Act, the notice provision works in the same way, except that the new Franchise Act only requires one additional notice rather than two. In addition, the new revision expanded the exceptions to the notice and cure requirement (that is, specific reasons by which the franchise agreement may be terminated without notice or the opportunity to cure) to include the following:

- bankruptcy or composition is filed against the franchisee or a corporate reorganisation and compulsory enforcement procedures are commenced;
- a promissory note or cheque issued by the franchisee is not duly paid due to insolvency, etc;
- a franchisee is no longer able to manage the franchise business due to force majeure or significant personal reasons, etc;
- a franchisee's public dissemination of false facts considerably damages the franchisor's reputation or credit, or the franchisee leaks trade secrets or important information regarding the franchisor that brings about a significant impediment to the franchise business;
- where the franchisee violates laws or regulations in relation to the operation of the franchise business and receives a notice of administrative action ordering correction (including imposition of administrative fines), but the franchisee fails to correct it within the time specified (10 days from receipt of notice if no deadline is specified);
- where the franchisee violates laws or regulations in relation to the operation of the franchise business and receives an administration action that, by its nature, cannot be corrected, including revocation of qualification, licence or approval or an order suspending business (except orders ordering suspension of business for less than 15 days);

- where the franchisee, after complying with the franchisor's demand for correction of breach pursuant to article 14, paragraph 1 of the Franchise Act, repeats the same violation within one year (in cases of renewal of the franchise agreement, the relevant period in the initial term is accumulated with the renewed term) from the date of the correction, provided that the foregoing does not apply where the franchisor, in its written demand for correction, fails to state the fact that the franchise agreement may be terminated without going through the procedure under article 14, paragraph 1) of the Franchise Act if the franchisee repeats the same violation within one year (from the date of the correction);
- a franchisee has been subjected to criminal punishment for an act related to the operation of a franchise shop;
- a franchisee operates a franchise shop in a manner that arouses concern for imminent danger to public health and safety; or
- a franchisee stops operation for seven consecutive days without justifiable reason.

28 In what circumstances may a franchisee terminate a franchise relationship?

Under the Franchise Act, no restriction or prior notice is required for franchisees to terminate their relationship. As a general principle of law, however, the franchisee may terminate the franchise agreement in the case of default by the franchisor. In addition, where the franchise agreement is seen as a 'continuing contract', the franchisee may also terminate the agreement based on the grounds that the purpose of the agreement has been frustrated as a result of unforeseeable circumstances.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Under the old Franchise Act, there were no restrictions imposed on the franchisor's right to refuse to renew the franchise agreement.

However, the new revision of the Franchise Act prescribes that if the franchisee requests a renewal between 180 days and 90 days prior to the expiration of the franchise agreement, the franchisor may not refuse to renew the franchise agreement without just cause. As exceptions, the franchisor is permitted to refuse to renew the franchise agreement in the following circumstances:

- the franchisee has failed to perform its payment obligations of the franchise fee under the franchise agreement;
- the franchisee has not accepted the terms and conditions of the franchise agreement or business policy that are generally accepted by other franchisees; or
- the franchisee has failed to observe the following important business policies of the franchisor that are deemed necessary for maintaining the franchise business:
  - matters pertaining to the procurement of a store or facility that is necessary for the operation of a franchise, or acquisition of licence, permit or approval as required by law;
  - matters pertaining to observance of production methods or service methods that are necessary for maintenance of quality of goods or services for sale; and
  - other matters that are deemed necessary for normal operation of the franchise as determined by Presidential Decree.

If the franchisee requests a renewal, the notice of refusal stating the reasons for the non-renewal must be provided within 15 days of receipt of the request for the renewal. If the notice of refusal (to the franchisee's request for a renewal) is not provided to the franchisee, or a written notice of non-renewal or change in terms and conditions (for the renewal) is not provided to the franchisee between 180 days and 90 days prior to the expiration of the franchise agreement, the franchise agreement will be deemed to have been renewed under the same terms and conditions therein.

As a cautionary note, even if the franchisee does not request a renewal, a franchisor must provide a written notice of non-renewal of the franchisee (between 180 days and 90 days prior to the expiration of the franchise agreement) if the franchisor has no intent or does not wish to renew the franchise agreement. If the franchisor first provided a notice of non-renewal (prior to the franchisee's request for renewal) within the above period, then the franchisee subsequently requests a renewal within the same period (despite the franchisor's notice of non-renewal), the franchisor may not refuse to renew the franchise agreement without just cause. In other words, the franchisor's notice of non-renewal (before the franchisee has made a request for renewal) would realistically work only as a reminder to the franchisee to decide whether to renew the franchise agreement or not.

The franchisee's right to request a renewal may only be exercised for a total duration of 10 years (including the term of the original franchise agreement), and if 10 years have lapsed, the franchisor may refuse to renew the franchise agreement regardless of its reasons (as long as a written notice of non-renewal has been provided).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Because it can be said that the franchisor–franchisee relationship is reciprocal, where both parties are creditors as well as debtors to each other (supply obligation on the one hand and payment obligation on the other hand), we are of the opinion that the franchisee should receive the consent of the franchisor prior to the transfer of the franchise business (transfer of its obligation) to a third party. In this regard, the Franchise Act, under article 6, paragraph 9, provides that the franchisee has to first obtain the prior written consent of the franchisor to assign the franchise business. Thus, a franchisor may restrict a franchisee's ability to transfer its franchise.

However, unless the parties have specifically agreed not to allow the transfer of ownership interests in a franchisee, there is no restriction on the franchisee's right to transfer ownership interests.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

The Franchise Act stipulates that 'the franchise fee', regardless of what it is called or what form it comes in, shall mean the amount that comes under the following:

(i) consideration that the franchisee pays to the franchisor in consideration for franchise management rights, such as the permission to use business marks or support and education for its operating activities, such as application fee, membership fee, franchise fee, education and training fee or down payment, etc;
(ii) consideration that the franchisee pays to the franchisor to secure payment for goods supplied by the franchisor or compensation for damages;
(iii) consideration that the franchisee pays to the franchisor for fixtures, equipment or goods supplied by the franchisor for the purposes of commencing the franchise at the time of the granting of franchise management rights;
(iv) consideration, specified in the Presidential Decree, that the franchisee pays to the franchisor on a regular or irregular basis in consideration for the support and education related to the use of business marks approved under its agreement with the franchisor, operating activities and other matters; or
(v) all other considerations that the prospective franchisee or franchisee pays to the franchisor for purposes of acquiring or maintaining franchise management rights.

In connection with the franchise fees under the above items (i) and (ii), the new revision of the Franchise Act has implemented a

system whereby the franchise fees may be deposited (for example, in an escrow account) with a certain financial institution instead of making a direct payment to the franchisor, and the franchisor is allowed to withdraw the franchise fee once the franchisee officially begins its operation of the franchise shop or after two months have elapsed from the date of execution of the franchise agreement. Here, the financial institution must be an institution in Korea as defined in the Presidential Decree.

In lieu of depositing the franchise fees with a financial institution, the franchisor may subscribe to an insurance policy (with the franchisee as the beneficiary) to cover the franchisee's risks. Once the franchisor subscribes to a policy, the franchisor is free to collect the franchise fees at any time.

With regard to the franchise fees deposit requirement in particular, it is difficult to find a financial institution that will open an escrow account for the benefit of a foreign franchisor. Therefore, for foreign franchisors, the only practical option is to subscribe to an insurance policy in lieu thereof.

Finding an insurance provider that offers a policy that is specifically focused for franchise fees purposes is also difficult. We have not yet seen any overseas insurance provider that offers such policy (this is probably because the insurance subscription requirement is unique to Korean franchise law). Even in Korea, most insurance providers do not offer such policy.

For purposes of illustration, a policy offered by an insurance provider in Korea is a policy created specifically for the purposes of franchise transactions and looks like this:

- the insurance premium is a flat rate of 0.667 per cent of the initial (upfront) franchise fee;
- for foreign franchisors who have no business presence in Korea there is an 'extra premium' of 60 per cent of the initial premium; and
- the period of coverage is for two months (which is in line with the two-months rule noted above).

Therefore, if the initial franchise fee is US$150,000:

- the premium would be US$1,000.50 (0.667 per cent of US$150,000: and
- the extra premium would be US$600.30 (60 per cent of US$1,000.50).

Hence, the total amount that the franchisor would need to pay to subscribe is about US$1,600.80.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no specific restrictions on the amount of interest that can be charged on overdue payments. However, if the interest is deemed excessive, it can be void for violating public policy.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no such laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency.

34 Are confidentiality covenants in franchise agreements enforceable?

In principle, confidentiality covenants in franchise agreements are enforceable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Apart from the specific rules applicable to a franchisor's conduct, the Franchise Act also promulgates a 'code of best practice'. Under article 4 of the Franchise Act, both parties to a franchise relationship must exercise good faith in the performance of each of their respective duties in connection with the management and operation of the franchise.

The franchisor's duties are defined in article 5 of the Franchise Act as follows:

- business planning for the success of the franchise;
- continuing efforts toward quality control of goods or services and development of sales techniques;
- installation of shop facilities and supply of goods or services to the franchisee at reasonable prices;
- education and training of the franchisee and its employees;
- continuing advice and support for the management and operating activities of the franchisee;
- prohibition against establishing a franchisor's directly managed shop or establishing a franchise business in a similar line of business to that of the franchisee within its business area during the period of the franchise agreement; and
- making efforts to resolve disputes through dialogue and negotiations with the franchisee.

The franchisee's duties are defined under article 6 of the Franchise Act as follows:

- making efforts to maintain the unity of the franchise and the good reputation of the franchisor;
- maintenance of inventory and display of goods in an appropriate manner in accordance with the franchisor's supply plan and consumer demand;
- compliance with appropriate quality standards as presented by the franchisor with regard to goods or services;
- use of goods and services as provided by the franchisor in the event of failure to stock goods or services that meet the quality standards provided in the preceding point;
- compliance with appropriate standards as presented by the franchisor with regard to the facilities and exterior of the place of business, as well as the means of transport;
- consultation with the franchisor prior to effecting any changes in the goods or services in which it deals or in its operating activities;
- maintenance and provision of the data necessary for unified business management and sales strategy formulation by the franchisor, including, but not limited to, accounting books on the purchase and sale of goods and services;
- provision to the officers, employees or agents of the franchisor of access to its place of business for the checking and recording of its business status and the data as set out in the preceding point;
- prohibition of any change in the location of its place of business or any transfer of franchise management rights without the consent of the franchisor;
- prohibition of any act engaging in the same line of business as that of the franchisor during the period of the franchise agreement;
- prohibition of disclosure of sales techniques or trade secrets belonging to the franchisor; and
- notification of any infringement of business marks by a third party to the franchisor if it becomes aware of such infringement, and appropriate cooperation with the franchisor to take necessary measures to prohibit such infringement.

The Franchise Act provides neither criminal penalties nor sanctions for a party's failure to adhere to the standards established. Therefore, we interpret most of these provisions as normative or best practice standards, rather than mandatory rules. Consequences will result only if a party violates the provisions incorporated into the terms of a contract.

Update and trends

In the past, during the process of registration of the disclosure document, the KFTC merely checked whether there were any different terms between the disclosure document and the franchise agreement and did not raise particular issues with the substance of the terms.

However, starting this year, the KFTC began to review applications for registration of disclosure documents more strictly than before. For example, the KFTC now raises issues if certain sections of the disclosure documents are not in accord with the provisions of the Franchise Act that are generally interpreted as mandatory provisions (ie, applicable regardless of governing law clause), such as termination notice requirement (see question 27), renewal requirement (see question 29) and franchise fee deposit (or subscription to an insurance policy) requirement (see question 31).

With regard to the format of the disclosure document, in particular, the Franchise Act provides that the KFTC may, from time to time, publicise a standardised format for disclosure documents and recommend its use. Because the Franchise Act does not mandate that these standardised formats be used, previously foreign franchisors only needed to prepare a Korean translation of the disclosure document in its original format, and since its original format generally contained all information that is required to be disclosed under the Franchise Act, the KFTC generally accepted and registered them.

However, starting this year, KFTC has been enforcing (rather than recommending) the use of their standardised formats. Therefore, foreign franchisors must keep in mind that those original formats that are used in other jurisdictions may no longer be accepted by the KFTC, and that they must now prepare disclosure documents in the standardised formats publicised by the KFTC.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, franchisees are deemed to be independent commercial entities; therefore, there are no laws that specifically treat franchisees as consumers for the purposes of consumer protection.

37 Must disclosure documents and franchise agreements be in the language of your country?

Under the Franchise Act, there is no requirement that the disclosure documents be prepared in the Korean language. However, because the Franchise Act prescribes that the disclosure document (that will be provided to the prospective franchisee) must be registered with the KFTC (see question 15), the KFTC may, on practical grounds, require the disclosure documents to be prepared in the Korean language for registration.

The Franchise Act does not prescribe that the franchise agreement be written in the Korean language, either. However, it is advisable for foreign franchisors to critically evaluate the English-language capabilities of any prospective Korean franchisees and be prepared to offer a Korean translation of the franchise agreement if the franchisee does not comprehend English or is not using consultants who are competent to assist with any language deficiency. In addition, when filing an application for registration of the disclosure document with the KFTC, a copy of the franchise agreement must be submitted, and if the franchise agreement is in another language, a Korean translation must also be submitted. Therefore, it is necessary to prepare a Korean translation of the franchise agreement for the purposes of registration of the disclosure document as well.

38 What restrictions are there on provisions in franchise contracts?

Article 12 of the Franchise Act places certain restrictions on the franchisor's behaviour, which are adapted from principles articulated in the MRFTA. Specifically, a franchisor may not, whether directly or through another enterprise, commit any act that falls under any of the following, which may obstruct fair trade in the franchise business (the restrictions, however, do not apply in cases where it is objectively difficult to protect the franchisor's trademarks or to maintain uniformity of product or services unless the activities listed below are permitted and such fact has been notified to the franchisee through the disclosure document before execution of the franchise agreement):

- refusal to transact:
  - refusal to provide business support (for example, suspension or refusal of the provision of real estate, services, equipment, products, materials and components necessary for operation of the franchise business);
  - unjust termination of contract; or
  - unjust refusal to renew contract;
- transactions with restrictive terms:
  - restriction of prices (for example, activities that improperly require the franchisee to maintain prices of products sold by the franchisee that are determined by the franchisor);
  - restriction of transaction counterparty (for example, that which improperly require the franchisee to transact with a particular transaction counterparty (including the franchisor) in relation to the acquisition or lease of real estate, services, equipment, products, materials and components required for the franchise business);
  - restriction on the sale of products or services (such restrictions would include activities that improperly require the franchisee to sell only particular products or services);
  - coercion of observance of business territory; or
  - activities similar to the cases described in the first, second, third and fourth sub-bullets above, which improperly restrict the business activities of the franchisee;
- abuse of bargaining power:
  - mandatory purchase (activities that require the franchisee to purchase or lease facilities, equipment, products, services, materials, components, etc, in excess of the volume necessary to engage in the franchise business);
  - making improper demands (improperly demanding that the franchisee provides economic profits or takes the burden of expenses);
  - improper establishment or amendment of contract provisions (establishing or amending contract provisions that make it difficult for the franchisee to perform or that are disadvantageous to the franchisee, or, in relation to the renewal of the franchise agreement, amending or establishing contractual terms that are clearly disadvantageous compared to the previous terms and conditions of the contract or terms and conditions of the contract with other franchisees);
  - interference with management (including acts that require the operation of a franchise with a particular person without proper cause); or
  - mandatory sales targets (unjustly establishing sales targets and forcing franchisees to meet such targets);
- establishing its own or its subsidiary's shop or franchise shop for the same business as the franchisee within the business territory of the franchisee during the term of the franchise agreement in breach thereof (however, the foregoing does not apply if the fact that the franchisor is not granting an exclusive business territory licence to the franchisee was notified to the franchisee in the disclosure document and the franchise agreement entered into also specifies that no exclusive licence is granted).

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Franchise Act was originally drafted to adapt the provisions of the MRFTA into the franchise context. Therefore, the Franchise Act is the general law that is applicable to franchises (the MRFTA would not generally apply to franchises since the Franchise Act is more specific to the franchise context).

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Korean legal system is a civil law system, originally adopting the European civil law system and Japanese legal system. The Korean judiciary system is three-tiered and consists of the Supreme Court (the highest court), the high courts (the intermediate appellate courts) and the district courts (the courts of first instance). There are five high courts and 18 district courts, divided into geographical districts.

Alternatively, the parties in dispute may resolve disputes relating to the franchise agreement via mediation or arbitration. In particular, the Franchise Act provides that a franchise transaction dispute mediation committee may mediate matters related to disputes over franchise transactions if requested by the KFTC or by the parties in dispute. The franchisor is free to reject a mediation request. However, if mediation is requested due to an alleged violation of the MRFTA or the Franchise Act, it is advisable for the franchisor to comply with the request, because upon refusal, the franchisor may find itself subject to corrective measures under the Franchise Act.

The Korean Commercial Arbitration Board (KCAB) is the only authorised institution of arbitration in Korea. The KCAB is dedicated to the settlement of commercial disputes as a neutral, unbiased and independent institution for administering and conducting arbitration, conciliation and mediation. Arbitration before the KCAB is an alternative way of producing impartial and fair resolutions to commercial disputes.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Unlike litigation before the courts of jurisdiction, arbitration awards are not appealable and, therefore, may resolve a dispute through a single proceeding. In addition, because arbitration procedures are not public, important information regarding the franchise transaction may be kept confidential.

However, there is no means to challenge an arbitral award, even if it is considered unjust. In addition, arbitration proceedings may take longer than adjudication before the court of first instance (in many cases, the dispute practically comes to an end when the judgment of the court of first instance has been given), meaning the dispute may be unnecessarily prolonged.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Aside from minor differences in connection with the obligation to report real estate acquisitions (see question 8) and the restrictions imposed by the Foreign Investment Promotion Act (see question 4), foreign franchisors are not treated differently from domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

In Malaysia, a business may be carried out through a number of different forms, including sole proprietorships, partnerships and companies or branch offices of foreign companies.

The principal form of business organisation that is most relevant and common to a typical franchisor would be a private limited company. In certain circumstances, a foreign company may opt to establish a branch office in Malaysia.

2 What laws and agencies govern the formation of business entities?

Where incorporation of a company is concerned, the relevant law is the Companies Act 1965 (CA). The relevant agency is the Companies Commission of Malaysia (SSM) (www.ssm.com.my).

3 Provide an overview of the requirements for forming and maintaining a business entity.

Briefly, the requirements for incorporating a company with the SSM and maintaining the company are as follows:

- the applicant must first apply to the SSM to determine whether the proposed name for the intended company is available;
- if the proposed name is available, the application will be approved and the name will be reserved for the applicant for a period of three months;
- the applicant must then lodge the following documents with the SSM within three months in order to secure the use of the proposed name;
  - memorandum and articles of association (which documents the company's name, objectives, the amount of its authorised capital (if any) proposed for registration and its division into shares of a fixed amount);
  - statutory declaration of companies (Form 6);
  - statutory declaration by a person before appointment as a director, or by a promoter before incorporation of a company (Form 48A), together with a copy of the identity card or passport (for a foreign director); and
  - a declaration by the named secretary in the form as provided, together with the identity card;
- a company must maintain a registered office in Malaysia, where all books and documents required under the provisions of CA are kept. The secretary of a company must be a natural person of full age who has his or her principal or only place of residence in Malaysia. The company must also appoint an approved company auditor to be the company auditor in Malaysia. In addition, the company shall have at least two directors whose principal or only place of residence is within Malaysia;
- directors are required to lay before the company at its annual general meeting: a profit and loss account, a balance sheet as at the date to which the profit and loss is made-up, and a director's report. The first meeting must be no later than 18 months after the incorporation of the company and subsequently there must be at least one in every calendar year. The company is also required to keep accounting and other records in order to sufficiently explain the transactions and financial position of the company and enable true and fair profit and loss accounts and balance sheets to be prepared from time to time.

4 What restrictions apply to foreign business entities and foreign investment?

Generally a foreign company cannot carry on business in Malaysia unless it incorporates a company as its subsidiary, sets up a branch office or registers a representative office in Malaysia. In certain circumstances, a foreign company may wholly own a Malaysian company: for example, if the foreign company has been granted Multimedia Super Corridor (MSC) status or has been granted the status of International Procurement Centre, Operational Headquarters or other special statuses which can be granted by various ministries.

Prior to 30 June 2009, the Foreign Investment Committee (FIC) of the Economic Planning Unit of the Prime Minister's Department set out general foreign investment guidelines (the FIC Guidelines) – namely, the FIC Guidelines on the Acquisition of Interests, Mergers and Takeovers by Local and Foreign Interests (the FIC M&A Guidelines) and the FIC Guidelines on the Acquisition of Properties by Local and Foreign Interests (the FIC Property Guidelines) – to regulate both foreign and local investment in Malaysia.

Generally, under the FIC Guidelines, companies incorporated in Malaysia may have in aggregate foreign interests of up to 70 per cent. The remaining 30 per cent must be held by Bumiputras (Malays). While the FIC Guidelines do not have the force of law but are merely a reflection of governmental policies and administrative guidelines, they are usually enforced administratively by various government agencies: for instance, approval for certain licences or permits will only be granted if FIC approval has been obtained. Effective from 30 June 2009, the FIC guidelines on the Acquisition of Interests, Mergers and Takeovers by Local and Foreign Interest have been repealed. Altrhough this has meant the abolition of the 30 per cent Bumiputera equity condition in these FIC Guidelines, other sector regulators impose equity conditions, and these continue to be effective. One such example is the Guidelines on Foreign Participation in the Distributive Trade Services, explained below.

As of 1 December 2004, all proposals for foreign involvement in distributive trade must obtain the approval of the Committee on Distributive Trade under the Ministry of Domestic Trade, Co-operatives and Consumerism (the Committee).

The Guidelines for Foreign Participation in the Distributive Trade Services (the Guidelines) include:

- opening of new branches;
- relocation or expansion of existing branches or outlets;
- buying or taking over of other operators' outlets; and

- purchase of land, premises and assets prior to obtaining the approval or licence from the local authority to operate distributive trade activities.

Distributive traders include wholesalers, retailers, franchise practitioners, direct sellers, product manufacturers and suppliers who channel their goods in the domestic market and commission agents or other representatives, including those of international trading companies of all nationalities.

The Guidelines imposed a general requirement that all proposals for foreign participation in distributive trade must obtain the approval of the Committee. In line with the national development policy, the Committee requires at least 30 per cent Bumiputra participation in the projects.

It should be noted that the Guidelines provide that all franchise businesses with foreign equity must be incorporated locally under the CA.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

All of a company or individual's income that is accrued in, derived from or remitted to Malaysia is liable to tax. Nevertheless, income derived from outside Malaysia and remitted to Malaysia by resident companies (except those involved in the banking, insurance, air and sea transportation business), non-resident companies and non-resident individuals are exempted from tax.

Whether resident or not, a company is assessable on income accrued in or derived from Malaysia. A company is considered resident in Malaysia if control and management of its affairs is exercised in Malaysia. A tax rate of 28 per cent applies to both resident and non-resident companies.

Non-resident individuals are subject to a final withholding tax of 10 per cent on royalties and 15 per cent on interest.

Apart from income tax, there are other direct taxes such as stamp duty and real property gains tax, and indirect taxes such as sales tax, service tax, excise duty, import duty and export duty.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The Employment Act 1955 governs all matters relating to employment. It applies to all employees whose wages do not exceed 1,500 ringgit per month and to all manual workers, irrespective of their wages. All other workers are governed by their employment contracts and common law principles developed through case law. Such common law principles impose certain basic obligations on employers and employees.

Companies are permitted to recruit foreign personnel in areas where there is a shortage of trained Malaysians. It is the government's policy to see that Malaysians are eventually trained and employed at all levels of employment. Foreign companies are also allowed to have certain 'key posts' permanently filled by foreigners. Key posts normally refer to full-time positions of office where the incumbents are the main persons in charge of, and are responsible for, a specific function at or near the highest level of management decision-making within the company. Any distributive trade company with a paid-up capital of 10 million ringgit and above will automatically be allowed three expatriate key posts. Any distributive trade company with a paid-up capital of less than 10 million ringgit but with at least 1 million ringgit will be considered for a maximum of one expatriate key post. The person applying for the key post must hold or have held a managerial position in the company's wholesale or retail business outside Malaysia for a period of not less than three years preceding the date of application for the work permit.

The risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor is very minimal. Notwithstanding this, to further reduce any risk, it should be expressly provided in the franchise agreement between the franchisor and franchisee that no such relationship exists, and the franchisee should display appropriately worded signage at the franchised location clearly indicating the franchisee's status as an independent undertaking.

7 How are trademarks and know-how protected?

Under the Trade Marks Act 1976 (TMA), trademarks (including service marks) can be protected with the Malaysian Intellectual Property Office (MyIPO) by way of use, registration, or both. Registration is the best method of protection, as it provides an exclusive right to the use of the trademark for the goods or services covered by the registration in Malaysia.

Registration of a trademark is available to an individual, partnership or company who intends to use or is using the trademark in the course of trade in Malaysia. All registered owners, whether local or foreign, are entitled to the same protection. Malaysian law also accords rights to unregistered trademarks or service marks under common law through the tort of passing-off. It is possible to register a trademark that is in a foreign language. A person's registration as the registered proprietor of a trademark in respect of any goods or services under the TMA shall, if valid, give or be deemed to have been given to that person the exclusive right to the use of the trademark or service mark in relation to the goods or services in the whole of Malaysia, subject to any conditions, amendments, modifications or limitations entered in the register.

Under the TMA, no one is entitled to sue for infringement unless the trademark has been duly registered. The registered proprietor's exclusive right to the mark is effective from the date of registration, which is deemed to be the date that the application to register is filed.

Malaysia acceded to the Paris Convention on 1 January 1989. Applicants may claim priority from their basic application in a member country of the Paris Convention, provided that the application in Malaysia is filed within six months of the date of basic application. Malaysia is also a signatory of the Nice Agreement. It has not acceded to the Madrid Convention for the International Registration of Marks and there is no indication as to when Malaysia may be likely to join the Madrid Protocol.

Know-how, trade secrets and confidential information are generally protected by secrecy agreements, undertakings, or both, that bind the recipient personally. Where no such agreements or undertakings exist, the common law of breach of confidence will apply. The requirements for an actionable breach of confidence would be:

- the information itself must 'have the necessary quality of confidence about it';
- the information must have been imparted in circumstances importing an obligation of confidence; and
- there must be unauthorised use of that information, to the detriment of the party communicating it.

The Franchise Act 1998 (FA) expressly provides for the protection of confidential information (see question 34).

8 What are the relevant aspects of the real estate market and real estate law?

Most franchised outlets are leased or tenanted properties rather than being owned by franchisees or franchisors. In Malaysia it is common for owners to enter into a tenancy agreement for a period not exceeding three years so as to avoid having to register the lease at the relevant land office. One has to fall back on general contract law, namely, the Contracts Act 1950, for much of the Malaysian law governing landlords and tenants.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Under section 4 of the FA, the statutory definition of a franchise is a contract or an agreement, either expressed or implied and whether oral or written, between two or more persons, by which:

- the franchisor grants to the franchisee the right to operate a business according to the franchise system as determined by the franchisor during a term to be determined by the franchisor;
- the franchisor grants to the franchisee the right to use a mark, or a trade secret, or any confidential information or intellectual property owned by the franchisor or relating to the franchisor, and includes a situation where the franchisor who is the registered user of, or is licensed by another person to use, any intellectual property grants such right that it possesses to permit the franchisee to use the intellectual property;
- the franchisor possesses the right to administer continuous control during the franchise term over the franchisee's business operations in accordance with the franchise system;
- the franchisor has the responsibility to provide the franchisee with assistance to operate its business, including such assistance as the provision or supply of materials and services, training, marketing, and business or technical assistance;
- in return for the grant of rights, the franchisee may be required to pay a fee or other form of consideration; and
- the franchisee operates the business separately from the franchisor, and the relationship of the franchisee with the franchisor shall not at any time be regarded as a partnership, service contract or agency.

In order to fall within the purview of the FA, a franchise must consist of all of the above elements.

10 Which laws and government agencies regulate the offer and sale of franchises?

The FA came into force on 8 October 1999. The Franchise Development Division of the Ministry of Domestic Trade, Co-operatives and Consumerism (MDTCC) is the governmental agency that regulates the offer and sale of franchises in Malaysia. The Ministry of Entrepreneur and Cooperatives Development (MECD) was disbanded in April 2009 after YAB Datuk Najib Tun Rajak took office as the new Prime Minister, and the Franchise Development Division has now been entrusted to MDTCC (formerly known as the Ministry of Domestic Trade and Consumer Affairs). Nevertheless, little should change: the key players and stakeholders remain the same and are still committed to creating and fostering an environment that is conducive to ensuring rapid growth of the franchise industry.

11 Describe the relevant requirements of these laws and agencies.

The Malaysian government has long been aware that franchising is one of the fastest ways to create and increase the number of local entrepreneurs and promote growth in the franchise industry in Malaysia. Essentially enacted to facilitate and monitor the growth of the franchise industry, the FA applies throughout Malaysia and to the sale of any franchise in Malaysia. Pursuant to the FA, franchisors, master franchisees and franchisees of foreign franchisors are required to seek approval from or register with (or both) the registrar of franchises before they can offer to sell or buy franchises in Malaysia.

12 What are the exemptions and exclusions from any franchise laws and regulations?

If a person is able to demonstrate that its business model does not fall within the definition of a franchise, in that it does not satisfy all the ingredients in the definition of the franchise, such business would not be covered by the provisions and purview of the FA.

Under the Franchise (Exemption) Order 2004, any person who has sold a franchise in Malaysia or to any Malaysian citizen prior to the commencement of the FA (8 October 1999) would be exempted from complying with section 54, namely the requirement to submit an application to the registrar.

Pursuant to section 58 of the FA, the minister may, by order published in the Malaysian Gazette, exempt, subject to such conditions as he or she deems fit to impose, any person or class of persons or business or industry from any or all of the provisions of the FA. To date, the only industry that is exempted under this provision is the petroleum industry.

Under the Franchise (Exemption) Order 2001 (PU(A) 27/2001), the minister has exempted from the provisions of the FA the petroleum industry's franchising:

- a petrol station business; and
- any other business operating together with the petrol station business referred to in the above bullet point, subject to the condition that the business operating together with such petrol station business:
  - is operated in the same premises as the petrol station; and
  - is franchised by the same petroleum industry franchising the petrol station business.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

One requirement that is highly unpopular among franchisors and local master franchisees is that they must be in operation for at least three years before they are permitted to appoint sub-franchisees. While this requirement is not expressly provided in the Franchise Act 1998 or any of the regulations, the authorities have taken the view that it is one of the prescribed requirements under law due to section 18 of the Disclosure Document, which requires the franchisors or master franchisees to submit audited financial statements for the past three years. There are apparently plans to reduce the time frame to one year for master franchisees of foreign franchisors. The Registrar of Franchises recently assured the franchise industry that this requirement will be reviewed and applied on a case-by-case basis.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In the case of a sub-franchising structure (namely where the foreign franchisor appoints a local master franchisee who will in turn will appoint sub-franchisees in Malaysia), the local master franchisee must provide disclosure to the foreign franchisor of the fact that it is a master franchisee and is not the franchisor of the franchise in question or of the trademarks owned by the foreign franchisor. As the foreign franchisor would have submitted an application for the franchise prior to the sale of the franchise to the master franchisee, relevant information pertaining to its operations and experiences would have been provided to the registrar during its application.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The franchisor must submit to a franchisee a copy of the franchise agreement, together with the disclosure documents (form BAF1), at least 10 days before the franchisee signs the agreement with the franchisor. Basically, disclosure documents provide a full overview of the franchise business system that will be franchised to the franchisee.

A franchisor's failure to submit such documents is an offence under the FA. If there is any material change in the disclosure documents, they must be amended and filed with the registrar of franchisees. The franchisor must submit an annual report (form BAF6) with the registrar. The report must contain updated disclosure documents.

16 What information must the disclosure document contain?

The disclosure documents contain a large amount of information, including, without limitation, the following:

- name, business address and type of business, including the franchisor's business experience;
- details of the intellectual property rights granted to the franchisee;
- types and amount of fees imposed on franchisees;
- other financial obligations, including advertising, training or service fees payable;
- whether the franchisee is required to purchase equipment or products from the franchisor or from a source designated by the franchisor and, if so, to identify the source;
- the obligations of the franchisor, prior to operating or during operation, in determining the business site;
- the territorial rights granted to the franchisee and circumstances when the boundary of the territory may be altered;
- the franchise term, terms for renewal and termination of agreement by the franchisor or franchisee, and the parties' obligations upon termination; and
- the franchisor is required to submit audited financial statements for the past three financial years and financial forecasts for five years. The requirement for financial forecasts for five years (instead of three years previously) were amended pursuant to the Franchise (Forms and Fees) (Amendment) Regulations 2007 which came into operation on 15 December 2007.

17 Is there any obligation for continuing disclosure?

Section 15 of the FA provides that a franchisor shall submit to a franchisee a copy of the franchise agreement and disclosure documents at least 10 days before the franchisee signs the agreement with the franchisor. This seems to suggest that if the franchisors were to sign new franchise agreements (for the renewed terms) with the current franchisee, they would have to provide such disclosure documents.

18 How do the relevant government agencies enforce the disclosure requirements?

It is a criminal offence under the FA to make false statements of material fact or to omit a material fact that renders the statement misleading in the disclosure documents. It is also a criminal offence if the franchisor fails to submit copies of the disclosure documents to the franchisee at least 10 days before the franchisee signs the franchise agreement.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

In event of violations of disclosure requirements, the franchisees may lodge a complaint against the franchisor with the Registry of Franchises.

A contract induced by misrepresentation is voidable at the choice of the innocent party. The innocent party may rescind the contract by giving notice to the other party and any party who has received any advantage under the contract is bound to restore it, or compensate the other party for it.

The general rule governing the extent of damages payable is laid down in section 74 of the Contract Act 1950:

When a contract has been broken, the party who suffers by the breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from the breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Unless the franchisor is a party to the contract between the sub-franchisor and sub-franchisees, the franchisor will not be liable to the sub-franchisees as there is no privity of contract between them. Nevertheless, in most agreements between the franchisor and sub-franchisor, there would be an appropriately drafted warranty and indemnity clauses to address this issue. Individual officers, directors and employees of the franchisor or sub-franchisor, as the case may be, will not be liable unless they are personally party to the contract or if the other party is able to lift the corporate veil to impute liabilities to them personally.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Apart from the FA, the provisions in the Contracts Act 1950 would be relevant and may affect the offer and sale of franchises.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Apart from the requirement to provide the franchisee with the disclosure documents and the franchisee's right of termination under Section 18(5) of the FA during the cooling off period, as well as the provision in Section 37 of the FA which provides that a person who, whether directly or indirectly, makes any untrue statement of a material fact or omits to state a material fact which renders his statement to be misleading commits an offence, no other general obligations for pre-sale disclosure would cover franchise transactions.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If the franchisor engages in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person in relation to an offer to sell or a sale of a franchise, the franchisor commits a criminal offence under the FA that will entitle the franchisee to lodge a complaint against the franchisor with the Registry of Franchises. If convicted, the franchisor may be liable for a fine of between 5,000 ringgit and 50,000 ringgit for the first offence. Further, the court may declare the franchise agreement null and void and may order the franchisor to refund any payments obtained from any franchisee or prohibit the franchisor from making any new franchise agreement or appointing any new franchisee.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The FA is the most specific and relevant law.

25 Do other laws affect the franchise relationship?

The Contracts Act 1950 also affects the franchise relationship.

26 Do other government or trade association policies affect the franchise relationship?

As well as the policies expounded by the Franchise Development Division of the Ministry of Domestic Trade, Cooperatives and Consumerism, other government policies such as the Distributive Trade Guidelines may have an impact on the franchise industry and franchise relationship. The Ministry of Domestic Trade, Cooperatives and Consumerism has plans to launch the National Franchise Development Blueprint, which is a long-term development plan to further develop the franchise industry. The National Franchise Development Blueprint is intended to outline new policies and directions including strategies and action plans to spur developments in the franchise industry. The specific timeline for the launch is yet to be announced.

The Malaysian Franchise Association (MFA) was formed in 1994 to support the implementation of government programmes to promote entrepreneurship through franchising. The MFA serves as a resource centre for current and prospective franchisors and franchisees, as well as for the media and public. The MFA provides input and liaises with government departments and agencies on matters concerning franchising. As well as setting guidelines and standards of ethical practice among its members, it serves as a forum through which expertise and experiences of members may be exchanged. The MFA also conducts seminars, exhibitions and educational programmes on franchising

Perbadanan Nasional Berhad (PNS), an agency under the Ministry of Domestic Trade Cooperatives and Consumerism, spearheads the government's efforts to develop the Malaysian franchise sector. PNS invests in the development of both local and foreign franchises, with the aim of offering Malaysian consumers a wider choice of high-quality products and services. PNS plays a pivotal role in identifying and acquiring foreign franchises and launching them in Malaysia, and acquires master franchisee rights to famous foreign brands such as Gloria Jean's Coffee. PNS also provides financial assistance to Bumiputera entrepreneurs venturing into franchise businesses via equity investment and franchise business financing. PNS has also set up a Franchise Academy to conduct various franchise related training programmes.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchisor may only terminate a franchise relationship under certain circumstances prescribed by the FA. For instance, section 31 of the FA provides that no franchisor shall terminate a franchise agreement before the expiration date, except for good cause.

'Good cause' includes:

- the franchisee's failure to comply with any terms of the franchise agreement; and
- the franchisee's failure to remedy the breach committed within the period stated in a written notice given by the franchisor, which shall not be less than 14 days, for the breach to be remedied.

Good cause also includes – without the requirement of notice and an opportunity to remedy the breach – instances in which the franchisee:

- assigns the franchise rights for the benefit of creditors or a similar disposition of the assets of the franchise to any other person;
- voluntarily abandons the franchised business;
- is convicted of a criminal offence which substantially impairs the goodwill associated with the franchisor's mark or other intellectual property; or
- repeatedly fails to comply with the terms of the franchise agreement.

In addition, section 32 of the FA may restrict the franchisor's ability to terminate a franchise relationship in that a franchisor commits an offence if it refuses to renew a franchise agreement or extend a franchise term without compensating a franchisee either by a repurchase or by other means at a price to be agreed between the franchisor and the franchisee, after considering the diminution in the value of the franchised business caused by the expiration of the franchise where:

- the franchisee is barred by the franchise agreement, or by the refusal of the franchisor at least six months before the expiration date of the franchise agreement, to waive any portion of the franchise agreement which prohibits the franchisee from continuing to conduct substantially the same business under another mark in the same area subsequent to the expiration of the franchise agreement; or
- the franchisee has not been given written notice of the franchisor's intention not to renew the franchise agreement at least six months prior to the expiration date of the franchise agreement.

Notwithstanding these provisions of the FA, a franchise term may be terminated before the expiry of the minimum term of five years in the following circumstances:

- where both parties mutually agree to terminate the franchise agreement; or
- where the court has decided that there are certain conditions in the franchise agreement which merit the agreement being terminated earlier than the minimum term.

Nothing in the FA precludes the franchisor from taking over and operating the business formerly operated by the franchisee after the franchise agreement has been terminated or has expired.

28 In what circumstances may a franchisee terminate a franchise relationship?

The FA does not expressly provide for circumstances in which a franchisee may terminate a franchise relationship. It does appear that the rights of the franchisee to terminate the relationship would be subject to the terms of the franchise agreement and that they would usually be based on good cause as provided in question 27.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The franchisor may refuse to renew the franchise agreement with a franchisee in the following circumstances:

- the franchisee has breached the terms of a previous franchise agreement;
- the franchisor has given at least six months' written notice to the franchisee prior to the expiration date of the franchise agreement; or
- the franchisor has waived the restraint of trade clause against the franchisee under section 32 of the FA.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, provided that such restrictions are contained in the franchise agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Although there is no express provision in the FA or any other law affecting the nature or amount of fees, there is a general provision in the FA that provides that a franchisor and a franchisee, in their dealings with one another, shall avoid the following conduct:

- substantial and unreasonable overvaluation of fees and prices;
- conduct which is unnecessary and unreasonable in relation to the risks to be incurred by one party; and
- conduct that is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system.

In addition to the above general provision, if a franchisor requires the franchisee to make payment of the franchise fee before signing the franchise agreement, including a payment which is part of a franchise fee, the franchisor must state in writing the purpose of the payment and the conditions for use and refund of the monies. If the franchise agreement is terminated during the cooling-off period, the franchisor must refund all monies, including the initial fees paid by the franchisee, after deducting the reasonable expenses incurred to prepare the franchise agreement for the franchisee. The franchisor would commit a criminal offence if it fails to do so.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The amount of interest charged on overdue payments should not be excessively high or it may not be recoverable.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There is no restriction on payments by a franchisee to a foreign franchisor in the franchisor's domestic currency (foreign currency).

34 Are confidentiality covenants in franchise agreements enforceable?

Yes, they are enforceable. Section 26(1) of the FA provides that a franchisee must give a written guarantee to a franchisor that the franchisee and its employees shall not disclose to any person any information contained in the operation manual or obtained while undergoing training organised by the franchisor during the franchise term and for two years after the expiration or earlier termination of the franchise agreement. Failure to provide such written guarantee or comply with the guarantee provided is an offence. Apart from being an offence under the FA, in the event of the franchisee breaching the confidentiality obligations, the franchisor may commence civil proceedings or proceedings regarding breach of the franchise agreement.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Under the provisions of the FA, it is provided that a franchisor and a franchisee shall act in an honest and lawful manner and shall endeavour to pursue the best franchise business practice of the time and place. Nevertheless, failure to comply with such provisions is not an offence.

Update and trends

The government of Malaysia is considering tax incentives to promote franchise as the preferred business expansion model. The government allocated 8 million ringgit in 2011, under the 10th Malaysian Plan, as a soft loan scheme to assist the lower income group to engage in small and micro franchises as franchisees. The amendment to the Franchise Act 1998 was expected to be tabled in Parliament in the latter part of 2011. Apparently, franchisees will be expected to register with the Ministry of Domestic Trade, Cooperatives and Consumerism under these new amendments to the laws.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

There is no law (including the Consumer Protection Act 1999) that treats franchisees as consumers for the purposes of consumer protection.

37 Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements may be in English.

38 What restrictions are there on provisions in franchise contracts?

Pursuant to the FA, there are various restrictions in relation to such provisions in the franchise contracts. They include, without limitation, the following:

- the duration of the franchise agreement must not be less than five years;
- the franchisee must give a written guarantee that it and its employees will not carry on any other business similar to the franchise business during the franchise term and for two years after the expiration or termination of the franchise agreement; and
- the franchisor must not unreasonably and materially discriminate between franchisees where charges are offered or made for franchise fees, royalties, goods, services, equipment, rentals or advertising services, if such discrimination will cause competitive harm to the franchisees.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Malaysia currently does not have a sui generis competition law that is relevant to the franchisor. Nevertheless, other forms of competition law are found in other principles of laws (tort of passing-off) and in related consumer protection laws such as the Trade Descriptions Act 1972 and the Consumer Protection Act 1999. The Malaysian Competition Act 2010 has been passed but is not in force as yet; it is expected to come into force on 1 January 2012. The Competition Act 2010 seeks to prohibit anti-competitive agreements, including horizontal and vertical agreements, between enterprises if they have the object or effect of significantly preventing, restricting or distorting competition in any market for goods or services. The Competition Act 2010 provides for the Commission to monitor, investigate and enforce the provisions of the Competition Act 2010 and establishes a Competition Appeal Tribunal that can review any decision made by the Commission and has powers to summon parties to give evidence, to procure and receive evidence on oath, etc. The Competition Commission has been established and headed by the former Chief Judge of Malaya and University Malaya Pro-Chancellor Tan Sri Siti Norma Yaakob. It is yet to be seen if there will be any specific guidelines or block exemption applicable for the franchise industry under the Competition Act 2010.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Malaysian legal system is based substantially on the English legal system and the principles of common law. English judicial decisions and other Commonwealth judicial decisions are considered by the Malaysian courts, but only as a persuasive rather than conclusive authority. Although Malaysia is federally constituted, its judicial system is a single-structured system consisting of superior and subordinate courts. The superior courts are the High Court of Malaya, the High Court of Sabah and Sarawak and the Court of Appeal. The subordinate courts are the magistrates courts and the sessions courts. The Federal Court is the highest judicial authority in Malaysia and is the final court of appeal.

The law offers equal protection for foreigners and foreign-owned companies. Commercial disputes may be resolved by arbitration. Malaysian law gives effect to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Unlike arbitration, which enjoys statutory recognition (the Arbitration Act 2005 came into force on 15 March 2006 and repealed the Arbitration Act 1952 and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards Act 1985), there is no statute providing for dispute resolution by way of mediation, as is found in some other jurisdictions. Nevertheless, in recent times mediation has been increasingly encouraged as an alternative mechanism for dispute resolution. It does appear that the Malaysian government is likely to adopt and emulate the Australian mediation concept and mechanism as prescribed under the Franchising Code of Conduct, a mandatory code under the Trade Practices Act 1974.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration is often promoted and considered as better and more efficient than litigation as a way to resolve franchise disputes, saving both money and time. Arbitration's rules of evidence and procedures are more relaxed and more simple, which usually means it takes less time and costs less to bring a franchise dispute to resolution. It is particularly attractive for foreign franchisors, as the proceedings and documents can be conducted in English. As well as flexibility regarding the choice of arbitration location, hearing dates can be scheduled around the needs and availability of the parties involved – unlike trial dates, which are fixed by the courts and beyond the control of those involved. Arbitration proceedings are generally held in private, and parties keep the proceedings and terms of the final resolution confidential.

Despite its many benefits, arbitration may not always be the best option. In certain circumstances, it may have various drawbacks and shortcomings that do not exist in litigation. The costs may be higher than anticipated, as the arbitrators' fees, administrative fees and other expenses to be borne by the parties are higher than those incurred in litigation. The arbitrator's decision-making power is more discretionary and flexible decision-making power than a judge's and the hearing is private, meaning the ramifications of choosing the wrong or unskilled arbitrator would be more serious. The less well-defined rules and fewer procedural safeguards adopted in arbitration may sometimes result in mistakes; due to the arbitrator's final and binding decision being generally unappealable (except in special circumstances), the decision will result in serious and unfortunate repercussions for one of the parties involved.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Requirements for registration under the Franchise Act 1998 differ significantly between foreign and domestic franchisors. A foreign franchisor is merely required to submit an application to the Registry of Franchises by way of a letter setting out various relevant information including, without limitation, its profile, extent of experience and knowledge in the franchise business and the number of franchise outlets, the financial forecast of the franchise business for five years, it's audited accounts for the last three years etc. A domestic franchisor, however, must submit extensive documentation, such as disclosure documents, a sample of the franchise agreement, three years of audited accounts and operational or training manuals, or both.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

There are basically two kinds of business (commercial and mercantile) entities that are regularly used by foreign franchisors to do business within Mexico by either utilising them as subsidiaries or as businesses with which franchisors may enter into franchise agreements. These entities are the stock corporation (SA) and the limited liability company (SRL). In both cases, these entities may also be of variable capital that facilitates the increase or reduction of their corporate capital without having to comply with special formalities. The liability of the holders of interest in any of these two types of entities is limited to the amount of their contributions to the corporate capital.

2 What laws and agencies govern the formation of business entities?

The formation and corporate maintenance of business entities are governed by the General Law of Business Organisations. Different government agencies have jurisdiction over business entities depending on the activities performed by them. The main agencies governing business entities' activities are the Public Registry of Commerce, where all commercial companies must be recorded, the Administration Revenue Service for tax matters and, in the case of foreign entities, the National Registry of Foreign Investments.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Business entities must be incorporated before a notary public and recorded with the Public Registry of Commerce of their corporate domicile. The deed of incorporation of a business entity consists of the by-laws and articles of incorporation evidencing the initial corporate capital, the names of the holders of interest in said capital, the appointment of directors and officers, and the express granting of powers of attorney to specific individuals to represent the company. The minimum number of shareholders or quota-holders to incorporate a stock corporation or a limited liability company is two. Once incorporated, any company having foreign participation in its corporate capital must be recorded with the National Registry of Foreign Investments and the record must be renewed on a yearly basis by submitting an economic, accounting and financial report.

4 What restrictions apply to foreign business entities and foreign investment?

The Mexican government's attitude towards foreign investment is, in general, an open one. Foreign investment in Mexico is regulated mainly by the general constitution and the Foreign Investment Law and its regulations, which exclusively reserve certain activities to Mexican entities without foreign investment, as well as certain activities to Mexican entities with a limit or maximum percentage of foreign investment. In general, the activities in which franchise systems participate in Mexico (such as the hospitality, restaurant, fast-food, automotive and healthcare industries, among others) are non-regulated activities; therefore, foreign investors may participate in these without any limitation or restriction.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Federal, state and local taxes are imposed in Mexico. Federal taxes are collected by the Administration Revenue Service, while state and local taxes are collected by the treasuries of the state and municipal governments.

In accordance with article 1 of the Income Tax Law, individuals and entities are bound to pay income tax in Mexico on the following income:

- Mexican residents, with respect to all their income, without regard to the location of its source;
- non-residents with a permanent establishment in Mexico, but only with respect to the income attributable to such a permanent establishment; and
- non-residents, with respect to income coming from a source located within Mexico, when they do not have a permanent establishment within Mexico or when, having a permanent establishment, the income is not attributable to such an establishment.

In regard to this, article 2 of the Income Tax Law provides that if a foreign resident performs activities within Mexico through an individual or entity (which is different from an independent agent), it would be considered that the resident has a permanent establishment in Mexico with respect to the activities performed by the said individual or entity on behalf of the foreign resident if such an individual or entity exercises powers of attorney to execute agreements in the name of or on behalf of the foreign resident. Likewise, it is considered that a foreign resident has a permanent establishment in Mexico when the foreign resident performs activities in Mexico through an independent agent and this agent carries out the said acts outside its normal activities or course of business.

Foreign franchisors not having a permanent establishment for tax purposes in Mexico, but obtaining an income from a source located within the Mexican territory, are normally taxed on income, which is a tax of a federal nature, and is paid in Mexico by the foreign franchisor through retention or withholding made by the corresponding franchisee.

Likewise, the Income Tax Law establishes that the benefits of international tax conventions shall be applicable when the taxpayer evidences residency in the corresponding foreign country. Mexico's Supreme Court of Justice has determined that the application of tax conventions holds precedence over the federal tax laws (such as the Income Tax Law). This means that a foreign franchisor, as a resident

for tax purposes of its country of origin, has the right to be submitted to taxation under the terms of the corresponding tax treaty or convention, if any, instead of being submitted to the provisions of the Income Tax Law. Normally, the applicable withholding tax rates included in international tax conventions to which Mexico is a party are lower than the income tax rate provided for in the Income Tax Law.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

None of the applicable Mexican laws contain provisions relating to the possibility of considering the existence of labour relations between a franchisor and a franchisee or between the employees of the franchisee and the franchisor. Nevertheless, when entering into a franchise agreement with a franchisee, the franchisor should bear in mind that under Mexican law, contracts are governed by their contents and not by how they are named. Therefore, if the franchisor incorporates or accepts the inclusion of provisions within the franchise agreement in error, that may be interpreted as constituting or creating labour relations and the Mexican labour courts would have sufficient authority to determine the labour obligations of the franchisor and find in favour of the individual franchisee or the franchisee's employees due to the nature of the agreement, regardless of its name. The courts could then penalise the franchisor for non-compliance with such labour obligations.

The most important element that could be used by a franchisee in order to consider the existence of labour relations would be the subordination between the franchisee and the franchisor, which means that all 'recommendations or guidance' provided by the franchisor are in fact considered 'imperative instructions' for the franchisee to comply with. Even though it seems difficult for a franchisor to be considered an employer of its franchisee, certain additional elements must be present, such as:

- periodic payments to be made by the franchisor to the franchisee;
- material evidence of the 'instructions' periodically provided by the franchisor to its franchisee;
- the franchisee must be an individual and not an entity; and
- the franchisee needs to have material evidence of its subordinated relationship with the franchisor and its being part of the same company of the franchisor, such as credentials, memoranda, etc.

To reduce the risk of a franchisor being considered an employer of its franchisee under Mexican law, it is suggested that the franchisor should require its prospective franchisee to create a Mexican company to enter into the franchise agreement, which in no way limits the right of the franchisor to request the individual with whom it has been dealing to also sign a franchise agreement as personal guarantor.

Likewise, the franchise agreement must contain a provision called 'absence of labour relations and non-representation', in which both parties state that they enter into the franchise agreement in their capacity as independent contractors and establish the distinction and independence between franchisor, franchisee and the franchisee's employees, among other stipulations.

In general terms, the franchise agreement must be reviewed to confirm that none of its language could be construed to be creating labour relations with its franchisee. Additional practical recommendations may be made on a case-by-case basis.

7 How are trademarks and know-how protected?

Trademarks in Mexico are protected through their registration at the Mexican Institute of Industrial Property (IMPI). Any holder of a trademark registration must prove use of the same, otherwise a cancellation action may be exercised by any third party claiming lack of use by the holder. The Industrial Property Law (IPL) allows for proving the use of a trademark through a licensee (franchisee) provided that the corresponding licence is recorded in the IMPI.

There is no legal obligation for franchisors or franchisees to register a franchise agreement with the IMPI; however, foreign franchisors should consider making such a registration for the purposes of proving the use of their trademarks and protecting their industrial property rights against third parties for the reason explained above. In order not to reveal confidential information contained in the corresponding franchise agreement to the IMPI and in the respective manuals being a part thereof, it is permissible to submit a summary of the franchise agreement containing only the essential information.

There are two alternatives that could be used jointly or separately to protect know-how in Mexico. One is through copyrights based on the federal Copyright Law, and the other is through patents or trade (industrial) secrets based on the IPL. In addition, and to efficiently safeguard franchisors' intellectual property rights, it is always advisable to execute confidentiality agreements with the individuals who will have access to information containing know-how.

Trade secrets are known under Mexican law as 'industrial secrets' and are specifically protected under the IPL. In some cases, disclosure of industrial secrets may be considered a felony. The breach of a confidentiality obligation may result in the payment of damages and losses caused, or of a conventional penalty (liquidated damages) if agreed in the corresponding franchise or confidentiality agreement.

Non-authorised use of intellectual property rights is considered an administrative infringement under the IPL and, therefore, the IMPI is entitled to exercise specific actions against the corresponding infringer. Certain violations to the IPL may be considered felonies.

8 What are the relevant aspects of the real estate market and real estate law?

There are some restrictions on the acquisition of real estate by foreigners or foreign-owned Mexican entities. As a general rule, a foreign individual or entity may directly own real estate in Mexico but foreigners (including individuals or entities) may not acquire direct ownership of land and water located within the 'restricted zone' that consists of a 50km strip of land inland from Mexican coasts and 100km from the country's borders. Although foreigners may not acquire direct ownership in the restricted zone, they can acquire other rights (similar to ownership rights which allow them to dispose of the real estate, and which are commonly used) over real estate in the following cases:

- wholly foreign-owned Mexican entities may directly acquire property within the 'restricted zone' to perform non-residential activities (industrial, commercial or tourism activities). Such acquisitions must be recorded with the Ministry of Foreign Affairs;
- if the real estate is for residential purposes, foreign individuals or entities and Mexican companies with foreign participation in their corporate capital (up to 100 per cent) may acquire the rights of use and benefit from the real estate through a trust; and
- foreign individuals or entities may take and grant a lease in any real estate and other properties in Mexico without any limitation.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

According to article 142 of the IPL:

A franchise exists whenever, in conjunction with a licence to use a trademark granted in writing, technical knowledge is transmitted or technical assistance is furnished in order to enable the licensee to produce or sell goods or render services in a uniform manner and with the operating, commercial and administrative methods established by the holder of the trademark, with the goal of maintaining the quality, prestige and image of the products or services distinguished by the trademark.

10 Which laws and government agencies regulate the offer and sale of franchises?

Franchises in Mexico are governed and regulated by the IPL and its regulations. The governmental agency in charge of applying the IPL is the IMPI. In addition, there are other laws that may have an application to franchises depending on the type of activity performed in Mexico, such as the Commerce Code, the Consumer Protection Federal Law, the Economic Competition Federal Law (Antitrust Law), the General Law of Business Organisations and the Federal Civil Code.

11 Describe the relevant requirements of these laws and agencies.

The IPL requires that, prior to granting a franchise, the franchisor's information (disclosure document) must be provided to the prospective franchisee at least 30 business days before the execution of the franchise agreement.

Additionally, as a result of the amendments to the IPL effective from 26 January 2006, franchise agreements must be in writing and contain the following minimum provisions:

- the geographical zone in which the franchisee shall mainly perform the activities that are the subject matter of the agreement;
- the location, minimum size and investment characteristics of the infrastructure, relating to the premises in which the franchisee shall carry out the activities deriving from the agreement;
- if applicable, the policies of inventories, marketing and advertising, as well as the provisions relating to the merchandise supply and the engagement with suppliers;
- the policies, procedures and terms for any reimbursement, financing and other considerations in charge of the parties;
- the criteria and methods applicable to determining the franchisee's commissions and profit margins;
- the characteristics of the technical and operational training of the franchisee's personnel, as well as the method or manner in which the franchisor shall provide technical assistance to the franchisee;
- the criteria, methods and procedures of supervision, information, evaluation and grading of the performance and quality of the services under the respective responsibility of the franchisor and the franchisee;
- the terms and conditions of any sub-franchise, in the event it is agreed by the parties;
- termination causes under the franchise agreement;
- events under which the parties may review and, if this happens, mutually agree to amend the terms or conditions of the franchise agreement;
- if applicable, provisions regarding the franchisee's obligation to sell its assets to the franchisor or the franchisor's designated representative, upon the termination of the franchise agreement; and
- if applicable, provisions regarding the franchisee's obligation to sell or transfer the shares of its company to the franchisor or to make the franchisor a partner of such company.

Commerce Code and Federal Civil Code

As previously stated, franchise agreements are governed by the IPL and by the general rules of contracts contained in the Commerce Code and the Federal Civil Code. Commercial activities and contracts in Mexico, such as franchise agreements, are regulated by the general principle of contractual liberty, which applies to all provisions and aspects of a franchise agreement not specifically regulated by the IPL.

Federal Consumer Protection Law

The governmental body in charge of applying this law is the Federal Consumer Protection Agency. In general, this law protects consumers and regulates the activities of providers selling goods and rendering services to the consumers. Its provisions include protection for consumers and restrictions regarding use of information pertaining to the consumers, information provided and advertisements, promotions and offers, services, credit transactions, real estate transactions, warranties and adhesion contracts, among others.

Federal Economic Competition Law

The governmental body in charge of applying this law is the Federal Competition Commission. In accordance with the provisions of this law, there are some restrictions on the general principles of contractual freedom, such as when, through agreements, arrangements or a combination of acts between economic agents, the production, processes, distribution or commercialisation of goods and services is diminished, harmed or impeded, in which case the situations are considered as monopolistic practices. Infringements to the provisions of the Federal Economic Competition Law may result in the nullity of the acts and agreements in violation of the law and the imposition of administrative fines or the payment of damages and losses to third parties.

12 What are the exemptions and exclusions from any franchise laws and regulations?

The IPL is the general applicable law, therefore all franchises operating in Mexico, either through the scheme of master franchise, subfranchise or individual or unit franchise, are subject to its provisions. The IPL does not provide for any exemptions or exclusions as to its applicability to franchises and does not provide the regulatory authority in charge of its application (IMPI) with the discretion to determine whether a particular distribution or similar arrangement is considered a franchise or not, regardless of its name. There are no exemptions for partnership relationships, wholesale distribution agreements or specific industries (for example, gasoline dealers or automotive dealers) if the relationship meets the definition of a franchise set forth in the IPL.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

In terms of the IPL and its regulations, the only requirement that must be met before a franchisor may offer a franchise is the submission of the disclosure document mentioned in the answers to questions 15 and 16.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The IPL makes no distinction in its applicability to master franchises or individual or unit franchises. Its provisions and the disclosure obligations apply to all types of franchises to be established in Mexico.

The IPL requires 'the grantor of a franchise' to provide disclosure to a prospective franchisee. This requires any franchisor, including a master franchisee acting as franchisor, to provide disclosure to the prospective franchisee.

Assuming the master franchisee holds sufficient rights in the franchise to execute a sub-franchise agreement, then the master franchisee would also qualify as the grantor of a franchise and be required to provide disclosure to a prospective sub-franchisee. Even if the franchisor is a party to the sub-franchise agreement, the master franchisee must provide the disclosure since it is the actual grantor of a franchise. In the case of a sub-franchising structure, the disclosure document must contain the same level of information applicable to any franchise, but, in addition, it must describe the relationship between the franchisor and the master franchisee, from which the rights of master franchisee to grant sub-franchises derives.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The IPL states that disclosure must be provided to the prospective franchisee or master franchisee at least 30 days prior to entering into the corresponding agreement. According to the provisions of the IPL, all terms provided for in the said law must be calculated on business days pursuant to the calendar published every year by the IMPI. The IPL does not provide for any obligation to update the information contained in the disclosure document, which must be accurate at the time it is delivered to the prospective franchisee.

16 What information must the disclosure document contain?

In accordance with the provisions of the regulations of the IPL, the following technical, economic and financial information must be provided through the submission of the disclosure document:

- name, corporate name or business name, domicile and nationality of the franchisor;
- description of the franchise;
- seniority of the original main franchisor and, if applicable, of the master franchisee of the business subject matter of the franchise;
- intellectual property rights involved in the franchise;
- amounts and concepts of payments that the franchisee must make to the franchisor;
- types of technical assistance and services that the franchisor must provide to the franchisee;
- definition of the geographical area in which the business exploiting the franchise operates;
- rights or restrictions to grant sub-franchises to third parties and, if applicable, the requisites the franchisee must fulfil to grant sub-franchises;
- obligations of the franchisee with respect to the confidential information provided by the franchisor; and
- in general, the obligations and rights of the franchisee arising from the execution of the franchise agreement.

17 Is there any obligation for continuing disclosure?

Once the disclosure document is delivered and the obligation contained in the applicable provisions of the IPL is fulfilled, no ongoing disclosure obligation exists. Though not addressed by the IPL, disclosure should be provided to both a renewing franchisee and to a transferee franchisee, but this does not imply the creation of a continuing disclosure obligation.

18 How do the relevant government agencies enforce the disclosure requirements?

The disclosure obligation may be enforced by the IMPI through the imposition of fines in the event of a violation of the said obligation.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Failure of a franchisor to provide the disclosure document at least 30 business days prior to the date of execution of a franchise agreement may result in the imposition of an administrative fine by the IMPI. This will only occur, however, if the franchisor fails to provide such information after a written request for it has been made by the prospective franchisee to the franchisor.

In the event of lack of veracity of the disclosed information, the franchisee will be entitled to request the judicial authority to nullify the franchise agreement and to award payment of corresponding damages and losses.

Under Mexican law, there are only damages (as a general figure) and losses; our laws do not contemplate the specific figure of other damages such as consequential and punitive damages, among others. According to the provisions of the Federal Civil Code, damages are defined as the decrease or reduction of the patrimony derived from the breach of an obligation, and losses are defined as the privation of a licit gain that would have been obtained as a consequence of the compliance of an obligation. A competent judge with jurisdiction over the matter would have to calculate the corresponding damages and losses based on the evidence offered by the affected party.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The only individual or entity liable for a breach of the disclosure obligation is the individual or entity that will effectively grant the franchise. There is no extended liability of the officers, directors or employees of the franchisor for violation of this legal obligation.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The only laws which govern the offering and selling of franchises are the IPL, the Regulations of the IPL, the Commerce Code and the Federal Civil Code, and, as previously stated, franchise transactions are ruled by the general principle of contractual liberty, provided that the terms and conditions contemplated by or contained in the relevant agreements are not against these laws.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

In addition to the obligation for all franchisors to provide and deliver a disclosure document to their prospective franchisees, which must comply with all requisites established by the IPL and its Regulations and be delivered at least 30 business days prior to entering into the corresponding franchise agreement, there are no other obligations

that would apply to pre-sale disclosure. The disclosure document may be prepared in Spanish or in any other language familiar to the prospective franchisee. There is no obligation to register the disclosure document or to obtain authorisation from any governmental agency as to the form and content of the disclosure document.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Depending on the specific fraudulent conduct of the franchisor, the franchisee may request the nullity of the franchise agreement, the payment of damages and losses and, in some particular cases, criminal prosecution for fraud.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Commerce Code, the Federal Civil Code and the general principles applicable to contracts and of contractual liberty are the laws and principles applicable to the ongoing relationship between the franchisor and franchisee; therefore, such a relation will be mainly governed by the terms and conditions of the franchise agreement.

25 Do other laws affect the franchise relationship?

The only laws regulating a franchise relationship are the ones mentioned in question 24.

26 Do other government or trade association policies affect the franchise relationship?

No other government or trade association policies affect the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

If there are no specific circumstances detailed in the franchise agreement for the anticipated termination or rescission of that agreement, then the provisions of the Federal Civil Code shall apply. These establish that if a party to a contract is in breach of its obligations derived from the corresponding agreement and the other party is in compliance with its own contractual obligations, the non-defaulting party shall have the right to request from the courts having jurisdiction over the matter the rescission of the contract based on the breach by the defaulting party, as well as the payment of corresponding damages and losses.

In addition, if, as a result of an event that is not attributable to any of the parties (that is, due to force majeure or acts of God), the performance of the obligations derived from the agreement is deemed to be impossible, any of the parties may request from the corresponding judicial authority a declaration of termination of the agreement without fault on any side.

Finally, if the agreement is executed for an undetermined period of time, any of the parties will have the right to terminate the agreement at any time, though prior notice must be given to the other party. Although there is no specific term for the anticipation of the delivery of the termination notice, the custom in Mexico is to deliver the said notice at least 30 calendar days prior to the effective date of termination.

28 In what circumstances may a franchisee terminate a franchise relationship?

In addition to the specific circumstances provided by the IPL that basically refer to the lack of veracity of the information disclosed, a franchisee may terminate a franchise agreement in the same circumstances applicable to a franchisor (see question 27).

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

If there are no renewal provisions or rights detailed by the franchise agreement, upon expiration of the duration of the agreement the franchisor may freely refuse to renew the agreement.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Pursuant to the provisions of the Federal Civil Code, a franchisee would not be authorised to assign its obligations derived from a franchise agreement without the previous consent of the franchisor. The parties may regulate the transfer of rights and obligations in the franchise agreement with the understanding that they may agree on restrictions for the franchisee to assign or transfer its rights and obligations in the franchise agreement and to subject such transfer to the prior written authorisation of the franchisor, which may be granted or denied at its sole discretion.

With respect to the transfer of ownership interests in the entity appointed as franchisee, the franchisor shall only have the right to restrict such a transfer if, as a consequence, it may modify the personal characteristics of the franchisee that were foreseen by the franchisor as the main motive for entering into the franchise agreement. Therefore, it is advisable to reflect in the franchise agreement that the franchisee must obtain the prior written authorisation of the franchisor for such a transfer.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees. All the same, depending on the nature of the goods or services for which are being paid, the tax treatment may have different implications. Normally, the international tax treaties to which Mexico is a party distinguish different concepts of payment such as royalties, technical assistance and business profits that have different withholding rates. Therefore, specific tax analysis of the concepts of payment that may derive from a franchise agreement is strongly recommended before entering into the agreement.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The franchise agreement is a contract of commercial or mercantile nature, regulated by mercantile laws such as the Commerce Code. As a consequence, according to the provisions of the Commerce Code, there are no restrictions on the amount or percentage of interest that may be charged by a franchisor to a franchisee on overdue payments, even if the franchisee is a natural person or a civil partnership.

If the parties fail to include the applicable default interest on overdue payments in the franchise agreement, then the franchisor will be entitled to charge the legal interest of 6 per cent per annum set forth in the Commerce Code.

Update and trends

On 6 July 2010, the Federal Law for the Protection of Personal Data in Possession of Private Persons (LPPD) came into force in Mexico. The LPPD is considered a public policy law and, therefore, it is mandatory for private persons and entities doing business or carrying out activities in Mexico.

The main objective of the LPPD is to protect personal data that can be possessed by private parties in order to regulate the rightful, controlled and informed use of such data so privacy and self-determination of people in connection with their private information can be guaranteed.

The LPPD protects all personal data, which is defined as all information related to an identified or identifiable individual (the proprietor). The law differentiates between personal data and sensitive personal data, stating that the latter are the personal data that affects the proprietor's most personal sphere or such information that, if not used properly, could lead to discrimination or could entail a serious risk to the proprietor. Sensitive personal data include, particularly, the information that can reveal racial or ethnic origin, present or future health status, genetics, religion, philosophical and moral beliefs, union membership, political opinions and sexual preference.

The regulated subjects are private individuals or entities that handle personal data (the responsible party). 'Handling' or 'treating' as defined by the LPPD, includes obtaining, using, revealing or storing personal data by any means available.

The exempted subjects are credit information companies (credit bureau), as regulated in the applicable legislation, as well as persons who collect and store personal data for personal use with non-disclosure and non-commercial intentions.

The responsible party in charge of handling personal data must abide by the principles of legality, consent, information, purpose, loyalty, proportionality and responsibility. Those principles are the foundation of the LPPD's main obligations.

The responsible party needs to take all necessary actions to make sure the mentioned principles are followed, even if a third party handles personal data under the responsible party's request. Those actions include establishing and taking security and administrative, technical and physical measures that allow the protection of the personal data from any harm, loss, alteration, destruction or non-authorised handling. Those security measures should be no less stringent than the ones the responsible party exercises for its own information and should be established according to the risk related to such information, its sensitivity and the technological advancements.

Personal data must be treated as confidential at all times, even after the relationship between the proprietor and the responsible party ends.

The treating of all information is subject to the proprietor's consent. Consent can be granted verbally, in writing, electronically or through any technology available. It can be explicit, through the means stated above, or implied, if the proprietor has access to a privacy notice, as explained hereinafter, and no opposition is expressed. Financial information or any other information related to a person's patrimony shall require explicit consent; meanwhile, sensitive personal data shall require explicit and written consent through a handwritten or digital signature. No sensitive personal data databases can be created without a reasonable justification.

A privacy notice shall be made available to proprietors, to let them know the purpose for acquiring the personal data. It should include the following:

- identity and address of the responsible party;
- purpose for handling the personal data;
- the option and means made available by the responsible party to limit the use or disclosure of personal information;
- the means available to access, rectify, cancel or oppose the use of personal data by the responsible party and revoke the proprietor's consent;
- details of the information to be transferred and to whom;
- the procedure and means that will be used by the responsible party to inform the proprietors of changes in the privacy notice; and
- details of whether the information to be acquired is sensitive personal data, if applicable.

The responsible party has to make sure that the privacy notice is respected at all times by the party or any related third parties.

The LPPD establishes that proprietors have the right to revoke their consent, and access, rectify, cancel or oppose the use of personal data in possession of the responsible party. Responsible parties shall establish a person or a personal data department who will process such requests.

The LPPD gives the Ministry of Economy (Secretaría de Economía) the faculty to issue normative guidelines, administrative provisions and other parameters necessary for the application and fulfilment of the law.

The LPPD states that it is applicable throughout the Mexican Republic. Taking into consideration the technology available today, international data transfer is not only possible but probable and personal data transfers in Mexico may involve individuals and equipment located in other jurisdictions. The LPPD partially addresses this issue, stating that the privacy notice should state if the responsible party has the intention to transfer personal data to national or international third parties. The application of the LPPD beyond Mexican territory seems unlikely, since it could be almost impossible for the authority to determine those cases where foreign entities effectively acquire personal data in Mexico and, therefore, if they are subject to the law.

In our opinion, the LPPD could be especially relevant to certain activities and business within the franchising industry, especially, the hotel franchising industry and any other franchise systems handling loyalty programs. Treatment of the information acquired and maintained in Mexico under such programmes should comply with the LPPD; particularly, consent should be obtained and the privacy notice should be made available to its members.

Furthermore, franchisors that have Mexican franchisees should also consider the provisions stated in the LPPD, especially if the franchisor requires its franchisees to provide information regarding their customers. The privacy notice should state that the acquired personal data may be transferred to the franchisor and the use the latter will give to such information.

For now, a privacy notice and consent procedure should be enough to comply with the LPPD. Nevertheless, the regulations of the LPPD, when issued, will probably (and hopefully) establish clear means of how to comply with the LPPD.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Parties to a franchise agreement can agree in the corresponding contract or agreement to make payments in any currency. But if according to the corresponding contract or agreement the payment is to be made within the territory of Mexico, then, pursuant to the provisions of the Monetary Law, the party obligated to make the corresponding payment may freely elect to make such a payment either in the foreign currency agreed in the contract or agreement or in Mexican currency (pesos) according to the exchange rate published by Mexico's Central Bank in the Official Gazette on the date of payment. If it is agreed that payments are to be made abroad, then the party obliged to make such a payment cannot elect to make it in Mexican currency based on the provisions of the Monetary Law.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants can be enforced in Mexico, especially if violation of the confidentiality obligation under the agreement is sanctioned through the payment of a conventional penalty (a figure similar to liquidated damages) and if the contractual breach constitutes a violation of the IPL. Pursuant to the provisions of the IPL, violation of a confidentiality obligation through the non-authorised disclosure of a trade (industrial) secret may be considered a felony and can be criminally prosecuted.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

In accordance with the provisions of the Federal Civil Code, the consent of a party to an agreement will not be valid if said party was in 'error' when granting its consent. The legal or factual error invalidates (nullifies) the agreement when such an error exists with respect to the reason that was foreseen in error by the party as the main motive for entering into the franchise agreement. In this regard, the Federal Civil Code describes 'bad faith' as the dissimulation of an error by a party to an agreement that was known by the said party. As a consequence, and interpreting the above-mentioned provisions of law in a contrary sense, the parties to an agreement such as a franchise agreement must deal with each other in good faith.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In principle, under the Federal Consumer Protection Law a 'consumer' is considered to be the natural person or entity that acquires or enjoys goods, products or services as the final beneficiary of the same and a 'supplier' is considered to be the natural person or entity that regularly offers, distributes, sells, leases or grants the use of goods, products, services or a combination of these. In terms of the Mexican legislation, a franchisee is normally considered to be a supplier and not a consumer. An exception to the above is that when a transaction between a franchisee and a third-party supplier (such as the franchisor) involves a claim equal to or less than 367,119.59 pesos, a franchisee could be considered a consumer under the Federal Consumer Protection Law and, therefore, the franchisee may benefit from the protection provided by such statute. In this regard, if the franchisee is an entity, it shall only be considered as a consumer if, in addition to complying with the aforementioned condition, the franchisee is considered to be a micro-entity or a micro-industry in terms of the Law for the Development of Competitiveness of Micro, Small and Medium Entities and the Federal Law for the Promotion of the Micro-Industry and Handcraft Activity.

37 Must disclosure documents and franchise agreements be in the language of your country?

The IPL does not impose any obligations for the disclosure documents and franchise agreements to be prepared in Spanish; however, the summary of the franchise agreement that should be recorded with the IMPI (see question 7) must be in Spanish.

38 What restrictions are there on provisions in franchise contracts?

As a result of the amendments to the IPL that came into effect on 26 January 2006, franchise agreements must be executed in writing and comply with the minimum requirements indicated in question 11.

Likewise, none of the parties to a franchise agreement are entitled to terminate or cancel (rescind) the agreement unless it is entered into for an undetermined period of time or except in the event of a just cause that can be foreseen in the agreement.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

As explained above, the law applicable to competition matters is the Federal Economic Competition Law. In accordance with the provisions of this law, there are some restrictions to the general principle of contractual freedom. If agreements, arrangements or a combination of acts between economic agents diminish, harm or impede the production, processes, distribution or commercialisation of goods and services, pursuant to such law, this would be deemed to be monopolistic practice.

Infringements to the provisions of the Competition Law may result in the nullity of the acts and agreements in violation of the law, the imposition of administrative fines and the payment of damages and losses to third parties. For example, the obligation imposed on a franchisee by a franchisor to sell its products at determined prices could be considered a monopolistic practice and, therefore, it is advisable to include in franchise agreements that the franchisor will provide the franchisee with a list of suggested retail prices which will not constitute an obligation on the franchisee, but merely a recommendation.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

If a dispute arises under a franchise agreement that is considered as a commercial or mercantile agreement, and if the parties to it decide to submit themselves to the applicable laws and competent courts, an ordinary commercial or mercantile procedure may be initiated. The final resolution issued by the corresponding local judge in the first instance may be appealed before the local court of appeals (a higher-level court also known as second instance). The final resolution issued by the court of appeals in the second instance may be challenged before a federal court through a constitutional procedure, also known as amparo, but only if during the process specific constitutional rights were violated or if the final resolution is issued against the principles of Mexico's constitution. The resolution issued by the court in the amparo procedure would be final and definitive.

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An alternative dispute resolution mechanism is arbitration, which may be subject to Mexican or foreign law. Awards that are issued under the law of a country that is party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards will be recognised and enforced in Mexico as long as such awards are not contrary to Mexico's public order laws. Foreign judgments and arbitration awards that do not contravene public order laws are enforced in Mexico through a recognition and enforcement procedure before a judge, by means of a homologation process, given that Mexico is a party to the United Nations Convention.

The dispute resolution alternatives (jurisdictional and arbitration) are in addition to and independent from any administrative infringement action that may be initiated by a franchisor against any person violating the provisions of the IPL, in which case the IMPI is authorised to impose provisional or precautionary measures that include the seizure of merchandise and the closure of premises.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

In general, arbitration may have more advantages than disadvantages, especially when the foreign franchisor does not have a local subsidiary and operations in Mexico. Arbitration has proved to be time-efficient and if Mexican law is governing the franchise agreement and the resolution of the dispute, it should be possible to enforce an arbitral award. Arbitration in the franchise industry also carries the advantage of allowing the resolution of a problem to be carried out by one or more arbitrators with the necessary expertise and knowledge in franchising, which is a subject not necessarily known or explored by the courts. The most important possible disadvantage is that in certain cases the related costs and fees could be much higher than those applicable in a jurisdictional procedure, depending on the agency administering the arbitration, its rules and the profile of the arbitrators.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

From a legal and practical view, domestic and foreign franchisors have equal treatment in Mexico and are equally protected and restricted in terms of Mexican legislation, but lack of knowledge of the domestic laws, administrative restrictions and commercial and operational customs, as well as the lack of legal advice from a competent Mexican law firm, are important elements that could hamper foreign franchisors' entry into the Mexican market.

Netherlands

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Franchises may be subject to any form of business entity existing under Dutch law, in particular:
- private limited liability companies;
- public companies;
- sole proprietorships;
- general partnerships; and
- limited partnerships.

Private limited liability companies and public companies are legal entities. General partnerships, limited partnerships and sole proprietorships are non-legal entities. The question of whether a business entity is a legal entity or not affects the franchisor's liability.

A legislative proposal regarding this topic has been submitted to the Senate. The proposal will change general partnerships into 'public partnerships'. Such public partnerships, as well as limited partnerships, will have the choice of becoming legal entities. Being a legal entity will not change the liability of the franchisor. The scheduled introduction date was 2011, but it has (again) been postponed until a date yet to be specified.

2 What laws and agencies govern the formation of business entities?

The formation of business entities is, in particular, governed by:
- book 2 of the Dutch Civil Code for legal entities;
- book 7A of the Dutch Civil Code; and
- the Commercial Code.

There are also several specific laws, for example:
- the Works Councils Act;
- the Commercial Register Act 2007; and
- the Commercial Register Decree 2008.

All business entities must be registered in the Commercial Register.

The above-mentioned legislative proposal will transpose the relevant articles from book 7A Dutch Civil Code and the Commercial Code to book 7 of the Dutch Civil Code.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The requirements for forming and maintaining a business entity depend on what form of business entity is incorporated. In the event that a private limited liability form is used by the franchisor, the following requirements apply:
- a minimum capital contribution of €18,000, which can be made in cash or in kind. In the case of a contribution in kind, an accountant's certificate is required. In the case of a contribution in cash, a bank statement is required;
- a statement of no objection from the Dutch Ministry of Justice; and
- a notarial deed of incorporation including the articles of association.

4 What restrictions apply to foreign business entities and foreign investment?

Business entities that are incorporated under foreign law, but are active on the Dutch market rather than within their own country, are subject to the Companies Formally Registered Abroad Act (CFRA Act). The CFRA Act does not apply to members of the European Union (EU members) and countries that are members of the European Economic Area Agreement. All other entities will have to comply with certain requirements, which also apply to Dutch entities (registration in the Commercial Register, statutory minimum capital and the filing of annual accounts with the Commercial Register where the business entity is registered).

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

In principle, taxable profits realised by corporate entities that are for tax purposes resident in the Netherlands – for example, Dutch limited liability companies (BV and NV) – are subject to the Dutch corporate income tax rate of 25 per cent insofar as their taxable profit is in excess of €200,000. The first €200,000 of taxable profit is taxed at a reduced rate of 20 per cent. Dividends received and capital gains derived from a shareholding to which the Dutch participation exemption applies are exempt from Dutch corporate income tax.

Dividends distributed by a Dutch tax-resident company are generally subject to 15 per cent Dutch dividend withholding tax. A reduced rate or an exemption from Dutch dividend withholding tax may be available; for example, as a result of the application of a tax treaty or if the Dutch participation exemption applies. In principle, dividends distributed to an EU shareholder holding more than five per cent are also exempt from Dutch dividend withholding tax. In general, Dutch corporate taxpayers can credit dividend tax withheld against corporate income tax due.

Individual shareholders holding more than five per cent in the nominal share capital of a company (substantial interest) are generally subject to Dutch individual income tax in respect of dividends received and capital gains derived from such substantial interest at a flat rate of 25 per cent. Individual shareholders holding less than five per cent in the nominal share capital of a company are generally subject to Dutch individual income tax at a flat rate of 30 per cent calculated over a deemed return of 4 per cent on the average value of such shareholder's total amount of savings and investments.

Individuals performing franchise activities in the Netherlands, either in the form of tax transparent partnerships or as sole entrepreneurs, are generally subject to income tax at progressive rates, up to a maximum rate of 52 per cent. Dutch individual entrepreneurs may apply a number of beneficial tax facilities.

No taxes are levied upon the set-up of a business in the Netherlands. Dutch capital tax, which was due on the incorporation of a company with capital divided into shares, was abolished from 1 January 2006.

The acquisition of Dutch real estate properties is subject to a six per cent Dutch real estate transfer tax. In certain circumstances, the acquisition of more than 33.33 per cent in a Dutch real estate company is also subject to Dutch real estate transfer tax.

Wages paid by a Dutch employer are subject to Dutch wage withholding tax and Dutch social security premiums. Dutch wage withholding tax is creditable against the Dutch individual income tax liability in full. Attractive tax benefits are available for foreign employees if these employees have certain specific skills that are scarce in the Netherlands.

Dutch value added tax is charged at a rate of 19 per cent, although reduced rates of 6 per cent and 0 per cent apply in respect of certain supplies, such as the supply of agricultural products. Imports performed by Dutch entrepreneurs generally are subject to Dutch value added tax. In principle, the importing entrepreneur may credit or refund the value added tax paid on the imported supplies. Exports from the Netherlands are generally exempt from Dutch value added tax.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

In principle, franchisees are deemed independent entrepreneurs. Hence, no labour and employment considerations apply. However, franchisees may qualify as 'employees' on the basis that the relationship between the franchisor and franchisee does not correspond with the franchise agreement as it is in fact an employment relationship. Case law shows that this is often the case with self-employed persons such as driving instructors and door-to-door salesmen.

If the agreement is considered an employment agreement, the franchisee is, inter alia, entitled to holiday allowance and payment during illness. Also, laws regarding termination of the employment agreement apply. According to tax law, the franchisor is required to withhold income tax and social security benefits in case the tax authorities deem the relationship between parties a (fictitious) employment relationship.

Each 'cooperation agreement', such as a franchise agreement, is considered on its own merits. The name and wording of the contract between the parties is not decisive. The courts look at the intention of the parties when entering into the franchise contract, as well as the way in which the parties have given substance to their relationship. If it is established that the franchisee is obliged to perform the agreed duties in person, the franchisor pays the franchisee, directly or indirectly, for these duties and a relationship of authority can be established which manifests itself in the right of the franchisor to give instructions which the franchisee must follow, an employment relationship can be assumed. Particularly in franchise relationships, the following criteria prove to be decisive: equivalence of the contracting parties, the ability of the franchisee to let someone else perform the duties (for example, third parties or employees of the franchisee), the franchisee bearing the business risk and economic independence of the franchisee.

As long as the franchisee is truly a franchisee, pursuant not only to the contract but also to its day-to-day activities, no employment relationship should be deemed to exist. Particularly if the franchisee is contracted via his or her Dutch limited liability company, the risk of an employment relationship is limited, at least from a civil law perspective. The tax authorities have a different view on this. However, to minimise the risk from a tax law perspective, the franchisor should ask the franchisee to submit a declaration of independent contractor status, which the franchisee can obtain through the Dutch tax authorities. Such a declaration is valid for one calendar year. If a franchisee can produce such a declaration, the tax authorities will in principle not assume a (fictitious) employment relationship for that year.

7 How are trademarks and know-how protected?

Registered trademarks are protected by the Benelux Treaty for Intellectual Property. The registrant of a Benelux trademark has exclusive rights for specific classes of goods or services in Belgium, the Netherlands and Luxembourg if a trademark is registered in the public trademark registry of the Benelux Office for Intellectual Property (BOIP). In addition, the registrant has exclusive rights for specific classes of goods or services in the European Union if a trademark is registered as a community trademark in the public trademark registry of the Office for Harmonisation of the Internal Market (OHIM) of the European Union. A preliminary trademark search can be conducted on the BOIP website, http://register.boip.int/bmbonline/intro/select.do?language=en.

In principle, know-how is not protected by any intellectual property right. However, know-how may be protected under the general provisions of Dutch unfair competition law (including civil tort). Know-how could be contractually protected by including confidentiality (non-disclosure) obligations in an agreement (for example, a franchise agreement). See question 34.

8 What are the relevant aspects of the real estate market and real estate law?

In the Netherlands, there are no restrictions on the acquisition of real estate by foreigners. Therefore foreign franchisors would not face difficulties should they wish to purchase real estate to lease to franchisees. However, franchisors will have to take the protection of lessees under the semi-mandatory Dutch lease law into account, even if the properties have been made available to the franchisees in the franchise agreement and no specific lease agreement has been drawn up.

In the Netherlands, there are two different tenancy regimes for the lease of commercial premises: the lease of retail space (including shops, restaurants, takeaways, etc); and the lease of the other commercial premises (including travel agencies, cinemas, the ticket offices of lotteries, bank branches, etc). Under the retail space regime, lessees are protected by various conditions of semi-mandatory lease law, including but not limited to:

- a minimum lease term of two times five years and limited grounds for termination by the lessor;
- termination or rescission can in principle only be effectuated judicially (also in the event of breach of contract); and
- the turnover rent may be affected by market rent review.

Under the regime of other commercial premises, the lessees only get protection of vacation. The lessees are entitled (within two months after the date of vacation) to request the court to extend the term of vacation.

The court can be requested to approve a deviation from semi-mandatory law.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no legal definition of a franchise in the Netherlands, but the Dutch Franchise Association (NFV) has produced the following guideline: 'Franchising is a system for distributing products and services and/or exploitation of technology, based on close and lasting cooperation between legally and economically independent businesses.'

The NFV (www.nfv.nl) is an association that acts directly in the interests of its member franchisors and indirectly in the interests of franchisees. Its primary goal is to promote the healthy and balanced development of franchising in the Netherlands.

10 Which laws and government agencies regulate the offer and sale of franchises?

Franchising is not specifically regulated in Dutch law. Instead, the general laws of contract apply. Book 6 of the Dutch Civil Code sets out the requirements relating to the formation of contracts. These provisions must be read in conjunction with the more general rules regarding juridical acts; that is, acts intended to invoke legal consequences provided in book 3 of the Dutch Civil Code.

However, the Dutch Competition Authority (NMa), which ensures compliance with European competition law, must be kept in mind (see questions 38 and 39).

Franchisors that are members of the NFV are bound by the rules in the European Code of Ethics for Franchising (Code) drawn up by the European Franchise Federation (www.eff-franchise.com).

There are no specific government agencies that regulate the offer and sale of franchises.

11 Describe the relevant requirements of these laws and agencies.

As franchise agreements are not specifically regulated in the Netherlands, such agreements are primarily governed by the freedom of contract principle; respective rights and obligations are defined by the will of the parties, as set out in the agreement.

All contracts concluded under Dutch law are subject to the general requirements of reasonableness and fairness (see question 35).

12 What are the exemptions and exclusions from any franchise laws and regulations?

There are no specific franchise laws or regulations in the Netherlands.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

As there are no specific franchise laws or regulations in the Netherlands, there are no specific requirements to be met before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The allocation of respective responsibilities between the franchisor and the sub-franchisor towards a (prospective) sub-franchisee will depend on what has been agreed between them. This is not specifically regulated by Dutch law. If nothing has been agreed, in principle, the sub-franchisor (assuming that this will be the contracting party of the sub-franchisee) shall be responsible for pre-sale disclosures towards the sub-franchisee.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Pre-contractual disclosure requirements stem from unwritten law and case law, which dictate the duty to inform (on the part of the franchisor) and the duty to investigate (on the part of the franchisee). Parties are entitled to rely on the accuracy of each other's information and must always bear in mind each other's reasonable expectations.

16 What information must the disclosure document contain?

Consistent case law indicates that when a franchisor presents a prognosis regarding the expected success of a new franchise location to a franchisee, the franchisor is liable if at a later stage such prognosis turns out to be faulty, regardless of whether the franchisor prepared such prognosis itself or instructed a third (independent) party to do so. Therefore a franchisor should be very careful when submitting any prognosis to a (potential) franchisee. It is not mandatory to provide a franchisee with a prognosis, but the franchisor will need to make available the terms of the licence and financial obligations under which the franchisee will operate. In the Netherlands, a franchisor will typically have a handbook containing know-how, instructions on the use of intellectual property, the look and feel of the franchise and other information relating to the franchise chain, which will be given to the franchisee before or upon conclusion of the contract.

17 Is there any obligation for continuing disclosure?

The obligation for continuing disclosure will mainly depend on what has been agreed in the contract between the franchisor and franchisee. Case law indicates that the franchisor has a duty of care, which means that if a franchisee does not reach the forecast turnover, the franchisor may have the continuing obligation to provide the franchisee with advice and assistance. Parties will have to reach a situation that is as far as possible in accordance with the spirit and purport of the franchise agreement, meaning that the franchisor and franchisee both benefit from the franchise.

18 How do the relevant government agencies enforce the disclosure requirements?

Not applicable – see question 10.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

The actions and legal remedies available to franchisees for violations of disclosure requirements vary as set out below.

A misinformed franchisee can base a claim for nullification on error if the franchisee can prove that the contract has been entered into under the influence of an error and would not have been concluded had there been a correct understanding of the facts. Such a claim for nullification will only succeed where the misinformation is of a sufficiently serious nature. An alternative would be to base a claim on deceit, but in this instance the franchisee would

have to prove intent on the part of the franchisor, which is generally very difficult to prove. Nullification has a retroactive effect. If the actions or omissions of the franchisor also qualify as a civil tort, the franchisor is obliged to compensate all of the franchisee's damages. On the basis of error the contract may, upon request, be modified by a judge (for example, the franchisee's contract price may be reduced).

An alternative course of action is to base a claim for (partial) rescission or specific performance on breach of contract in the case that the franchisee can prove that the franchisor has failed in the performance of an obligation. In the case of rescission for breach of contract, the defaulting party may be required to compensate the damages which the other party suffers as a result, unless the failure is not attributable to the defaulting party. If the franchisee can prove that the franchisor, by misinforming the franchisee, has committed a breach of contract, it can claim either rescission, alternative compensation or specific performance, all combined with losses due to delay.

In the case of breach of contract or tort, the franchisor has an obligation to compensate all damages of the franchisee. These damages include both losses and lost profits. The main principle is that the breaching party should bring the franchisee into the position it would have been in had the civil tort or breach of contract not been committed. The burden of proof regarding damages is on the franchisee. If damages cannot be assessed precisely, the Dutch court may estimate the amount of damages according to the general principles of reasonableness and fairness. In doing so, the Dutch courts have a large margin of discretion. The damages awarded will depend on the circumstances of the individual case.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

See also question 14. The potential liability of the franchisor or sub-franchisor will depend on what has been contractually agreed regarding responsibilities towards sub-franchisees. If nothing has been agreed, in principle the sub-franchisor (assuming that this will be the contracting party of the sub-franchisee) will be liable to the sub-franchisee. However, the franchisor may be liable to the sub-franchisor if the franchisor, in its turn, has neglected its obligations.

Under Dutch law, the private company with limited liability and the public company limited by shares both have legal personality (see question 1). In principle, therefore, liability rests with the business and not with individual officers, directors or employees. Individual officers or directors will only be exposed to liability in the event of improper management on their part which amounts to personal culpability of the directors. The burden of proof will rest on the franchisee.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See questions 10, 11 and 35.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

No, except as indicated in question 15 (the duty to inform and the duty to investigate).

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If a franchisor engages in fraudulent or deceptive practices, the franchisee may base a claim for annulment of the contract against the franchisor on the basis of deceit or error (misrepresentation). If the actions or omissions of the franchisor also qualify as a civil tort, which is always accepted in case of deceit, the franchisor has an obligation to compensate all of the franchisee's damages. See question 19 for an explanation regarding damages.

There is no distinct difference in legal protection when the franchisor has violated its disclosure obligations.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The ongoing relationship between the parties after the contract comes into effect will primarily be governed by the terms of the agreement concluded between them. The principles of reasonableness and fairness will also play an important role. See question 35.

25 Do other laws affect the franchise relationship?

The Dutch Data Protection Act (DPA) lays down several requirements for processing of personal data. 'Personal data' is any data relating to an identified or identifiable person and 'processing' means almost anything that can be done with personal data, such as collecting, storing, erasing, using or retrieving. The DPA applies to both processing of personal data by automatic means and processing other than by automatic means. The DPA also contains restrictions relating to the transfer of personal data to other countries. Applied to a franchising context, the DPA would be relevant, for instance, where the franchisee or franchisor collects customer details pursuant to a customer loyalty programme. The DPA is the Dutch implementation of the EU Data Protection Directive.

For details of competition laws that have an impact on franchise relationships, see questions 38 and 39.

26 Do other government or trade association policies affect the franchise relationship?

The Code may affect the franchise relationship where the franchisor is a member of the NFV. For example, the Code provides that the franchisor shall provide the franchisee with initial training and continuing commercial and technical assistance during the entire life of the agreement.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Either party may terminate the agreement for cause in the case of serious breach by the other party of its obligations. The criteria for what constitutes a serious breach should be carefully considered before actually terminating, since the Dutch courts will have the discretion to decide that a certain circumstance does not qualify as a sufficiently serious breach, notwithstanding the fact that this may have been agreed by the parties in the franchise agreement.

In case of termination by the franchisor without cause, a legal distinction should be made between contracts concluded for a definite and an indefinite duration. Contracts of definite duration can generally not be terminated before the end of the contract term. Early termination will in most situations result in liability of the terminating party. If a franchisor terminates a contract for a definite term prematurely (without cause), the franchisee can claim continued performance or damages. The damages could consist of lost profits calculated over the remaining term of the contract and costs and investments that the franchisee was not able to redeem due to the premature termination.

In case of a contract for an indefinite duration, the contract may in principle be terminated by either party. However, note that a franchisor may have to come up with a 'good reason' to be able to terminate the agreement. It will depend on the situation and the circumstances whether there will be good reason to terminate. Besides this, the franchisor will have to respect a reasonable notice period, the length of which depends on the circumstances of the matter. Currently there is a tendency in the Netherlands for courts to grant longer notice periods than before. While until recently it was quite usual that courts granted termination periods of up to a maximum of six to 12 months, currently there are some recent court decisions in which notice periods of two to three years have been granted, even when contractually the parties agreed to a shorter notice period. This is certainly something to take into account. Furthermore, the franchisor may have to compensate the franchisee upon termination for investments the franchisee may not be able to earn back, as well as for over-stock. So far, no (high) court has granted a franchisee payment of a goodwill compensation, even though this has now and then been suggested in literature.

If the franchisor terminates a contract without cause and does not respect a reasonable notice period, the franchisee could also claim continued performance during the period that should have been respected by the franchisor, or claim damages.

28 In what circumstances may a franchisee terminate a franchise relationship?

The rules that apply to the franchisor in principle also apply to the franchisee (see question 27).

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Whether a franchisor may refuse to renew the franchise agreement with a franchisee depends primarily on the content of the contract. If nothing in this respect has been arranged in the contract, case law indicates that a franchisor may refuse to renew a relationship where unforeseen circumstances have occurred that are of such a serious nature that the franchisee could not reasonably have expected the contract to be renewed. Furthermore, where the franchisor can prove that the franchisee is in breach of its material obligations, the franchisor may refuse to renew the agreement on the basis of breach of contract. In certain circumstances, the franchisor may be obliged to compensate the franchisee upon termination; for example, if the franchisor takes over the franchise at that location or at a new location within a short distance. Another example is when the franchisee has incurred significant costs in justified reliance on continued cooperation. In this circumstance, the franchisor may be required to compensate the franchisee. Finally, a franchisor may be able to terminate the relationship by not renewing the franchise agreement if it complies with the conditions set out in question 27 (a reasonable notice term and, in some situations, a 'good reason').

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A general provision regarding contract transfers is laid down in the Dutch Civil Code. A contracting party may, only with the consent of the other party, transfer its rights and obligations under the contract to a third party. Therefore, a franchisee may only transfer the franchise with the franchisor's consent. A franchisor will not normally refuse such a transfer where the third party meets the selection criteria. It can be contractually arranged that the franchisee should first offer the business to the franchisor on the same terms as those that the franchisee would offer to the third party.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Franchising fees are not regulated by law. In practice, however, different types of fee can be distinguished: firstly, an entrance fee, which is a one-off payment that the franchisee pays to the franchisor. It represents a contribution towards the costs that the franchisor has incurred in the expansion of its chain and establishment of goodwill. Secondly, a continuing franchising fee, which is a regular fee for the use of the franchise system. This is usually a percentage of profits that the franchisee has realised within a given term. A regular fee may also be due as a contribution towards advertising costs or promotional activities.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Under freedom of contract, the parties are free to agree on the interest rates to be applied. If the parties did not agree on any interest rate, Dutch statutory interest shall apply automatically in the event of late payment. The Dutch legal interest rate in commercial matters as of 1 January 2011 amounts to an annual percentage of 8 per cent.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Freedom of contract dictates that parties may agree to whichever terms they find mutually suitable, subject to the points in question 35.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable. The franchisee typically commits itself, for the duration of the contract as well as following its termination, to keeping all details of the franchisor's business operations confidential. This will typically extend to non-patented know-how materials.

Franchising contracts in the Netherlands may include a financial penalty provision that can be invoked in the event of the other party violating the confidentiality clause. The courts shall have

the right to mitigate such penalties. This mitigation right cannot be contractually excluded.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

There is a general legal obligation on parties to deal with each other in good faith. In the Netherlands, general civil law is governed by the principles of reasonableness and fairness. Franchise agreements are therefore also governed by reasonableness and fairness.

The principles of reasonableness and fairness may not only supplement the existing contract and relationship, but may also derogate from the contract that the parties agreed upon at an earlier stage. This means that every provision in an existing contract that is very one-sided (for example, a provision that the franchise relationship may be terminated by the franchisor at any given moment, respecting a notice term of 30 days) could be set aside by this principle of reasonableness and fairness. It is not possible to predict what kind of provisions may be set aside, since the court will consider all relevant circumstances, including the economic power of each party, the duration of the contract, the investments made by either party and what each party could reasonably expect from the other party. Dutch courts generally tend to protect 'weaker' parties at the expense of economically stronger parties. However, this certainly does not mean that simply by being a weaker party, certain clauses will be set aside. Again, this depends on all the circumstances in the matter.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In general, no. However, when dealing with a small franchisee, there is a possibility that general conditions may be annulled because of reflex action of articles 6:236–238 Dutch Civil Code. Also see question 35.

37 Must disclosure documents and franchise agreements be in the language of your country?

Freedom of contract dictates that parties may agree to draw up contracts in whichever language they choose. However, on the basis of the principle of reasonableness and fairness one could argue that disclosure documents and agreements should be made available in a language that the other party understands.

38 What restrictions are there on provisions in franchise contracts?

As in all other EU member states, Commission Regulation 330/2010 provides the relevant framework for the competition law assessment of all franchise agreements with an effect on trade between the member states. The EC Guidelines to the Commission Regulation can be found at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:130:0001:0046:NL:PDF.

This Regulation, inter alia, prohibits resale price maintenance as well as certain restrictions regarding the territory or group of customers that can be served. It is prohibited to limit so-called 'passive sales' by a franchisor, which includes sales via the internet. It also restricts the duration of a contract in the case that it contains a non-compete clause.

As regards purely domestic franchising agreements, the Commission Regulation equally applies by virtue of article 13a of the Dutch Competition Act (DCA). There are no additional Dutch competition laws relating to franchising agreements.

Regarding article 6 of the DCA (the prohibition of restrictive agreements), two de minimis thresholds apply. To franchising, only the lowest threshold applies (maximum of eight undertakings with a joint turnover of no more than €5.5 million in case of goods and €1.1 million in all other cases). The largest de minimis threshold (joint market share not exceeding 5 per cent and joint turnover not exceeding €40 million) does not apply to vertical agreements such as franchising.

Update and trends

There is a recent tendency for the Dutch courts to grant longer termination notice periods than before, in the event a supplier or franchisor terminates a distribution or franchise agreement. While until recently it was quite usual that courts granted termination periods of up to six to 12 months, there have been some recent court decisions in which notice periods of two to three years have been granted, even when contractually the parties agreed to a shorter notice period. What is reasonable and fair under the given circumstances is to a great extent not predictable and depends on all facts of the matter. This is certainly something of which to be aware.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Franchising agreements that do not meet the criteria set forth in Regulation 330/2010 and to which no de minimis thresholds apply will be prohibited on the basis of article 6.1 of the DCA or article 10 of the Treaty on the Franchising of the European Union, unless the four criteria of the legal exception of article 6.3 DCA or article 101(3) 7FEU apply.

Competition laws in the Netherlands are enforced both administratively and by means of civil litigation (private enforcement). The NMa can impose fines if a franchising agreement would disregard what is set forth in Regulation 330/2010, in particular if the agreement would contain any hardcore restrictions (eg resale price maintenance). The maximum statutory fine is 10 per cent of the undertaking's worldwide turnover.

A party to a franchising agreement claiming that the agreement infringes article 6.1 of the DCA or 101(1) 7FEU can invoke the nullity of the agreement (in whole or in part) before a Dutch court. The court will have to decide on the applicability of Regulation 330/2010 or the legal exception of article 6.1 DCA or article 101(1) 7FEU. If it decides in the affirmative, it will subsequently have to determine whether this leads to partial nullity (nullity of only the infringing clauses) or nullity of the agreement in its entirety. The latter will be the case if the court determines that without the infringing clause, the agreement would not (or would not on similar terms) have been concluded. In a few instances the court has nullified a franchising agreement in its entirety, notably because the franchisor engaged in resale price maintenance.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Franchise agreements will generally contain a dispute resolution clause, in which a competent court or a form of arbitration is explicitly chosen.

In the Netherlands, NAI arbitration (www.nai-nl.org) is well regarded and is in general less expensive than the more internationally well-known ICC arbitration.

In cases where there is no valid arbitration provision, the subdistrict court is competent in smaller claims (under the amount of €5,000) and for particular issues, such as employment and rent-related disputes. Larger claims may be brought before the civil judge of the district court. Due to a amendment of the Code of Civil Procedure, it is likely that the €5,000 limit will be raised to €25,000 as of 1 July 2011.

The Dutch Franchise Association can assist with mediation for parties seeking out-of-court remedies.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The principal advantages of arbitration include:

- arbitration offers a choice regarding the language of proceedings – the regular courts in the Netherlands only accept Dutch;
- it offers the possibility of agreeing on the country and area in which the proceedings will be conducted;
- it offers the possibility of choosing the number of arbiters and the time limitations;
- it is, generally speaking, concluded more quickly than regular court procedures;
- it may be dealt with by appointed experts instead of (or in addition to) lawyers; and
- parties can agree to observe secrecy in arbitration. Regular court proceedings are public.

The principal disadvantages of arbitration are:

- in general, it is much more expensive than regular court proceedings;
- regular court proceedings offer the possibility of appeal; and
- the quality of arbitration may not always be secured, depending on the actual arbitration forum, although NAI and ICC arbitration in general should be of good quality.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

In principle, there is no difference in the treatment of foreign and domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Most franchisors conduct business in New Zealand by way of an incorporated company. Sole traders and partnerships are used and occasionally a franchisor may be a trading trust. Joint ventures are uncommon in New Zealand. The relevant agency is the Ministry of Commerce.

2 What laws and agencies govern the formation of business entities?

The Companies Act 1993 applies to all companies incorporated in New Zealand and to companies with an overseas shareholding. It does not apply to companies incorporated in another country, unless said company has been registered as an overseas company on the New Zealand register. If a trading trust is used, the Trustee Act 1956 applies.

3 Provide an overview of the requirements for forming and maintaining a business entity.

A new company can be incorporated online at www.companies.govt.nz. The first step is to obtain name approval. Following this, an application to incorporate must be completed, naming all the directors and shareholders of the company, who must sign written consents both to act as directors and to become shareholders. The address of the registered office of the company and the address for service must be provided and both must be New Zealand addresses.

All new companies must be incorporated online. The name approval fee is NZ$10.22 and the incorporation application fee is NZ$153.33. Once an overseas shareholder holds 25 per cent or more of the shares in a company, that company must file financial accounts and be audited. Otherwise, if the shareholders pass a unanimous resolution that no auditor need be appointed then the company does not have to be audited. The Financial Reporting Act 1993 applies to all companies. When incorporating a new company it is wise to have a separate constitution (also known overseas as articles of association), otherwise the provisions in the Companies Act 1993 will apply. For example, any pre-emptive rights will only exist by way of a separate constitution and not in reliance upon the Companies Act 1993.

4 What restrictions apply to foreign business entities and foreign investment?

If a foreign business entity holds 25 per cent or more of the shareholding in a company, the company must be audited and must file financial statements pursuant to the Financial Reporting Act 1993. In relation to foreign investment, there are no barriers for funds coming into New Zealand. If a foreign entity wishes to buy land in New Zealand and the land is greater than five hectares in area, an application must be made to the Overseas Investment Office for consent to the purchase before it can proceed.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

The corporate tax rate for both resident and non-resident companies is 28 per cent. New Zealand has tax treaties with many countries – for example, Australia, the UK and the US – where non-resident withholding tax of 10 per cent must be deducted from all interest and royalty income before funds are repatriated. The overseas entity will be able to claim a tax deduction in the relevant country because a non-resident withholding tax certificate will be provided. If dividends are repatriated, non-resident withholding tax of 15 per cent must be deducted.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The Employment Relations Act 2000 applies in New Zealand. Union membership is voluntary, but there must be a written employment contract in relation to every employee. Strict procedures must be followed before employment can be terminated; breach of these procedures could give rise to a personal grievance action that may cost the employer many thousands of dollars. Any properly drafted franchise agreement should contain a clause stating that a franchisor and a franchisee are not in a relationship of employer or employee, but that any franchisee must comply with New Zealand employment law.

7 How are trademarks and know-how protected?

The Trademarks Act 2002 is the relevant statute and all trademarks must be registered in New Zealand. The relevant body to deal with is the Intellectual Property Office of New Zealand (IPONZ). Trademark registrations last for 10 years and must then be renewed. Know-how is protected by normal intellectual property laws and would be deemed to be included in what are called trade secrets; any properly drafted franchise agreement will include know-how in the definition of intellectual property and should contain a robust intellectual property clause.

8 What are the relevant aspects of the real estate market and real estate law?

All real estate in New Zealand is recorded by Land Information New Zealand (LINZ), which provides a registered title for each piece of land. Titles can be freehold, leasehold, strata, cross-lease or some combination. If the property being purchased is on a unit title (which would mean that there would be a stratum estate of freehold under the Unit Titles Act 2010) an overseas franchisor can own land subject to the discussion in question 4. Franchisors can lease commercial buildings without restriction. If real estate agents are engaged, they must comply with the Real Estate Agents Act 2008.

Franchisors who request real estate agents to find them premises will have to pay an agreed commission to the relevant agents. The Property Law Act 2007 is also relevant in relation to real estate and must be consulted.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no franchise-specific legislation in New Zealand, so there is no legal definition of a franchise.

However, the Franchise Association of New Zealand Incorporated (FANZ) was formed in July 1996 and all members must comply with the Code of Practice. This Code of Practice, in section 2.1, defines 'franchise' as meaning a business operated as a franchise, and that term is further defined in the rules as follows:

Franchise means the method of conducting business under which the right to engage in the offering, selling or distributing of goods or services within New Zealand includes or is subject to at least the following features:

- *the grant by a Franchisor to a Franchisee of the right to the use of a Mark, in such a manner that the business carried on by the Franchisee is or is capable of being identified by the public as being substantially associated with a Mark identifying, commonly connected with or controlled by the Franchisor; and*
- *the requirement that the Franchisee conducts the business, or that part of the business subject to the Franchise Agreement, in accordance with the marketing, business or technical plan or system specified by the Franchisor; and*
- *the provision by the Franchisor of ongoing marketing, business or technical assistance during the term of the Franchise Agreement.*

10 Which laws and government agencies regulate the offer and sale of franchises?

No government agencies regulate the offer and sale of franchises. However, there are a number of laws that must be complied with, including the Commerce Act 1986, the Fair Trading Act 1986 and the Real Estate Agents Act 2008. If a broker is used by a franchisor to assist with the sale of franchises, the discussion in question 8 will be relevant.

11 Describe the relevant requirements of these laws and agencies.

The Commerce Act 1986 is concerned with anti-competitive behaviour and restrictive trade practices. The Fair Trading Act 1986 is concerned with representations made by any party that amount to misrepresentations that may be innocent, negligent or fraudulent. There are monetary penalties in relation to breaches of both Acts. Some months ago, the government announced the results of the review of consumer laws in New Zealand and a number of acts will be amended over the next 12 months or so including the Fair Trading Act 1986.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Not applicable.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no law in New Zealand that would create such a requirement.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Legally, none is required. However, if a franchisor belongs to the FANZ, it must comply with the Code of Practice and publish a disclosure document. A sub-franchisor would have to provide a disclosure document to a potential sub-franchisee if that sub-franchisor was a member of the FANZ.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Again, there are no franchising laws requiring pre-contractual disclosure but great care must be taken to ensure that all representations are true and do not amount to misrepresentations that will fall foul of the Fair Trading Act 1986. A member of the FANZ must provide a potential franchisee with its disclosure document at least 14 days before the franchise agreement is executed and the disclosure document must be updated at least annually by the franchisor.

16 What information must the disclosure document contain?

The disclosure document must provide:

- the name, registered office and physical business address of the franchisor;
- the names, job descriptions and qualifications (if any) of the franchisor's directors, executive officers or principals;
- a detailed curriculum vitae of the business experience of the franchisor (and any related entities) and its directors, secretary, executive officers or principals;
- a viability statement with key financial information of the franchisor;
- details of any bankruptcies, receiverships, liquidations, placements in administration or appointment of a statutory manager, or materially relevant debt recovery;
- details of criminal, civil or administrative proceedings within the past five years;
- a summary of the main particulars and features of the franchise;
- a list of components making up the franchise purchase;
- details of any financial requirements by the franchisor of the franchisee; and
- other information listed in the code.

17 Is there any obligation for continuing disclosure?

The short answer is no, in relation to the Code of Practice of the FANZ. However, if there have been any material changes since publication of the disclosure document and a franchisor does not disclose these to a potential franchisee who subsequently signs a franchise agreement, the franchisee may have grounds to cancel the franchise agreement in the future pursuant to the Contractual Remedies Act 1979.

18 How do the relevant government agencies enforce the disclosure requirements?

There is no enforcement by government agencies in relation to disclosure requirements. Nevertheless, please note what has been stated under question 10: if a franchisor is a member of the FANZ and it does not comply with the Code of Practice in relation to disclosure requirements, that franchisor can be ousted from the FANZ.

If any franchisee suffers a loss at the hands of such a franchisor, the franchisee's remedies would be according to normal contractual laws and the franchisor would be vulnerable to an action for damages by the franchisee. As stated above, if there are any misrepresentations, the person suffering a loss may be entitled to make a complaint pursuant to the Fair Trading Act 1986 to the Fair Trading Division of the Commerce Commission.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Franchisees can make an official complaint to the Fair Trading Commission if information contained in any disclosure document is false or misleading. Furthermore, a franchisee could sue the franchisor for misleading conduct pursuant to the Fair Trading Act 1986. Damages are normally calculated from the date of loss and can include both actual and consequential damages. A franchisee may be entitled to cancel or rescind the franchise agreement pursuant to the Contractual Remedies Act 1979 and may be entitled to reimbursement or damages, or both.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

If a sub-franchisor misrepresented the position without recourse to a franchisor, the franchisor should not be liable in any way. If a representation is made by a director or employee of the franchisor or the sub-franchisor, the protection of a limited liability company may not protect that individual, who may be personally liable pursuant to the Fair Trading Act 1986. There is a specific provision in that act in relation to employees being liable for personal misstatements while in their employment.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The answer to the first question is not applicable. The answer to the second question is not applicable except in the case that if the franchisor was a member of the FANZ, both the Code of Practice and the Code of Ethics would apply.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 17, 18 and 19.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Franchisees could make a complaint to the Commerce Commission and request an investigation in relation to such activity. Such protection differs due to the fact that fraudulent or deceptive conduct should not occur in relation to franchise sales. Also, such franchisees could bring a civil action against the franchisor and it may be possible for the directors of the franchisor company to be called as separate defendants as they could be personally liable for damages if the franchisor company has no assets. This protection does not differ from the protection provided pursuant to existing civil laws in New Zealand.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

No specific laws regulate the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect.

25 Do other laws affect the franchise relationship?

No other laws affect the franchise relationship in New Zealand.

26 Do other government or trade association policies affect the franchise relationship?

No other government policies affect the franchise relationship. If a franchisor belongs to the FANZ then it must comply with both the Code of Practice and the Code of Ethics that may affect the franchise relationship. But if a franchisor does not belong to the FANZ then there are no other policies that may affect the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Events which could lead to termination must be specified in the franchise agreement. There must be some fault or misdemeanour on the part of the franchisee for a valid termination to be confirmed. Also, it is usual for a notice of breach to be issued by a franchisor to a specific franchisee and for the time limit for remedying the breach to have expired before the termination takes place. If a termination is unlawful, a franchisor would be able to seek redress from a court, with the remedies being either damages or an order from the court that the franchise be reinstated to the franchisee, which may then continue to conduct business pursuant to the franchise agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate a franchise relationship only if the franchisor has engaged in misrepresentations or fraudulent conduct as an inducement for the franchisee to enter the franchise agreement in the first place. Termination would be pursuant to specific sections as set out in the Contractual Remedies Act 1979. Further, if a franchise agreement specifically allows the franchisee the right to terminate on, for example, six months' notice, the franchisee would be able to give such notice if required to exit the franchise but would lose the right to sell its business and recoup the upfront franchise fee together with any goodwill paid to the franchisor.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

A franchisor may refuse to renew its franchise agreement with a franchisee if some provisions in the franchise agreement allow it to do so. If a franchisee has breached the franchise agreement in a

Update and trends

It is my opinion and as in my response to question 35, the Courts in New Zealand are moving towards implying a duty of good faith into franchise agreements. In the recent Consumer Law Reform in New Zealand the government did not take up the suggestion to put good faith in the legislation.

material way during the term or if two or more breach notices have been issued within a 12-month period, the franchisor may be able to block any renewal, provided the franchise agreement contains such a relevant clause. Further, if a franchisee is in default at the time of purporting to renew a franchise agreement, the franchisor could prevent such renewal.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity provided the franchise agreement contains a right of first refusal clause in favour of the franchisor. Further, any transfer or sale of a franchise by a franchisee is always subject to the consent of a franchisor, who should be able to say no without giving any reasons. The precise wording in any assignment or transfer clause is very important and if a franchise agreement contains such words as 'with such consent not to be unreasonably or arbitrarily withheld' then it would be harder for a franchisor to refuse consent.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees, but should an unfair interest rate be imposed – for example, 30 per cent or 40 per cent – the equitable doctrine of unjust enrichment may be available to assist a disgruntled and unfairly treated franchisee.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no restrictions on the amount of interest that can be charged on overdue payments. However, any ridiculous or oppressive amount is likely to be challenged by a franchisee or a franchisee's lawyer. If a franchisor wants to charge such a high rate of interest that it would be in the nature of an unjust penalty then that rate of interest may be unenforceable by the Court.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Laws and regulations exist restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic country. As discussed in question 5, in all cases non-resident withholding tax would have to be deducted. New Zealand has double taxation treaties in relation to many countries, so any tax paid in New Zealand by an overseas franchisor in relation to the repatriation of income should be able to be claimed as a tax credit in the franchisor's foreign country.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are enforceable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

There is a general legal obligation for parties to deal with each other in good faith, and a good faith clause should always be included in franchise agreements. The courts in New Zealand are moving towards implying a duty of good faith into franchise agreements if no such duty is expressly stated, but this has not happened yet. Both parties should act loyally and in good faith towards each other at all times, as that is the essence of any franchise relationship.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The Consumer Guarantees Act 1993 does not apply to a franchisee who purchases products from a franchisor, because both parties are in business. However, when a franchisee sells products or services to a customer, the Consumer Guarantees Act 1993 would apply and it is likely that this Act will be amended within the next 12 months following the Consumer Law Reform.

37 Must disclosure documents and franchise agreements be in the language of your country?

There is no legal requirement for disclosure documents and franchise agreements to be written in English, but since the major language of New Zealand is English, all parties would insist that the English language is used.

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38 What restrictions are there on provisions in franchise contracts?

There are no restrictions on provisions in franchise contracts except that there must be compliance with the Commerce Act 1986 as mentioned earlier, the main thrust being that there must be no price-fixing, anti-competitive behaviour or other restrictive trade practices. Obviously, all provisions must comply with New Zealand law.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

See question 38. The Commerce Commission enforces the Commerce Act 1986; its wide powers include declaring a transaction void, together with monetary penalties, and there is a current trend for the courts to award higher penalties if the gravity of the offence demands that the public should be protected. At present, it has no power to imprison a guilty party.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The lowest level court in New Zealand is the district court. For claims exceeding NZ$200,000, the High Court of New Zealand is the relevant body. Appeals from the High Court of New Zealand go to the Court of Appeal of New Zealand, which sits in Wellington. Appeals from the Court of Appeal go to the Supreme Court of New Zealand, which also sits in Wellington.

If a franchisor belongs to FANZ, the franchise agreement must contain a dispute resolution clause. The Code of Practice prescribes that mediation is mandatory, and it has a high chance of success. There is also the Arbitration Act 1996. A domestic franchisor who is not a member of FANZ can resort to court action, but the courts usually require an attempt to resolve the dispute by way of mediation. A foreign franchisor could issue proceedings in New Zealand and sue a particular franchisee, but again, the courts may require an attempt to settle any dispute by way of mediation. The governing law in any franchise agreement is important and most foreign franchisors require the governing law to be that of their home country.At the same time, it is recommended that foreign franchisors should stipulate that the governing law should be the laws of New Zealand, as it is far easier to take swift action in relation to a defaulting master franchisee or franchisee through the New Zealand courts and to apply New Zealand law.

There is also the Disputes Tribunal, whereby disputes between parties can go to a hearing before a referee with no lawyer representation allowed. The maximum amount of any claim is NZ$15,000, or NZ$20,000 if both parties agree.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The principal advantages of arbitration include the fact that a hearing date would usually be much earlier than a court hearing date, the costs should be lower than the costs of litigation, any arbitration is confidential between parties, so the result will not appear in the press or elsewhere and it should be more informal than litigation in the High Court. Disadvantages include the fact that one party may want publicity but will not get it, and enforcement of the arbitral award that may have to go down the path of litigation.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors still need to comply with the laws of New Zealand insofar as they affect them. The only way they would be treated differently from domestic franchisors may be in the area of taxation, where income of any sort that is to be repatriated from New Zealand to an overseas jurisdiction will be subject to non-resident withholding tax.

Puerto Rico

Walter F Chow
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Overview

1 What forms of business entities are relevant to the typical franchisor?

The most common type of entity for conducting franchise operations in Puerto Rico are corporations and limited liability companies.

A franchisor does not need to be authorised to conduct business in Puerto Rico in order to contract with a Puerto Rican franchisee. The franchisor should, nonetheless, evaluate if it needs to establish a local entity or register in Puerto Rico an existing entity, in view of the operations it will embark on in Puerto Rico.

2 What laws and agencies govern the formation of business entities?

The formation of corporations and limited liability companies is regulated by Act No. 164 of 16 December 2009, also known as the General Corporations Act. The Puerto Rico Department of State is the agency entrusted with governing the formation of these business entities.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The Puerto Rico statutes governing corporations and limited liability companies follow, in general, Delaware statutes.

In order to establish a Puerto Rican corporation or limited liability company, a franchisor must file a certificate of incorporation or a certificate of organisation, respectively, with the Department of State.

Foreign corporations and limited liability companies that are not organised under Puerto Rican laws are considered foreign entities. Foreign entities must be registered with the Puerto Rico Department of State in order to conduct business in Puerto Rico. To register a foreign corporation or a limited liability company, the franchisor must file the corresponding application and a certified copy of the certificate of existence document from the appropriate agency where the foreign entity is registered.

Domestic corporations and foreign corporations authorised to do business in Puerto Rico must file with the Department of State by 15 April of each year a corporate annual report that includes a balance sheet. Depending on the revenues of the corporation, the balance sheet will need to be compiled or audited by a certified public accountant licensed in Puerto Rico.

Domestic and foreign limited liability companies must pay an annual fee to the Department of State by 1 March of each year.

Fees apply to all the previously mentioned filings.

In addition to the filings with the Department of State, a person engaged in business in Puerto Rico must register themselves on or before 15 July of each year with the Merchants and Business Mandatory Registry of the Puerto Rico Trade and Export Company. Filings with the Puerto Rico Department of Treasury, municipalities and labour and employment-related agencies are also required.

4 What restrictions apply to foreign business entities and foreign investment?

There are no particular restrictions that apply to foreign business entities and foreign investments. Generally, foreign investors are not required to obtain government approval to invest in Puerto Rico; however, restrictions imposed by US federal legislation may apply to foreigners investing in particular industries (for example, communications).

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Federal taxation

Puerto Rico is considered a foreign country for US tax purposes; thus, in general, the US Internal Revenue Code (IRC) does not apply to Puerto Rican operations. US citizens residing in Puerto Rico, including those born in Puerto Rico, are generally exempted by the IRC from income taxes on Puerto Rican sourced income but are subject to US tax on most US and foreign sourced income.

Puerto Rican tax laws

Income Tax

The Puerto Rico Income Tax Act is based on the IRC. All natural and juridical persons with Puerto Rican sourced income are subject to Puerto Rican income tax on that income, unless expressly exempted. Resident individuals (those domiciled in Puerto Rico) are taxed on their worldwide income. Non-residents are taxed only on Puerto Rican sourced income and income effectively connected with the conduct of a trade or business in Puerto Rico (ECI). Normally, non-Puerto Rican sourced income is not ECI. However, such income is considered ECI if the foreign corporation or partnership has an office or branch in Puerto Rico and the foreign sourced income is attributable to the Puerto Rican office and consists of royalties on intangibles derived from the active conduct of such Puerto Rican business, dividends, interest or gain or loss from the sale of securities in a banking or finance business or income received by the business from trading securities for its own account and income received from the sale of goods outside of Puerto Rico through the Puerto Rican office (unless the goods are sold for use, consumption or disposition outside Puerto Rico). Resident foreign corporations or partnerships (those not organised in Puerto Rico but engaged in trade or business here) are taxed on all ECI.

Income tax rates

Individuals, trust and estates

Taxable income for taxable year 2011	Rate
US$5,000 or less	0%
Portion over US$5,000 but not over US$22,000	7%
Portion over US$22,000 but not over US$40,000	14%
Portion over US$40,000 but not over US$60,000	25%
Portion over US$60,000	33%

Taxable income for taxable year 2012	Rate
US$6,500 or less	0%
Portion over US$6,500 but not over US$23,000	7%
Portion over US$23,000 but not over US$41,300	14%
Portion over US$41,300 but not over US$61,300	25%
Portion over US$61,300	33%

Taxable income brackets and rates for taxable years commencing after 31 December 2013 are subject to compliance with fiscal responsibility tests (net revenues to the General Fund, expenditures and economic growth test).

Married individuals living together and both working filing jointly may opt to determine tax liability as individual taxpayers. A 5 per cent add-on tax applies to income in excess of US$100,000, US$200,000, US$300,000 and US$500,000 for taxable years 2011, 2012, 2013 and 2014, respectively (married taxpayers filing separate returns and married taxpayers filing joint returns, that so elect, determine the income level for purposes of the add-on tax in the same manner as an individual taxpayer). The add-on tax is eliminated for taxable years commencing after 31 December 2014. The tax is limited to an amount that will result in a flat tax, at the maximum rate in effect, on the taxpayer's entire taxable income increased by taxpayer's personal and dependent exemptions.

Tax on individuals is the higher of regular tax or alternate base tax (ABT). ABT applies only to the alternative minimum net taxable income over US$150,000. ABT rates are as follows:

Alternative minimum net taxable income	Rate
US$150,000 to US$250,000	10%
US$250,000 to US$500,000	15%
Over US$500,000	20%

Alternative minimum net taxable income levels are determined in the same manner as an individual taxpayer in the case of married taxpayers filing separate returns and married taxpayers filing joint returns that so elect. An alternative minimum tax foreign tax credit may be claimed against the ABT.

Net long-term capital gains are subject to a tax rate of 10 per cent, but the taxpayer may elect for the regular rate if it is lower.

There are also special alternative taxes to take into account. Dividend distributions by Puerto Rican corporations and by foreign corporations whose ECI (that includes Puerto Rican sourced income) is at least 80 per cent of the gross income of such foreign corporation for the prior three taxable years, are taxed at a 10 per cent tax rate.

An alternative tax of 10 per cent applies to non-exempt interest credited or paid on interest-bearing deposits (or those registered with a brokerage house as nominee) in certain local financial institutions. An alternative tax of 17 per cent applies to non-exempt interest credited or paid by an individual retirement account.

An alternative tax of 10 per cent is imposed on non-exempt interest on obligations issued by Puerto Rican corporations or partnerships, or by foreign corporations or partnerships whose ECI (which includes Puerto Rican sourced income) is at least 80 per cent of the gross income of such foreign corporation or partnership for the prior three taxable years. This 10 per cent alternative tax also applies to non-exempt interest on certain residential Puerto Rican mortgages.

The individual may elect to have normal tax rates apply if such tax rates turn out to be more beneficial than the alternative tax rates.

Non-resident US citizens are taxed on their Puerto Rican sourced income at the same rates as residents. However, certain items of Puerto Rican sourced income are subject to a 20 per cent withholding tax. On sales of Puerto Rican real property or stock, the withholding rate is 10 per cent.

Non-resident non-US citizens not engaged in business are taxable at a flat 29 per cent tax on Puerto Rican sourced fixed or determinable annual or periodic income and on net Puerto Rican sourced capital gains. The withholding at source at 29 per cent applies to everyone with such income, except that in the case of sales of Puerto Rican real property or shares of stock by a non-resident non-US citizen, the buyer withholds 25 per cent of the sales price (net of original cost).

The net income of an estate or trust shall be computed in the same manner and on the same basis as in the case of individuals, with the exception of allowable deductions for charitable contributions and additional deductions for certain distributions to legatees, heirs or beneficiaries.

Corporations and partnerships

For tax purposes Puerto Rico treats partnerships as pass-through or disregarded entities. Partnerships are not subject to Puerto Rico income taxes. Rather, the partners of a partnership that is engaged in trade or business in Puerto Rico are subject to Puerto Rico income taxes on their distributive share in the partnership's income or gains. Such partners are considered to be engaged in trade or business in Puerto Rico with respect to their distributive participation in the income, gains, losses, deductions and credits of the partnership. Corporations are subject to a tax rate of 20 per cent on net income. For foreign corporations, the tax applies to net ECI (which includes Puerto Rican sourced income). Also, should the corporation net income exceed US$750,000, it will be subject to additional income taxes on its net income exceeding US$750,000 at the following rates:

Income subject to additional taxes	Additional tax rate
Maximum of US$1,750,000	5%
Over US$1,750,000	US$87,500 plus 10% of the excess over US$1,750,000

Unless otherwise exempt, all corporations are also subject to an alternative minimum tax (AMT) equal to the higher of 20 per cent of alternative minimum taxable income (AMTI) or 1 per cent of the value of purchases of personal property acquired from a related person. The tax liability is the greater of AMT or the regular tax liability. AMTI is calculated by making various adjustments to the regular taxable income that has the effect of accelerating recognition of income.

Net long-term capital gains are taxed at 15 per cent. An alternative tax of 10 per cent is imposed on non-exempt interest on obligations issued by Puerto Rican corporations or by foreign corporations whose ECI (that includes Puerto Rican sourced income) is at least 80 per cent of the gross income of such foreign corporation for the prior three taxable years. This 10 per cent alternate tax also applies to non-exempt interest on certain residential Puerto Rican mortgages.

Foreign corporations engaged in trade or business in Puerto Rico are taxed on net ECI at the same rates as domestic corporations. If these companies derive less than 80 per cent of their gross income from Puerto Rican sources or from income effectively connected to the Puerto Rican trade or business for the three-year period ending with the taxable year, they are also subject to a 10 per cent branch profits tax. This tax is imposed on after-tax earnings of the company's Puerto Rican branch that are not reinvested in Puerto Rico (the dividend-equivalent amount). Foreign tax credits against Puerto Rican tax are allowed for foreign taxes paid on non-Puerto Rican sourced ECI. Deductions and credits attributable to Puerto Rican income are allowed only upon filing Puerto Rican income tax return reflecting the Puerto Rican income. Credit is allowed for taxes withheld at source.

Foreign corporations not engaged in trade or business in Puerto Rico are generally taxed on fixed or determinable annual or periodical gross income at 29 per cent to the extent amounts so received are considered to be from sources within Puerto Rico. Exceptions are dividend distributions that are taxed at 10 per cent. Certain royalties for use of industrial intangibles are also taxed at 2 per cent or 12 per cent. Gains derived from sources within Puerto Rico from sales or exchanges of capital assets that exceed losses allocated to sources within Puerto Rico from such sales or exchanges are subject to a 29 per cent tax. Interest on Puerto Rican bank deposits, real property mortgages constituted before 1 July 1995 and interest received from unrelated persons is exempt.

Municipal taxes and property taxes

A municipal licence tax is imposed on the gross receipts of the business conducted in a municipality. The tax rate cannot exceed 1.5 per cent for a financial business and 0.50 per cent in the case of all other types of businesses.

Construction tax on new construction and demolition is imposed by some municipalities based on the cost of the work. Tax rates vary depending on the municipal ordinance pursuant to which the construction tax is imposed.

Property tax on real and personal property is payable to the Municipal Revenue Collection Center (CRIM). There are 78 municipalities and municipal property tax rates vary, so that total combine rate ranges from US$5.80 to US$8.83 per US$100 of reported value of personal property and US$7.80 to US$10.83 per US$100 of assessed value of real property for fiscal year 2010-2011. Effective for fiscal years 2009-2010, 2010-2011 and 2011-2012, the assessed value of real property was increased tenfold, but the tax rate was decreased tenfold, so that the net tax remains the same prior to the increase in assessed values of real property. Personal property is self-assessed by the taxpayer. Real property is assessed by CRIM based on 1957-58 fiscal year values, well below present market values.

A municipal sales and use tax of 1.5 per cent is imposed by most municipalities on the retail sale, use, consumption or storage of a taxable item in a particular municipality. The municipal sales tax on taxable items must be paid by the consumer at the time of sale. Taxable items include tangible personal property, taxable services, admission fees and bundled transactions.

Licences, sales, use and excise taxes

Licences

Licences are required for the sale of cigarettes, vehicles and parts, gasoline, cement and guns and ammunition.

Sales and use tax

A general sales and use tax of 5.5 per cent is imposed on the retail sale, use, consumption or storage of a taxable item in Puerto Rico. The general sales tax on taxable items must be paid by the consumer at the time of sale. Taxable items include tangible personal property, taxable services, admission fees and bundled transactions.

Coupled with the municipal sales and use tax of 1.5 per cent described above, the aggregate sales and use tax would be 7 per cent.

Excise tax

Special excise taxes apply upon the introduction, sale, consumption, use, transfer or acquisition of cement, sugar, cigarettes, petroleum products, vehicles, alcoholic beverages and on plastic products manufactured outside Puerto Rico that do not comply with certain specifications.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Depending on the size of the local operations of the franchise, the franchisor may or may not have a local office or personnel stationed in Puerto Rico. The duties of such personnel typically relate to ensuring compliance with the franchise agreement and that the franchisor's trademarks, goodwill and reputation are enhanced and not adversely affected by the franchisee's operations.

If a local office is maintained or personnel are stationed in Puerto Rico, the franchisor – as an employer – will need to comply with all United States federal as well as all Puerto Rican labour and employment laws, as well as related payroll and Puerto Rican income tax withholding laws.

If the franchisor does not retain personnel in Puerto Rico to perform services on its behalf, in order to shield itself from employment-related claims by the franchisee's employees or being deemed to be the 'employer' of such employees, it needs to ensure the relation between the franchisor and the franchisee complies with the necessary separateness of an 'independent contractor' relation within the context of a franchise relation.

Although the employees of a well established or economically sound franchisee do not frequently present labour or employment claims against the franchisor, occasionally such claims are presented. To reduce the risk of such claims, the franchisor should do the following:

- ensure the franchise agreement disclaims any employment or agency relationship between franchisor and franchisee and that it specifies that hiring, firing, evaluation and discipline decisions relating to the franchisee's employees are the exclusive responsibility of the franchisee;
- require the franchisee to use its own corporate name and not the brand or franchise name in all employment related documents (employment policies, employee manuals, applications, disciplinary documents, identification cards, etc);
- require the franchisee maintain policies and procedures that comply with all applicable labor and employment laws, but the franchisor should not require adoption of its 'policies and procedures', nor should it provide such documents nor training related to same. Although the franchisor may monitor 'overall compliance' and provide recommendations, it should not become involved in day-to-day application of the policies;
- the franchisor should avoid frequent and close supervision of the work of franchisee employees on a regular basis.
- require the franchisee to identify itself, in all interactions with the public (such as phone calls and customer contacts) by its own name rather than the franchisor's name; and
- since Puerto Rico's unemployment and non-occupational insurance programmes use a more stringent 'ABC' test that has been invoked to hold a franchisor liable for a franchisee's failure to pay its required contributions to such programs, the franchisor may wish to consider closer compliance monitoring limited to such payments. See *Tastee Freez de Puerto Rico, Inc v Puerto Rico Department of Labour*, 111 DPR 809 (1981).

7 How are trademarks and know-how protected?

Under the trademark laws of the US and Puerto Rico, the principal method of establishing rights in a trademark or service mark (mark) is the actual use of the mark. Registration of a mark is not legally required but can provide distinct advantages and is highly recommended. Registration of a mark is prima facie evidence of ownership. Infringers are subject to various remedies, including one or more of injunction, actions for damages or seizure orders.

Registration in the US Patent and Trademark Office protects marks used in interstate commerce in Puerto Rico. However, there is still some uncertainty about the extent of protection in situations where infringement is strictly intrastate. Local registration offers various procedural advantages in the protection of a trademark so that both US and local registration are recommended.

Registration of a mark in Puerto Rico is accomplished by filing an application setting forth the mark and the goods or services with which it is used with the Puerto Rico secretary of state together with a sworn statement as to the applicant's right to use the mark, facsimiles of the mark as used or proposed to be used and payment of a US$150 fee. Applications may be filed based on existing use, in which case a specimen showing the mark as used with the claimed goods or services must be included. Applications may also be filed claiming an intent to use in commerce and, in this case, a use declaration setting forth the date of first use as well as a specimen showing how the mark is being used in commerce must be submitted within five years after filing the application. Registration is valid for 10 years from the filing date and may be renewed for successive 10-year periods thereafter, provided that, the owner of the mark files a sworn declaration of continuing use accompanied by a specimen showing the use before the term expires. During the fifth year after the application filing date, a similar declaration of continuing use must be filed otherwise the registration lapses. The following marks may not be registered in Puerto Rico:

(i) any mark contrary to the law;
(ii) any mark containing the flag, coat of arms or other insignia of Puerto Rico, of the US or of any state, municipality or nation, or an imitation thereof;
(iii) a person's name, nickname, picture or signature, unless consent is obtained;
(iv) words descriptive of products or services with that the mark is used;
(v) words indicating the type, nature or physical appearance of the product or service;
(vi) geographical names or terms indicating the origin of the product or services;
(vii) any geographical names or terms that are misleading or mis-descriptive;
(viii) any mark that is identical to another registered or known mark used for the same type of product or service;
(ix) any mark so similar to another that its use will cause confusion or deception in the public's mind;
(x) any mark that is identical or similar to a registered or pending registration mark, that is likely to cause confusion or error in the public's mind; or

(xi) any mark that is identical or similar to a famous mark that is known by the relevant market sector in Puerto Rico, even though the mark is not used in Puerto Rico.

As an exception to points (iv) and (vi), such marks may be registered if they have acquired a distinctive character through the use they have been given for the products or services for which registration is requested. Also, marks that contain both registrable and non-registrable materials may sometimes be registered if an exclusive claim to the problematic language is disclaimed.

Puerto Rico also recognises causes of action for dilution of marks by 'blurring' and by 'tarnishment'. Such causes apply to famous marks that are injured by certain actions. A mark may be diluted by 'blurring' when it is used in connection with goods or services other than those used by the original owner in such a way that people are confused as to the source of either the new or old goods or services. A mark is diluted by 'tarnishment' when the non-owner uses it in a way that damages the original through association with offensive or materials or goods or services of inferior quality.

Franchisors generally register relevant marks with both the United States Patent and Trademark Office and the Puerto Rico Trademark Registry. These marks are then licensed to franchisees, either in the franchise agreement or in separate licence agreements. Under Puerto Rico's Law of Marks enacted in 2009, licensing of marks may be recorded with the Puerto Rico Trademark Registry, but this option has not been widely used and is not favoured by franchisors.

Puerto Rico's new Trade Secret Law, Act No. 80 of 3 June 2011, (Trade Secrets Act) provides express protection for know-how. The Trade Secrets Act covers all information that is not generally known or accessible and provides its owner with an economic value or advantage, or from which another person might obtain economic value from disclosure. For protection under the Trade Secrets Act an owner must take appropriate measures to maintain the confidentiality of its information. The Trade Secrets Act does not provide an exhaustive list of measures that must be taken, but notes that the steps must be reasonable and provides examples such as:

- restricting the number of persons authorised to access certain information;
- requiring employees to sign a non-disclosure agreement;
- formally classifying information as confidential; and
- implementing technological restrictions on the transmission or use of information.

The Trade Secrets Act creates new causes of action against any person that:

- acquires from another person a trade secret that was acquired by improper means; or
- discloses a trade secret without the consent of the secret's owner, if the disclosing party knew or should have known the trade secret was obtained illicitly.

The Trade Secrets Act also attempts to maintain the secrecy of proprietary information by directing courts to take appropriate steps to guarantee the integrity and secrecy of a trade secret during any court proceeding, even those which are not specifically brought under the Trade Secrets Act. The main remedies available under the Trade Secrets Act are damages and injunctive relief and, in appropriate situations, awards of attorneys' fees or royalty payments. Franchisors should certainly consider the best way to use the Trade Secrets Act to protect valuable proprietary information, but the law has not been in operation long enough to evaluate the specific effects on franchise operations.

In addition to the Trade Secrets Act, the general Tort and Property Law of Puerto Rico as well as the unfair competition statutes and regulations may be used to protect trade secrets. Furthermore, rule 513 of the Puerto Rico Rules of Evidence declares trade secrets to be privileged information and rule 23.2(g) of the Puerto Rico Rules of Civil Procedure allows protective orders to prevent disclosure of trade secrets.

8 What are the relevant aspects of the real estate market and real estate law?

There are no special restrictions or conditions applicable to foreign franchisors as compared to domestic ones. Real estate is governed by the Civil Code of Puerto Rico, the Mortgage and Registry of the Property Act of Puerto Rico and, when applicable, the Notarial Act of Puerto Rico. There are basically no unexpected aspects of the real estate market and real estate laws applicable to franchisors, when compared to other US jurisdictions, with the notable exceptions described below regarding the consequences of not recording real estate interests in the Registry of the Property.

The most relevant aspect of Puerto Rican real estate law is the civil law concept that in order to be protected with regards to third parties, the lessee needs to have its real estate interest recorded in

the Registry of the Property; otherwise, the lessee would only have a contractual cause of action against the lessor should the leased property be sold to a third party.

In order to have access to the Registry of the Property, the real estate interest needs to be incorporated in a public deed executed before a notary public in Puerto Rico (or if executed outside Puerto Rico, it can be incorporated in a private document, notarised and then protocolised by a notary public in Puerto Rico). Furthermore, the authority of the appearing parties in the deed must be evidenced to the notary public by means of an authentic document that also needs to be notarised (that is, if executed outside Puerto Rico, it needs to be notarised in the jurisdiction in which it is executed and comply with all the required formalities). In the case of a partnership, the partnership agreement must also be in deed form and be included as a complementary document of the deed. The fees for the execution of the public deed and its recording in the Registry of Property are approximately US$5.50 per thousand dollars of valuation, allocated as follows: US$1.50 per thousand of valuation for Internal Revenue Stamps and US$4 per thousand of valuation for the recording voucher. The valuation of a lease, however, is limited to rent that is going to be paid during the term of the lease or the first 12 years, whichever is less and without consideration of any extensions to the original term of the lease. Furthermore, the recording of the lease requires a filing fee of US$10.50; allocated as follows: a US$10 filing voucher plus US$0.50 in internal revenue stamps required by the Puerto Rico Political Code. In addition, a mandatory fee must be paid to the notary before whom the deed is executed. The law provides for a mandatory fee of half per cent of the value of the transaction on the first US$5 million. For any amount in excess of US$5 million, the parties and the notary can agree on the notary fee (namely, only for the excess amount). Also, for leases with a term of less than six years, the owner of the leased property needs to consent to the recording of the lease at the Registry of Property. In leases for a term of six years or more (including leases for a term of less than six years, in which the lessee has the right, at its sole discretion, to extend the same for a period that would make the lease term, as extended, for a period longer than six years) that are in deed form, the lessee can request the recording of the deed at the Registry of Property without having the express consent of the owner of the property. If it is not in public deed, the lessee can demand that the lessor convert the lease into a public deed and then proceed to record the same.

The cancellation of a recorded lease also incurs several costs depending on the date of cancellation. If the lease is going to be cancelled because it expired pursuant to its own term, then the cancellation fee is a nominal amount of US$20.50; allocated as follows: a US$10 recording voucher plus a filing fee of US$10.50 (allocated as follows: a US$10 filing voucher and US$0.50 in internal revenue stamps). If the cancellation of the lease is requested before the expiration of the same, then the cancellation costs are to be calculated in the same manner as the recording costs (US$5.50 per thousand of the valuation as explained above).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Puerto Rico does not have any laws specifically regulating franchises, thus the term 'franchise' is not defined under Puerto Rican law.

Act No. 75 of 24 June 1964, as amended, also known as the Puerto Rico Dealers Act (Law 75) was enacted principally to govern dealerships. When defining a 'dealer's contract', Law 75 refers to the concept of franchise. Law 75 defines a 'dealer's contract' as a 'relationship established between a dealer and a principal or grantor whereby and irrespectively of the manner in which the parties may call, characterise or execute such a relationship, the former actually and effectively takes charge of the distribution of a merchandise, or of the rendering of a service, by concession or franchise, on the market of Puerto Rico'.

The concept of 'principal' is defined under Law 75, as the 'person who executes a dealer's contract with a dealer'. 'Dealer', in turn, is defined as the 'person actually interested in a dealer's contract because of the person being effectively in charge in Puerto Rico the distribution, agency, concession or representation of a given merchandise or service'.

Franchisors and franchisees have been considered principals and dealers, respectively, for purposes of Law 75.

In addition, see the discussion in 'Update and trends'.

10 Which laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises is not expressly regulated under Puerto Rican laws or by any government agency. Puerto Rico, however, is subject to US laws and regulations, including the Federal Trade Commission Franchising Regulations.

In addition, see the discussion in 'Update and trends'.

11 Describe the relevant requirements of these laws and agencies.

See question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Law 75 protects 'dealers'. As stated in the answer to question 9, under Law 75, a dealer is defined as any person who is effectively in charge of the Puerto Rico distribution, agency, concession or representation of a given merchandise or service. To the extent the person is effectively in charge, that person will be considered a dealer, regardless of whether it is an exclusive or non-exclusive relationship or if the agreement is in writing. There has been much litigation over who is or is not a dealer protected by Law 75. The courts have adopted the following characteristics to assist them in determining who is considered a 'dealer' under Law 75:

- promotion of the product;
- closing of contracts;
- keeping an inventory;
- fixing prices;
- negotiating terms of sales;
- delivery and billing responsibilities;
- authority to extend credit;
- advertising campaigns;
- assumption of risk;
- purchasing the product;
- maintaining facilities; and
- offering product-related services to clients.

The courts have continually applied the above criteria to determine who is considered a dealer under Law 75. The courts have also repeatedly stated that these criteria are not exhaustive and no one criterion is determinant nor is any particular criteria entitled to more weight than others. The absence of one or two or a few of the activities of a dealer is not sufficient grounds to sustain that the person is not a dealer. The courts generally take into consideration the totality of the activities of the person.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

See question 10.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

See question 10.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

See question 10.

16 What information must the disclosure document contain?

See question 10.

17 Is there any obligation for continuing disclosure?

See question 10.

18 How do the relevant government agencies enforce the disclosure requirements?

See question 10.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

See question 10.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

See question 10.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Franchise agreements will be subject to the general principles of contract formation found in the Civil Code of Puerto Rico.

Also, please note that typically franchise agreements are contracts of adhesion. In an effort to correct the presumed economic imbalance between the parties to an adhesion contract, Puerto Rican case law has established that the agreement shall be analysed in the manner most favourable to the weaker party, in all probability, the franchisor.

In addition, see the discussion in 'Update and trends'.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See question 10.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In Puerto Rico, a franchisor engaging in fraudulent or deceptive practices in connection with the offer and sale of franchises may incur contract or tort liability (or both). The franchisor may also be subject to penalties and liabilities under US law. Depending on the practice, the parties and the franchise agreement, an action may be brought before local or US courts, or arbitration.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Law 75 protects dealers (including franchisees) in Puerto Rico by providing that, notwithstanding the explicit provisions of any dealer contract, a principal cannot terminate, refuse to renew or impair an established dealer relationship unless there is 'just cause'. As previously stated, the agreement need not be in writing.

Law 75 overrides contractual provisions. Thus, the provisions of any franchise agreement must be read in the light of Law 75. In addition, Law 75 rights cannot be waived. Contractual provisions contrary to Law 75 will be unenforceable under the statute.

In addition, see question 10 as well as the discussion in 'Update and trends'.

25 Do other laws affect the franchise relationship?

The franchise relationship will be subject Puerto Rican and US antitrust laws. Puerto Rican antitrust laws are modelled on and closely resemble those of the US.

26 Do other government or trade association policies affect the franchise relationship?

No other government or trade association policies affect the franchise relationship.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Under Law 75, a franchisor may not terminate, refuse to renew or impair an established franchise relationship, unless there is 'just cause'. The statute defines 'just cause' as the 'non performance of any of the essential obligations of the dealer's contract, on the part of the dealer, or any action or omission on his part that adversely and substantially affects the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service'. There has been a significant amount of Law 75 litigation. However, the case law does not shed much light on what constitutes 'just cause'. Nevertheless, it is clear that a mere technical breach will not constitute 'just cause' and the breach must be substantial and relate to a material aspect of the relationship.

If there is no 'just cause', the franchisor will be liable for the wrongful termination, refusal to renew or impairment of the agreement. The law provides for a statutory penalty of five times average annual profits, an amount for goodwill and reimbursement for expenditures that cannot reasonably be utilised in a different endeavour.

The statute also allows an aggrieved party to seek a temporary injunction forcing the principal to continue the unwanted relationship until the issue of damages is resolved.

In addition see the discussion in 'Update and trends'.

Update and trends

Currently, there are two bills awaiting consideration in the Puerto Rico Legislative Assembly that would establish the Puerto Rico Franchise Act. These bills are very similar in nature. If either of them were enacted into law, no franchise owner could terminate a franchise agreement with a franchisee before its expiration date, without just cause. Similarly, a franchisor may not refuse to renew the franchise agreement with the franchisee except in certain described circumstances. Both bills specifically state that franchisee rights under Law 75 will not be affected.

A franchise is defined in these bills as the concession of exploitation rights over a product, activity or commercial name, granted by a company to one or various individuals in a determined zone.

The bills would prevent franchisors from signing franchise agreements with their franchisees in Puerto Rico in terms that are significantly discriminatory or unfavourable when compared to similar contracts in the United States, or its country of origin if the franchise does not exist in the United States. Similarly, franchises directly operated by the franchisor must be subject to the same conditions and obligations as franchises operated by third-party franchisees. All franchise agreements covered by this law must be ruled by Puerto Rican law, and any provision to the contrary included in the contract shall be deemed null.

At the time of writing, neither bill seems to have gained much traction during the legislative process.

28 In what circumstances may a franchisee terminate a franchise relationship?

Law 75 does not address the termination or non-renewal of a franchise relationship by the franchisee. The Civil Code of Puerto Rico, on the other hand, allows contracting parties to make the agreements and establish the clauses and conditions that they deem advisable, provided they are not in contravention of law, morals, or public policy. Thus, to the extent they are not contrary to law, morals, or public policy, the franchise agreement may provide for the circumstances in which a franchisee may terminate a franchise relationship. Also, under general contract principles, the right to rescind the obligations is considered as implied in mutual ones, if one of the obligated persons does not comply with what is incumbent upon him or her. Thus, to the extent the franchisor fails to fulfil his or her essential obligations under the franchise agreement, the franchisee may opt to terminate the franchise relationship.

In addition, see the discussion in 'Update and trends'.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

See question 27.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity for just cause. Law 75 provides that any contractual provision to prevent the Distributor's ability to freely sell, transfer or encumber any interest in the distribution business is unenforceable. Specifically, Law 75 provides that the:

> *[...] violation or non performance by a dealer of any provision included in the dealer's contract to prevent or restrict changes in the capital structure of the dealer's business, or changes in the managerial control of said business, or the manner or form of financing the operation, or to prevent or restrict the free sale, transfer or encumbrance of any corporate action, participation, right or interest that any person could have in said distribution business, shall not be considered as being just cause unless the principal or grantor shows that such non performance may affect, or has truly and effectively affected the interests of such principal or grantor in an adverse or substantial manner in the development of the market, distribution of the merchandise or rendering of services.*

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Other than the previously discussed tax provisions (see question 5), there are no laws or regulations affecting the nature, amount or payment of fees by the franchisee to the franchisor.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Puerto Rican laws and regulations do not set maximum charges and rates of interests that may be charged on credit granted for commercial purposes.

Please note that, in general, Puerto Rico law prohibits anatocism (namely, compounding of interest or charging of interest on unpaid interest). There are two exceptions. If a judicial demand is made for unpaid interest, then the law provides for the charging of legal interest (6 per cent) on the unpaid interest after judicial demand is made. The law also permits the parties to agree to capitalise unpaid interest as principal and, thereafter, to charge interest on such a capitalised amount. However, prior agreements to capitalise unpaid interest are not valid; the agreement to capitalise unpaid interest can only be made after the interest has accrued and remains unpaid.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no Puerto Rican laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency.

34 Are confidentiality covenants in franchise agreements enforceable?

To the extent the confidentiality covenant included in a franchise agreement is not contrary to law, morals or public policy, it will be enforceable. The inclusion of confidentiality covenants in franchise agreements is highly advisable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Puerto Rican law requires that all obligations be performed in good faith. In general terms, this implies that the parties to the franchise relationship act in a fair and cooperative manner.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No Puerto Rican law treats franchisees as consumers for the purposes of consumer protection or other legislation.

37 Must disclosure documents and franchise agreements be in the language of your country?

Spanish and English are the official languages of Puerto Rico. As long as the contracting parties understand the language used in the franchise agreement, there is no requirement that franchise agreements be in Spanish or English.

38 What restrictions are there on provisions in franchise contracts?

Law 75 overrides contractual provisions. Thus, the provisions of any franchise agreement must be read in light of Law 75. Contractual provisions contrary to Law 75 will be unenforceable under the statute.

Law 75 establishes several restrictions with which the provisions included in a franchise agreement must abide.

A franchisor may not terminate or refuse to renew the established franchise relationship, unless there is 'just cause'. Law 75 provides that any contractual provision to prevent the franchisee's ability to freely sell, transfer or encumber any interest in the franchise business is unenforceable. Similarly, quotas or goals established in the franchise agreement must adjust to the realities of the Puerto Rican market or may be held unenforceable.

Law 75 also provides that the choice of non-Puerto Rican law to govern the agreement is unenforceable under Law 75.

Further, any stipulation obligating a dealer to adjust, arbitrate or litigate any controversy arising from the dealer's contract outside Puerto Rico, or under foreign law or rule of law, shall be likewise considered as violating the public policy set forth by Law 75. The US Federal Arbitration Act pre-empts Law 75's restraint on arbitration outside of Puerto Rico. However, Law 75 was amended to require that a court with jurisdiction in Puerto Rico determines that such arbitration provision was subscribed freely and voluntarily by both parties. Further, the amendment established a rebuttable presumption that arbitration clauses are adhesion clauses to be interpreted and made effective as such.

Finally, Law 75 rights cannot be waived.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

See question 23.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The structure of the Puerto Rican court system is comparable to that of any of the states of the US. The Puerto Rican judicial branch consists of a Supreme Court, a Court of Appeals and the courts of first instance. Ultimate appeal is made to the Supreme Court of Puerto Rico and, in certain cases, to the US Supreme Court.

Puerto Rico also participates in the US district court system. The decisions of the US District Court for the District of Puerto Rico are reviewed by the US Court of Appeals for the First Circuit.

Mediation and arbitration are also viable and recognised mechanisms of dispute resolution in Puerto Rico.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The primary advantage of arbitration for a foreign franchisor is the ability to require the franchisee to hold the arbitration proceedings in the country of the foreign franchisor's residence. This gives the franchisor a 'home court' advantage. Furthermore, if the franchise agreement provides for the choice of other than Puerto Rican law to govern the franchise agreement, there is the possibility that the arbitrator may respect such a choice of law, notwithstanding the provision of Law 75 that the choice of other than Puerto Rican law is not enforceable in contracts governed by Law 75.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Under Puerto Rican law, foreign and domestic franchisors are subject to the same treatment.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

As a general principle, any form of business entity can be franchised. However, the typical franchisor would most likely use the form of a limited liability company (SRL) or a joint-stock company (SA).

The SRL is the most attractive business vehicle in Romania for both domestic and foreign prospectors, by virtue of its comparably low administrative, reporting and capital requirements and management flexibility.

The SA is the most complex form of business entity in Romania. Its advantages are the possibility of listing, as well as being entitled to perform any type of activity whatsoever (including banking and insurance, which cannot be undertaken by SRLs). On the downside, SAs require more intricate management, administrative and reporting formalities.

2 What laws and agencies govern the formation of business entities?

The formation and activity of business entities are sanctioned by Company Law No. 31/1990 and Trade Registry Law No. 26/1990.

Business entities are registered with the Trade Registry Office.

3 Provide an overview of the requirements for forming and maintaining a business entity.

A business entity gains legal personality upon registration with the Trade Registry. Registration formalities depend on the legal form of the business.

An SRL may be formed by a minimum of one shareholder and a maximum of 50. The shareholders may include individuals and business entities. A person, either natural or legal, cannot be the sole shareholder of more than one SRL. Moreover, an SRL cannot have as its sole shareholder an entity with a sole shareholder.

The shareholder liability is limited to the amount subscribed as participation to the company's share capital. The share capital of an SRL must be at least 200 lei, divided into shares with a minimum nominal value of 10 lei each. An SRL is managed by one or more directors who may have full or limited powers and who may be either Romanian or foreign nationals. There is no distinction between Romanian or foreign shareholders.

To register an SRL with the Romanian Trade Registry a registration application must be filed together with the following documents, inter alia:

- the company's articles of incorporation; proof of availability of the company name (standard form);
- proof regarding the registered seat;
- copies of ID or passports of the shareholders or directors and their notarised signature specimens;
- proof of capital contributions;
- standard affidavits by the shareholders, directors and auditors; and
- proof of payment of the appropriate duties and fees (stamp duties, registration fees, the Official Gazette publishing fee).

Foreign shareholders shall submit a notarised affidavit stating they are not fiscally registered in Romania and have no debts towards the Romanian state.

If a shareholder is a legal entity, additional documents are required:

- registration documents;
- a letter of good standing issued by their bank;
- the statutory decision for the establishment of the new company and for the appointment of a legal representative; and
- the power of attorney granted to the legal representative.

For VAT payment purposes, the company will fill in an annex to the registration application.

All foreign documents shall be apostilled and translated into Romanian by a sworn translator.

An SA requires a minimum of two shareholders, which may be individuals or legal entities. There is no maximum limit.

The minimum required capital is the equivalent of €25,000 (approximately 90,000 lei). The minimum par value of one share is 0.1 lei.

An SA may be managed by one or more directors or an executive board and a supervisory board.

If an SA is managed by directors, the number of such directors should always be odd. If there is more than one director, they may form a board of directors. Certain joint-stock companies which, pursuant to special laws, are subject to mandatory financial auditing, are managed by at least three directors.

If an SA is managed by an executive board and a supervisory board, the executive board manages the company and reports to the supervisory board. The supervisory board monitors the activity of the executive board and reports to the general meeting of shareholders.

SAs should have at least three internal auditors and an alternate auditor, unless the articles of incorporation provide for a higher number. At all times, the number of internal auditors shall be odd. Certain SAs that, pursuant to special laws, are subject to mandatory financial auditing – as well as SAs managed by executive and supervisory boards – shall be audited by both internal and external auditors, either natural or legal persons. The external auditors control the activity of internal auditors and perform the external auditing. The internal auditors organise the internal audit in compliance with the guidelines provided by the Chamber of Financial Auditors in Romania.

The registration procedure and documents are more or less similar to the ones required for the registration of an SRL, with the main exception that only 30 per cent of the share capital has to have been paid up upon incorporation, while the remaining 70 per cent is to be paid within either 12 months or two years depending on the nature of contributions (namely, in cash or in kind, respectively).

The Trade Registry will issue the registration certificate within six working days of the submission of the complete registration file. The certificate will bear the registration number and the sole registration code assigned by the Ministry of Finance. Fiscal registration of a company is done by the Ministry of Finance upon request by the Trade Registry.

Overall registration costs amount to approximately 600 lei, exclusive of notary public and translation fees.

When franchising in Romania, a franchisor must be the holder (namely, either owner or holder of rights) of the relevant intellectual or industrial property right, and must register it with the Romanian State Office for Inventions and Trademarks.

4 What restrictions apply to foreign business entities and foreign investment?

Foreign business entities and foreign investment are not subject to restrictions, with the exceptions of direct land ownership and certain public interest areas (for example, mining, air and railway transportation and energy).

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Romanian tax law does not discriminate between franchising and other business activities. Romanian franchisors, like any other business, are subject to income tax at a flat rate of 16 per cent applicable to both legal entities and natural persons, and VAT of 24 per cent.

A foreign entity can be subject to taxation when establishing a branch, a subsidiary or a representative office, or by becoming subject to withholding tax on its Romania-sourced income.

Unless a double tax treaty is in place, non-resident business entities are subject to 16 per cent withholding tax on revenues derived from Romania, such as:

- royalties, interest, dividends, and revenues from services performed in Romania, and revenues obtained from management and consultancy services, irrespective of where the services are performed;
- commissions; and
- revenues derived from liquidation of a Romanian legal entity.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

There are no labour and employment considerations relevant to the typical franchisor; therefore, the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor is practically nonexistent.

Franchise Law No. 79/1998 (the Franchise Law) explicitly stipulates that it is an obligation of the franchisor to ensure that the franchisee, by means of adequate publicity, represents itself as a financially independent entity.

7 How are trademarks and know-how protected?

The Romanian legal framework for the protection of trademarks is similar to that of other EU member states. Trademark protection is acquired by registration with the Romanian State Office for Inventions and Trademarks (OSIM) under the provisions of the Trademarks and Geographical Indications Law No. 84/1998 (the Trademarks Law). The Trademarks Law sets forth the requirements to register and have a trademark protected both locally and at European level. Following Romania's accession to the EU, virtually all community trademarks previously registered at the EU level are protected in Romania. Nonetheless, trademarks previously registered only at the Romanian national level are not protected across the EU countries unless separately registered. Trademarks under the Madrid System enjoy protection, provided the corresponding indication is in place.

Trademarks can be registered in Romania provided that:

- they are distinctive (namely, the trademark must be capable of identifying a product or a service in a manner that should allow consumers to recognise and acknowledge it as such);
- they are available (namely, the trademark does not infringe prior intellectual property rights);
- they are lawful (namely, the trademark does not comprise elements that are contrary to public order and morale, does not bear false or deceiving indications, or defamatory signs to the representative symbols of the state, to international organisations or things having the value of universal symbols); and
- in the case of logos, they can be graphically represented (namely, the symbol chosen to become a trademark must be fit for graphic representation by full lines, colour or design).

The registration of a trademark with OSIM grants its owner protection of the right to exclusive use for 10 years as of the date of the application (submission of complete documentation and fees). Registration is renewable indefinitely. The rights deriving from a registered individual trademark may be transferred in whole or in part.

Well known trademarks (namely, such trademarks that are widely recognised among consumers) enjoy protection prior to or even in the absence of registration.

Trademark licences are also subject to registration with OSIM.

Know-how is defined according to the Franchise Law as the set of formulae, technical details, documents, drawings and models, recipes, procedures, and other similar elements contributing to the manufacturing and marketing of a product. While some of the above elements may enjoy stand-alone protection under intellectual property laws or if registered with the Romanian Copyright Office or OSIM, know-how per se is protected under the Franchise Law, which stipulates the non-disclosure obligation of the franchisee during both contractual and post-contractual relations. Furthermore, know-how may also be protected on grounds of fair competition regulations: that is, it enjoys protection as a 'business secret'.

Another means of protection is provided by the Romanian State Office for Inventions and Trademarks, through a service entitled the 'Idea Envelope'. This service is a mechanism for the safe storage and protection of works and creative ideas that do not explicitly benefit from protection under the laws in force.

8 What are the relevant aspects of the real estate market and real estate law?

While there are no restrictions regarding real estate ownership in the case of domestic franchisors, whether foreign-owned or not, foreign individuals and entities may acquire land ownership depending on their place of residence, citizenship, and the nature of land to be purchased. The law differentiates among several classes of foreign nationals as follows:

- Romanian residents who are citizens or entrepreneurs of a member state of the EU may acquire land ownership in the same manner and under the same conditions as Romanian citizens;
- Romanian non-residents who are citizens or entrepreneurs of a member state of the EU may acquire land ownership as of five years since Romania's accession to the EU for residential land and seven years in the case of farmland or forest; and
- all other foreign citizens or entrepreneurs may acquire land ownership only when relevant bilateral international treaties between Romania and the foreign citizen's state are in place.

In respect of building structures, foreign citizens and entities may freely acquire ownership, whereas for the appurtenant land only the right of use is transferable.

Foreign investors may enjoy the benefits of using and developing land under different legal mechanisms such as leases, free-use agreements or concessions.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

A franchise is defined in article 1(a) of the Franchise Law as: 'a market system based on the continuous flow of cooperation between financially independent natural or legal persons, under which the party called the franchisor grants to the other party, called the beneficiary, the exploitation or development rights in a business enterprise, product, technology or service.'

10 Which laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises is regulated in the Franchise Law.

There is no government agency with specific authority over the offer and sale of franchises. Different aspects pertinent to franchise, such as competition (and especially distribution), are regulated by an autonomous administrative body, namely the Competition Council.

11 Describe the relevant requirements of these laws and agencies.

The Franchise Law regulates the pre-contractual, contractual and post-contractual relationship between franchisor and franchisee.

'Franchisor' is construed to mean any business entity:

- holding the rights in a trademark and exercising such rights for a period of at least the duration of the franchising agreement;
- granting the right to exploit or develop a business enterprise, product, technology or service to a beneficiary;
- providing the beneficiary with appropriate initial training to use the trademark; and
- employing its own staff and financial resources in trademark promotion, research and innovation, so as to ensure product development and viability.

To conclude a franchise agreement in Romania, the franchisor must have previously operated the relevant business for a reasonable time period, allowing for the acquisition of the know-how to be subsequently transferred under a franchise agreement.

In the pre-contractual phase, the franchisor is obliged to provide prospective franchisees with accurate information regarding the business so as to enable them to make an informed decision (see question 15).

The franchise agreement will necessarily comprise clauses indicating: the object of the agreement; the rights and obligations of the parties; the financial terms of contract; the duration of the agreement; and the terms of amendment, extension and termination.

The Franchise Law stipulates the minimum obligations of the franchisor, as shown in the franchisor definition above. The obligations of the beneficiary are to develop the franchise network in a manner consistent with the franchisor's concept; to provide the franchisor with all information relevant to their performance; and to refrain from disclosing the know-how, both during and after expiry of the franchise agreement.

Further, the franchise agreement will have to comply with the following principles:

- the duration of the agreement shall be so established as to allow the franchisee to redeem its franchise-related investment;
- if the agreement does not have an automatic termination upon expiry clause, the franchisor shall give sufficient notice to the beneficiary as to their intention of not renewing the agreement upon expiry;
- in any event, the termination clause shall clearly indicate such circumstances as may determine termination without prior notice;
- the agreement shall explicitly state the terms for assigning contractual rights, and especially for appointing a successor;
- the agreement shall stipulate a pre-emption right, should the franchise network development so require;
- the agreement shall incorporate a non-compete clause for the protection of know-how; and
- the beneficiary's financial obligations shall be explicitly determined, so as to foster achievement of common goals.

Another set of rules governs exclusive franchising, namely:

- the exclusivity fee shall be proportional with and added to the entry fee, if any;
- if no entry fee is applied, the franchise agreement shall indicate how the exclusivity fee is to be reimbursed in the case of termination;
- the exclusivity fee may be used to cover part of the franchise implementation costs or to delimitate the exclusive territory or the shared know-how;
- the exclusivity agreement will necessarily comprise a termination clause convenient for both the parties; and
- the duration of exclusivity shall be determined by the specific features of each franchise.

With regard to post-contractual relations between franchisor and franchisee, fair competition rules are applicable.

Romanian Competition Law No. 21/1996 transposes the European competition rules for the segment relevant to franchising.

12 What are the exemptions and exclusions from any franchise laws and regulations?

The Romanian legal provisions on franchise include neither exemptions nor exclusions.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

The Franchise Law requires that a franchisor has to have operated the relevant business and to have held and exercised rights in the relevant trademark for a period of time no shorter than the duration for which the franchise agreement is to be concluded (see question 11).

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In the case of a sub-franchising structure, the information to be disclosed should be such as to enable the sub-franchisee to make an informed decision about the business. The exact content of such information and the party that will disclose it (the franchisor or the sub-franchisor) is for the parties to decide.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The Franchise Law makes no reference to the disclosure procedure, to the form that the disclosure document should take, or to the frequency of updating.

The disclosure document, whatever the form, must be submitted before the franchisee undertakes any legal obligations with respect to the proposed business, the purpose thereof being that of enabling the franchisee to make an informed decision regarding whether or not to enter into the franchise relationship, as well as to calculate the prospected result and develop their financial plan.

It is common practice for disclosure to be updated upon renewal of contract.

16 What information must the disclosure document contain?

The Franchise Law stipulates that disclosure must include, as a minimum requirement:

- a description of the franchisor's experience in the proposed business;
- information on the financial conditions of the franchise agreement (ie the entry fee and royalties to the franchise network);
- the extent of the exclusivity, if any;
- information on the duration, renewal conditions and termination; and
- assignment of the franchise agreement.

In practice, additional information is usually provided to the extent that such other information is of interest to the franchisee in making its business decision; such disclosure items are commonly the ones included in the US Uniform Franchise Offering Circular.

17 Is there any obligation for continuing disclosure?

The Franchise Law does not expressly provide for continuing disclosure, but in practice, disclosure is updated upon the renewal of contract (see question 15).

Continuous disclosure may be contractually rendered compulsory by the parties to a franchise agreement. Independently, disclosure of certain events affecting or potentially affecting the contractual balance or the franchise network may be required by virtue of good faith and fair dealing.

18 How do the relevant government agencies enforce the disclosure requirements?

The Franchise Law mentions no sanctions for failure to provide relevant information of this nature; nonetheless, and in the absence of relevant government agencies, such requirements may be enforced by the courts.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

There are no special actions related to relief for violations of disclosure requirements. The franchisee may bring a suit against the franchisor for damages caused by non-disclosure or incomplete or inaccurate disclosure, in violation of both the Franchise Law and the general contractual law principle of good faith.

Damages are calculated according to the mechanism agreed in the franchise contract and, in the absence of a mechanism, on the basis of the damage incurred to the franchisee as proven in court.

In theory, criminal liability for misrepresentation is also possible.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Either the franchisor or the sub-franchisor may be jointly or severally liable for disclosure violations, according to the relevant contractual clause regarding disclosure.

Directors and employees may also be exposed to liability for disclosure violations under both the provisions of their labour contract and obligations resulting from the Franchise Law.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Aside from the specific requirements of the Franchise Law (see question 11) and the Competition Council, no other regulations and government agencies affect the offer and sale of franchises.

Nevertheless, franchising is subject to the general principles of contract and commercial law, as well as to those of consumer protection and competition law.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

Pre-sale disclosure is an explicitly regulated obligation on the part of a seller in the fields of franchising (see questions 11, 15 and 16), insurance and consumer protection. In addition to such targeted regulation of pre-sale disclosure obligations, virtually any sale or purchase transaction is built on pre-sale representations of the seller with regards the asset sold to the buyer (for example, mileage of a car, materials used in a building or, closer to the case in point, pending litigation, intellectual property, due taxes, etc of a company that is transferred). Since the rationale of such pre-sale disclosure, irrespective of subject matter, is to ensure that the parties make an informed decision when entering the contractual relationship, the principles governing the way disclosure is made are those of good faith, fair dealing, and exhaustive and accurate representations.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

For fraudulent or deceptive practices in the offer and sale of franchises, the franchisee may seek damages in court and reinforcement of the franchisor's obligations under the law or contract.

Both this sort of protection and the protection provided under the law sanctioning franchise sales disclosures are governed by the same legal and contractual guarantees.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The Franchise Law regulates the ongoing relationship between franchisor and franchisee once the franchise contract is effected (see question 11).

25 Do other laws affect the franchise relationship?

As well as the Franchise Law, the franchise relationship is subject to the general provisions of contract law, commercial law, consumer protection law, competition, and intellectual property law.

26 Do other government or trade association policies affect the franchise relationship?

The franchise relationship may to a certain extent be affected by the Romanian Franchise Association Code of Ethics. However, membership of the Association is voluntary and, as a non-governmental entity, the Association itself is devoid of statutory powers other than those in respect of its members.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchisor may terminate the franchise contract either upon expiry or for cause, if the franchisee fails to observe its obligations (for example, reaching a certain turnover threshold, violating disclosure terms or prejudicing the good name of the franchisor).

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchisee may terminate the franchise contract either upon expiry or for cause, if the franchisor fails to observe its obligations (for example, failing to provide specialised personnel for the implementation of know-how, failing to provide for a certain advertising volume for the franchised business, failure to renew trademark licence and failure to observe disclosure rules).

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The renewal of a franchise agreement is exclusively a matter of contractual freedom; hence, a franchisor may or may not renew the franchise agreement, in accordance to what has been agreed between the parties in this respect (please refer also to question 11).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Restricting the franchisee's ability to transfer its franchise or restricting transfers of ownership interests in a franchisee entity are exclusively matters of contractual freedom; hence, the parties may secede either way (please refer also to question 11).

31 Are there laws or regulations affecting the nature, amount or payment of fees?

None of the amounts paid by a franchisee to a franchisor are specifically regulated, being subject to the parties' agreement, with the sole reservation that such amounts shall be set so as to foster the achievement of common goals (please refer also to question 11).

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Romanian law does not restrict or set thresholds as to the amount of interest on overdue payments. Excessive interest (for instance, more than 20 per cent) may be reduced by the court, but case law decisions on this matter are not unanimous.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no such restrictions on foreign currency payments.

34 Are confidentiality covenants in franchise agreements enforceable?

While confidentiality covenants are enforceable, difficulty may arise in assessing and substantiating particular damages; therefore, clearly phrased contractual provisions as to penalties and compensation are advisable.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Franchising and franchise relationships are subject to the general legal obligation of dealing in good faith. The principle of good faith governs the parties' dealings throughout their relationship.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No Romanian laws treat franchisees as consumers for the purposes of consumer protection or other legislation.

'Traders' and 'consumers' are clearly distinguished under consumer protection law: the consumer is defined as a natural or legal person, or group of persons forming an association, that acts for purposes outside what could be deemed business activity.

The Franchise Law defines the franchisee as a 'trader', be it either a natural or a legal person, who is selected by the franchisor to develop the franchise network in accordance with the latter's concept.

37 Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements may be concluded in any language.

38 What restrictions are there on provisions in franchise contracts?

With the exception of competition law restrictions (see question 39) and certain compulsory guidelines regarding duration, exclusivity and termination of the franchise contract stipulated in the Franchise Law (see question 11), most of the provisions in a franchise agreement can be freely determined by the parties.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Romanian Competition Law No. 21/1996 (the Competition Law) prohibits anti-competitive agreements and practices and the abuse of a market dominant position. In this respect, the Competition Law represents the transposition of articles 101 and 102 of the Treaty on the Functioning of the European Union.

Provisions regarding vertical agreements are particularly relevant to the typical franchisor. EC Regulation 2790/1999 of 22 December 1999 on the application of exemptions to vertical agreements has been transposed into Romanian legislation by means of regulation of the application of articles 5 and 6 of the Competition Law, as approved under Order No. 87/16.04.2004 and the Guidelines for the application of article 5 of the Competition Law in the case of vertical agreements, as approved under Order No. 77/14.04.2004.

To the extent that vertical restraints resulting from franchise contracts benefit competition, especially inter-brand competition, exemptions apply on the condition that such contracts fulfil certain requirements and do not contain hard-core restrictions to trade. The conditions under which a franchise agreement is not deemed to be anti-competitive refer, inter alia, to:

- not directly or indirectly fixing purchase or sale prices;
- not limiting or controlling production, markets, technical development or investment;
- not allocating distribution markets or supply sources by territorial criteria, purchase value or other criteria;
- not imposing unequal terms for equivalent services to trading partners;

- not conditioning the conclusion of agreements on link clauses;
- not eliminating competitors from the market; and
- not limiting or preventing access to the market.

The negative effects on the market that may result from vertical restraints in a franchise contract, which both Romanian and EC competition law aims to prevent, are mainly:

- foreclosure of other suppliers or other buyers by raising barriers to entry;
- reduction of inter-brand competition between the companies operating on a market;
- reduction of inter-brand competition between distributors; and
- limitations on the freedom of consumers to purchase goods or services in a member state.

In respect of effect assessment, the Guidelines for the application of article 5 of the Competition Law in the case of vertical agreements and a considerable share of the Romanian Competition Council's practice indicate that franchisors with a market share of below 30 per cent do not need to notify the Competition Council to obtain an individual exemption.

Competition law aspects are enforced by the Competition Council – which imposes sanctions ranging from fixed fines to fines calculated as percentage of annual turnover, or even suspension of business – and the courts of law.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Romanian court system is a four-tier system comprising courts of first instance, intermediate appellate level courts, the High Court of Cassation and Justice, and the Constitutional Court. As of joining the EU, Romanian natural persons and entities have gained access to two additional courts of law, namely the Court of Justice of the European Communities and the Court of First Instance.

Romanian law allows for arbitration as an alternative to litigation in front of a court. A dispute may be referred for arbitration if so agreed by the contracting parties at dispute. Only disputes that can be financially assessed may be referred for arbitration.

Romania has ratified the main arbitration conventions of Geneva and New York. In terms of commercial disputes, the International Court of Arbitration functions in Romania as a permanent independent arbitration body attached to the Chamber of Commerce and Industry of Romania and Bucharest.

Franchisors, however, usually refer any disputes to the International Court of Arbitration of the European Chamber of Commerce, Industry and Franchise in Romania, due to the shorter duration of the proceedings.

Update and trends

The Romanian Franchise Law has seen no amendment in the past 12 years, while related case law has been quite uniform. While this is the sort of climate that hardly allows for hot topics, it is, nonetheless, a much appreciated stable foundation by international franchises seeking to expand to Romania.

However, October 2011 will witness the coming into force of the new Romanian Civil Code, alongside which the Commercial Code will be repealed – a major change, which will mean a considerable number of new institutions, both civil and commercial, find themselves bound under the same new Civil Code that will have a particular relevance to contractual mechanics, and thus indirectly to franchising as well.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration is generally considered by the dedicated doctrine to be more advantageous than state jurisdiction in terms of flexibility, confidentiality, time efficiency and, sometimes, cost.

Flexibility is of the essence in arbitration. The parties have the possibility of choosing the arbitrators from reputable professionals in the field circumscribing the dispute, while insufficient qualification in such field can be solid ground for an arbitrator to be recused.

The parties can also choose the structure of the panel: ie number of arbitrators, venue, and language of proceedings.

Confidentiality may be a considerable advantage for the foreign franchisor: the arbitration procedures can be closed, thus safeguarding commercial secrets by avoiding judicial publicity. Moreover, arbitrators are accountable under the law for breaching confidentiality.

Although this is not always the case, arbitration may prove to be less time-consuming than court adjudication, and the arbitration decision is final and binding for the parties.

Cost efficiency is generally deemed to be an advantage of arbitration, but it is a highly relative matter, since it always depends on the value and nature of the dispute.

For instance, witnesses and experts testify without taking an oath, and preliminary injunctions and interlocutory measures ordered by the arbitration court can only be enforced after obtaining a relevant decision from a court of law.

As the arbitration decision is mandatory and binding, the parties waive the right to have the dispute decided in the law court. Additionally, since arbitration awards are only subject to annulment on account of procedural matters, an erroneous decision cannot be easily overturned.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

There is no discriminatory treatment as to foreign franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The most common forms of business entities used by franchisors in Russia are the limited liability company (LLC) and the joint-stock company (JSC). Shares in a JSC can be publicly held and sold to a third party without offering them to other shareholders – the 'open JSC' – or held only by a limited number of shareholders (up to 50) and sold to other third parties in case other shareholders have not executed their pre-emptive right only – the 'closed JSC'. Although these entities play a major role in practice, the Civil Code of the Russian Federation (CCRF) also provides several different company structures, such as general or limited partnerships, which may also, under certain circumstances, be an appropriate legal form for conducting a franchise business.

Over the past few years, foreign franchisors have recognised wholly owned Russian subsidiaries as a relatively easy way of expanding their business into the Russian market. Among the two leading legal forms of Russian entities, the LLC appears to be more popular owing to the fact that it is easier to establish and the operation of an LLC is less time-consuming. Nevertheless, under some circumstances, a JSC might be the more appropriate choice for an investor, for example in certain joint-venture structures.

2 What laws and agencies govern the formation of business entities?

The CCRF is the basic law concerning legal forms in Russia. Additionally, LLCs and JSCs are governed by special laws; for example, the Federal Law on Limited Liability Companies No. 14-FZ of 8 February 1998 (the LLC Law) and the Federal Law on Joint-stock Companies No. 208-FZ of 26 December 1995 (the JSC Law). Transactions involving shares are additionally governed by the Law on the Securities Market.

According to the Federal Law on State Registration of Legal Entities that came into force in 2002, the local bodies of the Federal Tax Service of the Russian Federation (the registration authority) are responsible for the state registration of legal entities in Russia and make respective entries into the Unified State Register of Legal Entities. JSCs must in addition register their share issues with the Federal Service of Financial Markets.

3 Provide an overview of the requirements for forming and maintaining a business entity.

An LLC or JSC may be founded by one or more persons or legal entities. However, a sole shareholder that is a legal entity of either a Russian LLC or JSC may not in turn be owned by a sole shareholder that is also a business legal entity. The initial minimum share capital of an LLC and a closed JSC is currently 10,000 roubles. The initial minimum share capital of an open JSC is 100,000 roubles.

The number of shareholders in an LLC and in a closed JSC may not exceed 50. Once that number is exceeded, the JSC has to be transformed into an open JSC and the LLC has to be transformed into an open JSC or a production cooperative within one year.

As far as the registration of a company is concerned, for LLCs the following documents have to be collected, drafted and filed as one package with the registration authority:

- an application form signed by a director of the founding entity or entities before a notary;
- the resolution of the founders' meeting;
- the company charter;
- confirmation of the legal status of the founders: for example, trade register excerpt, certificate of incorporation regarding legal entities;
- confirmation of payment of the state registration fee (approximately US$80); and
- a guarantee letter regarding the future lease from the owner of the premises to be used as a corporate seat by the new LLC.

Documents from a founding foreign legal entity must be notarised and additionally certified (usually to be approved by an apostille) in the country of execution.

After registration with the federal tax service, which takes five working days from the filing of the required documentation package, the newly established legal entity has to be registered additionally with the mandatory social funds and the state statistics committee. An official company seal (stamp) must be obtained and a permanent bank account in Russia must be opened before starting business operations.

The whole registration procedure of an LLC takes about three to five weeks and costs approximately US$100 in state fees. The professional fee for the entire process of preparing and presenting the documents to the registration authorities will typically add between US$3,000 and US$10,000. Establishment of a JSC is more time-consuming owing to the necessity of additionally registering the share issues with the Federal Service for Financial Markets. Taking into account the rather bureaucratic registration procedure and often-changing details of legislation and filing rules, it is advisable for a foreign investor to use the services of experienced professionals to successfully and rapidly get through the registration procedure.

4 What restrictions apply to foreign business entities and foreign investment?

Foreign investments are mostly regulated by the Federal Law on Foreign Investments (1999) and the Federal Law on Strategic Enterprises (2008) in the Russian Federation. The Federal Law on Foreign Investments guarantees foreign investors the right to invest and to receive revenues from investments in Russia. To attract foreign capital, technology and other assets, the Law on Foreign Investments

states that foreign investors and investments must not be treated less favourably than domestic ones. Nevertheless, there are some exceptions, for example, concerning protection of the Russian constitutional system, state security and state defence, as well as sensitive industries, ownership of agricultural land and participation in so-called strategic enterprises. The Federal Law on Strategic Enterprises provides for definition and detailed investment regulations regarding strategic enterprises, but such provisions, usually, do not affect the franchising business.

Russian currency control regulations have been significantly simplified in recent years and can now be regarded as additional paperwork rather than as a real obstacle to transferring money. Foreign investments can usually be repaid without any problems. Nevertheless, it must be taken into account that Russian commercial banks are still in charge of currency control when conducting money transfers on behalf of their clients, and much paperwork must be done before a transfer from the currency control perspective.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Tax legislation in Russia does not distinguish between franchising and other forms of business. When a Russian legal entity is established to run franchising activities, the franchising fee is subject to Russian VAT (18 per cent of the turnover) and corporate income tax (20 per cent of the difference between income and business expenses). Russian franchising companies are also subject to other taxes, which all businesses in Russia have in common, such as withholding obligations regarding personal income taxes and social fund contributions imposed on personnel salaries, property and land taxes, etc.

If a franchising business is organised in Russia through the permanent establishment of a foreign entity, taxation of the foreign entity is similar to that of a Russian legal entity (so the permanent establishment must charge 18 per cent VAT on its franchising fee, pay corporate income tax, etc). The important question, however, is whether a permanent establishment can deduct from its taxable income business expenses incurred not only in Russia, but also abroad. This issue should be analysed in each particular case.

If a franchising business is organised in the form of a cross-border franchise contract between a foreign franchisor and a Russian franchisee (when the franchisor has no presence in Russia), the major taxation rules are applicable.

Under Russian tax law, services rendered within a franchising agreement are in general recognised as rendered in Russia if the franchisee is a Russian company. Thus, when paying a franchising fee to a franchisor having no permanent establishment in Russia, a Russian franchisee must withhold Russian VAT at the rate of 18 per cent. This VAT withholding obligation cannot be avoided in a cross-border franchising structure. The Russian franchisee can subsequently recover this VAT (it is deductible against sales VAT).

Franchising fees under a cross-border franchising agreement can be subject to Russian income tax withholding (20 per cent tax rate). All the same, a foreign franchisor can benefit from any double tax treaty made between Russia and the country where the franchisor is recognised as a tax resident. Currently, Russia has a wide network of such treaties and, as a rule, such treaties establish tax exemptions in Russia as regards royalties and other incomes typical for franchising relations. According to Russian tax legislation, the exemptions provided by double tax treaties may be applied only in cases where the foreign company that receives the income provides confirmation that it has a permanent legal land tax residency in the respective state.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

The Labour Code of the Russian Federation is the core legislation concerning employment issues. Foreign franchisors have to be aware that the Russian Labour Code provides all employees with minimum guarantees that cannot be superseded by any other agreement, since the Russian Labour Code is mandatorily applicable to all employees in the territory of the Russian Federation. Any employment contract has to be in writing and is generally entered into for an indefinite period of time. However, a probationary period of up to three months can be established for newly hired employees (up to six months for employees having the position of general director or chief accountant).

Russian law significantly limits cases where the conclusion of labour contracts with a certain term is allowed. In most cases, labour contracts must be concluded for an unlimited (unspecified) period of time and Russian employees may terminate such labour contracts at any time upon giving two weeks' notice. The grounds for an employer to fire an employee are very limited.

Employees in Russia have a labour book containing certain information on their employment history, necessary for obtaining state-provided pensions and other social benefits. Employers are responsible for making all recordings in a timely fashion to avoid employees' indemnification claims.

The employer is specified in the labour agreement and the labour book. According to Russian legislation, the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor is usually ruled out.

In order to employ a non-Russian citizen, the employer usually needs a framework permit for the employment of a specified number and type of foreign professional, and each foreign employee needs to obtain a personal working permit. The framework permit for the employer is often limited by a received quota that must be filed before May of the previous year: thus, obtaining working permits is a very bureaucratic procedure that must be prepared in advance. However, from July 2010 Russian legislation simplified the working permit procedure for 'high-qualified' employees whose annual income is at least 2 million roubles. The procedure for employing citizens of CIS countries is also simplified.

7 How are trademarks and know-how protected?

As of 1 January 2008, most regulations on the protection of trademarks and know-how (namely, trade secrets) are set forth in Part 4 of the CCRF. Russia is also a signatory to major international treaties on intellectual property rights, including the Paris Convention for the Protection of Industrial Property, the Patent Cooperation Treaty, the Madrid Agreement on the International Registration of Trademarks and the Protocol to the Madrid Agreement. Trademark registration with the Federal Services for Intellectual Property, Patents and Trademarks (Rospatent) is deemed a condition for protection of a trademark.

Know-how does not require registration and protection exists from the moment of its creation. Know-how is protected as long as it is kept secret, but therein lies its major disadvantage: if the secret information is disclosed to a third party, whether inadvertently or maliciously, all protection is lost. Thus, protection depends on the reliability of the parties who sign the confidentiality agreements and are given access to the information related to know-how.

The CCRF sets forth a wide range of protection measures for trademark and know-how infringement: indemnification for losses, contractual damages and penalties, deregistration (nullification) with Rospatent and court decisions on the prohibition of certain actions, etc. Exclusive rights to trademarks and know-how can, under certain circumstances, be protected through the provisions of the antimonopoly law.

8 What are the relevant aspects of the real estate market and real estate law?

The CCRF, the Land Code of the Russian Federation of 2001 and other legislation regulate transactions regarding land and other real estate. Land and buildings are treated in Russia as separate property. Acquiring ownership or a lease of real estate in Russia is a complex process because of the registration requirements, especially when the real estate is state-owned (non-privatised). Ownership, a long-term lease (more than one year), mortgages and some other titles to real estate and transactions are subject to state registration with the Unified State Register of Rights to Real Estate and Transactions (Real Estate Register).

Generally, land ownership by foreigners is allowed under Russian Law. Exceptions regarding foreigners and companies, in which foreign ownership constitutes 50 per cent or more, apply to special territories like border areas and agricultural land. In addition, a number of general prohibitions on privatisation of land (applying to both foreign and local entities) are stipulated in the Russian Law on Privatisation, as well as in the Land Code. In most cases where privatisation is not allowed, state-owned land may be leased under a long-term lease agreement that can provide enough legal security to the investor. Non-privatised land and buildings can be leased for a maximum term of 49 years; in practice most leases of commercial real estate properties do not exceed 10 years.

Private parties may negotiate the terms of leases themselves. For the sale and lease of non-privatised land and buildings, basic commercial conditions are set forth by either federal or local laws. For example, the rent for a lease of land from a local authority is usually calculated according to a specific formula endemic to the region. It is worth noting that an owner of a building located on non-privatised land is generally entitled either to lease or to acquire the land the building occupies. The purchase price for such an acquisition is regulated by federal law and can be specified by the local law.

Verification of a title to real property is based on the Real Estate Register, the information in which is publicly available in the form of extracts regarding certain real estate property and is provided to any person upon application to the Federal Registration Service. That said, Russian law provides only limited good faith protection to the acquirer, and verification of additional documents confirming the title is highly advisable.

Investors should seek experienced advice from professionals to avoid problems when acquiring and leasing real property.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Franchise agreements are expressly regulated by the CCRF and are called 'commercial concessions', while the franchisor is called the 'rightholder' and the franchisee is called the 'user'. According to article 1,027 of the CCRF, the franchisor must grant the franchisee, against remuneration and for a defined or undefined period of time, the right to use trademarks or service marks and (optional) rights to use other intellectual property rights; in particular, the right to use know-how.

For a trademark to be licensed to a franchisee it must already be registered with Rospatent or WIPO, with Russia designated as the registrant country before execution of the franchise agreement. The franchise must be used by the franchisee for its entrepreneurial activities.

It should be noted that as of 1 January 2008, the right to the company name is no longer a mandatory aspect of franchise agreements. Since that date a franchise agreement must provide the franchisee with a set of exclusive rights, including the right to conduct business using the franchisor's trademark The latter makes franchise agreements even more similar to licence agreements for trademarks that are regulated separately by Russian law and are often used as a contractual form for franchising instead of the real franchising agreements (namely, 'commercial concession' agreements).

According to the wording of the CCRF, the main difference between a franchising agreement and a licence agreement is that the franchising agreement establishes the granting of a number of exclusive intellectual property rights while a licence agreement establishes the granting of one intellectual property right, and in addition to exclusive rights, the franchisee can use the goodwill and commercial experience of the franchisor within the framework established by the franchise agreement.

10 Which laws and government agencies regulate the offer and sale of franchises?

Russia has one of the few legal systems in the world where statutory provisions regulate the entire franchise relationship. The governing provisions are those laid down in chapter 54 (articles 1,027 to 1,040) of the CCRF and general provisions of chapter 69 on licence agreements (articles 1,235 to 1,238).

Before 1 January 2008 franchising agreements were subject to double state registration – one with the Russian tax authority and another one with Rospatent. On 1 January 2008 the requirement of registration with the tax authorities was eliminated.

Under Rospatent regulations, the registration authority has to register a franchise agreement within two months if the parties have provided all relevant information and documents. In practice, registration takes much longer. The state registration fee is the same as for licence agreements on trademarks (service marks) and depends on the number of trademarks to which exclusive rights are to be granted: approximately US$250 per trademark.

11 Describe the relevant requirements of these laws and agencies.

A franchise agreement may only be concluded between business organisations or individuals acting as registered individual entrepreneurs. The agreement has to be concluded in writing and registered with Rospatent. A contract that is not registered with Rospatent is deemed invalid.

The registration requirement applies not only to conclusion of an agreement, but also to amendments and its termination.

Another significant requirement is that the franchisor must provide the franchisee with the technical and business documents (booklets, manuals on operating standards in which the know-how relating to the franchise system and the methods according to which their business is operated are summarised) and other information that may be necessary for the franchisee and its employees on issues related to the exercise of the rights granted under the franchise agreement. Unlike other jurisdictions, however, the extensive regulations on franchise agreements in chapters 54 and 69 of the CCRF do not include provisions on the franchisor's obligation to provide information prior to concluding the agreement. Whether or not this obligation arises from the general rules of the CCRF is subject to judicial clarification.

As a first step, Rospatent verifies whether the submitted set of documents is complete. As the second step Rospatent verifies whether the provisions of the franchise agreement are in line with mandatory requirements of Russian law and with each other.

Rospatent is basically not entitled to establish new regulations for the content of franchising agreements. Most of this agency's requirements relate to the form and detail of documents subject to filing and technical matters of registration.

12 What are the exemptions and exclusions from any franchise laws and regulations?

The CCRF franchising regulations apply to all legal entities and individual entrepreneurs and do not contain any exemptions or exclusions for any particular reason. Nevertheless, cross-border contracts may include a choice of law clause that may declare a different legal system applicable. Nevertheless, 'super-mandatory' (public policy) provisions of Russian law are applicable even when a foreign governing law is chosen. Given the lack of judicial decisions, it is not possible to list all the provisions that may be categorised as 'super-mandatory' by Russian courts. Russian registration requirements must be applicable as such super-mandatory provisions, in any case.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There are no such requirements. The only requirement is that a franchisor and a franchisee must be business organisations or individuals acting as a registered individual entrepreneur.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

As mentioned above, the CCRF does not include specific provisions on a franchisor's duties to provide information prior to concluding an agreement. Nevertheless, the franchisor has to provide the franchisee with all information required to exercise the rights granted once the contract is concluded. The sub-franchisor must make the respective disclosures to sub-franchisees.

In general, the terms of the agreement between a franchisor and a sub-franchisor do not have to be disclosed to the sub-franchisee. This excludes any information that is essential to the sub-franchisee, such as intellectual property rights and rights to grant sub-franchising that a (sub-) franchisee would usually require as confirmation of the (sub-) franchisor's authority to enter into the agreement.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

As mentioned above, pre-contractual disclosure is not explicitly specified in the CCRF. Because of legal uncertainty, potential franchisors should provide general information on the franchising scheme and other minimum requirements through pre-contractual disclosure. In the absence of an explicit provision on disclosure updates, it is advisable to update the information provided on a regular basis, because it is the franchisor's duty to provide the 'required' documents.

16 What information must the disclosure document contain?

The legislation adopted in Russia does not regulate disclosure in any detail. Nevertheless, article 1,031 of the CCRF provides that the franchisor must furnish its franchisees with technical and commercial documentation (booklets, manuals on operating standards in which the know-how relating to the franchise system and the methods according to which their business is operated are summarised) and other information that may be necessary for the franchisee and its employees on issues related to the exercise of the rights granted under the franchise agreement. Note that such disclosure is generally not pre-contractual, as presented above.

17 Is there any obligation for continuing disclosure?

Russian franchise law requires the franchisor to render continuous technical and consulting 'assistance' to the franchisee, including assistance in the ongoing training for its employees, unless the franchise agreement provides otherwise. Thus, unless excluded by the franchise agreement, the franchisor has an obligation to disclose information as part of this continuous assistance. There is no other continuing disclosure obligation on the part of a franchisor.

18 How do the relevant government agencies enforce the disclosure requirements?

See questions 10, 11, 15, 16 and 17.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

As mentioned above, the CCRF does not include specific provisions on franchisors' duties to provide information prior to concluding an agreement. In cases where the franchisor commits a substantial violation of disclosure requirements provided in the contract or resulting from the regulations on general contracts in the CCRF, or both, the franchisee may claim termination of the franchise agreement before a court (rescission by judicial decision). In the event of losses suffered by the franchisee through the franchisor's respective actions, the franchisee is entitled to claim damages. The damages under Russian law include actual losses and lost profits. The contractual damages can be limited to a certain amount, except in the case of intentional damages.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Liability for disclosure violations is not shared between the franchisor and sub-franchisor unless otherwise agreed by the parties in writing. Each party must file damage and other claims within its contractual relationship. Individual officers, directors and employees are usually not exposed to liability. Nevertheless, according to article 1,034 of the CCRF, the franchisor bears secondary responsibility in the case of third-party claims against a franchisee concerning the quality of the goods (or work or services) being sold (or fulfilled or rendered) by the franchisee in accordance with the franchise contract. For goods produced by the franchisee, the franchisor may bear joint and several liability with the franchisee.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The offer and sale of franchises is generally affected by the principles of contract law that are part of the CCRF. Under some circumstances, and depending on the transaction structure, the offering and selling of franchises can be subject to the Federal Law on Advertisement and Russian anti-monopoly regulations (Federal Law on Competition Protection and other legal acts), and the specific consent of the Russian Federal Antimonopoly Service may be additionally required. Depending on the subject matter of the franchise, franchised activities can also be subject to regulations on the certification of certain goods and services, licensing and similar requirements.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

As mentioned above, the CCRF does not include specific provisions on a franchisor's duties to provide information prior to concluding a franchise agreement.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

According to the general provisions of Russian legislation, the franchisee is entitled to demand termination of the franchise contract in court and to claim damages if the actions of the franchisor do not conform to the legislation of the Russian Federation. In rare cases, for example for fraudulent practices, it may be advisable to initiate criminal proceedings against the franchisor.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Except for the CCRF, such legislative regulation does not exist in the Russian Federation.

25 Do other laws affect the franchise relationship?

In addition to the CCRF, franchising is affected, inter alia, by laws on competition, intellectual property law, consumer protection laws and tax law. Real estate regulations can also be an issue.

26 Do other government or trade association policies affect the franchise relationship?

The Russian Franchise Association (RFA) has endorsed a mandatory code of conduct for its members; this may affect the franchise relationship and the way that members of the RFA may behave in a franchise relationship. Membership of the RFA is voluntary and the RFA has no statutory authority or power. There are no criteria for becoming a member of the RFA; it is relatively easy to become a member upon paying a rather small membership fee. More information about the RFA can be found on its website (www.rarf.ru).

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

If an agreement has been concluded for an indefinite period, each of the contracting parties is entitled to terminate the contact by giving six months' notice to the other party. According to the wording of the provision of the relevant law, the period of notice may not be shortened, but can be extended. Notice of ordinary termination is, unless otherwise agreed in the contract, excluded where a fixed-term agreement is concerned. Pursuant to the amendments of the CCRF entering into force in October 2011, the parties to franchise agreements, irrespective of whether being concluded for a fixed term or for an indefinite period of time, may agree that either party may withdraw from the agreement prior to its expiration upon 30 days' notice by paying a specified fixed sum.

Furthermore, pursuant to the amended CCRF, from October 2011 the franchisor is entitled to unilaterally withdraw from the franchise agreement in full or in part, if the franchisee breaches quality requirements for manufactured goods, rendered services or performed works, deviates from instructions with respect to using intellectual property or fails to pay the remuneration to the franchisor in time. For the first instance of such a breach, the franchisee must be given reasonable notice and opportunity to cure the breach. If the same breach occurs within a year after such notice, the franchisee may withdraw from the franchise agreement.

In addition, there is a right of termination on extraordinary grounds (significant contractual violations) by judicial decision.

Franchise agreements are terminated by law in the event of insolvency of one of the contracting parties. Since 1 January 2008, if the right of the franchisor to a trademark, service mark or trade designation is terminated, and provided that this right is part of the complex of exclusive rights granted to the franchisee under the franchise agreement and this terminated right is not replaced by an equivalent right, the franchise agreement can be terminated by the franchisee as well.

28 In what circumstances may a franchisee terminate a franchise relationship?

See question 27.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Generally, the franchisee is entitled to demand the renewal of the franchise agreement. The sole prerequisite is that the franchisee has duly fulfilled its obligations under the previous franchise agreement. Nevertheless, pursuant to the amended CCRF, from October 2011 the franchisor is not obliged to renew the franchise agreement on the previous terms and may propose the renewal terms in accordance with current market situation. If the parties fail to reach an accord on the terms of the renewed agreement, the franchisor is, for one year, restricted from granting to a third party the same franchise rights on the same conditions as those stipulated in the previous franchise agreement. Should the franchisor grant such rights to a third party, the former franchisee may demand that such rights be transferred to him or claim for the losses incurred as a result of the franchisor's refusal to renew the previous franchise agreement, or both.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

The franchisee's right to transfer the franchise may be granted or excluded in the franchise contract. A franchisor may not restrict transfers of ownership of a franchisee's entity unless the franchisee has sold or pledged to the franchisor a certain share in its entity. The franchise contract may provide the right to terminate the contract in that case or in other cases of change of control. Nevertheless, this ground for termination has not been significantly tested in Russian courts.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

The conclusion of a franchise agreement must contain an agreement on remuneration according to article 1,027 of the CCRF. Details of the remuneration are to be specifically agreed on by the contracting parties.

Article 1,030 of the CCRF provides the following examples: fixed non-recurrent or regular fees, deductions from proceeds, or a mark-up on the wholesale prices where goods are supplied by the franchisor. These forms of remuneration may be combined with each other, or parties may stipulate other forms of remuneration. In cross-border franchising agreements, the Russian franchisee may be obliged to withhold Russian taxes on behalf of the foreign franchisor, in particular VAT or withholding tax, or both (see question 5).

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The legislation does not specifically set a cap on the amount of interest. Nevertheless, in accordance with article 333 of the CCRF, the contractual penalties can be reduced by a court if it finds that they are not appropriate and do not correspond to the violation. Russian state courts tend to interpret excessive interest rates on overdue payments as contractual penalties and recognise them up to a certain limit (usually a bit higher than the current refinancing rate of the Russian Central Bank or the level of inflation, or both).

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

Where cross-border franchising is concerned, payments may be made in a foreign currency, including the franchisor's domestic currency.

If the franchisor and the franchisee are Russian legal entities or entrepreneurs, payments may be made only in roubles. Nevertheless, a local franchise agreement may provide for the setting of fees in a foreign currency and their payment in roubles at a certain exchange rate.

34 Are confidentiality covenants in franchise agreements enforceable?

The CCRF already stipulates that the franchisee must not disclose confidential information provided by the franchisor. Confidentiality covenants in franchise agreements are enforceable if they are drafted in sufficiently clear language and the confidential information is treated by the providing party in line with specific Russian legal requirements regarding know-how (trade secrets).

According to the CCRF, know-how includes knowledge of any kind (eg relating to the product, technical, business-related, or operational processes), as well as the results of intellectual processes in scientific or technical areas and expertise in the processes of business activities, if they have a real or potential economic value due to the lack of their knowledge by third parties; if third parties have no legal access to them; and if they are classified as trade secrets by the entitled person.

A set of information is considered a trade secret after the franchisor has:

- created a list with information representing the trade secret;
- limited access to that information by erecting rules of procedure to regulate the use of the information and ways to control it;
- registered all persons with access to the information and persons who will be provided with access in the future;
- regulated the handling of information by entering into agreements with employees and business partners; and
- documented the trade secret information and applied an annotation 'trade secret', including the name and address of the entitled rightholder.

Since it is often difficult to prove specific damage related to disclosure, it is advisable to stipulate contractual penalties for breach of confidentiality obligations.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Good faith is a general legal principle in Russian law. Nevertheless, there is presently no case law at the highest court level concerning franchising based on this principle.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

There is no such law.

37 Must disclosure documents and franchise agreements be in the language of your country?

In practice, yes, because registration of a franchise agreement with the Rospatent requires a Russian version or a certified translation. With regard to disclosure documents, it is not obligatory but a Russian version (or at least a reliable translation) is advisable to avoid unnecessary disputes with franchisees who are not fluent in foreign languages and authorities that are controlling business operations.

38 What restrictions are there on provisions in franchise contracts?

The CCRF prohibits embedding provisions into a franchise agreement by virtue of which the franchisee is obliged to sell goods or render services, or both, exclusively to customers that come from the territory defined in the franchise agreement. There are other restrictions imposed on the parties to a franchise contract that apply by law but, owing to the variety of legal arrangements, are beyond the scope of this questionnaire.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition law in Russia is mostly contained in the Law on the Protection of Competition that came into effect in October 2006. In July 2009 the Russian Competition Law was amended – for a long time it had been expected that special rules for vertical agreements relating to franchising would be enacted.

The amended Competition Law basically sets forth the exemptions regarding franchising agreements' contractual terms and conditions (other than limitations for monopolists and dominant business entities, which are usually not relevant for franchising). This liberalisation of competition law with regards to franchising may however, only be for the short term, since new amendments to the law could be enacted.

Russian franchise law expressly permits franchise agreements to contain certain restrictions:

- dedication: the franchisee may be obligated not to accept, from any competitor or potential competitor of the franchisor, any rights similar to those it has accepted from the franchisor;
- location: the franchisee may be obligated to obtain the franchisor's consent for the specific location(s) of the commercial premises to be used by the franchisee in operating the franchisor's business;
- design: the franchisee may be obligated to obtain the franchisor's consent for the external and internal design of the premises, clothing of the personnel, cooking batteries or plates, or all of the above; and
- price: under the amended CCRF, from October 2011, the franchisor has the right to determine the price of goods sold, and the price of works (services) provided by the franchisee.

Moreover, the recent amendments to the CCRF have eliminated the prohibition to contractually stipulate that the franchisee may not sell goods (render services or perform works, or both) to certain categories of customers.

Update and trends

In July 2011, a new law on amendments to provisions of the CCRF regarding franchising agreements was adopted. This law became effective in October 2011 and the answers in this chapter take this law into account. It contains a number of important changes to the regulation of franchising in Russia. In particular, the previous Russian law prohibited the franchisor from setting or limiting resale prices. The new law explicitly states that the franchisor is entitled to do so, if stipulated in the agreement. In addition, the regulations on the right of the franchisee to unilaterally withdraw from the agreement (please see question 27) and the changes in renewal conditions (please see question 29) are introduced by this new law.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The Russian judicial system consists of the Constitutional Court, the courts of general jurisdiction and the state arbitrazh (commercial) courts. The courts of general jurisdiction hear criminal cases, civil disputes between individuals, and disputes arising from administrative relationships among individuals and state bodies.

Franchising issues are heard before the state arbitrazh courts, where disputes regarding business activities are resolved. The procedural rules applicable in the Russian state arbitrazh courts are based on the general principles of procedural law adopted in continental Europe. With certain exceptions, the procedure is inquisitorial. One of the main advantages of state arbitrazh courts is a trial period of only a few months, since the courts generally must consider cases within three months of receipt of the application.

The enforcement of Russian state court rulings is carried out by the bailiff service. A foreign state court judgment may be enforced in Russia if such a judgment has been recognised by a Russian court, which will only be the case if international treaties apply or reciprocity is ensured.

Unlike in other jurisdictions, there has been very little practice of mediation and other forms of alternative dispute resolution in the Russian Federation. Russian mediation law was adopted at the end of July 2010 and entered into force as of 1 January 2011. The application of mediation is limited by a number of conditions.

Foreign companies may refer disputes to a private arbitration tribunal located either within or outside of Russia. Awards issued by international arbitration can be enforced in Russia after their recognition by a Russian state arbitrazh court. The recognition procedure is stipulated by law in accordance with the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The major advantage of arbitration is the arbitrators' experience with cross-border agreements, especially when a matter is governed by a foreign law. Unfortunately, Russian judges in state courts are often not that familiar with handling contracts governed by non-Russian laws. The independence and incorruptibility of the arbitrators is also an issue: from time to time, corruption can still be seen in Russian state courts of the first and second instance, despite the government's anti-corruption measures.

On the other hand, Russian state courts are usually very fast in taking decisions (between one and six months in each instance) and their decisions do not need additional recognition to be enforced.
The question of arbitrability of disputes is still under debate in Russia. The following disputes are generally regarded as not arbitrable:

- insolvency disputes;
- certain corporate disputes;
- disputes governed by Russian administrative law (eg with state authorities), including competition, tax, and privatisation disputes; and
- disputes related to Russian real estate which may affect registration entries in a real estate register.

Furthermore, regarding arbitration, it should be kept in mind that the award rendered by the arbitrators can be enforced only after it was recognised by the state courts of the country where enforcement should be conducted. Therefore, in addition to the arbitration proceedings, state court proceedings must be passed successfully.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

We are not aware of such regulations or practice.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The two most common business entities are companies and close corporations. Incorporation proceedings are relatively straightforward with regard to both of these types of entities. A private limited liability company may have between one and 50 shareholders. External companies can also be registered.

The registration formalities for close corporations are much simpler than for companies. Members of a close corporation must be natural persons and there may be no more than 10 members. These entities have been designed for small businesses and would generally not be appropriate for large or medium-sized foreign investors.

The new Companies Act (Companies Act No. 71 of 2008) that came into effect on 1 May 2011, establishes two categories of business entities, namely profit companies and non-profit companies. The two most common business entities relevant to the typical franchisor are public companies and private companies – both categorised as profit companies under the new Companies Act. Incorporation proceedings are relatively straightforward with regard to both of these types of entities. There is no limit on the number of shareholders that either of these companies are obliged to have. However, a private company is prohibited from offering any of its securities to the public and the transferability of its securities is restricted. External companies can also be registered. The Companies Act provides that external companies must be registered within 20 business days after it first begins to conduct business within the republic.

Previously, it was possible to register a close corporation in terms of the Close Corporations Act. A close corporation was obliged to have at least 10 members, all of whom were natural persons. The Close Corporations Act has been amended so that no new close corporations will be registered after 1 May 2011.

2 What laws and agencies govern the formation of business entities?

The registrar of companies and the registrar of close corporations deal with the registration of companies and close corporations at the South African Companies and Close Corporations Office (Companies Office). The relevant Acts that govern these entities are the Companies Act and the Close Corporations Act.

The commissioner of companies deals with the registration of companies at the South African Companies Intellectual Properties Commission. The relevant act that governs companies is the Companies Act. The Companies Act also establishes a Companies Tribunal whose function is to adjudicate any application made to it. The Companies Tribunal also serves as a forum for the voluntary resolution of disputes.

3 Provide an overview of the requirements for forming and maintaining a business entity.

Incorporation proceedings in South Africa are relatively straightforward. A private company (designated by the term 'Proprietary Limited') must have at least one shareholder, but may have no more than 50. There is no restriction on foreign shareholding levels. Share certificates in respect of shares purchased by foreigners should be endorsed non-resident for exchange control purposes. There is no minimum capital requirement.

The first shareholders of a company are the persons who subscribe to the memorandum and articles of association of the company. For each new company, a memorandum and articles of association must be submitted to the registrar of companies, together with certain other statutory forms.

In the ordinary course of events, incorporation takes approximately two to three weeks from a name being reserved, but in special circumstances, it can be effected in a shorter time. On registration, the registrar will issue a certificate of incorporation and a certificate to commence business. Only when the latter certificate has been issued may the company commence business. Nevertheless, it is possible for pre-incorporation contracts to be concluded by persons acting as trustees for the company to be formed. Any such contract must be in writing, must be disclosed in the memorandum of association and must be ratified by the company on incorporation.

There is no requirement that directors must be South African citizens or residents. A return must be filed in respect of each director stating his or her nationality and place of residence. All companies have to make an annual return for each financial year. Every company is obliged to have an annual audit and have audited financial statements prepared.

The registration formalities for close corporations are much simpler than for companies. Members of a close corporation must be natural persons and there may be no more than 10 members. They are not required to have audited accounts prepared. An annual return must be filed with the registrar of companies. These entities have been designed for small businesses (a close corporation is cheaper and quicker to establish and maintain) and would generally not be appropriate for large or medium-sized foreign investors.

Incorporation proceedings in South Africa for public and private companies are relatively straightforward. A private company is designated by the term 'Proprietary Limited' or '(Pty) Ltd' and a public company is designated by the term 'Ltd' or 'Limited'. There is no restriction on local or foreign shareholding levels imposed on private or public companies. Share certificates in respect of shares purchased by foreigners should be endorsed non-resident for exchange control purposes. There is no minimum capital requirement.

One or more persons may incorporate a profit company (namely, a private company or a public company). Each incorporator of a company is a first director of the company and serves until sufficient directors are first appointed or first elected to satisfy the minimum requirements of the Companies Act or the company's memorandum of incorporation. For each new company, a memorandum of incorporation must be submitted to the commissioner of companies, together with a notice of incorporation.

In the ordinary course of events, incorporation takes approximately four to six weeks from a name being reserved. On registration, the commissioner of companies will assign to the company a unique registration number, enter the prescribed information concerning the company in the companies register, endorse the notice of incorporation, and issue and deliver a registration certificate to the company. Only when the latter certificate has been issued may the company commence business. Nevertheless, it is possible for pre-incorporation contracts to be concluded by persons acting as trustees for the company to be formed. Any such contract must be in writing, entered into before the company comes into existence and ratified or rejected (completely, partially or conditionally) by the board of the company within three months after the date on which the company was incorporated. Pre-incorporation contracts need not be filed at the Companies Commission nor is it required that they be notarially certified.

There is no requirement that directors must be South African citizens or residents. The company is, however, obliged to file a statutory form containing the personal details of directors with the Companies Commission. All companies have to file an annual return for each financial year. Only public companies are obliged to appoint an auditor, an audit committee, a company secretary and have its annual financial statements audited. Private companies are only obliged to appoint an auditor if it is required by the Companies Act or the Companies Regulations to have its annual financial statements audited each year; or the company's memorandum of incorporation requires its annual financial statements to be audited.

In terms of the Income Tax Act, both public and private companies are obliged to appoint a public officer who is a natural person resident in South Africa. The public officer of a company is the representative taxpayer in respect of the income of the company. Public officers are responsible and answerable for doing all things necessary under the Income Tax Act and every notice, process or proceeding that under the Income Tax Act may be given to, served upon or taken against a company, may be given to, served upon or taken against its public officer.

4 What restrictions apply to foreign business entities and foreign investment?

There are a number of ways in which investments may be made by a foreigner or foreign-owned company in South Africa, such as:

- forming a company in South Africa, which is the most common procedure. This may be wholly owned or held jointly with other local or foreign shareholders. The formed company can then become engaged in business by setting up a 'greenfield' operation, buying an existing business or setting up in partnership or joint venture with a South African person or company;
- the investor buying or taking over all or some of the shares in an existing private company that has already established a business or will establish a business. Such shares can be held directly by the foreign investor. There is no restriction on foreign shareholding levels. Share certificates in respect of shares purchased by foreigners should be endorsed non-resident for exchange control purposes. There is no minimum capital requirement;
- the investor setting up a branch office. If the investor is a company or corporation this will involve registering the branch as an external company in terms of the Companies Act;
- the investor forming a joint venture with a South African entity, either through a South African subsidiary or directly in partnership;
- the investor setting up up a business trust; or
- the investor forming a partnership with another investor or with a South African person. The investor can also establish a business of his, her or its own as a sole proprietor. Partnerships and sole proprietors do not enjoy limited liability in South Africa.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

On 1 January 2001, South Africa moved from a source-based income tax system to a residence-based income tax system. The new system entails that South African residents get taxed on their worldwide income, as opposed to the old system, where income was taxed from a source within or deemed within South Africa.

Tax consists of direct taxes (corporate and individual) as well as certain indirect taxes including value added tax (VAT), stamp duty, uncertificated securities tax, etc.

The corporate rate of tax for companies and close corporations is currently 29 per cent.

Secondary tax on companies (STC) of 12.5 per cent is paid on dividends declared by any resident company. The combined effect of the corporate tax rate and STC is that companies that distribute the greater portion of their profits by way of dividends, are effectively taxed at a rate of 36.89 per cent.

The current VAT rate is 14 per cent. VAT is payable on the supply of goods and rendering of services by a South African-registered VAT vendor on goods imported into South Africa. Any person (including corporations) carrying on a business in South Africa, and whose business taxable supplies exceed the threshold of 300,000 rand (excluding VAT) per annum, is expected to register as a VAT vendor.

Dividends declared by local companies are exempt from tax. Dividends declared by foreign companies with shareholders resident in South Africa are taxable.

A withholding tax of 12 per cent is levied on royalties. The withholding tax on royalties or similar payments is not payable where the royalty is paid to a non-resident company, where the royalty is derived from any trade carried on through a branch or agency in South Africa and the amount of the royalty is subject to tax in South Africa, or where the royalty is paid to a person (other than a person whose place of residence is in a neighbouring country) in respect of the use of any printed publication of any copyright. Royalties payable to a non-resident from a South African source are subject to a withholding tax of 12 per cent.

Capital gains tax (CGT) became effective from 1 October 2001. The maximum CGT rate is 10 per cent for individuals, 14.5 per cent for companies and close corporations, and 20 per cent for trusts.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Employment in South Africa is regulated by the law of contract and by statute. There is a network of legislation providing minimum protection for employees out of which employers and employees may not contract. This legislation is found in a number of acts that regulate, inter alia, maximum hours of work, overtime rates, minimum periods of annual leave, notice of termination, organisational rights in respect of trade unions, strike law, rights and responsibilities of employers and workers in the event of retrenchments, insolvency and transfers of businesses, protection from unfair dismissal and the prohibition of unfair discrimination.

It is extremely unlikely that a franchisee or an employee of a franchisee could be deemed an employee of the franchisor, as the franchisor and franchisee corporate entities are completely separate. Only if the franchisor did something different, such as entering into an employment contract with the franchisee or an employee of a franchisee which would engender, suggest or imply an employer – employee relationship, could this risk arise. In the ordinary course of a typical franchisor – franchisee relationship, where they are contracted by a way of a franchise or licence agreement, the franchisee or the employees of the franchisee will not be deemed employees of the franchisor.

7 How are trademarks and know-how protected?

Trademarks are regulated by the Trade Marks Act 1993. The Act is administered by the registrar of trademarks, based in Pretoria, who controls the register of trademarks. The Act allows for the registration of trademarks capable of distinguishing the goods or services of a person in respect of which they are registered, or proposed to be registered, from the goods or services of another person either generally or (if applicable) subject to limitations.

Trademarks are registered for 10 years, but may on application be renewed for an unlimited number of 10-year periods. The Act makes provision for the protection of well-known international marks. Some protection is also provided for unregistered trademarks under the common law relating to unlawful competition and 'passing off'.

Know-how and trade secrets are protected under the common-law principles pertaining to unlawful competition. There are no registration formalities, but the information must in fact be secret in the sense that it is only known on a confidential basis to a limited circle of people, and must be of economic value to the trader in his business. An action for damages for unlawful competition must be brought within three years of the infringement becoming known to the plaintiff. In the case of ongoing infringement, proceedings for an injunction may be brought for as long as the infringement continues.

8 What are the relevant aspects of the real estate market and real estate law?

South Africa has an advanced land registration system in place. Title registration is possible because each registered unit of land is surveyed and represented on a diagram or general plan. South Africa has an accurately beaconed boundary system.

In addition to the conventional title deed registration system, there is also a sectional title system in place to cater for larger buildings, such as blocks of flats and commercial property complexes, similar to condominium development in many other countries. Each major regional centre in South Africa has a Deeds Registry Office covering all land in the region and controlled by a registrar of deeds.

A person domiciled in another country is free to acquire immoveable property in South Africa.

An external company may also acquire immoveable property in South Africa, provided the company registers its memorandum and articles of association in the Companies Office.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

In terms of the new Consumer Protection Act that came into operation in 1 April 2011, the definition of a 'franchise agreement' is as follows:

- an agreement between two parties, being the franchisor and franchisee, respectively;
- in which, for consideration paid, or to be paid, by the franchisee to the franchisor, the franchisor grants the franchisee the right to carry on business within all or a specific part of the Republic under a system or marketing plan substantially determined or controlled by the franchisor or an associate of the franchisor;
- under which the operation of the business of the franchisee will be substantially or materially associated with advertising schemes or programmes or one or more trademarks, commercial symbols or logos or any similar marketing, branding, labelling or devices, or any combination of such schemes, programmes or devices, that are conducted, owned, used or licensed by the franchisor or an associate of the franchisor; and
- that governs the business relationship between the franchisor and the franchisee, including the relationship between them with respect to the goods or services to be supplied to the franchisee by or at the direction of the franchisor or an associate of the franchisor.

10 Which laws and government agencies regulate the offer and sale of franchises?

Foreign persons are free to conclude franchising agreements with local persons. Franchising is regulated by common law. In addition, the new Consumer Protection Act deals with certain aspects of franchising. It introduces aspects such as equity, reasonableness and no unjust prices.

In terms of the new Consumer Protection Act there are certain formalities to entering into a franchise agreement. Under section 7 of this Act a franchise agreement must:

- be in writing and signed by or on behalf of the franchisee;
- include any prescribed information or address any prescribed categories of information, such as disclosure which has been published in the regulations; and
- be in clear and understandable language.

Furthermore, a franchisee may cancel a franchise agreement without cost or penalty within 10 business days of signing such agreement by giving written notice to the franchisor and the minister may prescribe information to be set out in franchise agreements either generally or within specific categories or industries. Regulations were published and came into force on 1 April 2011.

Most contracts tend to be subject to South African law, but there is no general bar to any foreign law serving as the governing law as long as there is some nexus between the law and the contract. The parties are free to agree on which court will have jurisdiction, or alternatively, agree that any disputes will be referred to mediation or arbitration. In short, the parties have to some extent, free scope to regulate their relationship as they deem fit.

11 Describe the relevant requirements of these laws and agencies.

See answer to question 10.

12 What are the exemptions and exclusions from any franchise laws and regulations?

See answer to question 10.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no law or regulation currently in place (other than the provisions of the Consumer Protection Act), which creates a requirement that must be met before a franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

FASA, which is a voluntary membership, non-profit organisation, requires that a disclosure document be furnished to the prospective franchisee or sub-franchisee by the entity with whom they are contracting. It would be reasonable to disclose at least that a franchisor – sub-franchisor or franchisor – master franchisee relationship exists.

According to the Consumer Protection Act regulations, if the franchise agreement is related to a master franchisee, the master franchisee's identity must be disclosed.

The definition of a franchise agreement is set out under question 9 above. The parties to a franchise agreement are described as a franchisor and franchisee. In terms of the disclosure requirements, every franchisor must provide the prospective franchisee with a disclosure document, dated and signed by an authorised officer of the franchisor, at least fourteen days prior to the signing of a franchise agreement. Both a master franchise agreement and a sub franchise agreement will fall within the definition of a franchise agreement. It is our understanding that in each agreement, it is the person or entity granting the rights, who is obliged to provide a disclosure document.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

In terms of regulation 3 of the Consumer Protection Act regulations, every franchisor must provide a franchisee with a disclosure document, dated and signed by an authorised officer of the franchisor, at least fourteen days prior to the signing of the franchise agreement. There are no requirements regarding how often the disclosures must be updated.

16 What information must the disclosure document contain?

In terms of Regulation 3 of the Consumer Protection Act, disclosure must be given at least fourteen days prior to the signing of a franchise agreement and this must include the details set out below.

Although international best practice has for many years dictated that competent disclosure should be given to franchisees, this has previously not been law in South Africa. The Franchise Association of South Africa has, for many years, however, required for membership that franchisors should furnish franchisees with a competent agreement, a compliant disclosure document, as well as an operations manual. The CPA regulations also set out requirements in relation to disclosure documents that are required to be furnished to franchisees at least fourteen days prior to the signing of a franchise agreement.

As a minimum a disclosure document must contain:

- the number of individual franchised outlets;
- the growth of the franchisors turnover, net profit and the number of individual new franchised outlets for the immediate preceding year;
- a statement of confirmation that the franchisor is able to pay its debts as and when they fall due; and
- written financial projections of the franchised business or of franchises of a similar nature, together with particulars of the assumptions upon which these representations are made.

The disclosure document must be accompanied by an accounting officer or auditor's statement confirming, inter alia, that the business of the franchisor is a going concern, that it is able to meet its current and contingent liabilities, as well as its financial commitments and that the franchisors annual financial statements have been prepared in accordance with generally accepted accounting practice.

In addition, the disclosure document must also be accompanied by a list of current franchisees, their contact details, and a clear statement that the prospective franchisee is entitled to contact any of the franchisees listed, or alternatively to visit any outlets operated by those franchisees. In addition, an organisation chart depicting the support system in place for franchisees should also be attached.

17 Is there any obligation for continuing disclosure?

No.

18 How do the relevant government agencies enforce the disclosure requirements?

The Consumer Protection Act and its regulations came into operation on 1 April 2011 and it is not yet entirely clear how the Consumer Protection Commission would enforce the disclosure requirements. A claim process and related provisions have been published.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Franchisees will be entitled to institute proceedings in terms of the relevant franchise agreement if a violation of the disclosure requirements occur. The legal remedies would include cancellation of a contract and claiming damages on the basis of misrepresentations or non-disclosure. Damages would be calculated on the actual losses of the franchisee. This may include reimbursement or damages or both.

As mentioned above, it is the franchisor or the entity granting the rights in each instance that is required to provide disclosure. If disclosure given by a franchisor, to a master franchisee, that then provides the same disclosure to a sub-franchisee and this is found to be incorrect or inaccurate, the franchisor could certainly be liable for the losses incurred or damages suffered as a result.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

See question 19. A director or member of a corporate entity can be held personally liable in certain instances such as, for example, if it trades recklessly with the corporate entity.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

Common law applies to all contracts entered into and in relation to which South African law applies. Key concepts of the new Consumer Protection Act include reasonableness, equity and no unjust prices. It is also necessary in terms of the CPA regulations to include provisions in the contract which relate to assignment of rights. The leading franchise association in South Africa is the Franchise Association of South Africa (FASA), which can be found at www.fasa.co.za.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See question 16.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

The Consumer Protection Act assists with aspects such as fraud and deceptive practices. There are, however, remedies under common law for fraudulent, negligent or innocent non-disclosure or misrepresentation, which include cancellation, damages or both.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

See question 10.

25 Do other laws affect the franchise relationship?

In accordance with section 3 of the Competition Act, the Act applies to all economic activity within, or having an effect within, South Africa. The Act aims to promote and maintain competition in South Africa through provisions relating to merger control, restrictive practices and the abuse of dominance. Nevertheless, the objects of the legislation are not merely limited to the promotion of competition but include public interest objectives, such as ensuring that small and medium-sized enterprises have an equitable opportunity to participate in the economy.

26 Do other government or trade association policies affect the franchise relationship?

See question 25.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The new Consumer Protection Act regulates certain aspects of franchising including, inter alia, reasonableness, equity and no unjust prices. It is also regulated by common law. The rights and obligations of the parties would be set out primarily in the franchise agreement.

Certain formalities are set out in the Consumer Protection Act as mentioned above. Franchise agreements must be in writing and signed by or on behalf of the franchisee. Legal firms are able to provide all necessary assistance. Most contracts tend to be subject to South African law, but there is generally no bar to any foreign law serving as the governing law as long as there is some nexus between the law and the contract. The parties are free to agree on what court will have jurisdiction, or alternatively, agree that any disputes will be referred to arbitration. In short, parties have, to an extent, free scope to regulate their relationship as they deem fit, provided that the provisions of the Consumer Protection Act are complied with.

28 In what circumstances may a franchisee terminate a franchise relationship?

The new Consumer Protection Act that deals with certain aspects of franchising introduces, inter alia, reasonableness, equity and no unjust prices. Franchising is also regulated by common law. The rights and obligations of the parties would, primarily, be those reflected in their written agreement.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

See question 28.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes. The franchisor should insert appropriate provisions into the franchise agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

The new Consumer Protection Act deals with certain aspects of franchising including, inter alia, reasonableness, equity and no unjust prices. It is also regulated by common law. In most instances reasonable market-related provisions are inserted.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

South Africa's National Credit Act regulates the maximum amount of interest that may be charged on overdue accounts from time to time.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

South Africa's exchange control provisions regulate payments to foreign franchisors. Application for exchange control approval is, in most instances, a fairly straightforward process and is primarily dealt with by leading banks. If difficulties arise, assistance can be sought from a law firm.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes. Confidentiality and non-disclosure covenants and agreements are enforceable in South African law.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

The new Consumer Protection Act introduces concepts such as, inter alia, equity, reasonableness and no unjust prices. These principles are similar to acting in good faith. Common law also provides remedies for fraudulent, negligent and innocent misrepresentation and non-disclosure prior to entering into agreements. Certain actions may also be contra bonos mores.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

A new Consumer Protection Act came into operation on 1 April 2011 and treats franchisees as consumers.

Update and trends

Key franchising aspects of the Consumer Protection Act

Unprepared or weaker franchisors including, particularly, those who do not prescribe to competent franchisor practices or fail to provide reasonable value to the franchisees might find themselves vulnerable to a variety of difficulties, due to the coming into operation of the Consumer Protection Act.

In terms of the Act, the definition of 'franchise agreement' is fairly broad and may well extend not only to full business concept franchise agreements, but also to licence, agency and distribution agreements, which creates a risk for the franchise industry and to any relationship or contract that falls within this broad definition.

The franchise agreement must be in writing and signed by, or on behalf of, the franchisee. It must also include prescribed information such as information that would generally be found in a disclosure document and must be stated in plain and understandable language. The disclosure requirements will be set out in the regulations which should be published during or about July 2010. The regulations are also likely to set out additional information which will be necessary in relation to certain categories of information or industries.

There is a 10-day cooling off period during which a franchisee may cancel a franchise agreement, without cost or penalty, by simply giving notice to the franchisor.

The general effective date of the Act was 1 April 2011. In terms of the transitional provisions, the Act will not apply to pre-existing franchise agreements, as of that date. It appears however that that it will apply to any franchise agreements renewed thereafter. The Act will, from that date, probably apply to at least some transactions which are entered into between the franchisor and franchisee, in relation to the sale of products or provision of services.

The Consumer Protection Act is in the nature of a consumer bill of rights and includes many key concepts such as the right to equality; privacy; choice; disclosure and information; fair and responsible marketing; honest dealing and fair agreements; fair value, good quality and safety and suppliers accountability, certain of which will be briefly covered below.

With regard to the right of choice, section 13 of the Act provides that a supplier (franchisor) must not require as a condition of offering to supply or supplying any goods or services or as a condition of entering into an agreement that the consumer must:

- purchase any other goods or services from that supplier;
- enter into any additional agreement with the same or another supplier; or
- agree to purchase any goods or services from a designated third party.

The points above apply unless the supplier can show that the convenience to the consumer in bundling the goods and services outweighs the consumer's limitation of choice; or the bundling of these goods or services appears to result in economic benefit to consumers. It is a defence to any contravention of this section, if the goods or services are reasonably related to the franchisor's branded products or services. This phrase is not particularly clear. It is suggested that consideration be given to, for example, providing for core and non-core products and services in franchise agreements. The core products or services would be the primary, unique or the most important products or services that are related to the brand or franchise. 'Reasonably related' to the brand is also not defined and a brief justification or explanation about how the products are unique, important and related to the brand, might reduce any vulnerability.

With regard to the aforementioned key concepts of the Act, the following should be noted:

- a person must not use physical force, coercion, undue influence, pressure or unfair tactics in the marketing or supply of goods and services;
- a supplier must not by words or conduct express or imply a false, misleading or deceptive representation concerning a material fact or fail to correct an apparent misapprehension;
- a supplier must also not supply goods and services at manifestly unfair, unreasonable or unjust prices, or require a consumer to waive any rights including terms that are unjust, unfair or unreasonable;
- a term or condition will be unfair, unreasonable or unjust if it is excessively one-sided or inequitable, or if the consumer relied on a false, misleading or deceptive representation, or notice of an onerous or unusual clause was not given.
- the attention of the consumer must be drawn to any limitation of liability of the supplier, assumption of risk of the consumer, any indemnity and any fact acknowledged by the consumer; and
- any provision of an unusual character or nature, or the presence of which is not reasonably to be expected, must be notified to the consumer.

The powers of a court or tribunal to ensure fair and just conduct, terms and conditions are substantial. If such a court or tribunal determines that a transaction or an agreement is in whole or in part unconscionable, unreasonable or unjust, the court may make an order it considers fair and reasonable in the circumstances including the restoration of money or property to the consumer and compensation to the consumer for losses or expenses in relation to the transaction; and order the supplier to cease any such practice.

In addition, a court may also make an order severing any part of an agreement, provision or notice, or if it is reasonable to do so, alter it to render it lawful. It may also declare the entire agreement, provision or notice void, as from the date it took effect and may make any order that is just or reasonable in the circumstances.

As a result franchisors should:

- keep a full document trail and record of all communications with franchisees;
- ensure that all communications and dealings with the franchisees are true, accurate, fair and reasonable;
- require a franchisee to do a proper assessment on the location and the franchisor should do the same;
- choose franchisees very carefully and complete and sign the franchise agreement properly;
- also point out any unusual or onerous clauses, and wait for the ten-day cooling-off period to lapse before doing anything further;
- honour obligations in terms of the franchise agreement, as well as all representations made by its employees, as well as those set out in the disclosure document;
- support and encourage the franchisee to perform as soon as possible, so as to avoid difficulties; and
- provide good quality products and services promptly at reasonable prices, as every statement, representation, non-disclosure, action or inaction may be relevant to legal proceedings at a later stage.

It is also very important to note that circumstances, provisions or terms of an agreement that are reasonable at the time of signature of the agreement may become unreasonable or unjust at a later time. As a result the franchisors should, on an ongoing basis, have an awareness of and comply with the provisions of the Act.

It is further recommended that franchisors audit their franchise agreements and disclosure documents for compliance regarding the following:

- the general franchise provisions of the Act;
- the industry and activity specific requirements to be set out in the regulations; and
- to ensure that the disclosure document is accurate, sufficiently comprehensive, reasonable and fair.

37 Must disclosure documents and franchise agreements be in the language of your country?

The regulations for the new Consumer Protection Act that came into force on the 1 April 2011 are intended to deal with disclosure requirements. We would be inclined to recommend, at least for practicality purposes, that these be in English, as it is the primary business language in South Africa.

38 What restrictions are there on provisions in franchise contracts?

In accordance with section 3 of the Competition Act, the Act applies to all economic activity within, or having an effect within, South Africa. The Act aims to promote and maintain competition in South Africa through provisions relating to merger control, restrictive practices and the abuse of dominance. Nevertheless, the objects of the legislation are not merely limited to the promotion of competition

but include public interest objectives, such as ensuring that small and medium-sized enterprises have an equitable opportunity to participate in the economy.

The concerns of the Competition Commission include, horizontal and vertical relationship collusion, retail price maintenance, exclusive territories, exclusive dealing, tying of products and intellectual property rights.

The Competition Commission, which enforces the provisions of the Competition Act, recognises the nature and contribution of franchising. It also recognises that franchise agreements are not necessarily anti-competitive, despite the provisions of the Competitions Act, and that there may be, in fact, efficiency, technology and pro-competitive benefits. It is essential that franchisors do not dictate minimum prices and minimum discounts to franchisees.

The new Consumer Protection Act provides that franchise agreements must be drafted in clear and understandable language.

The definition of a franchise agreement in terms of the Consumer Protection Act is fairly broad and includes a full business concept franchise arrangement, as well as similar arrangements such as licence, distribution and agency arrangements or contracts.

It is very important to note that in terms of the Act, there is no threshold whatsoever in relation to any franchise or similar agreement or arrangement. As a result, any such agreement or arrangement falls within the Consumer Protection Act and its regulations.

There are fairly comprehensive provisions in the regulations as to what a franchise agreement should include and these are set out below:

- firstly, a franchise agreement must reflect at the top of the first page, a statement to the effect that 'a franchisee may cancel a franchise agreement without cost or penalty within ten business days after signing such agreement, by giving written notice to the franchisor';
- secondly a franchise agreement must contain provisions which prevent the following:
  - unreasonable or overvaluation of fees, prices or other amounts;
  - conduct which is unnecessary or unreasonable in relation to risks to be incurred by one party; and
  - conduct that it is not reasonably necessary for the protection of the legitimate business interests of the franchisor, franchisee or franchise system;
- thirdly, a franchise agreement must also contain a clause in terms of which the franchisor is not entitled to any undisclosed direct or indirect benefit or compensation, unless this is disclosed in writing, together with an explanation thereof;
- fourthly, a franchise agreement should contain numerous other provisions and we would like to highlight the following:
  - a description of the goods or services which the franchisee is entitled to render or sell;
  - obligations of the franchisor;
  - obligations of the franchisee;
  - a description of the business system;
  - direct or indirect consideration payable to the franchisor;
  - details of territorial rights, if granted;
  - a description of the proposed site, premises or location;
  - details of the intellectual property licensed;
  - details of the master franchisee, if relevant ;
  - details of initial training and ongoing training and assistance;
  - terms and conditions relating to the duration, renewal, goodwill and assignment;
  - full details of any marketing fund, including that the funds are deposited into a separate account, that any such funds are used for marketing and advertising purposes of the goods and services of the franchise system and that full financial statements of all receipts and expenses, will need to be provided;
  - any restrictions imposed on the franchisee;
  - full particulars of the financial obligations of the franchisee including the initial fee, working capital, royalties, total investment required and other amounts payable;
  - the effect of termination or expiration of the franchise; and
  - if requested in writing, an explanation of terms or sections not understood.

Although certain of the points are traditionally found in the average competently drafted franchise agreement, franchisors will now need to check and audit their franchise agreements so as to ensure that they are compliant. The regulations may, of course, be updated from time to time and franchisors will therefore need to remain abreast of any such new or updated regulations. Further, if any written explanation of a term or section is given, this must be legally correct, failing which the franchisor risks being bound to an incorrect explanation.

Although international best practice has, for many years, dictated that competent disclosure should be given to franchisees, this has previously not been law in South Africa. The Franchise Association of South Africa has for many years, however, required for membership, that franchisors should furnish franchisees with a competent agreement, a compliant disclosure document, as well as an operations manual. The CPA regulations also set out requirements in relation to disclosure documents that are required to be furnished to franchisees at least fourteen days prior to the signing of a franchise agreement.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

See question 38.

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40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

South Africa has an independent High Court judiciary drawn principally from the ranks of senior advocates (barristers), attorneys (solicitors) and academics. At present, there is a split bar divided between attorneys and advocates, but attorneys can acquire the right of appearance in the High Court. Both branches of the profession are well established and competent. There is an established and sophisticated hierarchy of courts, namely:

- magistrates' courts in each town and city with limited jurisdiction, for example up to certain amounts;
- High Courts with territorial jurisdiction over provinces or parts of provinces and the power to adjudicate, generally, on all disputes, plus certain appeal functions;
- the Supreme Court of Appeal, which sits in Bloemfontein, exercising appellate jurisdiction over all the High Courts; and
- the Constitutional Court, which sits in Johannesburg and has both original and appellate jurisdiction on constitutional matters.

The High Courts and the Supreme Court of Appeal may make an order concerning the constitutional validity of an act of parliament, provincial legislation or administrative conduct of the government, but an order invalidating the legislation of parliament must be confirmed by the Constitutional Court.

Alternative forms of dispute resolution have become increasingly popular. Arbitration is governed by the Arbitration Act 1965.

Professional bodies specialising in arbitration services and alternative dispute resolution have been formed and are used extensively, particularly in labour-related matters. All building and engineering contracts can and generally should contain clauses providing for mediation and arbitration. Parties are free to agree on a governing law and to the jurisdiction of international arbitration forums such as the ICC and LCIA. FASA provides a mediation service, primarily to its members.

The Franchise Association of South Africa is in the process of developing an ADR system that will include negotiations, mediation and arbitration.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Some of the advantages of arbitration include that, if properly managed, it can be quicker and less expensive than litigation in the courts. A significant advantage is to be able to choose a good arbitrator who may be a specialist in the subject matter of the dispute. The parties also have far greater control of the time, place and process to be followed in an arbitration than they do in court proceedings. Arbitration proceedings can also, however, be more expensive because the costs of the arbitrator need to be paid for, and if the parties do not cooperate, difficulties and delays could arise.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreigners are generally not treated differently. There are, however, various statutes or aspects that would be relevant and need to be dealt with, such as exchange control regulations and tax.

Spain

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Overview

1 What forms of business entities are relevant to the typical franchisor?

A franchisor can perform its activity through the following types of capital companies:

- joint-stock company (SA);
- European joint-stock company (SE);
- limited liability company (SRL);
- new limited liability company (SLNE); and
- limited partnership by shares (SCom.pA).

Less frequently, a subsidiary of a foreign entity or partnership can be used as a form of business entity.

2 What laws and agencies govern the formation of business entities?

Royal Legislative Decree 1/2010 of 2 July (in force as of 1 September 2010 and as modified by Royal Law-Decree 13/2010, of 3 December 2010 and by Act 2/2011 of 4 March 2010) lays down the standards governing capital companies. The Commercial Register Regulation (RRM) is also applicable to such companies' incorporation and functioning.

The formation of a business entity is governed by the Central Commercial Register and the Provincial Commercial Registers where the company has its corporate domicile.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The company's incorporation requires the signature of a public deed (including the by-laws) by the founding partners before a notary public. The deed must be registered at the Commercial Register.

The following documents must be obtained, prepared and presented in order to execute the public deed of incorporation:

- a certificate (issued by the Central Commercial Register) stating the availability of the company name;
- identification documents, which must be presented to the notary by the shareholders. If the shareholders are represented, their representative must also show a notarised power of attorney;
- the by-laws have to contain certain minimum information. For example, company's name, corporation's purpose, address, share capital and its distribution in shares or parts, etc; and
- the company must have a minimum share capital (in money, goods or rights). For an SA, the amount is €60,000; for an SRL, it is €3,000. These funds must be deposited in a bank account (if the capital is paid up in money). The bank issues a certificate of deposit that must also be shown to the notary public. In the case of capital paid in goods or rights, it will be necessary to identify them and their economic value and, in some cases, to provide an expert's report on their value.

The company must apply for a tax identification number before the Spanish Tax Administration. No tax has to be paid for the incorporation.

The company is able to start operating upon its registration with the Commercial Register, although some preliminary transactions can be carried out beforehand. Companies also need to legalise their books, to issue a tax declaration for the beginning of their activity and to be duly registered before the Social Security Administration.

The maintenance of a company mainly requires the directors' annual preparation of the annual accounts, and the annual shareholders' meeting (by which the annual accounts and the directors' activity are approved). If the company reaches some specific requisites, auditors are appointed. Annual accounts must be filed with the Commercial Register.

4 What restrictions apply to foreign business entities and foreign investment?

Generally, foreign business investments are not subject to particular restrictions. Nevertheless, in some cases investors are obliged to make official disclosures of their investments, such as, previous declaration of investments when the investor is domiciled in a country that is considered a tax haven, regardless of the amount, and previous administrative authorisation for certain special sectors (television and radio, weapons, gambling or national defence). Certain investments have to be communicated ex-post to the authorities for statistical, administrative or economic purposes. This is especially true for investments in real estate that exceed €3 million, and if, regardless of the amount, the money comes from a tax haven.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

There is no specific tax on franchising activities; the general tax system applies.

By and large, companies with their tax residence in Spain are taxed on all their income, regardless of where the income was generated or where the payer is domiciled. Companies not residing for tax purposes in Spain are generally subject to a corporate tax on income derived in Spain, although double-tax conventions (if applicable and depending on the tax residence) provide for special rules.

Value added tax (VAT) is imposed on the delivery of goods and services. The general governing principles of this tax are standardised within the EU.

VAT is valid in the Spanish peninsula and the Balearic Islands. A special indirect tax is applied in the Canary Islands: the Canary General Indirect Tax (IGIC). The cities of Ceuta and Melilla have a tax on production, services and imports (IPSI).

No taxes are due for incorporation, capital increases and mergers.

When the franchisor purchases real estate, either VAT (together with the tax on documented legal acts) or tax on the transfer of assets has to be paid. Tax on urban land value increase is also incurred, but this has to be paid by the seller (although it is normally passed on by contract to the purchaser).

Ownership of real estate is subject to annual local property tax. In cases of leases of real estate, the agreement is subject to the tax on the transfer of assets and the income is subject to income tax and VAT.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Franchise agreements are understood to be contracts between independent entrepreneurs and do not entail the existence of an employer–employee relationship. Nevertheless, some risks can arise, such as being considered an employee of the franchisor if the franchisee does not act as a real independent entrepreneur.

The franchisee can also be seen as a mere supplier of manpower rather than an employer and the franchisor and franchisee can be seen as a group of companies for labour purposes, with the consequence of joint liability of both in light of obligations to employees. In general, such joint liability is triggered when the real employing entity within the group cannot be distinguished and the use of different legal personalities is considered fraudulent.

Some measures can be adopted to avoid these risks. The franchisee must itself be a real company with its own assets and liabilities and must retain power over its own materials and personnel to carry out its organisational responsibilities. Thus, the franchisee must not merely be the supplier of a workforce for the franchisor and the franchisee must manage its own employees, being responsible for their salaries, attendance, social security contributions, etc.

7 How are trademarks and know-how protected?

Trademarks are protected mainly by the Trademarks Act. The main means for protection is registration: the first to register is given priority. Trademark registration entitles the owner of the trademark to the exclusive right to use the trademark commercially and the right to prohibit its use by third parties. The owner of the trademark can claim, among other things:

- the adoption of measures to avoid violations;
- damages caused by the violation;
- the destruction of products illegally using the trademark; and
- the publication of the decision granting the owner these rights.

The Unfair Competition Act protects know-how. The violation of secrets (defined as the disclosure or exploitation of industrial or other business secrets accessed illegitimately or legitimately with a non-disclosure obligation, without the consent of the owner) is considered unfair competition.

Some aspects of know-how (for example, documents and software) can also be protected by the Intellectual Property Act.

8 What are the relevant aspects of the real estate market and real estate law?

Spain's real estate market was subject to speculation until the market bubble burst in 2008. As a consequence, it has still not been very active up to 2011 and, according to most predictions, prices have further still to fall.

Real estate purchases have to be formalised in a public deed before a public notary and registered at the Land Register (the payment of all taxes related to the purchase is needed).

When the franchisor leases the premises to the franchisee, the agreement is principally subject to the freedom of the parties, except for some general obligations foreseen in the Urban Lease Act (for example, warranty and procedural questions in the case of litigation). In the absence of agreement, the Act will be applicable and the Civil Code would be the second step.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The legal definition of a franchise is an activity in which an undertaking (the franchisor) grants to another party (the franchisee), for a specific market and in exchange for financial compensation (either direct, indirect or both), the right to exploit its own system to commercialise products or services already successfully exploited by the franchisor. The contents of this system must include, at least:

- the use of a common name or brand or any other intellectual property right and uniform presentation of the premises or transport means included in the agreement;
- communication by the franchisor to the franchisee of certain technical knowledge or substantial and singular know-how that has to be owned by the franchisor; and
- technical or commercial assistance, or both, provided by the franchisor to the franchisee during the agreement, without prejudice to any supervision faculty to which the parties might freely agree in the contract.

10 Which laws and government agencies regulate the offer and sale of franchises?

The offer and sale of franchises is governed by the Retail Commerce Act 7/1996 of 15 January, as amended by Act 1/2010 of 2 March. Article 62 is particularly applicable to franchise agreements. The Act is completed by Royal Decree 201/2010 of 26 February on Franchise Agreements. The Draft on Distribution Agreements Act, if adopted (see 'Update and trends'), will replace these rules.

The administrative agency in charge of franchise matters is the Franchisors' Register, which is administered by the General Directorate of Commercial Politics of the Ministry for Industry, Tourism and Commerce.

Regional franchisors' registries can be created if the regions' respective legislation foresees it.

11 Describe the relevant requirements of these laws and agencies.

According to the rules applicable to franchising, a franchisor (and also a foreign franchisor, with some exceptions) should be registered in the Franchisors' Register and must provide certain information (see question 16). These obligations should be dealt with no later than three months after the franchisor's activities in Spain begin.

Registration is not a prerequisite of starting the activity; nevertheless, if registration does not take place within three months of the start of the franchisor's activities in Spain then penalties of €6,000 to €30,000 may be incurred.

Franchisors are also obliged to communicate to the Franchisors' Register any modification of the information already provided. This communication has to be made within the term of three months since the change has taken place.

Each January, franchisors are also obliged to communicate to the Franchisors' Register any closing or opening of premises (whether owned or franchised) during the previous year. If this information is not disclosed, an infringement procedure can be followed against the franchisor and a fine of €6,000 to €30,000 could be imposed.

As an exception, franchisors established in an EU member state and without a permanent establishment in Spain but acting in freedom to provide services will only be obliged to communicate to the register the commencement of their activities.

Franchisors have an obligation to provide certain information to potential franchisees (see question 14 etc).

12 What are the exemptions and exclusions from any franchise laws and regulations?

Franchising rules are applicable to commercial franchise agreements independently of the sector.

Nevertheless, a contract granting the exclusive commercial right of distribution is not necessarily a franchise contract if it is simply a contract through which a vendor promises to buy – under some circumstances – merchandise that is normally trademarked from a seller who grants the vendor exclusivity within a certain zone (also under certain conditions) and grants assistance to purchasers.

The following are not considered franchises:

- the granting of a manufacturing licence;
- the cession of a trademark to be used within a determined zone;
- the transfer of technology; and
- the granting of a logo or commercial trademark name.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

After the modification of the Retail Commerce Act, that has been in force since 3 March 2010, it is not necessary to have previously registered on the Franchisors' Register.

Royal Decree 201/2010 of 26 February contains a number of elements regarding information that must be disclosed to potential franchisees before any agreement is signed or any payment is made. See question 16.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

In a master franchise agreement, the franchisor grants to the master franchisee the right to exploit a franchise in a particular market in exchange for financial compensation (either direct or indirect or both) with the intention of signing franchise agreements with third parties. The master franchisee assumes the position of the franchisor in this particular market.

In case of a sub-franchising structure, therefore, pre-sale disclosure to sub-franchisees must be made by the master franchisee (sub-franchisor).

The information required concerning the franchisor and the contractual relationship between the franchisor and the sub-franchisor is the following:

- identification of the franchisor:
  - name,
  - registered address,
  - information about the entry in the Franchisors' Register,
  - if it is a company, its capital stock in the last balance sheet, indicating what proportion is paid; and the Commercial Register information, if appropriate;
- if the franchisor was a foreign franchisor, information about its entry in the Franchisors' Register according to its legal obligation; and
- proof of having obtained a licence for the Spanish use of the trademark and other devices of the Franchisor (indicating their duration), as well as any judicial procedures that could affect the use of the trademark.

Moreover, the sub-franchisor must give the Franchisors' Register the following information about its own franchisor: name, registered address, type of business entity, duration of the master franchise agreement and an assertion that it has signed the agreement granting the franchise by the main franchisor.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Pre-contractual information (see question 16) has to be communicated to the franchisees by the franchisor at least 20 working days before the signature of the franchise agreement or pre-agreement, or before any payment is made to the franchisor by the future franchisee.

On the other hand, information to be disclosed to the Franchisors' Register has to be given to the regional Register or, if the regional legislation does not provide for such obligation, to the central one.

No specific legal provision obliges the franchisor to update to franchisees the information already disclosed. Franchisors are obliged to update this information directly to the Register (see question 11 for updating obligations and annual information).

16 What information must the disclosure document contain?

Franchisors must disclose the following specific information in an accurate and not misleading manner in writing to the potential franchisee:

- identification of the franchisor (name, registered address, information of the commercial registry and stock capital, indicating if it is fully paid up or in what proportion), including details of the entry in the Franchisors' Register. Foreign franchisors must disclose information about their registry at the Franchisors' Register according to their national regulations;
- justification of ownership or licence for the use of any trademark or similar device and any judicial claim affecting it, as well as the duration of the licence;
- a general description of the sector in which the franchise operates, including details of its most relevant elements;
- the franchisor's experience, including the date of incorporation and the main steps in its evolution and the development of the franchise network;
- the contents and characteristics of the franchise and its exploitation, including a general explanation of the business, special characteristics of the know-how and the permanent commercial or technical assistance the franchisor will provide to franchisees, and an estimation of the necessary investments and expenses to start a business. If the franchisor is offering figures on the volume of sales or results of the placement of the business to the potential franchisee, these should be based on experience or information that can be fully justified;
- the structure and extent of the network in Spain, including the way it is organised and the number of establishments opened in Spain (either directly owned or through franchises), indicating the cities, as well as the number of franchisees having left the network in the preceding two years, indicating the reasons; and
- essential elements of the franchise agreement, including the rights and obligations of the parties, conditions for its termination or renewal, economic obligations, exclusivity clauses and limitations imposed on the franchisee in order to run the business.

Moreover, a franchisor should disclose to the Franchisors' Register information about the franchisor (name, address and Commercial Register information); property and intellectual rights (information about ownership or licensing rights and their duration),

a description of the business, namely, the network (number of premises), seniority of the franchise activity and the number of franchisees having left the network in Spain in the preceding two years; information about the contract with the franchisor (in cases where there is a sub-franchisor) and the documents attesting the power of attorney (in cases where the franchisors are registered through a representative).

17 Is there any obligation for continuing disclosure?

There is no specific obligation for continuing to disclose information to current franchisees once the agreement has been signed. As mentioned in question 11, there is an obligation to update the information provided to the Franchisors' Register.

18 How do the relevant government agencies enforce the disclosure requirements?

The enforcement of disclosure requirements is usually entrusted to the competent bodies at the regional governments (autonomous communities) – usually the region's authority for commerce or economy.

Lack of compliance with the disclosure requirements to franchisees can be considered a minor infringement, possibly leading to an administrative penalty of up to €6,000. Lack of compliance with the obligation to annually update information is considered a severe infringement and could lead to an administrative penalty of €6,000 to €30,000.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

If the disclosure requirements are violated by the franchisor and, if in the absence of this violation, the franchisee would have not signed the agreement, the franchisee may sue the franchisor in a civil action. If the violation was consciously done by the franchisor then the franchisee can ask for the contract to be nullified. If the violation was not deliberate, then indemnity for damages can be demanded.

There are no specific rules or criteria by which to calculate franchisees' damages for violation of disclosure obligations. In general terms, damages must be justified by the party asking for them.

Generally, if the franchisee cancels the franchise contract, it will not be entitled to reimbursement or damages unless the termination is due to a previous breach by the franchisor.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In the event of disclosure violations where there is a sub-franchise, liability is assumed by the party who occasioned them. It will be necessary to review each of the contracts (franchise and master franchise agreement) and to refer to the level of liability, negligence and behaviour of all parties. In general, the franchisee can claim against the sub-franchisor in as far as it is responsible for the information disclosed, and the sub-franchisor can claim against the franchisor if the disclosure violation is imputable to it.

In general, from a commercial standpoint, the individual officers, directors and employees of a franchisor or sub-franchisor (in cases of entities whose liability is limited) will not be held liable for acts realised by these entities. In very specific situations prescribed by the application of commercial legislation, directors can be held responsible for the actions undertaken by the company.

Finally, every individual will respond personally for criminal violations committed by that individual and also for the civil consequences of such criminal violations.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

General civil and commercial legislation principles are also applied to the offer and sale of franchises. In particular, the principle of good faith in commercial relations and the principle of freedom of contract.

The European Code of Ethics for Franchising is applied in Spain but it does not replace national or European rights.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

No.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If a deceit regarding the disclosure of information has produced a patrimonial disposition against franchisee's interests (and normally also to the benefit of the franchisor who perpetrates this for financial gain), criminal charges can be brought. Such a deceit will be regarded as fraud or corporate crime if the falsification refers to the corporate annual accounts or to another document that should reflect the franchisor's legal and economic situation.

The franchisor could also be accused of falsification of documents but, according to the particular case, this could be understood as the means through which the fraud was committed. Criminal actions are also publicly prosecuted.

From another perspective and on certain occasions, a civil action for unfair competition might be commenced, particularly for a violation of good faith and, among other things, for acts of deceit, confusion, denigration, exploitation of another's reputation, discrimination and economic dependence.

The norms of unfair competition permit actions to declare disloyalty, to enjoin conduct, to rectify its effects, to rectify deceitful or misleading information, to remedy damages and to recognise unfair financial benefit.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

No specific law regulates the relationship once the contract comes into effect.

25 Do other laws affect the franchise relationship?

Other laws affecting franchise agreements include:

- the Commission Regulation (EU) 330/2010 of 20 April 2010 on the application of article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices;
- the Commercial Code (22 August 1885);
- Act 3/1991 on Unfair Competition (3 January, modified by Act 29/2009)
- Act 17/2001 on Trademarks (7 December);

Update and trends

The Spanish government has presented to parliament a Draft on Distribution Contracts Act. The document was published in the Official Bulletin of the Spanish Congress on 29 June 2011.

The legal procedure for the draft to be approved as an Act has begun and it has been submitted for amendments (the last term set for 18 July 2011) that could modify the final version. The draft is intended to be approved as a new Act in the forthcoming months depending on the schedule of parliamentary elections.

Distribution agreements affected by the draft include commercial franchising agreements that are defined in a similar way as mentioned in question 9. The draft also regulates specifically the franchisor's obligations to be registered and the disclosure information in similar terms as those mentioned in these comments.

The draft attempts to provide better transparency in the sector and to promote the competitiveness and the balance of the parties using a culture of dialogue and mediation in the eventual conflicts arising between them. It also establishes contractual rules in the case of absence of regulation between the parties with some general dispositions concerning information obligations, prices, commercial objectives and minimum purchases, exclusivity, direct sales, trademark and advertising activities, and bonuses and discounts.

The draft also regulates the duration of the agreements (by a reference to the amortisation of the expenses) and the consequences of their termination (including rules on goodwill compensation and damage indemnities).

Regarding an appeal for the annulment of the proceedings (extraordinary procedure) (see question 40), the Spanish Parliament is discussing a Draft on Facilitation Procedural Measures Act in order to increase the amount to appeal before the Supreme Court to €800,000 instead of €150,000.

- Act 11/1986 on Patents, Inventions and Utility Models (20 March);
- Royal Legislative Decree 1/1996 Intellectual Property Law (12 April);
- Royal Legislative Decree 1/2007 (16 November), General Act for Consumer Protection; and
- Act 15/2007 on the Defence of Competition (3 July).

26 Do other government or trade association policies affect the franchise relationship?

The principal association of franchisors is the Spanish Association for Franchises (AEF), which belongs to the Iberian and American Franchise Federation (FIAF), the European Franchise Federation and the World Franchise Council.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

A franchising contract can be of a determined or an indeterminate length.

If the contract has a determined length, the contract will end upon the agreed term. It can also be terminated upon a breach of contract, death (in the case of individuals) or the liquidation of any of the parties (in the case of companies).

If the contract is of an indeterminate duration, any of the parties can terminate the contract by a previous notice. Since there is no legal norm regulating the previous notice, this notice should be sent with a reasonable anticipation depending of the particular circumstances of each agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

The circumstances in which a franchisee can terminate the franchise contract are the same as those in which a franchisor can terminate the contract (see question 27).

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Yes, the franchisor can refuse to renew the agreement for any of the reasons listed in the agreement, or simply because the franchisor does not wish to renew it.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Restrictions relating to the nature, amount or payment of fees are relative to connected operations and transfer prices. The relationship between franchisor and franchisee should be established under market conditions and as a relationship between independent entities.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Generally, the amount of interest is freely agreed to by the parties.

In the absence of an agreement, Act 3/2004 of 29 December (as modified by Act 15/2010 of 5 July) that establishes the means for collection in the case of default in commercial operations is applied. This Act establishes the general obligation to pay within the period of 60 days from the receipt of the goods or services; parties are not free to modify this term. In the case of default, the debtor has to pay the interest agreed to or (in the absence of such agreement) the interest decided upon by the Central European Bank, as prescribed by law, with an addition of seven points.

The Act for the Repression of Usury (23 July 1908) is applied when a transaction is considered similar to a loan agreement. This Act nullifies any stipulation of interest that is notably higher than the usual and which is manifestly disproportionate to the circumstances of the specific case.

In cases where there are connected operations, interest should also be calculated according to the norm for transfer prices.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There are no restrictions on making payments to a foreign franchisor in the franchisor's own currency.

34 Are confidentiality covenants in franchise agreements enforceable?

A franchisor can impose confidentiality agreements before, during and after the expiration of the agreement.

Before the contract is signed, this possibility is expressly foreseen in Royal Decree 201/2010 and will affect all the information the franchisor is obliged to disclose.

During and after the franchise agreement, parties are free to stipulate these kinds of clauses.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, the general norms of common law demand that contracts be made in good faith. This rule is applied to franchise contracts through preliminary negotiations, the signing of the contract and the relationship during the carrying out of the contract. Moreover, case law considers that franchise contracts, even though they are not specifically regulated, are subject to good faith and mutual confidence (Supreme Court, Decision No. 754/2005 of 21 October confirmed by Decision No. 145/2009 of March 9).

Acts contrary to good faith can be addressed legally as acts of unfair competition, among other options.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The Consumers' Act foresees that an entity can be considered as a 'consumer' if it acts in a field outside its commercial activity.

37 Must disclosure documents and franchise agreements be in the language of your country?

No specific rule foresees this.

38 What restrictions are there on provisions in franchise contracts?

In general terms, franchise contracts contain the typical restrictions that are usual in other jurisdictions for the same kind of contracts. These restrictions must usually be examined in light of the parties' freedom to regulate their relationship and, in some cases, under European law, particularly regulations on competition. Some of these restrictions include:

- territorial exclusivity has to be expressly mentioned and agreed in the contract; and
- resale price maintenance clauses have been considered null and void by the Supreme Court (Case 567/2009, 30 July) when the franchisor has not only recommended prices to the franchisee but has sent a list of resale prices. These clauses have been considered restrictive even in cases where:
  - for some products only a minimum price or a minimum and a maximum price was fixed; and
  - the price was fixed not for all products, but only for some of them.

Minimum purchase clauses may be admitted but have to be considered together with the franchisor's obligation to supply to the franchisee, the franchisee's freedom to purchase goods from different authorised providers and the reasonableness of the minimum purchase that is agreed.

Restrictions on sources of supply clauses have been admitted by Spanish courts. Article 3 of Royal Decree 201/2010 expressly mentions, as an essential element of the disclosure document, exclusivity clauses and limitations to the franchisee's freedom to run its business.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Competition rules regarding both national and European law are applicable to franchise contracts.

Franchise contracts that actively or potentially restrict or limit competition are considered prohibited by article 101/1 of the Treaty on the Franchising of the European Union and Article 1.1 of Act 17/2007 of the Defence of Competition.

That said, neither article is applied to vertical agreements under the circumstances and conditions foreseen in Commission Regulation (EU) 330/2010 (20 April). Provisions of Article 1/1 of Act 17/2007 will not be applied, without the necessity of a previous decision, to franchise agreements that do not impose on the companies involved restrictions that are not indispensable for a better commercialisation or distribution of goods and that do not allow the possibility of eliminating competition with respect to a substantial part of the products or services concerned.

The National Commission for Competition or the regional authorities for the defence of competition can prosecute and sanction prohibited conduct when such conduct is not considered to be exempted from the application of the cited norms according to the affected market (national or regional).

On the other hand, commercial courts are also authorised to apply the prohibitions and consequences of restrictions of competition to the private relationship between franchisors and franchisees.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

There are two main types of procedures within civil jurisdiction: verbal and ordinary procedure. Generally, a verbal procedure is given for claims under €6,000, while ordinary procedure is foreseen for claims above €6,000 or claims whose amount is not determined beforehand.

The competent court is generally the Court of First Instance where the defendant is domiciled, except where parties have agreed otherwise, and without prejudice to the application of the EU norms.

The sentence issued by the judge of first instance can be appealed (a de novo review of the full case) before the Provincial Court.

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After this sentence, there are two subsequent ways to appeal. An extraordinary appeal on the basis of procedural error: the court competent to resolve such problems is the Superior Court of Justice of the Autonomous Region (according to the Final Disposition 16 of the Civil Procedural Act or by the Supreme Court while the necessary amendments are not adopted). Only infractions of the norms regarding jurisdiction or competence (except territorial competence), infractions of regulatory norms of the sentence or infractions of procedural guaranties that determine the nullity or produce the inability of one of the parties to defend themselves legally can be alleged. The other appeal available is for the annulment of the proceedings (extraordinary procedure): the Supreme Court resolves such matters based on the infraction of the applicable law (as long as the amount exceeds €150,000), or in cases in which there may exist contradictory jurisprudence on the matter.

From the lodging of the initial complaint, the plaintiff can solicit from the court 'preventative measures' to secure the effective judicial protection that is solicited.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitral submission to a Spanish arbitrator is valid, provided some essential elements are respected (including written form and an express provision in the contract).

Arbitration is recommended if parties trust the equanimity and fairness of the arbitrator and in some circumstances because of the arbitrator's special expertise. All the same, the disadvantages of this system in the case of a foreign arbitral decision should also be considered: a special exequatur procedure (with its inherent costs) is required in order for the decision to be enforced in Spain (article 46 of the Spanish Arbitration Act – last amendment by Act 11/2011 of May 20 as well as the New York Convention of 1958).

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are treated no differently from national franchisors, other than the exceptions mentioned in the response to question 11 for franchisors established in the European Union.

Sweden

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Overview

1 What forms of business entities are relevant to the typical franchisor?

In Sweden, there are essentially three types of legal entities through which a franchisor can perform its business: trading partnerships, limited partnerships and limited liability (by shares) companies. The typical franchisor would be a private limited liability company.

2 What laws and agencies govern the formation of business entities?

General provisions on trading partnerships and limited partnerships are provided by the Partnerships Act (1980:1102), and provisions on limited liability companies (private and public) are provided by the Swedish Companies Act (2005:551). Public limited liability companies are those companies that can offer ownership via shares on the open market (mainly listed companies). All other limited liability companies are referred to as private limited liability companies.

The above-mentioned business forms are to be registered with the Swedish Companies Registration Office, which is the authority responsible for the formation and registration of business entities.

3 Provide an overview of the requirements for forming and maintaining a business entity.

A trading partnership

A trading partnership is incorporated when two or more partners have agreed to perform business and registered the company at the Swedish Companies Registration Office. A limited partnership is, according to the Partnership Act, a trading partnership in which one or more, but not all, of the partners have reserved their liability for the company's obligations.

The ongoing relationship between the partners in a trading partnership, as well as in a limited partnership, is governed by the partnership agreement. In the absence of provisions in the partnership agreement, the Partnership Act provides various terms. In order to change the nature of the partnership agreement, a unanimous decision between the partners is needed.

The company name, as well as the registered office, must be provided on letters, invoices, etc, in its full legal form and should be used exactly as it is registered.

Trading partnerships and limited partnerships are required to maintain the accounting records and to pay income taxes, for example, payroll tax and income tax on any profits. If one of the partners is a legal entity, the trading partnership or limited partnership has to file its annual report and auditor's report (if required) at the Swedish Companies Registration Office.

The registration of a trading partnership or limited partnership generally takes about four to six weeks.

A limited company

A limited company is formed when one or more founders resolve to form a limited liability company. A founder must be a natural person resident within the EEA, a Swedish legal entity or a legal entity with its registered office within the EEA.

To incorporate a limited liability company, the founders will have to draft a memorandum of association containing information regarding appointed directors and auditors, if required, subscribe for all the shares in the company and pay for the shares. Should none of the appointed directors be resident within Sweden, the board of directors has to appoint a person who is resident in Sweden and is authorised to receive service of process. The appointed auditor has to be an authorised or approved public accountant and must be resident in Sweden, namely, if the company is required to have an auditor.

The founders shall complete, date and sign the memorandum of association; thereafter, the appointed board of directors shall file for registration of the company at the Swedish Companies Registration Office.

Among other things, the board of directors is responsible for maintaining accounting records, keeping a register of the shareholders and filing the company's annual report and auditor's report to the Swedish Companies Registration Office for each financial year, irrespective of whether the company has been active or dormant. The annual report and the auditor's report (if required) are public documents that give the general public the opportunity of scrutiny.

The registration of a limited liability company generally takes two to four weeks. According to the Companies Act, the company name is to be stated on letters, invoices, etc, in its full legal form and should be used exactly as it is registered. A public limited company that does not have the word public in its company name shall place the designation '(publ)' after its company name.

Similar to the company name, the registration number and the place where the board of directors has its registered office are to be stated on letters, invoices, etc. The place where the registered office of the company is located means the municipality stated in the section of the articles of association on the registered office (and thus also in the Companies Register).

Other

All information regarding registered entities is publicly available. For further details visit the Swedish Companies Registration Office's website, www.bolagsverket.se.

Any company employing staff is required to be registered as an employer at the Swedish Tax Authority and to pay payroll taxes.

4 What restrictions apply to foreign business entities and foreign investment?

There are no restrictions on foreign ownership (direct or indirect) or investment in Sweden. The country's support of the principles of free trade and international remit ability of capital has resulted in an open attitude towards foreign ownership and investment.

It is generally recognised that foreign investment has the advantage of introducing capital and employment opportunities as well as new technology and marketing techniques. Facilities and incentives available to local enterprises for the promotion of industrial development are available also to foreign entities that wish to set up business here; that is, there are no facilities or incentives aimed specifically at foreign investors. During the past three decades most restrictions affecting foreign investments have been lifted and foreign investments do not generally require permission. It should be mentioned that as Sweden is a member of the EU (since 1995), the principle of free movement of capital and trade and non-discrimination against entities and individuals of member states prevails.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

In Sweden there are no provisions in tax law that specifically relate to franchising. This means that ordinary tax rules on business income apply.

Corporate tax

Foreign corporations operating a branch or otherwise from a permanent establishment in Sweden are subject to a 26.3 per cent corporate tax on the net income derived from the permanent establishment. No tax is imposed on the distribution of proceeds from a permanent establishment. Companies incorporated in Sweden also pay a corporate tax of 26.3 per cent on their net profit.

Participation exemption

Non-resident entities are not taxed in Sweden on capital gains from the disposal of shares. For corporations that are tax resident in Sweden, dividends and capital gains are exempted from tax when the shares are held for business purposes. Shares are considered to be held for business purposes if any of the following requirements are met: the shares are not listed; the holding corresponds to at least 10 per cent of the voting power; or the holding is otherwise related to a business performed by the holder or a company related to the holder.

Withholding tax

Dividends to a foreign corporate shareholder are exempt from withholding tax to the same extent that a dividend is exempt from tax if distributed to a Swedish resident shareholder. An additional requirement is that the receiving company is subject to a corporate tax comparable to the tax levied on a Swedish company. This means that withholding tax is normally imposed only on dividend distributions to tax haven companies. The statutory withholding tax rate on dividends is 30 per cent. Tax treaty provisions may apply in specific cases. There is no withholding tax on interest payments.

Royalty payments

Franchise fees are normally treated as 'royalties' for income tax purposes. There is no withholding tax in Sweden on royalty payments to a foreign entity. Instead Swedish-source royalties are taxed as a special form of income from a permanent establishment. This means that a foreign entity that receives royalties from Sweden should pay the 26.3 per cent corporate tax as if the royalties were income from a permanent establishment in Sweden. However, royalties are subject to tax treaty provisions that generally prescribe tax liability only in the state of residence of the receiving party. This means that royalties are normally exempted from tax in Sweden when the receiving party is resident in a treaty jurisdiction. Treaty provisions have to be checked in each individual case.

Special rules apply on royalty payments between related companies in EU jurisdictions. As a main rule, intra-group royalties within the EU are taxed only in the jurisdiction of the receiving party (EU Directive 2003/49/EC).

Payroll taxes

Statutory employer social security contributions amount to 31.42 per cent (as of 2011) of total salary and benefits paid to the employee. A reduced rate of 15.49 per cent or 10.21 per cent applies on salary payments to young and older employees (aged 18 to 24 and over 64). Preliminary tax has to be withheld on salary payments. Payroll taxes are normally due on a monthly basis.

Tax treaties

Sweden has an extensive network of tax treaties (currently 84 countries).

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

There are no specific labour and employment considerations for typical franchisors. Provided that the franchisee is an independent entity acting on its own behalf and in its own name when paying salary and entering into employment contracts, there is hardly any risk that a franchisor will be regarded as an employer or joint employer based merely on the fact that the franchise agreement, for example, requires the franchisee to comply with the applicable employment laws or collective bargaining agreements, including any local minimum wage requirement. The same applies if the franchisor's prior acceptance is required with regard to employment of key personnel.

Moreover, there may be situations whereby the EC Transfer of Undertakings Directive (and Swedish local equivalent) applies: for example, if one franchisor or franchisee takes over the business of the other. In such a case, the relevant business' employees will transfer to the acquirer.

In other respects, it should be noted that the Swedish Discrimination Act (the Act) prohibits discrimination on various grounds, including sex, transgender identity or expression, ethnicity, religion or other belief, disability, sexual orientation and age. The Act also prohibits orders or instructions to discriminate against someone. Hence, a franchisor may not instruct a franchisee to discriminate.

7 How are trademarks and know-how protected?

Trademarks are protected by registration under the Swedish Trademarks Act. Registration protects the use of the trademark in relation to a specific class of goods or services. Trademark protection can also be achieved provided it can be proven that the mark is established on the market, which is the situation when it has become well known to a significant portion of the consumers of the goods or services available under the mark. Certain protection may also be sought under the Swedish Marketing Act for passing off.

Know-how is usually protected by way of a confidentiality undertaking in the franchise agreement, which is enforceable in Sweden.

8 What are the relevant aspects of the real estate market and real estate law?

In Sweden it is possible to hold land either by freehold, site leasehold or leasehold. The only existing form of complete and absolute ownership in Sweden is by freehold. (Site leasehold is a form of leasehold of land owned by the state or a municipality, but the holder is, in principle, in the same legal position as the owner of a freehold.) Since acquiring freehold property usually requires a significant capital investment, leasehold is the most common form for franchises, in particular when starting up a franchise system or entering new markets and locations.

A lease of real property is governed by different regulations depending on in what manner the property is leased. Generally, if the object of a lease is a building or a part thereof, it is considered a

lease in accordance with the tenancy regulation that is incorporated in chapter 12 of the Swedish Land Code. Commercial leases are usually valid for a settled period of time and there are no limits regarding minimum terms.

A tenant has indirect (economic) legal protection of the lease, from which it follows that a right to compensation arises if the landlord does not have a legitimate reason for terminating the lease (the legitimate reasons being stipulated in the tenancy regulation). The minimum compensation corresponds to an amount equivalent to one year's rent. However, it is common that this matter is regulated in the lease agreement and that the tenant and the landlord sign a separate agreement excluding the right to compensation in accordance with chapter 12 section 57–60 of the Swedish Land Code. Such an agreement is generally valid if it is approved by the Rent Tribunal.

Proper location of the premises is always important for a franchise activity. It is therefore often important for the franchisor to have control over the premises. This is possible if the franchisor rents the premises from the landlord and subleases it to the franchisee or, if the franchisee rents the premises directly from the landlord, if there is a provision in the lease agreement stipulating that the lease agreement shall transfer to the franchisor if and when the franchise agreement is terminated. If the landlord refuses transfer without reasonable cause, the Rent Tribunal can permit the transfer.

If the franchisor concludes the lease agreement with the landlord, the franchisor should observe that the lease agreement needs to provide a right to sublease to the franchisee. The terms of the sublease agreement should reflect the terms of the lease agreement and the franchise agreement needs to take the terms of the lease agreement into account (synchronisation), particularly with respect to termination provisions, so that the franchisor can give vacant possession of the lease at the expiry of the lease agreement and avoid being stuck for a time without any franchisee.

If premises are not identified when the franchise agreement is negotiated, the franchisor should consider making the franchise agreement conditional upon the signing of a lease agreement of premises approved by the franchisor. The same applies if a planning approval or other kind of authority decision is required to furnish or change the proposed premises.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The closest one can get to a legal definition is the definition of a franchise agreement in the Swedish Franchise Disclosure Act. It was enacted in October 2006 and the definition of a franchise agreement reads in rough translation as follows:

> *In this law, franchise agreement is intended to mean an agreement by which an entrepreneur (the franchisor) agrees with someone else (the franchisee) that the latter, against compensation paid to the franchisor, shall use the special business idea of the franchisor for the marketing and sale of goods and services. Further conditions for an agreement, according to this law, are that the franchisee, under the agreement, shall use the distinctive trademark and other intellectual property rights of the franchisor and cooperate on the occasion of recurrent controls of the observance of the agreement.*

It has been argued in the literature on the subject that the statutory disclosure obligation could be avoided entirely by not including a recurrent control system in the franchise agreement.

The Swedish Franchise Association (SFA) provides a similar definition in its ethical standards. These standards apply only to members (www.franchiseforeningen.se). However, when it comes to the statutory pre-contractual disclosure requirement, the definition in the disclosure regulation does of course apply.

10 Which laws and government agencies regulate the offer and sale of franchises?

Apart from the aforementioned Swedish disclosure regulation that is also elaborated on in questions 14 to 20, there are no laws or agencies that specifically regulate the offer and sale of franchises.

Competition law may have an impact on franchises, for example, by way of prohibiting certain restrictive terms of franchise agreements. The Swedish Competition Authority monitors the Swedish Competition Act. See question 39 for more information on competition law.

The SFA provides ethical standards that apply to members only (www.franchiseforeningen.se).

11 Describe the relevant requirements of these laws and agencies.

See questions 14 to 20 for information on pre-contractual disclosure and question 39 for further information on Swedish competition law.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There are no exemptions or exclusions, but as mentioned in question 9, it has been argued that the entire disclosure obligation may be set aside by not including a control system in the franchise agreement. See questions 14 to 20 for further information on pre-contractual disclosure and question 39 for information on Swedish competition law.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

No such requirement exists by way of law. The ethical standards of the SFA require that the franchise system must have a track record and at least one franchisee before introduction of the system. The standards are only binding on members of the SFA.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

The disclosure regulation does not distinguish between different types of franchisors. Therefore, it is the sub-franchisor that shall provide the franchisee with the required information. As a further consequence, in a sub-franchising structure the master franchisor shall provide the sub-franchisor with the required information in ample time before conclusion of the agreement.

See question 16 with regard to what type of information should be disclosed. In a sub-franchising structure the sub-franchisor need not disclose information concerning the franchisor or the contractual or other relationship between the franchisor and the sub-franchisor if it is not necessary in order to correctly describe the franchise activities (minimum requirement number one); the total number of franchisees within the system, how big they are, where they are located and the contact details of those closest (minimum requirement two); the IP rights involved (minimum requirement four); or any sourcing requirements (minimum requirement five).

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

The Swedish regulation is a pure disclosure regulation and does not require filing, registration or authority notification of the disclosure

document. As to form and timing, it provides that pre-contractual disclosure should be made in ample time before the franchise agreement is concluded and that disclosure should be made in writing in understandable language. Ample time means approximately two weeks, but depending on the circumstances this could, in exceptional cases, be less.

16 What information must the disclosure document contain?

The Swedish disclosure regulation provides one general requirement and eight minimum requirements. The general requirement provides that the franchisor shall provide the franchisee information about the implication of the agreement and such other factors that are needed in consideration of the circumstances. The eight minimum requirements are:

- a description of the franchise activity that the franchisee is to engage in;
- information on the other franchisees with which the franchisor has concluded an agreement within the same franchise system, and the volume (scope) of their activity (this requirement probably entails accounting for the total number of franchisees within the system, how big they are, where they are located and the contact details of those closest, so that the potential franchisee can make contact and obtain further information);
- information on the compensation that the franchisee shall pay the franchisor and other economic conditions for the franchise activity;
- information on the intellectual property rights that will be granted;
- information on the goods or services that the franchisee is obliged to buy or rent;
- information on non-completion undertakings that shall apply during or after the termination of the franchise agreement;
- information about the term of the agreement, conditions for modification, prolongation and termination of the franchise agreement, as well as the economic consequences of termination; and
- information regarding how a dispute under the agreement shall be settled and the liability for costs of such a settlement.

There is no requirement that disclosure should be made in Swedish; only that it should be made in writing and in clear and understandable wording. If there is any doubt that the recipient of the information may not have a good knowledge of, for example, English, it is advisable to provide the information in Swedish.

17 Is there any obligation for continuing disclosure?

There is no requirement to update a disclosure made pursuant to the Swedish disclosure regulation. Material changes to a franchise may however trigger an obligation to re-disclose if the franchise agreement can, in reality, be regarded as a new agreement.

18 How do the relevant government agencies enforce the disclosure requirements?

The Swedish Market Court is the enforcing body and proceedings may be brought before the court by a franchisee or an association having a justified interest in representing business people or entrepreneurs.

In the case of violation of the disclosure obligations, the Market Court may order the franchisor to disclose, in the specific case or for future offerings, the missing information. An administrative fine can be appended to the order.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

As mentioned, the Swedish disclosure regulation is a pure disclosure regulation, meaning that apart from the pre-contractual disclosure obligation, it does not regulate the relationship between the franchisor and the franchisee. Therefore, neither civil actions by franchisees nor criminal penalties are available on the basis of the disclosure regulation.

As in any other pre-contractual or contractual relationship, withholding, distorting or providing false information may lead to consequences in relation to a franchise, and consequently all remedies for pre-contractual and contractual wrongdoings, including damages and cancellation of the contract, may be available. In principle, the right to compensation for pre-contractual damages does not cover loss of profit. Also in principle, contractual damages are calculated on the basis that the economic position of the aggrieved party should be restored to what it would have been had the breach of contract or the wrongdoing not taken place, meaning that loss of profit may be included.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The disclosure regulation does not distinguish between master franchisors and sub-franchisors. Therefore it is the sub-franchisor that is under obligation to provide the information to the franchisee. In relation to a franchisee, the sub-franchisor is therefore closest to liability, and possible remedies are accounted for in questions 18 and 19. As long as there is no criminal liability involved – for example, for fraud – officers and directors of franchisors will not personally be exposed to liability.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The offering and selling of franchises is subject to Swedish contract law and general contractual principles.

The SFA requires its members to comply with its ethical standards, which are substantially based on the European Code of Ethics for Franchising. Membership is voluntary and therefore franchisors who are not members do not have to comply with these standards. The standards require franchisors to have undertaken a trial operation of the business before launching the franchise, to prove ownership of all intellectual property associated with the franchise and to provide initial and ongoing training to the franchisee.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

There are no statutory rules on seller's disclosure outside the mentioned disclosure regulation, but general principles of loyalty or fair trading and dealing may, depending on the circumstances in the specific case, provide that the seller shall not withhold information that the seller understands may be of decisive importance to the buyer.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

If a franchisor engages in fraudulent or deceptive practices, the franchisee may have a remedy for fraudulent misrepresentation. To bring an action, the franchisee must prove, on the balance of probabilities, that the franchisor made a false statement that he or she knew or believed to be false at the time it was made, and that the franchisee was induced into entering the agreement by it. If the franchisee is able to prove this, then it will be able to treat the contract as null and void and, potentially, claim damages.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There is no specific law regulating the ongoing relationship between a franchisor and franchisee after the franchise contract comes into effect. Swedish contract law and general principles of contract law apply.

Swedish contract law provides for contract modification under specific circumstances. Contract terms may be modified or set aside if deemed unfair (unconscionable) in view of the contents of the contract, the circumstances prevailing at the time the contract was entered into, subsequent circumstances or the circumstances in general. This follows from article 36 of the Swedish Contracts Act. When determining the applicability of the provision in question it is stated that special regard should be paid to the need to protect those who, in their capacity as consumers or otherwise, hold an inferior bargaining position. Although there is no legal obstacle preventing an application in commercial relationships with balanced bargaining position, the principle purpose of article 36 is to protect consumers and others, whether individuals or legal entities, who are in a consumer-like position from unfair contract terms. No Supreme Court precedent exists in which the provision has been applied to commercial relationships in which the inferior party was not a consumer or a typical small-scale enterprise (in a consumer-like position). However a recent arbitration award rendered by a panel in which one of the arbitrators was a Supreme Court judge suggests a change towards a more general application of article 36 in commercial relationships. Most franchisees would probably not fall into the consumer-like category but the smaller ones, such as the one-person shop, may do so. If this is the case, special consideration should be made when drafting contract provisions concerning, inter alia, limitation of liability termination, penalties and arbitration.

25 Do other laws affect the franchise relationship?

Laws such as the Sale of Goods Act and the International Sale of Goods Act (CISG) may apply, and principles such as the UNIDROIT Principles of International Commercial Contracts, the Principles of European Contract law (PECL and PELSC) and the Draft Common Frame of Reference (DCFR) may imply certain terms into contracts between the franchisor and the franchisee. The said principles may be applied when the contract or the law is silent or needs filling out or interpretation. This is clearly demonstrated by a recent precedent (NJA 2009, page 672) in which the Supreme Court filled out the termination provision of a distributor agreement by stipulating a reasonable notice period of three moths. The ethical standards of the SFA may also affect the relationship, but only in relation to members of the SFA.

The Swedish Personal Data Act may affect the relationship insofar as where the personal integrity of customers and personnel of the franchise system is concerned. Implemented pursuant to the European Data Protection Directive, the act applies to controllers of personal data who are established in Sweden, or cases in which the controller of personal data is established in a third country (a state not included in the EU or EEA, for instance the US) but uses equipment situated in Sweden for the processing of personal data. It applies to all such processing of personal data that is wholly or partly automated. Personal data – for instance, information pertaining to customers, suppliers or employees – may be processed only if the registered person has given his or her consent to the processing or if the processing is necessary to fulfil certain purposes: for instance, to enable the performance of a contract or a purpose that concerns a legitimate interest of the controller of personal data if the interest is of greater weight than the interest of the registered person in protection against violation of personal integrity. If data about a person is collected, the controller of the data shall in conjunction voluntarily provide the registered person with information about the processing of the data.

In the main, it is prohibited to transfer personal data to a third country that is undergoing processing. This also applies to the transfer of personal data for processing in a third country unless the third country has an adequate level of protection for personal data. But if consent by the registered persons is not a viable route to take, contractual solutions (implementation of the standard contractual clauses adopted by the EU commission) or the Safe Harbor Principles (applicable to US entities only) may be used to comply with the Act and transfer personal data to entities in, for example, the US.

Furthermore, binding corporate rules (BCR) may be adopted. BCR are internal rules that establish consistent and compliant requirements for the use of personal data within a multinational company. BCR makes it possible for the local data protection agencies to authorise the transfer of personal data to third countries within the meaning of the act or directive. This is a flexible and efficient way of complying with the rules in the act or directive and transferring personal data to entities in third countries. For the company to adopt and use BCR, it must be able to guarantee adequate protection of personal data with regard to its transfer to a third country. The BCR must apply generally and throughout the corporate group, irrespective of the place of establishment of the members or the nationality of the data subjects whose personal data are being processed. BCR provides a uniform minimum standard for every entity within the group. If applicable local law provides a higher level of protection than that established by the standard, the requirements of local law will apply. The internal rules of a corporate group cannot replace the data protection obligations by which the members of the corporate group are bound by law but it forms a practicable tool for large multinationals who would otherwise perhaps need to incorporate a vast network of bilateral intragroup agreements in order to provide for international transfers of personal data within the group. DLA Nordic has successfully acted for a multinational group seeking exemption from the prohibition based on adopted BCR (the first application ever in the Nordic countries).

As to the relationship between a franchisee and its customers, various general laws (private and public) such as the Contracts Act, the Sale of Goods Act, the Consumer Sale of Goods Act, the Personal Data Act, various other consumer protection regulations, the Marketing Practices Act, the Competition Act and sector-specific related regulations, to name a few, will apply to the franchise activities in the same way that they apply to any other local business activity.

For information on competition law, please see question 39.

26 Do other government or trade association policies affect the franchise relationship?

No, not in principle. However, the SFA imposes ethical standards applicable to its members. See question 21 for brief information on these standards.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

As already mentioned, apart from the disclosure regulation, Sweden has no specific franchise relationship law, so it is up to the parties to agree on the conditions for termination. Due to the risk that even in a franchise relationship, specific regulations in existence applying to agents could be invoked, the parties should regulate whether or not rights on termination, severance or goodwill pay shall apply. As mentioned under question 25, the risk is clearly demonstrated by a recent precedent (NJA 2009, page 672) in which the Supreme Court filled out the termination provision of a distributor agreement by stipulating a reasonable notice period of three months. In view of this, and in particular when a long-lasting relationship that is silent as to the notice period is being terminated without cause, it is recommended that the franchisor observes a three- to six-month notice period.

A franchise agreement will typically contain terms allowing the franchisor to terminate for material breach of contract or insolvency of the franchisee. Swedish law imposes no specific requirement relating to the termination of franchise agreements. Swedish general contractual principles allow either party to terminate by virtue of a fundamental breach of contract by the other party. In addition to the right to terminate, damages are also available as a remedy.

28 In what circumstances may a franchisee terminate a franchise relationship?

Subject to the specific termination rights it may have under the franchise agreement, the general contractual principles stated under questions 25 and 27 will apply also to the franchisee.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Subject to any renewal provisions in the specific franchise agreement, there is no general legal obligation for a franchisor to renew. All the same, franchisees are usually given the right to renew for at least one further period, generally of the same length as the first. Renewal is not usually granted unless the franchisee has performed adequately. The right to renew can be made conditional upon, for example, the re-entering into of the current form of agreement, completion of refresher training or payment of legal costs.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor may restrict the franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity. The franchise agreement usually stipulates that the franchisee has no right to transfer the franchise without the franchisor's consent.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws or regulations affecting the nature, amount or payment of fees. For principles on contract modification, please refer to question 24.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

In principle, interest can be charged at the rate agreed between the parties. If no rate of interest is agreed, the Swedish Interest Act stipulates a per annum rate of 8 per cent over a specific official interest rate that is announced from time to time by the Central Bank of Sweden. For principles on contract modification, see question 24.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No such restrictions apply at present. Sweden abolished exchange controls a long time ago (and exchange controls are not allowed within the EU).

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants in franchise agreements are, in principle, enforceable if correctly drafted. In practice enforcement may be more difficult.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

There is a general contractual principle (or theory) that the parties shall deal with each other in good faith. The principle is also reflected in the previously mentioned UNCITRAL, PECL and DCFR principles. The ethical standards of the SFA also impose on its members an obligation to deal fairly with one another.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

No such specific law or regulation exists. Nevertheless, as mentioned under question 24, article 36 of the Swedish Contracts Act provides means for contract modification for the purpose of protecting primarily consumers. The provision may also be applied in favour of those in a consumer-like position and has on a few occasions been applied to typical small-scale enterprises and arbitration clauses, which clauses were set aside by the courts.

37 Must disclosure documents and franchise agreements be in the language of your country?

There is no requirement that disclosure should be made in Swedish; only that it should be made in writing and in clear and understandable wording. If there is any doubt that the reader of the information may not have a good knowledge of English, for example, it is advisable to provide the information in Swedish.

38 What restrictions are there on provisions in franchise contracts?

As mentioned, Swedish contract law provides for contract modification under specific circumstances. Contract terms may be modified or set aside if deemed unfair (unconscionable) in view of the contents of the contract, the circumstances prevailing at the time the contract was entered into or subsequent circumstances, or the circumstances in general. This follows from article 36 of the Swedish Contracts Act. Although there is no legal obstacle preventing an application in a commercial relationship with a balanced bargaining position, the principal purpose of article 36 is to protect consumers and others, whether individuals or legal entities, who are in a consumer-like position from unfair contract terms. No Supreme Court precedent exists in which the provision has been applied to commercial relationships in which the inferior party was not a consumer or a typical small-scale enterprise (in a consumer-like position).

Update and trends

There are no trends or hot topics but the precedent mentioned in answer to question 27 should be noted. It demonstrates the importance not to leave any gaps in the franchise agreement when, for example, it comes to notice period for termination, severance pay and or goodwill pay – as the courts may, if the franchisee's dependence on the franchisor resembles an agent/principal relation, fill such gaps using agency principles and those are generally regarded less favourable from a franchisor perspective.

Also, as mentioned under question 24, the change in application of article 36 of the Swedish Contracts Act (contract modification) towards usage in non consumer-like relations should be noted. In that case a limitation of liability clause was modified against the party relying on monetary limitation.

All the same, a recent arbitration award decision given by a panel in which one of the arbitrators was a Supreme Court judge suggests a change towards a more general application of article 36 in commercial relationships. Most franchisees would probably not fall into the consumer-like category but the smaller ones, such as the one-person shop, may do so. If this is the case, special consideration should be made when drafting contract provisions concerning, inter alia, limitation of liability, termination, penalties and arbitration.

Restrictions may also follow from competition law. For such restrictions, see question 39.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Sweden became an EU member in 1995. The Swedish Competition Act is, in principle, a blueprint of the EU competition regulation. In addition, the EU regulation is, in principle, directly applicable in the member states. Below is a brief account of the major features of a rather complex regulation.

Article 101 of the Treaty on the Functioning of the European Union (TFEU) (formerly article 81 of the EC Treaty) and the corresponding Swedish prohibition prohibits agreements, decisions or concerted practices that may affect trade between member states and that have as their object or effect the prevention, restriction or distortion of competition. The Swedish prohibition applies where agreements affect trade within Sweden; article 101 applies where they affect trade between member states. Franchise agreements may fall under either prohibition, subject to the exceptions and exemptions set out below.

An agreement will fall within the prohibition only if it has as its object or effect an appreciable prevention, restriction or distortion of competition within the aforementioned respective geographical areas. In determining whether an agreement has an appreciable effect on competition, the Swedish Competition Authority (KKV) will, under article 101, have to regard the European Commission's Notice on Agreements of Minor Importance. This states that a franchising agreement (which is a vertical agreement) will normally fall outside the prohibition if the market share of each party does not exceed 10 per cent if the agreement is concluded between actual or potential competitors, or 15 per cent if concluded between those who are not competitors. However, if the franchise agreement is de minimis but contains hard-core restrictions, it will be prohibited under article 101. Hard-core restrictions include price fixing, resale price maintenance and absolute territorial protection (division of markets) and will be dealt with further below.

By reference, the general thresholds in the European Commission's Notice on Agreements of Minor Importance are also applicable under the Swedish prohibition. However, there is one difference. According to the KKV Notice on Agreements of Minor Importance, parties to an agreement where neither firm reaches a turnover of 30 million kronas will not be considered to be effecting competition if their combined market share is below 15 per cent of the relevant market.

Vertical agreements are those between undertakings that operate at different levels of the production or supply chain, such as most franchise agreements. Many of the obligations contained in franchise agreements can be assessed as being necessary for the protection of intellectual property rights or to maintain the common identity and reputation of the franchised network. Therefore, by virtue of the EC Block Exemption for Vertical Agreements, which is by reference also applicable under the Swedish Competition Act, franchise agreements may fall outside the prohibitions. The block exemption will, however, not apply if the market share held by the supplier exceeds 30 per cent of the relevant market in which it sells the contract goods or services or, in the case of 'exclusive supply' obligations, if the buyer has more than a 30 per cent share of the relevant market in which it purchases the contract goods or services.

There are no provisions regarding the duration of a franchise agreement itself. But the block exemption will not cover any direct or indirect non-compete obligations contained in a franchise agreement that runs for an indefinite period or in excess of five years. Non-compete obligations (exclusive purchase agreements) that are renewable under the terms of a franchise agreement, so that they will in effect be in excess of five years' duration, are held to have been concluded indefinitely. A non-competition restriction that goes beyond the said limitations is, however, permitted when the obligation is necessary to maintain the common identity and reputation of the franchised network. Such a restriction will then fall outside article 101 TFEU, meaning that the benefit of the block exemption will not be needed. In these circumstances, the duration of the non-compete obligation is irrelevant as long as it does not exceed the duration of the franchise agreement.

There is also a block exemption for distribution systems within the motor industry.

If none of the above exemptions apply, a franchise agreement may meet the conditions for individual exemption under article 101(3) TFEU or section 2.2 of the Swedish Competition Act, respectively. To qualify for an individual exemption, the overall economic benefits of the agreement must outweigh the effect on competition. Where the supplier is dominant in the market, any restrictions must be objectively justifiable.

As mentioned, hard-core restrictions are always forbidden and thus disqualify application of a block exemption. Franchise agreements can be exclusive distribution agreements and are permitted provided they do not allow for absolute territorial protection. Other restrictions on territories or customers to which a distributor can make sales or provide services are considered hardcore restrictions. For example, a ban on passive (unsolicited) sales is a hard-core restriction. Direct or indirect price fixing (for example, agreeing a minimum sale price or level of discount) and resale price maintenance are hardcore restrictions (but a maximum sale price restriction may be imposed). The block exemption will not apply if a franchise agreement includes any of these restrictions.

European and Swedish competition law also prohibit the abuse of dominant market position. Since this applies in principle only to a business with a market share of 40 per cent or more of the relevant market, very few franchisors are considered dominant and therefore affected by the prohibition.

As to the enforcement of competition law, the enforcing authorities, KKV and the European Commission, may carry out an investigation into suspected competition law infringements. The Commission will only be involved if the suspected infringements could affect the trade between member states. The enforcing authorities have significant powers through which to investigate suspected anti-competitive behaviour, including entering and searching business premises (dawn raids) and imposing heavy fines. For more on Swedish competition law and on KKV visit www.kkv.se.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

In civil cases, proceedings are commenced by the person who has the claim (the claimant). The claimant must try to prove the liability of the other party (the respondent) on the balance of probabilities. The choice of court depends on where the other party resides or has its place of business, but a number of other circumstances may also be decisive. Often, the parties agree on either arbitration (first and final instance) or a specific public court as an agreed forum of first instance. In commercial relations the most common way to settle disputes is arbitration, a sort of private court where party-chosen impartial arbitrators handle the dispute and render an award. An award may be enforced in any country that has signed the New York Convention. The procedures for arbitration may, depending on the choice of the parties, be subject to law or to a certain set of rules administered by an institute, such as the arbitration rules of the Arbitration Institute of the Stockholm Chamber of Commerce (www.sccinstitute.se). The Swedish court system for civil law disputes consists of three instances, the district court, the court of appeal and the supreme court. There are restrictions on appeals to the second and third instance.

As mentioned, the Swedish disclosure regulation requires disclosure on how a dispute under the agreement shall be settled and of the liability for the costs for such settlement.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The advantages of arbitration in Sweden include the fact that the legal community in Sweden is highly reputed for its knowledge and experience in arbitrating international commercial disputes; the swift and non-public arbitration procedure; and the access to easy and swift enforcement of an award.

Disadvantages include the fact that the costs are rather high in comparison with court proceedings in Sweden, although not necessarily in comparison with international arbitration in other European countries.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not treated differently from domestic franchisors in any way.

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Switzerland

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Overview

1 What forms of business entities are relevant to the typical franchisor?

While there is no requirement for a foreign franchisor offering or selling franchises in Switzerland to form a Swiss corporate vehicle for this purpose, many do. Franchisors have a variety of legal forms from which to choose; however, the most common form is the stock corporation (AG), followed by the limited liability company (GmbH). The latter has become more and more popular in the past few years. The minimum share capital of an AG amounts to 100,000 Swiss francs divided into shares with a nominal value of at least 0.01 Swiss francs. Upon incorporation, 20 per cent of the par value of each share must be paid in cash, by a contribution in kind or by a set-off; in all cases the contributions made must total at least 50,000 Swiss francs. For the establishment of a GmbH a minimum capital of 20,000 Swiss francs is required, which must be fully paid either in cash, by a contribution in kind or by a set-off. The capital of the GmbH may be divided into shares with a par value of at least CHF 100 Swiss francs each. Both the AG and the GmbH are limited liability companies. Only the AG qualifies for a listing on a stock exchange in Switzerland, namely the SIX Swiss Exchange or the BX Berne Exchange.

2 What laws and agencies govern the formation of business entities?

The formation of business entities is governed by the Swiss Code of Obligations (CO). AGs and GmbHs must be registered with the commercial register in the canton of their registered office. The Commercial Register Ordinance governs the technicalities of the registration.

3 Provide an overview of the requirements for forming and maintaining a business entity.

An AG or a GmbH may be formed by one or more physical persons or legal entities. The founders have to declare formation in a formal act, the minutes of which must be notarised. In this act the founders have to adopt the articles of incorporation, appoint the company's officers, subscribe to the shares or contributions and record that the promised contributions have been made. The articles of incorporation contain, in particular, the name and the registered office of the company, its purpose and its share capital. The board of directors (or, in the case of the GmbH, all members) are responsible for the management and the representation of the company. Nevertheless, the day-to-day management and representation can also be delegated if the articles so provide. Foreign franchisors must be aware that for AGs and GmbHs it is mandatory that at least one person resident in Switzerland with individual signature right must be entitled to represent the company. This person may be a board member, a manager or another officer in the case of an AG, or a managing officer or manager in the case of a GmbH. If joint signature rights by two are granted only, the above resident and function requirements must be met by two individuals.

4 What restrictions apply to foreign business entities and foreign investment?

See question 8 regarding the acquisition of real estate by persons abroad. There are no other requirements specific to foreign franchisors in Switzerland.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Switzerland is a confederation of 26 cantons (states) with about 3,000 municipalities. Taxes are levied at the federal and cantonal or communal levels. This system leads to a certain degree of tax competition between the cantons, and therefore to relatively low tax rates compared to other countries in Europe or worldwide.

Resident individuals are subject to personal income and net wealth tax. Partnerships (and similar groups of persons without legal personality) are transparent for tax purposes, with the partners being taxed individually. Generally, non-residents deriving income from Swiss sources may be subject to certain withholding taxes, but admission fees and royalties payable to foreign franchisors are generally not subject to Swiss withholding taxes.

Federal income tax is regulated in the Federal Direct Tax Act (DBG). There is no federal net wealth tax. Cantonal and municipal income and net wealth taxation is incorporated in the different cantonal tax laws. Resident companies are subject to federal corporate income tax, as well as to cantonal and communal corporate income and capital tax. In addition, in most cantons corporate bodies are subject to church tax. The federal corporate income tax rate is 8.5 per cent or 7.8 per cent on a net basis, taking into consideration that in Switzerland, all taxes due by corporate taxpayers are deductible for the purposes of determining the tax base. The cantonal tax rates vary considerably. Generally, pursuant to the decision BGE 134 I 303 of the Federal Supreme Court, the business of a franchisee generally does not qualify as a permanent establishment of the franchisor even if premises of the franchisor are rented by the franchisee. Therefore, no limited tax duties arise for franchisors in the cantons in which their franchisees are domiciled.

In general, the Swiss value added tax (VAT) system is in line with the Sixth Directive of the European Union. Deliveries and services rendered in Switzerland by a taxable person are in principle subject to VAT. Taxable persons are classed as entrepreneurs exercising a business activity in Switzerland if their turnover exceeds 100,000 Swiss francs per year. The legal form of the business has no influence on liability to VAT. All persons (also private individuals) must pay VAT if they import services exceeding 10,000 Swiss francs per year. In addition, persons (including private individuals) importing goods from abroad are subject to VAT if they are liable to customs duties. The ordinary VAT rate is 8 per cent. Reduced rates apply for, among other things, lodging services and the personal consumption of food, pharmaceuticals and newspapers. Services related to franchise relationships are subject to VAT and do not benefit from special rates.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

According to Swiss law, franchisees are considered to be 'independent contractors'. Nevertheless, where the terms of the franchise contract provide for dominance of the franchisor, thereby substantially limiting the entrepreneurial freedom of the franchisee, there is a certain risk that protective provisions of Swiss employment law are applied by analogy in connection with the franchise relationship. In a major case, BGE 118 II 157, the Federal Supreme Court confirmed that employment law provisions on abusive termination and the respective indemnifications must be applied by analogy to such relationships. This risk may be reduced in the franchise contract by limiting the level of control and influence that a franchisor may exercise and by extending the franchisee's entrepreneurial freedom. Nevertheless, in cases where subordination is less marked, there is a risk that protective provisions of Swiss agency law could be applied by analogy to a franchise relationship. The compensation for clientele must be mentioned specifically. Unfortunately, further decisions of the Federal Supreme Court that might offer guidance regarding these issues have not been rendered.

7 How are trademarks and know-how protected?

In Switzerland, trademarks may be protected in two ways: franchisors can register trademarks nationally with protection in Switzerland, or via an international trademark (IR-trademark) based upon a foreign trademark. The World Intellectual Property Organisation (WIPO) in Geneva is responsible for registering and administering international trademarks, whereas the Swiss Federal Institute for Intellectual Property handles national applications. The scope of protection is the same whether the trademark is registered nationally or internationally. Notoriously known trademarks are an exception to the registration principle. The Swiss Trademark Act (MSchG) is based on a liberal concept of trademarks: basically, all graphically representable signs may be used as trademarks in the legal sense as long as they may serve as an indication of origin for the goods or services claimed by the trademark. Trademarks, except for famous ones, are protected only for the goods and services for which they are registered. Infringement of a registered trademark occurs by the unauthorised use of either an identical or a similar trademark for identical or similar products, if such trademark is likely to cause confusion. Statutory remedies are (in particular) injunctive relief, claims for damages and, to a certain extent, claims for the defendants' profits and attorneys' fees and costs. Switzerland also provides an opposition system to allow the elimination of infringing trademarks from the registry within a certain period.

Know-how as such is not protected as intellectual property by any specific act. Nevertheless, by qualifying know-how as confidential information, protection may be provided by the terms of the franchise contract. In cases of unfair competition through the use of know-how, a franchisor may obtain protection through the Swiss Unfair Competition Act (UWG). Such unfair competition may, upon petition, be punished by imprisonment for up to three years or a monetary penalty pursuant to the Swiss Penal Code (StGB).

8 What are the relevant aspects of the real estate market and real estate law?

In Switzerland, no specific regulations apply for franchisors only. The Federal Act on the Acquisition of Real Estate by Persons Abroad (BewG, usually referred to as Lex Koller) governs and, in certain areas, restricts the acquisition of real estate by foreigners. Nevertheless, real estate which is used for commercial purposes, such as manufacturing or retail premises or offices, may be acquired without authorisation. There are no other requirements applying to foreigners that a franchisor conducting business in Switzerland must observe.

Besides the restrictions of the BewG, the general rules of the Swiss Civil Code (CC) as regards the acquisition of real estate and the general rules of the CO are applicable. Among other things, these rules provide for notarisation of purchase contracts for real estate.

Under Swiss tenancy law, tenants and lessors are, in principle, free to arrange their tenancy agreement. Nevertheless, the CO and an ordinance specifying the provisions on tenancy (VMWG) contain various protective provisions in favour of tenants, such as compliance with specific formalities when giving a notice of termination or when increasing the rent.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

Neither the CO nor other acts or regulations define franchise contracts. According to Swiss legal authorities and the Swiss Federal Supreme Court, a franchise contract is deemed to be an ongoing contractual relationship involving close cooperation between the parties. The relationship embraces the sale and resale of goods or services through independent and self-employed franchisees on their own account and risk but under a uniform distribution concept provided by the franchisor. The franchisee receives ongoing assistance, training and advice from the franchisor and may use the latter's labels, trademarks, know-how, equipment or other property and intellectual property rights. The franchisor usually reserves the right to issue directives and thus to maintain a certain degree of control over the business activities of the franchisee.

10 Which laws and government agencies regulate the offer and sale of franchises?

As already indicated, franchise contracts are not regulated by a special statute; nor are they monitored by a specific agency. In particular, there are no pre-contractual disclosure provisions (see question 14). Therefore, the general provisions of the CO, the CC and, to some extent, intellectual property laws, the Swiss Unfair Competition Act and the Swiss Act on Cartels and other Restraints of Competition are applicable. The principle of good faith plays an important role with regard to contractual negotiations and the respective conduct of the parties. Therefore contractual negotiations have to be serious and any disclosed information, particularly with respect to the basic elements of the franchise contract, has to be true. Furthermore, the disclosed information shall also contain all information a franchisee may, in view of the disclosed information and under the principle of good faith, expect to be disclosed.

As regards general terms and conditions, which play an imminent role in franchise relationships, Switzerland does not have a specific act on general terms and conditions. The existing rule of the Swiss Unfair Competition Act in this respect hardly ever applies. Nevertheless, pursuant to the Swiss Federal Supreme Court, there exist certain rules with regard to the adoption and interpretation of general terms and conditions. Individual agreements differing from the general terms precede the provisions in the general terms and conditions.

11 Describe the relevant requirements of these laws and agencies.

Not applicable.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Not applicable.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

No, under Swiss law no such requirements exist. Nevertheless, the Swiss Franchise Association (www.franchiseverband.ch) requires that potential members fulfil certain requirements in order to be admitted: for example, they must have been in business for a minimum period of two years prior to the admission, and they must operate their franchise system with at least two franchisees.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

As already indicated, pre-contractual disclosure provisions are neither regulated by a special statute nor monitored by a specific agency, and this is the the case both for franchise and sub-franchise contracts. The general provisions of the CO and CC and the respective rules apply (see question 10). Nevertheless, the ethics code of the Swiss Franchise Association, a self-regulatory organisation, contains certain provisions regarding disclosure and, in particular, pre-contractual disclosure with which members of the Swiss Franchise Association must comply. In summary, pre-contractual disclosure must contain information about the market relating to the franchise, the products or services to be the subject of the franchise relationship, the franchisors' organisation and its experience with regard to the respective franchise system, the franchise package, the contractual duties (in particular the estimated financial commitment of the franchisee), the franchise contract and all related documents and all alternative distribution channels for the contractual products or services. Members of the Swiss Franchise Association must disclose such information in writing at least 20 days before signing the franchise contract. These rules apply for the relationship between the franchisor and its franchisees and between the franchisees and sub-franchisors (master franchisees). Nevertheless, the rules of the ethics code of the Swiss Franchise Association do not apply to the relationship between franchisors and master franchisees. Since disclosed information may contain business and/or industrial secrets, including know-how, conclusion of a confidentiality agreement before the disclosure is highly recommended.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

No specific compliance procedure exists under Swiss law. Nevertheless, disclosure of all relevant information in writing is recommended for reasons of evidence. The ethics code of the Swiss Franchise Association can be used as a guideline in this respect (see question 14).

16 What information must the disclosure document contain?

Swiss law does not provide for any specific pre-sale disclosure provisions. Beyond the applicable general provisions of the CO and the CC, the ethics code of the Swiss Franchise Association can be used as a guideline (see questions 10 and 14).

17 Is there any obligation for continuing disclosure?

Swiss law does not provide for specific obligations relating to continuing disclosure. According to Swiss legal authorities and the Swiss Federal Supreme Court, a franchise contract is deemed to be an ongoing contractual relationship involving close cooperation between the franchisor and the franchisee. In particular, the franchisee receives ongoing assistance, training and advice and the franchisor usually reserves the right to issue directives and, accordingly, to maintain a certain control over the business activities of the franchisee. Thus, the contracting parties have a general duty to act in good faith and assist each other in achieving contractually agreed objectives. Therefore, the franchisor is generally obliged to inform its franchisees about material developments, particularly the marketing concept, and about all other material aspects that the franchisee needs to know of in order to run its business successfully. Because Swiss law does not provide specific obligations in this regard and ongoing disclosure obligations may vary from case to case depending on the specific circumstances, it is advisable to include disclosure obligations in the franchise contract.

18 How do the relevant government agencies enforce the disclosure requirements?

Not applicable.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

As the franchisee may have not entered into the franchise agreement if full disclosure had been made, it may rescind or terminate the franchise contract and claim damages. Nevertheless, the courts take into consideration the experience and knowledge of the franchisee. Pursuant to the *culpa in contrahendo* liability, a franchisee is generally entitled to claim that it should be placed in the position it would have been in had the franchise agreement never been concluded. The franchisor may be ordered to reimburse the fees and expenses incurred in connection with the franchise relationship, with any income made being deducted.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

In principle, sub-franchisors are liable for fulfilling their obligations (as outlined in questions 14 and 17) towards the franchisees. Nevertheless, a sub-franchisor could take recourse against the franchisor if the latter violated its obligations towards the sub-franchisor. In principle, no individual officer, director or employee of the franchisor is liable to the franchisor's business partners as long as the franchisor is a corporation. Nevertheless, in certain circumstances, members of the board of directors, directors or officers of a Swiss corporate franchisor may become liable, directly or indirectly, if they intentionally or negligently violate their duties of care and thus cause damage to either the franchisee as a creditor or to the corporation. Further, acts of officers, directors or employees which violate provisions of criminal law may lead to their direct liability.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

See questions 10 and 14.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

See questions 10 and 14.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Regarding civil claims, see question 19. Regarding criminal proceedings, the franchisee could file a complaint against the respective individuals. A criminal conviction for fraud pursuant to the Swiss Penal Code may lead to imprisonment for up to five years or a monetary penalty. A criminal conviction for deceptive acts under the Swiss Unfair Competition Act may lead to imprisonment for up to three years or a monetary penalty. Further, a corporate franchisor can be punished with a fine of up to 5 million Swiss francs if such fraudulent or deceptive act can not be attributed to a natural person due to the deficient organisation of the company.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

The ongoing relationship between the parties of a franchise contract is mainly regulated by the general provisions of the CO and the CC (see questions 17 and 35).

25 Do other laws affect the franchise relationship?

Like the offer and sale of a franchise, the franchise relationship itself is mainly regulated by the general provisions of the CO. To some extent it is also regulated by the special provisions of the CO regarding the application of labour and agency law provisions by analogy (see question 6), the CC, the Swiss Unfair Competition Act, the Swiss Cartel Act and intellectual property laws (trademarks and patents).

26 Do other government or trade association policies affect the franchise relationship?

The Swiss Franchise Association provides for some standard business policies, but membership of the association is not compulsory. Nevertheless, many franchisors are members, as such membership may have a positive impact on the reputation of the franchisor.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Franchise relationships, like other continuing contractual relationships, end due to lapse of time, termination with notice or upon mutual agreement. Pursuant to the leading case of the Federal Supreme Court regarding franchise contracts, claims for compensation are possible in the case of improper or abusive termination of a franchise relationship. Nevertheless, the Federal Supreme Court confirmed that continuing contractual relationships may be terminated without a notice period if there is good cause. Good cause is assumed whenever an ongoing contractual relationship becomes intolerable for one of the contractual partners. Bear in mind that if the contract provides for a definition of the term 'good cause', or if it enumerates behaviours which constitute 'good cause', this serves only as an indication of what the contractual parties deem to be intolerable. It does not bind the court and, in particular, such contract clauses do not limit the possibility of immediate termination in case of other undefined or enumerated 'good causes'. An immediate termination must be communicated to the other party within a reasonably short time of the occurrence of the event which gave rise to the intolerable situation. Unfortunately, in its leading case regarding franchise contracts, the Federal Supreme Court did not state what the effects of an immediate termination should be if there is no 'good cause' justifying such immediate termination.

Update and trends

Company identification number
As from January 2011, the Federal Act on the Company Identification Number came into force. Each company is, or will be, attributed a unique and permanent number. This new identification number will replace all existing identification numbers in use by the public administration reducing administrative burden. The introduction of the identification number is due to take place gradually. In this regard especially, certain modifications of the Value Added Tax Act were made. In particular, the new identification number will be allocated to new taxpayers instead of the current VAT number. This identification number should be stated on the invoice with a reference to the taxpayer's VAT registration. As of January 2014, only the new company identification number will be valid. Until that date, both the existing VAT number and the new company identification number may be used in the course of business. The Swiss Federal Tax Administration (FTA) recommends making the necessary amendments (with regard to IT, invoices and other business documents) as soon as possible to avoid additional cost.

28 In what circumstances may a franchisee terminate a franchise relationship?

The same legal restrictions apply as in the case of termination by the franchisor (see question 27).

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Swiss contract law is dominated by the principle of freedom of contract. Therefore, the conclusion or renewal of a franchise contract is subject to the parties' mutual agreement. Nevertheless, if one party has started to make investments based on the other party's promises or declarations of its intention to renew the franchise contract, later refusal may entitle the other party to file a claim for compensation. Under certain circumstances a franchisor may be forced to enter into or renew a franchise contract with a franchisee according to the Swiss Cartel Act.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes, it is possible to introduce restrictions to that effect in the franchise contract. In practice, transfers are commonly made subject to the franchisor's prior written approval. Likewise, it is possible to make a transfer of ownership (including pledge) in an incorporated franchisee subject to the franchisor's prior written approval.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no specific laws or regulations affecting the nature, amount or payment of fees. They are solely a matter of negotiation between the parties. If the agreed fees constitute an obvious disparity to the franchisor's performance by exploiting the distress, inexperience or improvidence of the contractual partner, the franchise contract may, in general, be rescinded within one year, and restitution for the considerations already given may be claimed.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Interest rates are subject to negotiation between the contracting partners. In the absence of an agreement, the CO provides for a standard rate of 5 per cent per annum for overdue payments, even if the parties

agreed on lower interest rates. If a higher interest rate has been agreed in the contract, such higher interest may also be claimed during the period of the default. Nevertheless, usury may lead to imprisonment for up to five years or a monetary penalty, and if the offender makes a trade or business of such act it may be penalised by imprisonment for a period of between one and 10 years.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

No, in fact, pursuant to the provisions of the CO, financial debts must be paid in the legal tender of the owed (foreign) currency. Nevertheless, the debtor is entitled to pay in the national currency based upon its value at the date of maturity unless, through the use of the term 'actual' or another similar addition, literal performance of the contract has been agreed upon.

34 Are confidentiality covenants in franchise agreements enforceable?

Confidentiality covenants are enforceable according to Swiss law. The franchisor may ask for an injunction and claim damages in case of a breach of confidentiality by the franchisee. In order to avoid difficulties regarding proof of damages, it is recommended to provide for a liquidated damages clause which is triggered by each breach. It is also recommended that nothing contained in the covenant shall prevent the non-breaching party from seeking specific performance of the breaching party's obligations, and from seeking damages in excess of the liquidated damages.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, such a general legal obligation exists under Swiss law (see questions 10 and 17).

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

In general, franchisees are not treated as consumers under Swiss statutory laws.

37 Must disclosure documents and franchise agreements be in the language of your country?

The language of documents and agreements is subject to the parties' discretion. Nevertheless, if a Swiss court is competent to decide on claims arising out of the franchise contract, generally the documents will have to be translated into the court's official language, which will be one of the country's four official languages (German, French, Italian and Romansh). The court's official language principally depends on the region in which it is located. The Swiss Franchise Association's code of ethics stipulates that all agreements and covenants in connection with the franchise relationship must be in the official language of the franchisee's location, or, if they are drafted in another language, must be translated by an accredited translator.

38 What restrictions are there on provisions in franchise contracts?

Swiss law is based on the principle of freedom of contract and therefore the parties may negotiate franchise contracts freely, even if a large number of restrictions need to be followed. Major restrictions are provided by the antitrust and competition regulations (see question 39) or regulations regarding the acquisition of real estate by foreigners (see question 4). There are also general restrictions stemming from the CO and the CC: for example, protective measures from labour and agency law applied by analogy or the principle of good faith (see question 35).

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Protection of competition is, in principle, dealt with by the Swiss Cartel Act. The Act applies to private or public undertakings that are parties to cartels or to other agreements affecting competition, that exercise market power or that participate in concentrations of undertakings which must be notified. The Swiss Competition Commission (SCC) is responsible for the administration of the Swiss Cartel Act. Whenever a practice seems to hinder or prevent competition in an unlawful way through the concerted behaviour of market actors, abuse of dominant position or a merger which must be notified, the SCC takes direct action against the originators. The SCC may act upon notification or on its own behalf; therefore, any practice set forth in a franchise contract as a vertical agreement in the sense of the Swiss Cartel Act that hinders or prevents competition in an unlawful way may be contested and investigated by the SCC. Since the revision of the Swiss Cartel Act effective as of April 2004, in principle, vertical agreements on fixed or minimum prices or on the allocation of territories, which have the effect that sales by other distributors into these territories are prohibited, are invalid. Such restrictions may be sanctioned by fines of up to 10 per cent of the Swiss turnover made by the violator in the preceding three financial years. Further guidance by the SCC regarding vertical agreements may be found in the general notice on the application of these rules to different categories of vertical agreements. The general notice also deals with non-competition clauses and restrictions regarding cross-supplies. A revised notice considering changes introduced by the revised vertical agreements block exemption of the European Commission, became effective on August 2010 and respectively on August 2011 for vertical agreements which were already in force as per August 2010.

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40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

Switzerland is a civil law jurisdiction. Because of the country's federal structure, the 26 cantons (states) have a certain autonomy regarding the organisation of their courts. The Swiss court system traditionally distinguishes between civil, criminal and administrative courts. Civil courts are responsible for civil and commercial matters. The Swiss Code of Civil Procedure and the Swiss Code of Penal Procedure govern the civil and penal court procedures in Switzerland, which used to differ between cantons before January 2011. The Swiss Federal Supreme Court is primarily a court of last resort. Within the limitations of Swiss procedural law (especially Swiss International Private Law and the Lugano Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters), franchisors and franchisees are free to agree on arbitration proceedings or choose their preferred jurisdictions and applicable laws.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Arbitration can provide substantial benefits for the parties to a dispute. In principle, it may resolve disputes more efficiently than litigation, saving time and ensuring confidentiality. In addition, arbitration allows the parties to control the process, to obtain, in principal, an award which may be not appealed against, and to reduce translation costs in cases where the contractual parties' documents are not mainly in one of the official Swiss languages (see question 37).

But franchisors also have to bear in mind that arbitration procedures do not always result in the expected benefits. It is crucial that the franchisor assesses his exact needs before deciding on arbitration, and in particular the appropriate form, namely, ad hoc or institutional arbitration. For example, in cases where only a low amount is in dispute, arbitration may result in disproportionate costs. Furthermore, limited discovery and procedural safeguards may cut both ways. Considering these disadvantages and the good reputation of the Swiss commercial courts (as the first and only cantonal instance in the cantons of St Gallen, Zurich, Aargau and Berne, appealable only to the Federal Supreme Court), arbitration is recommended in cases where high amounts are in dispute or where secrecy is very important.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

In general, foreign franchisors are not treated differently from domestic franchisors. There are, however, areas where foreigners (especially if they are not domiciled in the EC/EFTA region) are subject to special restrictions. Such restrictions apply for example with regard to the acquisition of real estate (see question 4) and to residence and work permits regarding individuals.

Thailand

Chanvitaya Suvarnapunya and Athistha Chitranukroh

DLA Piper (Thailand) Limited

Overview

1 What forms of business entities are relevant to the typical franchisor?

A franchise agreement in Thailand is simply a contract governing rights and duties between parties; therefore, almost all forms of business entities could be relevant to a franchisor. Nevertheless, the most typical choice of business entity for a franchisor in Thailand is a limited liability company (private or public).

For a public liability company, it is generally more preferable for a large-scale business requiring investment from the public to list its stocks for sale on the Thai stock market. A private limited liability company is more suited for a medium or small-size franchise business since there will be fewer restrictions and statutory compliance requirements compared to establishing a public limited liability company. In addition, the concept of a corporate veil has been adopted in the corporate provisions under Thai law; unlimited liability may not be imposed on the owners of the business (stakeholders) beyond what they have invested in the form of equity.

2 What laws and agencies govern the formation of business entities?

As Thailand is a civil law jurisdiction, the Civil and Commercial Code (CCC) is the main source of law that governs the formation of business entities in Thailand. The relevant agency for the formation of entities is the Thai Ministry of Commerce. For a foreign investor, the Foreign Business Act also provides further legislation concerning foreign-owned businesses in Thailand. If the structure is in the form of a public limited liability company, the Public Company Act is also applicable.

3 Provide an overview of the requirements for forming and maintaining a business entity.

The specific requirements for forming and maintaining a business entity depend on the kind of business entity, whether it is public or private and whether it is owned by Thai nationals or foreigners.

For a private company, which is the most common type of entity, the minimum number of shareholders is three persons and at least one director is required. Its registered capital must be at least 25 per cent paid up but there is no stated minimum capital requirement under the CCC.

To maintain a private company, an annual general meeting of shareholders must be held once at least in every 12 months. An audited financial statement and an up-to-date list of shareholders must be filed annually. Twice a year, a private company must file tax return (namely, a half-year income tax return and an annual income tax return).

However, for most types of business entity the process is fairly straightforward, unlike that of other jurisdictions.

4 What restrictions apply to foreign business entities and foreign investment?

As mentioned above, under the Foreign Business Act, if a company is fully owned or majority-owned by foreigners (namely, not Thai nationals), it is restricted in the types of business it can conduct in Thailand. For example, such a business cannot operate a newspaper or radio station, engage in certain types of farming or operate a business involving national security, natural resources or arts, culture and traditional customs without receiving prior approval from the government. Under the Foreign Business Act, a foreign-owned company, or a company where majority ownership belongs to foreigners (a foreign-owned company), is permitted to conduct franchising business activities only after obtaining applicable foreign business licences from the Thai Ministry of Commerce (MOC).

The approval of a foreign business licence is at the discretion of the MOC and is evaluated on a case by case basis. Based on past experience, if such a business is approved for a foreigner and is to be conducted in Thailand, the authority would take into account, any impact on:

- national security;
- development of the national economy and society of the country;
- Thai culture and tradition;
- the preservation of the environment, energy and national resources; and
- the business sector in which Thais are not ready to compete with non-Thai businesses.

The process is very time-consuming.

In addition, US nationals, including companies, are permitted to hold a majority share in Thai companies carrying on certain business activities that would otherwise be prohibited under the Foreign Business Act (as mentioned above). A US exempted foreign business certificate is still required for a US owned company prior to conducting business (including franchising business activity) in Thailand and it normally takes six months to obtain such a certificate.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Royalties paid to franchisors are subject to income tax in Thailand. If a franchisor receiving royalties is a company incorporated in Thailand or a Thai branch of a foreign company, royalties are considered to assessable income of the recipient to determine the net profit. If net profit occurs it is subject to a 30 per cent corporate income tax. The rate may be lowered if a company is considered to be a 'small or medium enterprise' (SME). But if a franchisor is a foreign entity not operating a branch in Thailand, the franchisee is required to withhold 15 per cent of royalties paid to the franchisor and remit the tax to the Revenue Department.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

There are no labour or employment considerations that are specifically relevant to franchisors. Under Thai labour law, an employment relationship exists where one party (the employer) has authority and direct control and command over another party (the employee). It is therefore unlikely that the relationship between the franchisor and franchisee could fall within the definition of employment.

To be safe, the franchise agreement should specify that the relationship between the franchisor and the franchisee cannot in any way be interpreted as employment. There should also not be any terms and conditions under the franchise agreement granting the franchisor direct control and command over the franchisee.

Another concern that may arise when entering into a franchise agreement is that the established relationship could be interpreted as an 'agent–principal relationship'. Thai CCC provisions require that if the agent, in the course of their appointment, commits any wrongful act to another party, the principal will be solely responsible or jointly liable. To avoid misinterpretation of the franchisor–franchisee relationship as an agent–principal relationship, an explicit statement must be made in the franchise agreement that the relationship arising from the agreement could not by any means be interpreted as an agent–principal relationship.

7 How are trademarks and know-how protected?

As in other countries, trademarks are secured to their owners once registered with the Thai authorities, as required under the Thai Trademark Act. The Thai Trademark Act imposes civil and criminal penalties on those who infringe the rights of the trademark owner (for example, the unauthorised use of the trademark or use of any other trademark similar to the one that has already been registered).

The licensing of a trademark must be made in the form of a written licensing agreement registered with the Thai authorities. Non-compliance with this registration requirement will render the licensing void and not enforceable under Thai law. Another advantage of having a licensing agreement (either incorporated into the franchise agreement or in a separate agreement), is that restrictions regarding use of the trademark can be specifically imposed on the licensee (namely, franchisee).

Know-how is protected under the Trade Secrets Act of 2002. This Act protects against the unauthorised disclosure of trade secrets, even allowing courts to issue an injunction against such disclosure. Nevertheless, a franchisor must take adequate precautions with regard to its trade secrets by entering into a confidentiality agreement with a franchisee, either separately or within the franchise agreement itself. It is only by demonstrating that such careful steps have been taken to protect trade secrets that a franchisor can be protected under the Trade Secrets Act. Similarly, in the most recent draft of an act that will specifically govern franchise agreements, a franchisee is prohibited from revealing any franchise information that has been previously specified by the franchisor in the contract.

8 What are the relevant aspects of the real estate market and real estate law?

At present, there is no specific franchise or retail law controlling franchise businesses. The relevant Thai laws concerning franchise businesses specifically in relation to real estate are the Town Planning Act and the Building Control Act. Such laws control the size and area permissible for specific types of building including retail and wholesale stores.

Under the current draft Retail Act, wholesale or retail businesses would require a licence before commencing operations if they have:

- a business area of at least 1,000m^2;
- a combined income or estimated combined sales of all branches in the previous fiscal year, or estimated earnings in the first year of business of 1 billion baht or more; or
- have received consent from an operator under the first or second points above to use intellectual property or other rights at a specified location or for a specified period (namely, the franchisee).

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

As there is currently no legislation that specifically governs franchise agreements, there is no legal definition of a franchise. Nevertheless, the most recent draft of new franchise legislation defines a franchise as:

the operation of a business in which one party called a 'franchisor' agrees to let the other party, the 'franchisee,' use its intellectual property rights, or to use its rights to operate a business during a specified time or in a specified area, such operation being under the direction of the franchisor's business plan, and the franchisee having a duty to reimburse the franchisor.

10 Which laws and government agencies regulate the offer and sale of franchises?

As mentioned previously, there are currently no laws that specifically regulate all aspects of the offer and sale of a franchise in Thailand. Nevertheless, there are multiple sources of law that contain relevant provisions, including the CCC (related to the establishment and enforcement of contract), the Trademark Act of 1991 (related to the licensing of the trademark), the Trade Secrets Act of 2002 (related to know-how), the Foreign Business Act (controlling the participation of businesses to be conducted by a foreign-owned company), the Trade Competition Act (restricting conditions of the agreement) and the Thai Revenue Code.

According to the draft Retail and Franchise Acts, the Central Commission on Retail Trade (Retail Commission) and the Central Commission on Franchise Business (Franchise Commission) will be created. The Franchise Commission will directly control the operation of franchise businesses and will regulate the type and wording of franchise agreements. The Retail Commission will control the retailers operating in the marketplace including the expansion of stores.

11 Describe the relevant requirements of these laws and agencies.

The requirements of laws and agencies are only relevant to a few basic elements of franchise agreements, apart from restrictions set out under the Trade Competition Act (see question 39), and many of the terms of a franchise agreement are left open to the parties for negotiation under the contract law provisions of the Thai CCC.

The licensing of a trademark requires registration with the government agency for enforcement and the Thai Revenue Code imposes tax obligations on the franchisor. Once the draft Franchise Act comes into effect, it can be expected that certain terms and conditions may be imposed to control franchise businesses in Thailand.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Since there is no specific franchise legislation, there are no exemptions or exclusions. Nevertheless, the most recent draft of the Franchise Act would exclude or impose more requirements on franchise agreements formed outside Thailand.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

At present, there is no statutory requirement to be met by a franchisor before offering a franchise to a franchisee. Nevertheless, according to the draft franchise act, we expect that generally, a franchisor, if a juristic person, must be a company incorporated under Thai law. In addition, a franchisor must have conducted its business to be offered as a franchise for at least two years and have been earning profit from a minimum of two existing branches for at least two accounting years. It if meets those eligibility qualifications, it must also apply for a licence to operate a franchise business in Thailand. Once it has obtained the licence, the franchisor can then offer its franchise to a franchisee.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Thai law does not specifically cover sub-franchising, and nor does the most recent draft of franchise legislation. Therefore, it seems likely that the same disclosure rules that apply to franchisors and franchisees will also apply in cases of sub-franchising.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Currently there is no law in Thailand that forces companies to make pre-contractual disclosure. Even under the most recent draft of the Franchise Act, which requires disclosure, there is no requirement that the disclosure must be made before the signing of a contract.

16 What information must the disclosure document contain?

Under current legislation, no specific information must be disclosed in a franchise agreement. Nevertheless, this is likely to change if the most recent draft of the Franchise Act is followed. The draft includes a requirement that after a franchise agreement is made, the franchisor must reveal all information that is necessary for operating the franchise business within 60 days. What kinds of information are to be considered 'necessary' have not been specified, so unless this is changed in future drafts of the bill, the requirement will exist but will remain fairly vague.

17 Is there any obligation for continuing disclosure?

At present, there is no regulation obligating franchisees or franchisors to disclose or continue to disclose information.

18 How do the relevant government agencies enforce the disclosure requirements?

Since there is no legislation forcing specific information disclosure, no specific government agencies are responsible for enforcing disclosure requirements.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Under current legislation, a franchisee would probably have to seek relief for non-disclosure under the Unfair Contract Terms Act of 1997 or certain other laws depending on the specific situation. At the same time, under the draft Franchise Act, if a franchisor fails to disclose all necessary information within 60 days after the agreement is made, the franchisee has the right to cancel the contract, to no longer be bound by it and to be reimbursed for all expenses and damages incurred as a result of the contract.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

The draft franchise act and other related laws provide no information on this issue. It depends on the terms and conditions of the agreements between the concerned parties.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The general principles of contract law and bargaining in good faith are applicable to the offer and sale of franchises. The courts in Thailand generally uphold contracts made between parties as long as they are demonstrated to be bargains at arm's length made in good faith. This is especially true with regard to franchise agreements under the current law, because there is no specific legislation differentiating franchise agreements from other kinds of contracts.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

At present, there is no general rule on pre-sale disclosure or franchise-specific rules requiring a franchisor to disclose certain information or documents or both to a potential franchisee or for a franchisee to disclose to a sub-franchisee.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Fraudulent or deceptive practices that cause any damage to the franchisee are subject to wrongful act provisions under the Thai CCC. This allows the damaged party (franchisee) to file a lawsuit against the damaging party. Nevertheless, a concept of punitive damages has not been adopted under Thai law. Therefore, damages are equivalent to what has actually been suffered as a result of such fraudulent or deceptive practices. It should be noted that no related provision regarding franchise sale disclosure law is found in the draft Franchise Act.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific laws that govern the entire ongoing relationship between the franchisor and franchisee after the contract comes into effect. Nevertheless, for the period following the expiry of the contract, Thai courts' interpretation of the Unfair Contract Terms Act and the Trade Competition Act is that after termination

of the agreement, the confidentiality clause and competition clause may last for a period of five years with limited jurisdiction (for example, within Thailand or Asia). Otherwise, it will be deemed as an unfair contract term and will therefore be void and unenforceable.

25 Do other laws affect the franchise relationship?

The laws listed in question 10 may affect the franchise relationship, depending on the circumstances.

26 Do other government or trade association policies affect the franchise relationship?

No specific policies exist that would significantly affect the franchise relationship. Nevertheless, it should be noted that the government has a general policy of supporting agreements between private parties, including franchise agreements, because such agreements encourage economic growth and development.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

There are no specific circumstances under which a franchisor may terminate a franchise relationship, and there are no specific legal restrictions on doing so either. This is the case under both current legislation and the most recent draft of the Franchise Act. Nevertheless, if the franchisee breaches the contract, the franchisor may have the right to terminate the relationship under regular contract law. Similarly, contract law would require the franchisor to compensate the franchisee for early termination of contract without cause.

28 In what circumstances may a franchisee terminate a franchise relationship?

Current legislation provides no specific circumstances under which a franchisee can terminate a franchise relationship. The most recent draft of the Franchise Act allows the franchisee to terminate the contract if all necessary information has not been disclosed by the franchisor within 60 days after the formation of the agreement. The only other way for a franchisee to get out of a franchise relationship would be through breach of contract by the franchisor or termination of contract without cause by the franchisee.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

This depends mainly on the contractual agreement between the franchisor and the franchisee, as there is no specific statutory law governing the issue.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Yes. Under the terms of a franchise agreement, a franchisor may restrict a franchisee's ability to transfer its franchise or ownership interests, as long as the restriction was initially agreed upon in the contract. There are currently no specific laws that give franchisors special power in this area, but parties are generally free to agree on such restrictions.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

Under current legislation there are no such laws or regulations. The most recent draft of the Franchise Act requires that the payment of fees be made, but it does not specify the nature or amount of those fees.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

There are no restrictions on the amount of interest that can be charged if the amount is set forth in the contract. Monetary penalties can be imposed for late or overdue payments. At he same time, it should be noted that if the amount of the penalty is unreasonably high, the Thai courts are empowered to adjust the amount to a reasonable sum. Determination of an unreasonably high penalty is determined by the Thai courts on a case-by-case basis.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There is no requirement under Thai law or the draft Franchise Act requiring payment to be made in Thai currency. This depends primarily on the agreement between the parties concerned.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes. Confidentiality covenants in franchise agreements are generally enforceable as Thailand allows for freedom of contract. Additionally, the Trade Secrets Act provides added protection for the trade secrets of franchisors, and the most recent draft of the Franchise Act provides even more protection regarding confidentiality. Nevertheless, the period of enforceability of the confidentiality covenants should not last for longer than five years after the expiry of the contract.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes. Under section 5 of the CCC there is a fundamental legal obligation on parties to deal with each other in good faith. This requirement affects franchise relationships in the same way it does all other areas of law. If a party does not deal in good faith, the Thai courts may find the agreements to be void, or void them at the option of the other party.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Under the current Thai Consumer Protection Act, franchisees fall within the definition of consumers. Such consumers are generally entitled to five basic rights: namely, the right to be informed, the right to choose, the right for safety, the right to remedy and the right to fair contract terms. In 2008 the Consumer Case Procedure Act was passed in order to simplify the procedures and to reduce any costs for consumers seeking to file a complaint against business operators. Under the Act, the newly introduced concept of 'class action procedures' was recognised. Similar to other jurisdictions, the class action procedure (representative action) is a form of lawsuit enabling a large group of people to collectively bring a claim to court. At present, we are not aware of any claims currently following the class action procedure.

37 Must disclosure documents and franchise agreements be in the language of your country?

Disclosure documents and franchise agreements can be in Thai or in another language which is subsequently translated into Thai.

38 What restrictions are there on provisions in franchise contracts?

There are currently no specific restrictions on provisions in franchise contracts under the most recent draft of the Franchise Act. Nevertheless, the draft does require at least the following to be provided:

- the date of the contract and the date the contract becomes effective;
- the rights, duties and responsibilities of the franchisor;
- the rights, duties and responsibilities of the franchisee;
- the time period and area in which the franchisor gives permission to the franchisee to use its intellectual property rights in operating its business;
- any deposits, fees and other costs that the franchisee must pay the franchisor; and
- agreements regarding contract renewal, cancellation, transfer of rights and return of money in the event that the franchisor breaches the contract.

Also see question 39 for additional requirements under the Thai Trade Competition Act.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

The Thai Trade Competition Act prohibits any business operator (namely, franchisor) from entering into an agreement with another business operator (namely, franchisee) to conduct any act amounting to a monopoly, reduction of competition or restriction of competition in the market of any particular good or a service, such as:

- fixing selling prices or restricting the sale volume;
- fixing buying prices at a single price or restricting the purchase volume;
- entering into an agreement to have market domination or control;
- fixing conditions to enable one party to win a bid or tender or to prevent one party from participating in a bid; or
- fixing geographical areas or customers to whom each business operator may sell goods or provide services, etc.

Update and trends

Due to the uncertain political situation in Thailand at present, no clear indication exists as to when the draft franchise act will be final, or whether it will ultimately be enacted into binding law.

If violation of the above causes damage to another party, that party is entitled to claim compensation from the damaging party. The act also allows the Thai Consumer Protection Commission or a trade association to initiate a claim on behalf of the damaged party.

Normally the damaged party files its requests to the Consumer Protection Commission to initiate the claims on their behalf (to save costs), but this process can be slow and time-consuming.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

The court system is similar to the court system in other civil law jurisdictions. Other dispute resolution procedures, such as mediation and arbitration, are also available to parties engaged in a franchising agreement.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

Foreign franchisors contracting with Thai local franchisees often choose arbitration, whether foreign or domestic, as the dispute settlement mechanism. The main reasons for such a decision are as follows: expedited hearing (in comparison with the Thai court process), less formality, and the ability to choose a more familiar language.

Nevertheless, even though this expediency and flexibility is advantageous, the arbitration award must be submitted to a Thai court for enforcement if the adverse party refuses to comply – the award has no enforcement power of its own. The room for challenging the award when it is being enforced through the Thai court is quite slim.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Other than the different legal requirements for business entity formation and taxation as discussed, foreign franchisors are treated in the same way as domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

The main distinction regarding business entities is establishment as a real person company (unlimited company or general partnership) or an equity company (capital stock company). A typical franchisor would establish an equity company, especially in view of the favourable consequences regarding liability. At the same time, there are different types of equity companies that can be established by a franchisor. The two main alternatives are limited liability companies and joint-stock companies. They differ from each other in many ways, but in principle limited liability companies are easier and less costly to establish and easier to operate after establishment. On the other hand, joint-stock companies are more suitable for comprehensive shareholding structures and have the advantage of placing no liability on its shareholders with regards to (public or private) company debt. The franchisor, in consideration of these facts, may establish the type of business entity that serves its needs most.

2 What laws and agencies govern the formation of business entities?

The Turkish Commercial Code is the main regulation governing the formation and regulating the characteristics of business entities. There are also a number of communiqués dealing with the steps and phases for the establishment of business entities.

It should be noted that the new Turkish Commercial Code (which was published in the official journal on 14 February 2011) will be in force as of 1 July 2012. The new code brings major improvements and amendments on issues like transparency in regard to companies, obligation of independent auditing, regulations regarding company groups, increasing power of minority shareholders and accounting standards in line with International Financial Reporting Standards (IFRS).

3 Provide an overview of the requirements for forming and maintaining a business entity.

The formalities mainly depend on the type of the business entity that will be formed. In general terms, however, with regard to the formation of an equity company, the phases are:

- the composition of the articles of association of the company, which includes information on the shareholders, the representation, addresses, etc;
- the notarisation of the articles of association, which must be signed by all the shareholders; and
- application to the relevant trade registry accompanied by the notarised articles of association and other necessary documents (which are listed in the relevant communiqué) for the establishment of the entity to be registered and announced. In legal terms the date of announcement is the date of establishment.

4 What restrictions apply to foreign business entities and foreign investment?

It must be noted that any company registered in the Turkish trade registry is accepted as a Turkish company. The shareholding structure is not relevant to such determination. Consequently, there is no concept of 'foreign business entity' if the company is established in Turkey and is registered in the relevant trade registry. Nevertheless, article 5 of the Regulation for Implementation of Foreign Direct Investment Law indicates that companies and branch offices subject to the provisions of the Foreign Direct Investment Law (referring to companies involving foreign real or legal entities as their shareholders, no matter what the percentage) shall submit a form titled 'FDI Operations Data Form'. This form must be submitted to the Undersecretariat of the Treasury, Foreign Investment Directorate before the end of May every year. The aim and scope of the regulation is monitoring foreign investment activities.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

If the franchise fee is paid to a related party, it will be subject to Turkish transfer pricing regulations, under the Corporate Tax Law, article 13. According to the said legislation, all types of royalties should be paid at arm's-length prices.

Turkish tax legislation usually recognises two kinds of licence (royalty) payments:

- the cross charge of the IP generation costs to the Turkish subsidiaries; and
- arm's-length royalties, which are fixed as a percentage multiplied by net sales of the Turkish subsidiary.

The current Corporate Tax Law recognises the deduction of IP generation costs if the expenses concerned are related to the generation and maintenance of income in Turkey and if the portion of the costs to be allocated to the Turkish entity is in line with the arm's-length cost allocation keys.

Under Turkish transfer pricing legislation there are no specific provisions for royalty fee setting mechanisms. The conditions below are sought when the Turkish subsidiaries are questioned on the deductibility of royalty payments to the group companies abroad:

- the royalty rates and the method of calculation should be in line with the arm's-length principle under Turkish transfer pricing regulations;
- the royalty rates are defendable based on available comparable royalty payments; and
- the IP owner's interest in the proper production, quality and branding of goods in the Turkish market shall be presented very clearly (by way of documentation). This should be linked to the Turkish subsidiary's developing business in Turkey with the use of the IP generated by the IP owner.

Especially with the adoption of the 2007 transfer pricing legislation in Turkey, the burden of proof to support any royalty payment lies with the Turkish company, especially with the adoption of the 2007 transfer pricing legislation in Turkey. It should be noted here that there is an important annual Transfer Pricing Documentation requirement for Turkish companies that must include every inter-company transaction of the Turkish entity with foreign related parties.

It should also be noted that there is a certain risk of questioning the profitability of the franchise company in Turkey if the royalty fee reduces the corporate tax base of the company.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Turkish Labour Law identifies the employee as 'a natural person working under an employment contract'. The main elements of an employment contract under Turkish law are:

- the commitment of the employee to perform and provide services according to the employer's wishes;
- the service of the employee being rendered in return for remuneration; and
- an agreement between the employer and the employee including the above-mentioned conditions.

Considering that the franchisor and the franchisee are two 'business persons' (which is a concept defined in the Turkish Commercial Code) aiming to maximise profit instead of a natural person serving an employer under an employment contract, there is only a slim possibility that the franchisee could be considered as an employee of the franchisor.

7 How are trademarks and know-how protected?

Other than contractual safeguards for such purposes, the trademark or the know-how shall be registered before the Turkish Patent Institute for absolute protection. It should also be noted that Turkey is a member of the World Intellectual Property Organisation (WIPO).

8 What are the relevant aspects of the real estate market and real estate law?

Law No. 5444, amending the law on real estate and establishing the conditions for foreigners to acquire real estate in Turkey, was finalised on 29 December 2005 and came into force when it was published in the official journal on 7 January 2006. Accordingly, the route for foreigners to purchase real estate or real rights in Turkey has been reopened.

There is reciprocity between Turkey and the country of the foreigner purchasing land regarding legislation permitting foreigners to acquire real estate, and the total area of the acquired real estate and real rights should be 2.5 hectares at most.

The Council of Ministers have the authority to determine the areas of land that shall not be acquired by real persons and commercial companies (established in foreign countries according to these countries' laws) on account of such land being culturally essential or important for Turkish defence and security.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The only specific regulation dealing with franchise agreements has been the Block Exemption Communiqué regarding Franchise Agreements of the Competition Authority, which came into force on 16 December 1998. The said Communiqué has been abolished and replaced by the Block Exemption Communiqué on Vertical Agreements on 14 July 2002 (whereas the Communiqué is applicable also to franchise agreements).

The above-mentioned and abolished Communiqué regarding Franchise Agreements identified the Franchise Agreement as:

an agreement whereby the franchisor grants to the franchisee the right to employ franchise in order him to market specific goods and/or services, in return for a direct or indirect contribution, and at least covers the obligations:

- *to use a common brand or enterprise name, and make the facilities and/or transportation vehicles look uniform;*
- *to transfer know-how to the franchisee by the franchisor; and*
- *to support the franchisee by the franchisor commercially and technically on a continuous basis during the agreement.*

10 Which laws and government agencies regulate the offer and sale of franchises?

As mentioned above, there is no specific legislation or any regulation governing franchise agreements in Turkish law. The concept of franchise and the content of franchise agreements are considered mainly in case law, which includes the decisions of the Competition Board and the Supreme Court.

11 Describe the relevant requirements of these laws and agencies.

The Supreme Court, in its decision dated 25 June 2001 No. 2001/4917, has defined franchise agreements as follows:

Franchising is a long-term and continuous contractual relation that one party which is holding a concession in terms of a product or a service, grants the other party such concession for enabling the other party carry out the commercial business in relation with the said concession subject to conditions, time frame and limitations and also bearing the responsibility of providing support and information with regards to the organisation and administration of the business.

12 What are the exemptions and exclusions from any franchise laws and regulations?

There is no such law or regulation; however, any practice that is not in line with the above-mentioned definition of the Supreme Court would result in not being considered as a franchise agreement or a relation.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There is no such requirement by law.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

There is no pre-contractual disclosure requirement for franchising agreements under Turkish law. In that sense, the disclosure obligation of the franchisor and the sub-franchisor shall be determined in accordance with the franchise contract and the contractual requirements.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

There is no pre-contractual disclosure requirement for any type of contract regulated in Turkish law but article 1 of the Turkish Code of Obligations indicates that in order for a contractual relation to

be complete, the will of the parties shall be coherent and compatible. The pre-contractual disclosure requirement shall be evaluated accordingly. Specifically, article 28 of the Turkish Code of Obligations provides that if a party has entered into a contractual relationship as a result of fraudulent acts of the other party, he or she shall not be bound by such a contract.

It must also be noted that there are types of agreements that are required to be registered to a private registry, which is quite different from a pre-contractual disclosure requirement. For example, financial lease (equipment leasing) agreements shall be registered with a public notary, primarily to enable third parties to monitor such agreements. Such agreements are not put into effect unless the registration procedure is completed.

16 What information must the disclosure document contain?

As there is no specific law dealing with the content of such documents, the obligation of disclosing information shall be evaluated within the scope of the general principles of the Turkish Code of Obligations. In that sense, the main elements (namely, the factors that would affect the decision of the counterpart to be involved in the contract or not) shall be disclosed and shared.

17 Is there any obligation for continuing disclosure?

Again, in line with the principles mentioned in the Turkish Code of Obligations, one party shall keep the other party informed regarding any information that would have an effect on the performance of the other party. This principle would play an even more important role taking into consideration an ongoing and continuous relationship such as a franchise contract.

18 How do the relevant government agencies enforce the disclosure requirements?

As mentioned in question 4, Turkish companies that have foreigners as shareholders must continue submitting the FDI Operations Data Form to the Undersecretariat of the Treasury, Foreign Investment Directorate. This form includes a subsection where details of the 'licences, know-how, technical assistance, franchise agreements and transfers' of the company are requested. This form shall be submitted to the Undersecretariat of the Treasury, Foreign Investment Directorate before the end of May every year. As stated above, the aim and scope of the regulation is monitoring foreign investment activities, rather than an intention to govern the disclosure requirement of franchise agreements.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

In line with the provisions of the Turkish Code of Obligations, any information revealed between the parties during the pre-contractual phase that is later understood to be not in compliance with the initial wills of the parties would disrupt the validity of the contractual relation between the parties.

In such a case the compensation for the damages shall be requested from the court by the party who faced damage thereof. The damages include actual and prospective damages (loss of profit, loss of business opportunity, etc).

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

As there is no law regulating such a scenario, the party that is liable for disclosure shall be determined in accordance with the terms of the contract. As a general principle, the liable party in the case of sub-franchising would be the sub-franchisor as a result of it being the party to the sub-franchising contract (if there is no term in the master franchising contract dealing with such an issue).

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The above-mentioned rules are the general principles of law that affect the offer and sale of franchises. These principles, which would affect the offer and sale of franchises, derive mainly from the Turkish Code of Obligations, the Turkish Commercial Code and the laws regarding intellectual property rights. The competition and competition law aspect of the subject are discussed below.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

The pre-sale disclosure requirements regarding franchise contracts are based on general obligations that exist in the above-mentioned laws and regulations.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

In accordance with the general principle of 'confidence and trust' that must be established between the parties during the formation of the contract, the parties shall not engage in misleading acts or appearances. Otherwise the contract might be deemed null and void in accordance with the above-mentioned first and other relevant articles of the Turkish Code of Obligations. As there is no law regarding franchise sale disclosure, this is the only remedy if a franchisor engages in fraudulent or deceptive practices.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

There are no specific rules for such purpose. The contractual terms (unless they violate the general principles of Turkish law) shall define the ongoing relation between the parties.

25 Do other laws affect the franchise relationship?

In this regard, the content of the Block Exemption Communiqué on Vertical Agreements are taken into consideration. The contractual impositions on the franchisee that are not in compliance with the communiqué, the outcome of non-compliance, the exceptional cases and the duration of the non-compete obligation during and after the term of the contract have all been regulated within the said communiqué.

Depending on the case, the rules contained in the Turkish Commercial Code regarding business agents might be applicable to franchising contracts. The franchisee has not been mentioned as one of the prototype business agents by the Code; Nevertheless, depending on the nature of the franchising relation and the clauses in the franchise contract, the rules regarding agency, commissioners (or other matters regulated by law) might be applicable to the franchising relationship.

Furthermore, the general provisions regarding representation regulated in the Turkish Obligations Code might be applicable to a franchising relationship and would be taken into consideration. The notion of 'abuse of economic dependence' has been invoked by the Supreme Court several times in disputes involving supplier–agency, employee–employer and leaser–lessee relations. In this regard, it might be likely that the said notion would be invoked by the court in a dispute concerning a franchising contract. All the same, there is at present no case law involving such an assessment.

26 Do other government or trade association policies affect the franchise relationship?

No such policies directly affect the franchise relationship; Nevertheless, the government or other authorities may interfere (within the limits of the law) if the relationship has an undesired impact on governmental policies (such as, possibly, foreign trade policy).

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Parties are free to choose between a contract for a fixed term and a contract for an indefinite period, in line with the general principle of contractual freedom, which includes the term of the contract. The main differences would be regarding the termination of the contract. A contract signed for a fixed term shall only be terminated through a justifiable cause or in return for compensation during its term. Otherwise, the contract shall continue to be in effect until the expiry of its term. Nevertheless, a contract signed for an indefinite period shall be terminated through a regular termination notice any time (unless no notice period has been introduced in the contract).

It shall also be noted that the above information depends on the content of the agreement and, particularly, on the termination clauses and on the definitions of justifiable causes (if any) for termination.

Turkish law does not require a minimum period of notice for the termination of a franchise contract made for an indefinite period. Actions that constitute a material breach of the contract and of the notion of franchising shall justify earlier termination. The Supreme Court in its decision dated 3 July 2006, No. 2006/7900, stated that:

> *[A] franchise agreement is a type of agreement that builds a continuous relation between the parties and the contract shall not come to an end unless the parties terminate the contractual relation at their own discretion. Principally, the contracts made for indefinite periods shall be terminated either by ordinary or extra ordinary terminations. In this regard when the contract is being terminated without any cause this would be an ordinary termination, however, if the contract is being terminated by a party on the grounds of justifiable and material cause this would be an extra ordinary termination.*

28 In what circumstances may a franchisee terminate a franchise relationship?

As there is no distinction by law, the same reasoning indicated in question 27 shall also to apply to termination by the franchisee.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Again, in line with the general principle of contractual freedom, a franchisor may refuse to renew an agreement with a franchisee. At the same time, the amount of investment by the franchisee would be decisive in determining the amount of compensation, if any, granted to the franchisee if the decision not to renew the agreement could not be justified by the franchisor.

Furthermore, such preference of the franchisor (not renewing the agreement) might be challenged if the service or the product subject to the franchise agreement constitutes an 'essential factor' for the franchisee to carry out its activity.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

The franchise agreement might contain clauses that oblige the franchisee to obtain the franchisor's consent before transferring its franchise or again transferring ownership interests in the entity. Nevertheless, such a restriction shall only be binding upon the franchisee, not before third parties who are not aware of such a clause. Consequently, the transfer of the franchise (even with the existence of a restrictive clause in the franchise agreement) would be valid and the franchisor may only seek compensation as a result of the violation of the agreement.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

The parties are free to determine the amount and the currency of the fees. At the same time, the taxation of the fee transfer is another aspect that is realised through the relevant articles of the tax codes.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

The amount of interest on overdue payments determined by the parties in the agreement shall be valid on the condition that such a rate shall not lead to ruination of the other party. On the other hand, if the parties have not decided on an interest rate in the agreement, there is a specific amount of interest designated by law for commercial disputes (including franchise matters) that is renewed each year.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

There is no such restriction by law unless the franchisor's domestic currency is one of the currencies that is in circulation within the Turkish Republic.

34 Are confidentiality covenants in franchise agreements enforceable?

The confidentiality covenants in franchise agreements are enforceable but the penalty amount determined in the agreement may be reduced by the court if it exceeds the damage caused by a breach thereof.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Yes, article 2 of the Turkish Civil Law regulates the obligation of acting in good faith (bona fides) by the parties. For this reason, the acts of the parties would be assessed by the court in line with this general principle at the signing of the agreement and also throughout the term of the agreement.

Update and trends

Turkey's growing economy has led to a positive impact on the number of franchisees and franchise agreements that have been recently concluded within Turkey. As the purchasing power in the Turkish market has increased remarkably, master franchisors have started seeking prospective business partners (franchisees) with the view of entering the Turkish market.

On the other hand, the growing desire and tendency of creating local Turkish trademarks (especially with regards to Turkish cuisine and local culture) have led to Turkish franchisors searching for franchisees in order to enter into foreign markets, especially in the food sector.

As a result of such developments, the need for the implementation of a legal framework of franchising within the Turkish legal system will be a hot topic within the coming years.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

The definition of a consumer in the Act on the Protection of Consumers is 'a real person or a legal entity who utilises or benefits from a product and/or a service without any commercial or occupational aim'. Based on this definition a franchisee shall not be treated as a consumer.

It must also be noted that article 4 of the Law on the Protection of Consumers provides that the manufacturer, seller, dealer, agency and importer of defective goods, as applicable, are jointly responsible before consumers.

37 Must disclosure documents and franchise agreements be in the language of your country?

As a general principle, the document shall be in Turkish if the parties to the agreement are both Turkish. If, however, one party is a foreigner the document might also be presented in another language besides its Turkish version. The Turkish version would, however, prevail in such a case.

38 What restrictions are there on provisions in franchise contracts?

According to the Block Exemption Communiqué on Vertical Agreements, a non-compete obligation shall not be introduced for an indefinite period or more than five years and shall not forbid the members of the selective distribution system from selling the branded products of designated competing providers. A non-compete obligation that is not in compliance with the said conditions would result in the agreement violating the Act on the Protection of Competition.

Additionally, article 5 of the Block Exemption Communiqué on Vertical Agreements indicates that:

> *[A] non-compete obligation may be imposed on the purchaser provided that it does not exceed one year as of the expiry of the agreement, with the conditions that the prohibition relates to goods and services in competition with the goods or services which are the subject of the agreement, it is limited to the facility or land where the purchaser operates during the agreement, and it is necessary for protecting the know-how transferred by the provider to the purchaser.*

Furthermore, possible limitations as to the customers or geographical regions to which the franchisee may sell would principally result in the franchise contract being excluded from the scope of the Block Exemption Communiqué for Vertical Agreements and thus it would be in violation of the Act on the Protection of Competition (unless the agreement qualifies for individual exemption). But, again as mentioned above, the communiqué regulates some exceptions and in this way validates the use of such restrictions.

The exceptional cases where such restrictions may lawfully be imposed are:

- provided that it does not cover the sales to be made to customers of the purchaser, the restriction by the provider of active sales to an exclusive region or exclusive group of customers assigned to it or to a purchaser;
- restriction of sales of purchasers operating at the wholesale level in relation to end-users;
- restriction of the performance of sales by the members of a selective distribution system to unauthorised distributors; and
- in the case of parts supplied with a view to combining them, restriction of the purchaser's selling them to competitors of the provider who holds the position of a producer.

Finally, as per the Block Exemption Communiqué for Vertical Agreements, preventing the purchaser from determining its own selling price would again result in the agreement being excluded from the scope of the block exemption (thus violating the Act on the Protection of Competition).

Nevertheless, the principles of case law indicate that the franchisor shall be entitled to impose a maximum resale price or suggest a recommendation price to the seller, although the seller is contractually not obliged to comply with such recommendation.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

A franchise agreement is regarded as a vertical agreement, thus it is within the scope of the Block Exemption Communiqué on Vertical Agreements. The relevant articles of the regulation (for franchise agreements) are provided in question 38.

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The competent authority for the enforcement of competition law is the Competition Authority, which may initiate an investigation on its own initiative as well as according to complaints raised by third parties.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

There are four types of jurisdiction in Turkish law. These are constitutional jurisdiction, administrative jurisdiction, military penal jurisdiction and civil jurisdiction. The Law Concerning Civil Procedure regulates the jurisdiction mechanism with regards to civil law disputes arising within the boundaries of Turkey. There are mandatory and non-mandatory rules concerning jurisdiction in the law as some rules concerning jurisdiction are considered to correlate with public policy.

The notion of jurisdiction in Turkish law is composed of two concepts. First is determining the type of court (for example, the court of peace, the court of first instance, the commercial court) that will deal with the dispute (namely, the 'assigned court') and the second is determining the geographical location of the court that will deal with the dispute (namely, the 'competent court'). The rules on the assigned court are supposed to be mandatory and may not be altered. Nevertheless, some of the rules regarding the competent court are mandatory (for example, disputes in relation to real estate shall be dealt with in the courts of the region where the real estate is located) and some are not. The mandatory rules regarding the competent court may not be modified through an agreement, whereas the others may.

The available dispute resolution procedures indicated in the Law Concerning Civil Procedure are litigation and arbitration.

It should also be noted that article 47 of the Code Concerning Private International Law and Civil Procedure indicates that parties are able to chose a different (foreign) jurisdiction in the agreement, provided that there is a foreign element in the case and the court assigned by law is not exclusively competent (namely, the jurisdiction clause in the law that is replaced by the agreement is not a mandatory one).

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

The answer to this question mainly depends on the type of arbitration and the location chosen. Nevertheless, in general terms, considering the lengthy trials before the Turkish courts, parties would benefit from a faster procedure of arbitration. Even so, recognition in Turkey of an arbitral award that has been obtained from an arbitral tribunal abroad would, again, take substantial time.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

In legal terms there is no different treatment for a foreign franchisor compared to a domestic franchisor (as mentioned above, except for the submission of the FDI Operations Data Form to the Undersecretariat of the Treasury, Foreign Investment Directorate for companies containing foreigners as shareholders).

A domestic franchisor's access to the market and local knowledge should be mentioned as expected advantages in practical terms for a foreign franchisor.

United Kingdom

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Overview

1 What forms of business entities are relevant to the typical franchisor?

Almost all franchisors operate as a limited company – apart from the limited liability afforded, such companies are often perceived (wrongly) to be more substantial businesses than unincorporated businesses.

It is also possible to set up a limited liability partnership (LLP), which has separate legal liability and is more akin to a limited company than to a traditional partnership, but these are rare.

The responses provided here are by reference to the legal system in England and Wales. Scotland's legal system differs in some relatively minor respects.

2 What laws and agencies govern the formation of business entities?

A sole trader is not subject to any specific legislation. An LLP is incorporated under the Limited Liability Partnership Act 2000, while a partnership is subject to common law rules and the Partnership Act 1980 (PA). A company is regulated by the Companies Acts 1985, 1989 and 2006. All companies are required to be registered at Companies House and are subject to further regulatory requirements, including providing annual returns and accounts (unless they are exempt).

3 Provide an overview of the requirements for forming and maintaining a business entity.

Sole traders, which tend to be relatively small concerns, are not subject to any specific legislation in terms of formation or maintaining the business. Nevertheless, they are required to pay income tax on profits generated by the business.

The PA does not provide a complete code of partnership law. The rules of equity and common law apply except where they are inconsistent with the PA. To satisfy the definition of a partnership, two or more persons must be carrying on a business. The factors for determining the existence of a partnership include common ownership of property, sharing of gross returns and the receipt of a share in profits. The existence of a partnership is always a question of fact. Partners are liable for the debts and obligations of the partnership without limit.

A company is formed under the Companies Act by a process called registration, which involves submitting at least form INO1 and a fee with the registrar of companies, the official responsible for the registering and maintaining the records of companies. A company comes into existence on the issue of a certificate of incorporation. Details of the registered office, annual returns and accounts must be filed with the registrar unless the company is exempt from filing accounts.

An LLP will also have to be registered with the registrar of companies and a certificate of incorporation will be issued. To achieve incorporation, two or more persons must subscribe their names to the incorporation documents and pay a fee. The LLP's name must end with LLP and a statement about the intended location or the registered office must be provided. LLPs will be required to file accounts and annual returns, and to make the relevant notifications regarding any changes to membership and to its registered office.

Companies and LLPs are required to display their company registration details and registered office address on their letters and order forms. The names of all partners have to appear on business letters and order forms. Sole traders are also required to disclose their names on such documents. Further, any business that employs staff is obliged to have in place, and to maintain, employers' liability insurance.

4 What restrictions apply to foreign business entities and foreign investment?

UK Trade and Investment (www.ukti.gov.uk) is a government agency that helps foreign businesses to invest and locate in the UK and grow internationally. The UK is the fifth largest economy in the world and is one of the easiest places in Europe in which to set up and run a business.

There are generally no restrictions on foreign ownership or investment in the UK and there is little or no regulation on foreign ownership of companies. Foreign franchisors have no difficulty setting up in the UK.

Foreign nationals from outside the European Union will need a visa and a certificate of sponsorship from a UK-registered business. The UK now has a points-based system (PBS) and it is for the company to ensure that those it wishes to employ meet the criteria of the PBS. The sponsor is also responsible for its migrant employees and must report any unexplained absences, etc, to the UK Border Agency. The government has introduced a limit of 21,700 for workers entering the UK from outside the EU to take effect in 2011-12 across Tier 1 and 2 of the PBS.

Among other legislation and regulations, the foreign franchisor will have to comply with the Data Protection Act 1998 and money laundering requirements (for opening a bank account), and accounting and tax considerations must be taken into account.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

There are no special tax rules that are applicable to franchisors. Unincorporated businesses are assessable to tax on a current-year basis, which means the profits for the accounting period ending within the current tax year are assessed for tax that tax year. There are special rules for the first and last periods of trading. With partnerships, each partner's share of profit, after expenses and capital allowances, is assessed on him individually, using the profit-sharing ratio that applies in the accounting period ending in the tax year in question.

A company is chargeable to corporation tax on its profits by reference to its accounting periods and not tax years, as is the case with sole traders and partnerships. Where a company distributes retained profits to its shareholders as a dividend, the shareholder will be liable to pay tax on the net dividend received. Companies are obliged to self-assess their corporation tax liability and are required to submit a corporation tax return with their set of accounts on an annual basis. Failure to do so, or failure to pay the corporation tax in time, may result in penalties.

The tax treatment of the initial fee needs to be given careful consideration. The UK tax system draws a distinction between capital and revenue expenditure and receipts. Part of the initial fee payment is usually consideration for the grant of rights to operate the franchise, and the balance is usually attributable to goods or services provided to equip the franchisee and to help launch the business. The great majority of the initial fee will be a revenue receipt in the hands of the franchisor.

A foreign business will not be subject to UK tax unless it is permanently established in the UK, for example, if it had a subsidiary or branch. If this is the case, the foreign entity may be subject to UK tax.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Any entity that takes on employees will be required to comply with UK anti-discrimination laws, which prevent discrimination on grounds of sex, race, sexual orientation, disability, religion and age. A franchise agreement will often require that a franchisee comply with all relevant laws and regulations, which include employment legislation.

In *Autoclenz Limited and Belcher & Others*, 2011, UKSC 41, the Supreme Court decided (agreeing with the Court of Appeal) that the contractual documents entered into by the parties did not reflect the true agreement between the parties. It decided that even though the agreements gave the car valeters an option to work, described them as franchisees and as independent subcontractors in a contract referred to as a franchise agreement, the individuals were in reality workers and were therefore afforded the protection of employment legislation. In practice, very few franchisees are likely to be treated as employees.

7 How are trademarks and know-how protected?

The franchisor's trade name and trademarks, confidential information and know-how are essential elements of what the franchisor provides to the franchisee. It is a requirement of the Code of Ethics issued by the British Franchise Association (BFA Code) that the franchisor either is 'the owner or [has] the legal rights to the use of its network's trade name, trade mark or other distinguishing feature' (section 2.2).

Trademarks in respect of goods and services can be registered in the UK under the Trade Marks Act 1994 in specific classes and, upon registration, provide protection against unauthorised use. It is also possible to obtain a Community Trademark that enables the trademark owner to rely on a single registration with effect throughout the European Union (via the OHIM in Alicante) and an international registration that is filed under the Madrid Protocol administered by WIPO.

It is possible to bring a claim for the tort of passing off, whether or not a trademark has been registered, if a person seeks to take advantage of the reputation of another's goods or services by adopting a similar name or get-up or otherwise implying a link between his product or service and another's. One has to establish that the infringer has made a misrepresentation that is calculated to, and does, cause injury to the business or to goodwill.

The franchise agreement or operations manual will contain various provisions with regard to the protection of intellectual property that includes confidential information (know-how).

8 What are the relevant aspects of the real estate market and real estate law?

In England and Wales, land is held by way of 'freehold' or 'leasehold'.

If the business model requires the use of prime retail outlets, then the franchisor may have to take a lease and grant their franchisees a sub-lease of the premises, although this is becoming less common. Granting a sub-lease to a franchisee provides much greater control over the outlet for a franchisor. It is not uncommon for a landlord to require a third party to guarantee the performance of the tenant, particularly where the franchisee is of limited financial means.

If the lease and sub-lease procedure is adopted, it is important for the franchisor to exclude the lease from the provisions of the Landlord and Tenant Act 1954, which, if applied, would give a franchisee security of tenure so that the franchisee could not be evicted from the premises following termination of the franchise agreement.

If a franchisor does not take a lease and grants a sub-lease, a deed of option can be used so as to oblige the franchisee to transfer the premises to the franchisor on termination of the franchise agreement, subject to the consent of the landlord.

If the franchise agreement contains an option to renew, the lease should reflect this.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

There is no legal definition of franchising and no franchise-specific legislation. Most reputable franchisors join the British Franchise Association (BFA) (www.thebfa.org), a self-regulatory body. Membership of the BFA is voluntary. The BFA has adopted the European Franchise Federation's definition of franchising, which provides (inter alia):

> *Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and on-going collaboration between legally and financially separate and independent undertakings, the Franchisor and its Individual Franchisees, whereby the Franchisor grants its Individual Franchisees the right, and imposes the obligation, to conduct a business in accordance with the Franchisor's concept [...].*

10 Which laws and government agencies regulate the offer and sale of franchises?

There are no specific agencies that regulate the offer and sale of a franchise that is governed by the general law, where the overriding principle is 'caveat emptor' (buyer be aware). A prudent buyer should undertake all necessary due diligence and obtain advice from BFA-affiliated professionals prior to entering into the franchise agreement.

11 Describe the relevant requirements of these laws and agencies.

While not specifically aimed at franchising, certain laws have had an impact on drafting franchise agreements, for example, the Fair Trading Act 1973 and Fair Trading Schemes Act 1996, which regulates pyramid selling, and for competition law see question 39.

Under the Trading Schemes Act 1996 (the 1996 Act) franchise systems are likely to be treated as a trading scheme and will have to comply with the 1996 Act, unless they fall under one of two exceptions (see question 12). The purpose of the 1996 Act is to regulate pyramid selling that arises when distributors are encouraged to or

discover that it is it more remunerative to find other sub-franchisees (who in turn are encouraged to find sub-franchisees, etc) than to sell the goods or services that are allegedly the subject of the franchise. While the 1996 Act does not prohibit pyramid selling, it seeks to control it by regulating three aspects, namely, the control of advertising, the imposition of a 'cooling-off' period and the control of contractual provisions.

12 What are the exemptions and exclusions from any franchise laws and regulations?

Franchisors who operate a single-tier trade scheme are exempt from the Trading Schemes Act 1996 if all franchisees operate at a single level (except for the franchisor) or where all franchisees are registered for VAT.

See question 39 for further information on Competition Law issues.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

There are no such legal requirements, but the BFA Code requires a franchisor to:

- have successfully operated a business concept for a reasonable time in at least one pilot unit before starting its franchise network. Company-owned units can provide the basis for a pilot operation, but to gain the right experience the pilot should be run by a 'manager' on an arm's-length basis to test the system and infrastructure;
- be the owner or have the legal rights to the use of the network's trade name, trademarks or other distinguishing identification; and
- provide the individual franchisee with initial training and continuing commercial and technical assistance during term of the agreement.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Except for what is set out in question 15, there is no specific requirement for pre-sale disclosure to sub-franchisees in the UK. The BFA Code requires disclosure to be made to any prospective franchisee. This includes providing a copy of the Code of Ethics and full and accurate written disclosure of all information material to the franchise relationship prior to the execution of the binding documents.

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

There is no specific legislation that provides for pre-contract disclosure. Nevertheless, the BFA Code stipulates that advertising for franchise recruitment must be free of ambiguity and misleading statements. Further, where there are direct or indirect references to future possible results, figures or earnings to be expected by individual franchisees, these should be objective and factually based and must not be misleading. The BFA also requires its members to refund deposits paid by prospective franchisees if they do not proceed, although it is acceptable to deduct related and verifiable expenses.

16 What information must the disclosure document contain?

This is not applicable, but see questions 14, 15 and 22.

17 Is there any obligation for continuing disclosure?

No.

18 How do the relevant government agencies enforce the disclosure requirements?

When applying for membership of the BFA, applicants must commit themselves to comply with the Code of Ethics. See questions 14 and 15.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

Not applicable; see above.

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Not applicable; see above.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The offer and sale of a franchise is not subject to any specific law, but is subject to the overriding application of contract law and, in particular, laws relating to misrepresentation.

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

As mentioned in answer to questions 14 and 15, the BFA Code must be adhered to. A copy of the code should be provided as part of the franchisor's disclosure. A franchisor should also provide a franchisee with its latest certified balance sheet and profit and loss accounts and details of each director and the senior executive staff of the franchisor. A franchisor should also disclose (inter alia) how many franchisees they have, how many franchisees have terminated their franchise agreements within the previous year and why, how many franchise agreements were terminated by the franchisor within that year and why and whether it is involved in any disputes (whether litigation or arbitration) with current or former franchisees. Where franchisors use brokers to assist in marketing and recruitment, they must ensure that the BFA Code is complied with by the broker. In addition, the franchisor must be careful not to make any misrepresentations; see question 23.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Where a franchisee has relied on a statement (of fact or law) made by the franchisor, whether this was made orally (at exhibitions, seminars, awareness days) or contained in sales literature (franchise prospectus, the franchisor's website, or financial projections or the

business plan for the franchisee), in entering into a contract that turns out to be untrue, the franchisor may be liable for a claim of misrepresentation. This remedy is not specific to franchising. An action for fraudulent misrepresentation occurs where a false statement is made knowingly, or without belief in its truth, or recklessly as to its truth. Misrepresentation can also be innocent or negligent.

Clauses that seek to limit liability for misrepresentation are often included in franchise agreements. Nevertheless, such disclaimers are of no effect where the franchisor has committed a fraudulent misrepresentation. With fraudulent or negligent misrepresentation the franchisee may claim rescission and damages, whereas for innocent misrepresentation the court has the discretion to award damages. Rescission means that the contract is set aside and the parties are put back into the position in which they were before the contract was made; as such, damages can be substantial.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

Apart from general contract law principles, there are no specific laws regulating the ongoing franchise relationship. See question 25 for other laws of general application that may affect franchise relationships.

25 Do other laws affect the franchise relationship?

There are no specific laws. Franchise agreements are not treated any differently to other commercial contracts. Nevertheless, two areas of general law are particularly relevant to franchising.

The Data Protection Act 1998 (DPA) governs the processing of personal information held on living and identifiable individuals. It applies to the 'processing' of 'personal data', both of which are widely defined, and means that practically any business operating in the UK that holds information about individuals, whether employees, customers or anyone else, is affected by the DPA. A breach of data protection laws can lead to criminal as well as civil liability. All the obligations under the DPA fall upon the 'data controller', who is defined as the person who (either alone or jointly or in common with other persons) determines the purposes for which and the manner in which personal data is, or is to be, processed. In the franchising context, franchisors and franchisees are both usually data controllers, although franchisees are sometimes data processors rather than data controllers.

Under the DPA, anyone who processes personal information (names, addresses, etc) to include a franchisee must comply with the eight data act principles, which include ensuring that the information is fairly and lawfully processed, is kept accurate and is processed for a limited purpose. It must be kept secure and must not be kept for any longer than necessary.

In many franchises the franchisor will require the franchisee to provide customer information to the franchisor, and franchisees will not be able to comply with data protection legislation. This highlights the need for the franchise agreement to set out what the franchisee must do to comply with data protection legislation and for the franchisor to facilitate compliance.

It is not uncommon for franchise agreements to contain exemption clauses that seek to limit or exclude the franchisor's liability for representations made at the pre-contract stage; for example, when supplying projected profit or turnover figures. In assessing the enforceability of exemption clauses, reference must be had to the Unfair Contract Terms Act 1997 (UCTA), which applies where a party seeks to limit its liability or where the contractual party seeks to avoid the consequences of misrepresentation by reliance on exclusion clauses. Franchise agreements are likely to be treated as standard form documents, and therefore any exclusion clauses will only be valid insofar as they are fair and reasonable.

Additionally, the Bribery Act and CRC Scheme will also have an effect. Section 7 of the Bribery Act 2010 (which came into force in July 2011) creates a new strict liability offence for companies and partnerships of failing to prevent bribery occurring within their organisation. The section 7 offence could apply in a franchising context. The only defence to a prosecution under section 7 is if a franchisor has put in place adequate procedures designed to stop corruption. The bribery prohibited by the Act applies whether it takes place in the UK or elsewhere, provided that the business being prosecuted carries on its business in the UK. Under section 7, a person associated with the franchisor bribes another person if there is the intention of obtaining or retaining business for the franchisor or to obtain or retain an advantage in the conduct of business for the franchisor. The Act defines an 'associated' person as one who performs services for or on behalf of the person being prosecuted. What 'performing services' means is vague and the Act indicates that it will be determined by reference to the relevant circumstances.

Generally speaking, franchisees do not perform services for or on behalf of the franchisor, but instead perform services for or on behalf of themselves and are therefore not likely to be associated. Moreover, franchisees generally obtain and retain business for themselves and the franchisor benefits from it, but it is unusual for franchisees to obtain and retain business for the franchisor though this could happen, for instance, with national account work. A franchisor should insert a prohibition against bribery in the manual along with a procedure for dealing with bribery issues.

If a franchise satisfies all four of the rules of the definition of a franchise set out within the Environmental Agency, CRC Energy Efficiency Scheme (CRC), it will be required to participate in the CRC from April 2010. The CRC is a new regulatory incentive to improve energy efficiency in large public and private sector organisations and reduce the amount of carbon dioxide emitted in the UK. While overall responsibility for compliance with the requirements of the CRC will lie with the franchisor, franchisees are required to provide such information and assistance as the franchisor may reasonably require in order to enable it to register for, and comply with, the CRC.

26 Do other government or trade association policies affect the franchise relationship?

Most reputable franchisors and franchise professionals are members of, or affiliated to, the BFA. The BFA Code sets out a best practice guide for franchisors, consultants and franchisees. Members are required to accept and adhere to the BFA Code, which sets out standards in franchise advertising, recruiting and selection and dispute resolution.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

Most well-drafted franchise agreements will contain an express provision for terminating franchise agreements immediately in the event of a serious breach by a franchisee (for example, abandonment, serious criminal conviction, insolvency, repetitive breach or incurable breach of a material provision of the franchise agreement). Other provisions can include providing the franchisee with an opportunity to rectify the breach within a specified period. The BFA Code (paragraph 2.4) provides that a franchisee should be given notice of any contractual breach and, where appropriate, should be granted a reasonable amount of time to remedy a default.

The franchisor (and franchisee) also have an overriding common-law right to terminate the agreement by accepting the franchisee's repudiatory breach (where it is clear that the party in breach no longer wishes to be bound by the terms of the agreement), which will bring about an immediate end to the franchise agreement.

28 In what circumstances may a franchisee terminate a franchise relationship?

A franchise agreement is most unlikely to contain an express right allowing a franchisee to terminate the franchise agreement. Nevertheless, a franchisee may terminate the agreement under common law where a franchisor has committed a repudiatory breach of contract.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

The BFA Code provides that the contract should state 'the basis for any renewal of the agreement' (paragraph 5.4). This wording does not make it obligatory that there should be renewal, but if renewal is available, its basis should be contained in the contract.

Most franchise agreements lasting five years (the usual period in the UK) will contain two 'guaranteed' renewals and will set out the conditions that a franchisee will have to satisfy in order to apply to renew the franchise agreement. Such conditions are likely to include the franchisee not being in substantial breach during the term of the franchise.

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

A franchisor will wish to control who becomes a member of its franchise network, and this is achieved through regulating the way in which a franchisee can sell, dispose of or transfer the franchisee business. The agreement will contain provisions to ensure that a franchisor's consent is obtained prior to the transfer and that the new incoming franchisee meets with the franchisor's approval and has the necessary skills required to ensure that the franchise is a success. The agreement will also contain an option for the franchisor to purchase if or when the franchisee decides to sell his or her business.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

There are no laws affecting the nature, amount or payment of fees.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Most agreements will contain provision for the franchisor to charge interest on any late payments at the rate agreed by the parties. Sometimes these interest rates can be high – around 24 per cent per annum – but very high rates could be treated as an unenforceable penalty clause. The Late Payment of Commercial Debts (Interest) Act 1998 can be relied on in order to claim interest on late payments. The rate is currently set at 8 per cent per annum above the Bank of England interest rate.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

A franchise agreement may contain some provision applicable to the payment of continuing fees that deal with the time at which the payment is to be converted, and at what rate. The UK does not enforce any exchange restrictions.

34 Are confidentiality covenants in franchise agreements enforceable?

Yes.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

There is no general legal obligation requiring contracting parties to act in good faith with each other. Nevertheless, the BFA's Code does require the parties (both franchisor and franchisee) to exercise fairness in their dealings with each other.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

It is very unlikely that franchisees will be treated as consumers for the purposes of consumer protection laws.

37 Must disclosure documents and franchise agreements be in the language of your country?

While there is no specific legislation on disclosure, the BFA Code requires that the franchise agreement be translated (by a sworn translator) or drafted into the official language of the country of the franchisee.

38 What restrictions are there on provisions in franchise contracts?

There are no restrictions. The BFA Code provides some guidance as to the duration of the agreement in the statement that 'it should be long enough to allow the individual franchisee to amortise their initial investment specific to the franchise' (section 5.4).

See also questions 39, 40 and 41.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Article 101 of the Treaty for the Functioning of the European Union (previously article 81(1) of the EC Treaty) (article 101) regulates agreements, decisions or concerted practices that may affect trade between member states and that have the object of distorting competition. The UK has passed its own legislation modelled on article 101, but obviously without the need for any effect on trade between member states (chapter 1 of the UK Competition Act 1998). If an agreement is prohibited by article 101, the offending provisions (and in some case the whole agreement) are void and the parties can be subject to fines. Vertical agreements are agreements between undertakings that operate at different levels in the production or supply chain.

Franchise agreements are vertical agreements and have the potential to affect competition, especially if they contain territorial restrictions, pricing obligations or non-compete requirements. It is not possible to remove these restrictions from formal agreements and to 'hide' them in commercial practices, because Article 101 applies not only to agreements but also to concerted practices.

Many franchise agreements may not be caught by the legislation, because they are treated as being of 'minor importance' or have been entered into by 'small and medium-sized enterprises'.

Vertical agreements (including franchise agreements) have been exempted from competition laws by the new vertical agreements block exemption and the accompanying revised vertical restraints guidelines that were adopted by the EC on 20 April 2010.

The new block exemption, which is available from the Commission's website (http://ec.europa.eu/competition/antitrust/legislation/vertical.html), was published with guidelines that are available on the same website. The guidelines are extremely important when it comes to understanding the block exemption. The block exemption applies to all new agreements entered into after 1 June 2010, and existing agreements have to comply with it as from 1 June 2011.

Almost all properly drafted franchise agreements contain a provision whereby the franchisor, on receiving advice that its franchise agreement does not comply with EU legislation, can change the agreement so that it does comply. This clause will enable changes to be made to existing agreements before the 1 June 2011 deadline. The block exemption expires on 31 May 2012.

Three areas covered by the block exemption are particularly relevant in a franchising context. They are: price, territory (passive/active sales), and non-compete obligations (in-term and post-term).

Price restrictions

Resale price maintenance is a 'hard-core' restriction (contained in article 4 of the block exemption). If this is contained in a franchise agreement, none of the other provisions of the agreement will be exempted. Not all price restrictions are prohibited: franchisors can set maximum prices and can recommend prices, provided that these are recommendations and are not mandatory. Franchisors cannot set minimum prices either by means of express contractual provisions in the franchise agreement or by indirect methods such as threatening franchisees who step out of line, offering rebates or free products such as marketing collateral for those who comply with minimum prices, or imposing price monitoring (see paragraph 48 of the Guidelines for more information on this).

Territory restrictions

These restrictions are also viewed as 'hard-core'. Exclusive territories are not quite as exclusive as they once were, as the Commission draws a distinction between active and passive selling. Active sales are sales made by franchisees who have taken active steps to obtain that customer; passive sales are sales made as a result of unsolicited enquiries from customers. A franchisor can prevent active sales outside a franchisee's territory but cannot prevent franchisees from undertaking passive sales in respect of customers outside their territory.

Internet sales

The Commission takes the view that internet sales are 'in principle' passive sales and, therefore, cannot be prohibited (for an analysis of the Commission's view on internet sales, reference should be made to paragraph 52 of the Guidelines). The Commission does recognise that not all internet sales will be passive sales because, for instance, if a franchisee makes use of a search engine to optimise its website's rating in territories outside its own allocated territory, this could be an active sale. Franchisors cannot prevent franchisees from having their own website, but can set quality standards for franchisees' websites in precisely the same way that they may set quality standards for retail premises or the vehicles that they use.

Non-compete obligations (in term)

In-term non-compete obligations are also prohibited (contained in article 5) and are therefore grey list and not hardcore restrictions, which means that only the clause containing the restriction is void and unenforceable and not the whole agreement. A non-compete obligation is, for the purposes of the block exemption, an obligation on a franchisee not to be involved in a similar business or an obligation on a franchisee to purchase at least 80 per cent in value (occasionally volumes can be used) of its required purchases from the franchisor or its nominated supplier.

The Commission, however, recognises that a non-compete obligation lasting for only five years should be permitted. It is for this reason that most franchise agreements in the United Kingdom last for five years. The five year exemption still applies even where the franchise agreement is renewed after each five years. The five-year period can be increased if the franchisor owns the premises from which franchisees operate to the length of the lease granted by the franchisor to the franchisee.

Update and trends

The UK continues to resist franchise legislation whether relating to disclosure or registration. The BFA is seeking to strengthen its regulatory function by including franchisees in its structures so that it can argue that it represents all 'stakeholders' within franchising.

Non-compete (post-term)

This is another grey list restriction. Post-termination non-compete covenant are prohibited unless they are indispensable for the protection of the franchisor's know-how. Changes have been made to the definition of know-how, the know-how must be secret (as it had to be in the previous block exemption) but except that now following redrafting of what is 'secret' it appears less likely that franchisors would be able to argue that although none of the elements of its know-how are secret the compilation of these non-secret elements do make it secret. In practice, a franchisor's know-how – usually contained in operating manuals – would be unlikely to be secret.

If the know-how is capable of protection, it is permissible to impose post-termination non-compete covenants for a period of one year preventing an ex-franchisee from being involved in competing goods or services from the 'premises and land' that it had previously used. In other words a franchisor cannot prevent a franchisee from opening next door and the limited permission for non-compete covenants does not, on the face of it, apply to non-premises based franchises such as van distribution franchises. It is not clear whether this is intended and helpfully the Guidelines refer to 'point of sale' rather than premises and land.

The provisions referred to above relating to post termination non-compete covenants could have a very serious effect on franchising but the Court of Justice, which is the ultimate authority on European matters, took a less 'tough' stance on post-termination non-compete covenants in its *pronuptia* decision and, as a result, it may be that franchisors would be able to rely on the Court of Justice's decision rather than the Block Exemption and Guidelines to impose a non-compete covenant.

For the first time in 2010 an English court had to deal with an argument from a former franchisee (against whom enforcement of the post-term non-compete in the franchise agreement was being sought) that the covenant did not comply with section 2 of the Competition Act 1998 (which is modelled on article 101 TFEU). At the interim application, the High Court relied on the *pronuptia* decision and indicated that whether the post-termination non-compete covenants falls outside the scope of section 2 depends on whether it is essential to prevent the risk that know-how and assistance provided by the franchisor to the franchisee will, after termination, be used by the franchisees' competitors.

Please note that similar responses will be given in all EU countries and so may need to be amalgamated.

The EC or UK competition law authorities may carry our investigations into anti-competitive activities. In the UK, the OFT is the principal law enforcement agency (www.oft.gov.uk). The competition authorities have significant investigative powers that include entering and searching business premises and imposing fines. The EC's involvement is limited to where there has been a suspected infringement that affects trade between member states.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

If the parties are unable to settle a claim, they will be required to follow the pre-action protocol (if relevant) before issuing court proceedings. There is no franchise specific dispute resolution protocol.

It is possible to issue a civil claim in either the relevant county court or the High Court, depending on the financial value of the claim. The claimant will be required to prove his or her claim on the balance of probabilities. At all stages in the dispute, the rules encourage parties to consider alternative means of dispute resolution (ADR). The BFA operates a Mediation and Arbitration Scheme to resolve franchise disputes. The later is a formal process that results in a binding resolution of the dispute; see also question 41. Mediation is a much more informal method, whereby an independent mediator helps the parties to negotiate a settlement. Mediations are often business driven and results orientated where the parties are free to discuss, not just those contractual issue which are dispute, but the whole commercial arrangement. Mediation is voluntary, without prejudice and is only binding once a settlement agreement has been entered into. It is not uncommon for a franchise agreement to include a clause that obliges the parties to consider forms of ADR prior to commencing court proceedings in all cases, other than where urgent injunctive relief is required. Choice of jurisdiction and law is a matter agreed on by the parties in the agreement.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

In addition to the arbitration service offered by the BFA, the London Court of International Arbitration also offers an arbitration scheme. The LCIA offers a combination of the civil and common law systems. It provides flexibility for parties and the tribunal to agree on procedural matters; speed and efficiency of arbitrator's appointments, means of reducing delay and counteracting delaying tactics. They also have a range of interim remedies, for example, security for claims and costs. Nevertheless, an arbitrator will conduct a formal enquiry process where the parties are required to produce documents and witness statements and this could be as costly as conventional court-based litigation. An arbitrator's findings are final on the matter and may only be appealed to a High Court judge.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not treated any differently from domestic franchisors.

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Overview

1 What forms of business entities are relevant to the typical franchisor?

While it is not required for a foreign franchisor offering or selling franchises in the US to form a US entity for that purpose, many do. In any case, franchisors doing business in the US must include in their franchise disclosure documents financial statements in accordance with US generally accepted accounting principles (GAAP), as revised by any future government-mandated accounting principles, or as permitted by the Securities Exchange Commission. Below is a general description of the most common US entities.

Partnerships, limited liability companies and corporations are relevant to the typical franchisor in the US. The decision as to which entity to use is generally guided by concerns of liability and taxation.

Partners in a general partnership have joint personal liability for the obligations of the partnership. Other forms of partnerships, such as limited partnerships, limited liability partnerships and limited liability limited partnerships, provide limited liability to some or all of the owners. Partnerships and limited liability companies provide 'pass-through' taxation, which means that the entity is not taxed, but the owners must report the entity's income on their individual tax returns. Limited liability companies and corporations generally provide limited liability to all their owners.

For ease of disclosure, many companies choose to form a franchise subsidiary of their existing business entities solely for franchising purposes. Nevertheless, many franchisors choose not to have the franchisor entity serve as the parent to other affiliated entities or to franchisor-owned franchises, since doing so often complicates and adds expense to the franchisor's annual audit.

2 What laws and agencies govern the formation of business entities?

Almost all business entities are formed under state law rather than federal law. All states have statutes governing the formation of corporations and have adopted some form of the Uniform Limited Liability Company Act. Nevertheless, the common law controls to the extent that it has not been superseded by statutory law. Most states have adopted the Uniform Partnership Act or the Revised Uniform Partnership Act, or both, and virtually every state has adopted some form of the Revised Uniform Limited Partnership Act.

All states recognise limited liability companies, which are frequently used for privately owned businesses where the owners desire pass-through taxation.

Most states have some form of limited liability partnership statute, although the amount of liability protection varies from state to state. The formation of limited liability partnerships is governed by state limited partnership statutes, which vary. In general, each state's secretary of state or department of corporations regulates business entity formation.

3 Provide an overview of the requirements for forming and maintaining a business entity.

A general partnership comes into existence by the mere association of two or more persons or entities to carry on as co-owners of a business for profit, whether or not they intend to form a partnership. No written document or government filing is required. By contrast, limited partnerships, limited liability partnerships, limited liability companies and corporations require filing with the secretary of state or similar regulatory body of the applicable state prior to formation. The content of each filing varies and is specific to the type of entity being formed.

Formation of a limited liability company requires the filing of 'articles of organisation' with the state. Once a limited liability company is formed, the members adopt an 'operating agreement' to govern the conduct of its affairs.

Corporations are required to file 'articles of incorporation' with the relevant state. Each state has its own requirements for the contents of the articles. In most jurisdictions, the corporation comes into existence upon filing.

4 What restrictions apply to foreign business entities and foreign investment?

There are a variety of direct and indirect federal controls on foreign investment under statutes, enforced by many different agencies. The Exon-Florio Amendment to the Defense Production Act of 1950 is the primary federal control on foreign investment in the US. The Exon-Florio Amendment grants authority to the federal government to disapprove any proposed investment that may threaten national security.

The US PATRIOT Act of 2001 and Executive Order 13,224 impose restrictions on transactions with suspected terrorists and those associated with suspected terrorists. The government has compiled a list of persons or entities that are suspected terrorists, and franchisors and others must be careful to ensure that they are not transacting business with any person or entity on this list. The PATRIOT Act also expands the definition of a 'financial institution'. Some franchisors may qualify as a financial institution and be subject to additional reporting and compliance obligations.

The federal government also imposes certain reporting and disclosure requirements on foreign investors. For example, the International Investment Survey Act of 1976 requires 'US affiliates' of foreign companies to file various reports regarding their financial status. Additionally, many state laws regulate limited aspects of foreign investment but are subordinate to the various federal laws governing foreign investment.

5 Briefly describe the aspects of the tax system relevant to franchisors. How are foreign businesses and individuals taxed?

Federal income tax statutes and regulations tax entities by using either pass-through taxation or double taxation. Pass-through taxation requires owners of a business entity to pay taxes on the net income of their entity as if they had received the income directly, and it allows them to deduct the entity's losses as their own. Double taxation means the entity is itself a taxpayer, separate and apart from its owners; therefore, the entity must report its income and pay its own income tax.

In a franchise relationship, a US franchisor is taxed on up-front franchise fee payments and royalties as ordinary income rather than 'capital gains'. Capital gains are the profits that a seller makes when it sells an asset that qualifies for capital gain tax treatment. Capital gains are taxed at lower rates than ordinary income. Due to the continuing interest in the franchise rights, a franchisor will not be able to treat the sale of a franchise as a sale or exchange of a capital asset that would qualify for capital gains treatment. The US Internal Revenue Code provides that the payments are treated as capital gains only if the franchisor does not retain a 'significant power, right, or continuing interest'. Most franchisors do retain rights or a continuing interest in the franchise rights granted and so do not qualify for capital gains treatment.

After a transfer of the franchise, the franchised business or the franchisee (or any interest therein), a franchisee must determine whether the payments are deductible as a business expense or whether they must be amortised. To qualify for business expense treatment, the payments must be contingent on the productivity, use or disposition of the franchise, trademark, trade name or know-how, and the payments must be substantially equal in amount and paid serially throughout the franchise term at least annually. Thus, royalties will typically qualify as deductible expenses.

Foreign businesses and individuals are taxed on their US-sourced income. There are both personal and corporate federal income taxes. Federal tax rates on individuals are approximately 10 per cent to 35 per cent; rates on corporations are approximately 15 per cent to 35 per cent. Federal law requires withholding on royalties payable to foreign franchisors, although the withholding is reduced or eliminated under income tax treaties the US has with many other nations. States also have the power to tax franchisors. Some states have income taxes and some states do not. State individual rates are generally under 15 per cent and state corporate rates are generally under 10 per cent. While the rules and rates of taxation vary by state, the common characteristic is the pressure on the state governments to seek additional revenues, and the likelihood is that this pressure will continue for at least the next several years. In some cases, a franchisor will want to determine whether it can resist taxation on the grounds of lack of 'nexus' or otherwise.

6 Are there any relevant labour and employment considerations for typical franchisors? What is the risk that a franchisee or employees of a franchisee could be deemed employees of the franchisor? What can be done to reduce this risk?

Because a franchisor and a franchisee are distinct business entities, a franchisor's relationship with franchisees and their employees is not generally an employer–employee relationship subject to state and federal labour regulation. Rather, franchisees are usually considered to be 'independent contractors'. At the same time, in a few isolated situations, franchisees have been found to be 'employees' due to the excessive degree of control that the franchisors exercised.

An employer–employee relationship between a franchisor and a franchisee and its employees would result in tax, employment law and liability consequences for the franchisor. More specifically, if a franchisee were found to be an employee of the franchisor, the franchisor would be required to pay employment taxes relating to the franchisee and would have to comply with all aspects of employment law in dealings with the franchisee. Furthermore, if the franchisee were an employee of the franchisor, there is a substantial risk that the franchisee would be considered the franchisor's agent and, therefore, the franchisor would be responsible for the franchisee's acts and omissions. Nevertheless, franchisor–franchisee relationships can usually be structured to avoid these risks if certain factors are taken into account and certain practical precautions are taken.

For instance, the Internal Revenue Service (IRS) considers 20 factors in determining whether an employment relationship exists for federal employment tax purposes. These include whether:

- the worker's services are integrated into the business operations of the franchisor;
- the franchisee's set hours of work are established by the franchisor;
- the franchisee must perform services in the order or sequence set by the franchisor;
- the franchisor makes hourly, weekly or monthly payments to the franchisee;
- the franchisor ordinarily pays the franchisee's business or travelling expenses, or both;
- the franchisor furnishes significant tools, materials and other equipment to the franchisee; and
- the franchisee invests in facilities used in performing services.

Courts have frequently used the following six factors to analyse the existence of an employment relationship under the Fair Labor Standards Act (FLSA):

- the degree of the alleged employer's right to control the manner in which the work is to be performed;
- the alleged employee's opportunity for profit or loss depending upon his or her managerial skill;
- the alleged employee's investment in equipment or materials required for his task, or his or her employment of helpers;
- whether the service rendered requires a special skill;
- the degree of permanence of the working relationship; and
- whether the service rendered is an integral part of the alleged employer's business.

In addition to bearing these factors in mind, to avoid the tax and employment law implications of an employment relationship, the franchise agreement should be drafted to state that the franchisor and franchisee are independent contractors and not agents, joint venturers, partners or employees of each other. The franchise agreement should require the franchisee to, at all times, identify him, her or itself conspicuously as the owner of the franchised business and if an employment relationship does in fact exist (for example, pursuant to an analysis under the IRS or FLSA factors (or both) enumerated above), the designation or description of the relationship by the parties as anything other than that of employer–employee will not be dispositive. While the parties' intent regarding the nature of their relationship is a consideration, it is the parties' actual conduct that truly defines them. Practically speaking, the franchisor must give the franchisee significant autonomy over the day-to-day operations of the franchised business, including, but not limited to, the hiring, firing and management of employees. The franchisor must limit its control over the franchisee to what is necessary to maintain uniform operations among its franchisees and uniform quality among their products and services to protect and enhance the franchisor's brand and trademarks.

7 How are trademarks and know-how protected?

The US is a signatory to the Madrid Protocol. Under US law, the Lanham Act is the federal statute that is the primary protection for trademarks. It protects names or symbols that a party uses to identify and distinguish its goods or services. Unlike most other countries, US trademark law determines priority in ownership rights based on who was first to use the marks, not who was the first to file an application for registration. A franchisor strengthens its trade identity by registering, but a certain extent of trademark rights can be estab-

lished by use without registration. A registered mark is infringed by the unauthorised use of the same or a similar mark that is likely to cause confusion, mistake or deception. Statutory remedies include injunctive relief and recovery of damages, the defendants' profits, attorneys' fees and costs.

US state and federal copyright law protects originality and creativity embodied in works fixed in a tangible medium of expression. Additionally, nearly all states have adopted some form of the Uniform Trade Secrets Act, which protects valuable confidential business information.

The Federal Trade Commission regulates unfair and deceptive trade practices by businesses. The Federal Trade Commission Act lists specific practices that are considered unfair and deceptive, but a practice may be found to be unfair and deceptive even if it is not specifically listed and is often used to prevent unauthorised use or misappropriation of proprietary competitive information, goodwill or processes.

Various states have enacted statutes that expressly protect trade secrets and confidential information. These vary but, in general, provide civil and sometimes criminal penalties for the theft of trade secrets and confidential information. State case law expands on these statutes, as well as on common law principles that protect trade secrets and confidential information. With the growth of information technology, federal statutes, as well as certain state statutes, now specifically prohibit use of electronic measures (hacking) to steal confidential information, trade secrets or otherwise access password-protected systems. Many franchisors use electronic information systems and, therefore, may make use of these new statutes.

8 What are the relevant aspects of the real estate market and real estate law?

The real estate market in the US is competitive and varies widely from state to state. The real estate market and real estate law generally do not have a substantial impact on franchising, unless the franchisor elects to acquire or lease property to lease or sublease (as applicable) to its franchisee for the franchisee's use in operating the franchised business.

Laws and agencies that regulate the offer and sale of franchises

9 What is the legal definition of a franchise?

The Federal Trade Commission's Trade Regulation Rule on franchising (the FTC Rule) regulates the offer and sale of franchises nationwide. The FTC Rule defines a 'franchise' as any continuing commercial relationship or arrangement in which the terms of the offer or contract specify, or the franchisor promises or represents, orally or in writing, that:

- the franchisee will have the right to operate a business that is identified or associated with the franchisor's trademark or to offer, sell or distribute goods, services or commodities that are identified or associated with the franchisor's trademarks;
- the franchisor will exert or has the authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
- as a condition of obtaining or commencing operations of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

If any of these elements are missing, the relationship will not be covered by the FTC Rule, regardless of how it is characterised.

In addition, many states have franchise 'registration/disclosure' or franchise 'relationship' laws (or both) which define franchises. More than one state's law may apply to a particular relationship.

Under most state franchise laws, there are three elements that constitute a franchise. Somewhat similar to the FTC Rule, these state definitions require payment of an initial or ongoing fee (or both) by the franchisee for the use of the franchisor's system and proprietary mark, and a substantial association of the franchised business with the franchisor's proprietary mark. They differ from the FTC Rule in that the third element varies by state and requires either a 'marketing plan or system' substantially prescribed by the franchisor, or a 'community of interest'. A marketing plan usually exists where advice or training is given regarding the operation of the franchised business and the sale of the franchisor's products or services. A community of interest is typically defined as an ongoing common financial interest between the franchisor and the franchisee in the operation of the franchised business.

10 Which laws and government agencies regulate the offer and sale of franchises?

The FTC regulates franchises under federal law. Under the original FTC Rule, the FTC combined its regulation of franchises with that of 'business opportunity ventures'. Business opportunity ventures are not currently covered in the revised FTC Rule, but the FTC has a 'business opportunity rule' that addresses business opportunity ventures separately from franchises. The FTC is currently in the process of proposing revisions to the existing business opportunity rule. It is relatively rare that a franchise programme meets the FTC Rule definition of a business opportunity venture and so this discussion will not cover such ventures.

The FTC Rule requires disclosure by franchisors before any offer or sale is made, unless an exemption applies. The FTC Rule does not govern the ongoing franchisor–franchisee relationship. Rather, it only imposes pre-sale disclosure requirements and does not require any registration or filing. In addition, 14 states have laws regulating the offer and sale of, and requiring pre-offer filings or registration of, franchises, as well as imposing pre-offer and pre-sale disclosure requirements. They are: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Oregon regulates offers and sales, but requires no filing. In addition, 21 states, as well as the District of Columbia, Puerto Rico, and the US Virgin Islands, have statutes that regulate the terms of the franchisor–franchisee relationship. These states are: Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. The areas of primary concern under state relationship laws are the termination, renewal and transfer of franchise rights.

Generally, state franchise statutes apply when:

- the offer originates within the state;
- the offer is directed by the franchisor to a prospective franchisee within the state or to a resident of that state;
- the offer is received within the state;
- meetings between the franchisor and prospective franchisee occur in the state; or
- the franchised business will be operated in, or the franchise territory is, entirely or partially in the state.

Nevertheless, these jurisdictional factors vary by state, so franchisors need to be aware of the possible application of multiple states' franchise laws. In addition, approximately half of the states have 'business opportunity' laws that require similar registration or disclosure procedures. Exceptions from them are usually available to franchisors who license a registered trademark. Nevertheless, exemption filings must be made in certain states in order to qualify for the exemptions.

11 Describe the relevant requirements of these laws and agencies.

The FTC Rule requires franchisors and franchise brokers to make pre-sale disclosures to prospective franchisees. States with franchise registration or disclosure laws also require pre-sale disclosures to the prospective franchisee. Additionally, these states require the franchise offering to be registered with the state. Certain state franchise registration or disclosure periods differ from the FTC Rule in terms of the time period for pre-sale disclosures and annual update or renewal registrations. Also, the information to be disclosed under state franchise registration or disclosure laws varies slightly, and state franchise regulators often write comment letters to franchisors requiring that disclosure documents be modified to meet the states' particular concerns before a registration application is approved. As a result, a registration application may be delayed, sometimes for weeks or even months. Some states are more difficult to register in than others (see question 15).

If a franchisor wishes to make a 'financial performance representation' (FPR) to prospective franchisees, the franchisor must strictly comply with the FTC Rule's requirements regarding FPR disclosure, as well as any applicable state law requirements. The FTC Rule defines an FPR as any representation, including any oral, written or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits. Franchisors should exercise caution when making an FPR. If the franchisor does not strictly comply with the FTC's requirements, the franchisor must not make an FPR to prospective franchisees. Franchisors are prohibited from making FPRs unless: the franchisor has a reasonable basis for making the FPR; the franchisor has written substantiation for the FPR at the time the FPR is made;and the franchisor includes the FPR in its disclosure document together with certain other required disclosures.

12 What are the exemptions and exclusions from any franchise laws and regulations?

The FTC Rule exempts lease arrangements in which an independent retailer sells its own goods and services from premises leased from a larger retailer in that retailer's store, instances where a franchisee is required to pay less than US$500 before or during its first six months of operations, oral franchise agreements, and 'fractional' franchises. In addition, the FTC Rule exempts petroleum marketers and resellers covered by the Petroleum Marketing Practices Act. It also contains the following three exemptions, collectively referred to as the 'sophisticated investor exemptions':

- large investment exemption, which exempts franchise sales where the initial investment is US$1 million, exclusive of unimproved land and franchisor financing;
- large franchisee exemption, which exempts franchise sales to ongoing entities with at least US$5 million net worth and five years of prior business experience; and
- insiders' exemption, which exempts franchise sales if one or more purchasers of at least a 50 per cent ownership interest in the franchise has been, within 60 days of the sale, and for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchises, or the administrator of the franchised network; or who has been, within 60 days of the sale, for at least two years, an owner of at least a 25 per cent interest in the franchisor.

Many of the FTC Rule exemptions do not have correlating exemptions under state franchise disclosure laws, but some state laws do have some similar exemptions.

Some of the exemptions or exclusions of most interest to franchisors available under state franchise registration/disclosure laws include, but are not limited to:

- large franchisors or experienced franchisors who exceed a specified net worth and who have had a minimum number of franchisees for a minimum period of time;
- offers or sales that are renewals, extensions, or substantially similar to franchises already owned by the franchisee;
- certain sales of a franchise by a franchisee or a sub-franchisor; and
- offers or sales to a financial institution or life insurance company.

Not all states have any or all of these exceptions, and they often apply only to registration, not disclosure. Because the FTC Rule applies to all states, an exemption under state law will not relieve a franchisor from its obligation under the FTC Rule to a prospective franchisee.

13 Does any law or regulation create a requirement that must be met before a franchisor may offer franchises?

A franchisor must be in compliance with any applicable state registration and disclosure requirements before that franchisor may offer franchises.

14 In the case of a sub-franchising structure, who must make pre-sale disclosures to sub-franchisees? If the sub-franchisor must provide disclosure, what must be disclosed concerning the franchisor and the contractual or other relationship between the franchisor and the sub-franchisor?

Under the FTC Rule, if a sub-franchisor sells a franchise, it is jointly responsible with the franchisor for compliance with all franchise disclosure laws. Additionally, registration states require separate registration by the franchisor of the offer of sub-franchise rights and separate registration by the sub-franchisor of its offering of sub-franchises (see also question 20).

15 What is the compliance procedure for making pre-contractual disclosure in your country? How often must the disclosures be updated?

Disclosure is made to prospective franchisees by using a disclosure document in a format that conforms to the requirements of the FTC Rule. The FTC Rule expressly permits franchisors to comply with pre-sale disclosure obligations electronically (via CD-ROM, e-mail, or a download from a website), as long as they do so in compliance with the procedural requirements set forth in the FTC Rule.

The FTC Rule requires that disclosure be made to a prospective franchisee at least 14 calendar days before the franchisee signs any franchise or other binding agreement with, or makes any payment to, the franchisor or any of its affiliates in connection with the proposed franchise sale, or earlier than those 14 calendar days if the prospective franchisee has 'reasonably requested' such earlier disclosure. In addition, certain state laws require that disclosure be made earlier in the sales process than the FTC Rule does.

A franchisor will be considered to have furnished a disclosure document if:

- a copy of the document was hand-delivered, faxed, e-mailed or otherwise delivered to the prospective franchisee by the required date;
- directions for accessing the document on the internet were provided to the prospective franchisee by the required date; or
- a paper or tangible electronic copy (for example, computer disk or CD-ROM) was sent to the address specified by the prospective franchisee by first-class United States mail at least three calendar days before the required date.

Additionally, it is a violation of the FTC Rule for a franchisor to alter unilaterally and materially the terms and conditions of the basic franchise agreement or any related agreements attached to the disclosure document without furnishing the prospective franchisee with a copy of each revised agreement at least seven calendar days before it signs the revised agreement. Changes to an agreement that arise out of negotiations initiated by the prospective franchisee do not trigger this seven-calendar-day period.

The FTC Rule pre-empts inconsistent state regulation but allows the states to impose higher disclosure standards or require additional disclosures. The North American Securities Administrators Association and the states have effectively adopted the FTC Rule as is, but may elect to impose minimal additional requirements. Some states do, in fact, have a relatively small number of additional requirements. This allows franchisors to continue to prepare a 'multi-state' form of disclosure that includes each state's mandated modifications to the disclosure document.

Pursuant to the FTC Rule, disclosure documents must be updated within 120 days of the end of the franchisor's fiscal year. Depending on the registration state, franchisors must update their disclosure documents (and state franchise registrations) either 90, 110 or 120 days after the franchisor's fiscal year-end, or within one year of the approval effective date of the registration.

Furthermore, franchisors generally must immediately update their FTC disclosure documents upon the occurrence of material changes. A material change is defined as:

> *Any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchised business or which has any significant financial impact on a franchisee or prospective franchisee.*

Additionally, if a franchisor amends its disclosure document after the initial disclosure but before a sale is consummated, the amended document should be delivered to the prospective franchisee.

16 What information must the disclosure document contain?

The FTC Rule requires a disclosure document to contain the following information:

- identifying information as to the franchisor and any of its controlling parent companies, predecessors and certain affiliates;
- business experience of the franchisor's directors and officers and any other individuals who will have management responsibility relating to the sale or operation of the franchise;
- litigation history of the franchisor and its directors and officers;
- domestic and foreign bankruptcy history;
- all initial fees charged in connection with the purchase of the franchise;
- recurring and non-recurring fees to be paid by the franchisee;
- estimated initial investment;
- restrictions on sources of products and services;
- the franchisee's obligations under the franchise or related agreements;
- financing arrangements;
- the franchisor's obligations regarding assistance, advertising, computer systems and training;
- territory;
- trademarks;
- patents, copyrights, and proprietary information;
- the franchisee's obligation to participate in the actual operation of the franchised business;
- restrictions on what the franchisee may sell;
- renewal, termination, transfer, and dispute resolution;
- public figures involved with the franchise;
- any financial performance representations the franchisor wishes to make to prospective franchisees;
- outlet and franchisee information, including contact information for former franchisees;
- audited financial statements prepared in accordance with United States generally accepted accounting principles or in a format that the United States Securities and Exchange Commission has approved;
- contracts; and
- acknowledgement of receipt of the disclosure document.

17 Is there any obligation for continuing disclosure?

The purpose of the disclosure document is to provide information to persons and entities who are considering the purchase of a franchise. Thus, there is no requirement to provide disclosure documents on an ongoing basis to existing franchisees, but, subject to a number of exceptions, exemptions and qualifications, there is often a requirement to provide a disclosure document to an existing franchisee who is purchasing an additional franchise or renewing an existing one.

18 How do the relevant government agencies enforce the disclosure requirements?

The FTC is responsible for enforcement of the FTC Rule. Following investigation, the FTC may commence an enforcement action against a franchisor if a violation is discovered. Enforcement usually occurs through a court order which will contain injunctive provisions enjoining the franchisor from continuing the violation.

Moreover, all of the state registration or disclosure statutes create their own enforcement structure. These statutes vest investigatory and prosecuting power in the state administrator. Also, state administrators have the authority to issue ex parte stop orders prohibiting franchise sales activities by individuals or entities whom the state administrator believes may be violating the franchise statute until a hearing can be conducted. Some state franchise statutes provide for criminal enforcement and private rights of action. Criminal enforcement on the state level usually occurs through the state attorney general's office. Some have their own specialised franchise investigators. While certain states' franchise laws also contain provisions that allow for criminal penalties for violations, they are rarely utilised.

19 What actions can franchisees take to obtain relief for violations of disclosure requirements? What are the legal remedies for such violations? How are damages calculated? If the franchisee can cancel or rescind the franchise contract, is the franchisee also entitled to reimbursement or damages?

The FTC Rule does not grant an aggrieved franchisee the right to bring a legal action. Only the FTC itself can maintain an action for violating the FTC Rule. The FTC may bring civil actions, which seek monetary penalties, injunctive relief and consumer redress. The FTC can require rescission, reformation, payment of refunds or damages, or some combination of these. The FTC can also issue cease-and-desist orders for franchisors who fail to comply with franchise laws. Civil penalties in federal actions allow for recovery of up to US$11,000 per day for each violation.

State registration or disclosure laws provide a private right of action for franchisees; these laws also authorise the state administrator directly, or through the state attorney general, to bring an action on behalf of the people of the state to enjoin unlawful acts or practices or to enforce compliance with the franchise laws. Available remedies under state franchise laws include denial or revocation of state franchise registration, consumer redress in the form of actual and sometimes consequential damages, or rescission, injunctions, civil penalties, and criminal sanctions for wilful violations.

All states have passed Deceptive Trade Practices Acts (DTPAs), sometimes referred to as 'little FTC Acts', which prohibit deceptive acts or practices in the conduct of trade or commerce.

The acts are designed to protect consumers from unfair or deceptive trade practices by providing a private cause of action even when there might not be one under general principles of law or under the FTC Rule. Some states make failure to comply with the FTC Rule a per se violation of the DTPAs, while other states make it evidence of a violation. About half of the states provide minimum statutory damages, and many states allow the court to award triple damages or punitive damages (see also question 23).

20 In the case of sub-franchising, how is liability for disclosure violations shared between franchisor and sub-franchisor? Are individual officers, directors and employees of the franchisor or the sub-franchisor exposed to liability? If so, what liability?

Under the FTC Rule, if a sub-franchisor sells a franchise, it is jointly liable with the franchisor for any violations. The FTC imposes liability on the officers and directors of corporate franchisors for violations of the FTC Rule.

Most state franchise laws expressly impose joint and several liability for disclosure violations on all partners, directors, principal officers, controlling persons, and employees who aid a violation or are responsible for compliance. Most state franchise laws specifically address sub-franchisors.

21 In addition to any laws or government agencies that specifically regulate offering and selling franchises, what are the general principles of law that affect the offer and sale of franchises? What other regulations or government agencies or industry codes of conduct may affect the offer and sale of franchises?

The general common law of fraud and misrepresentation applies to the offer and sale of franchises. Furthermore, most states have statutes that prohibit unfair and deceptive practices.

General contract, antitrust and fair-dealing principles affect the offer and sale of franchises. The Sherman Act, the Robinson-Patman Act, the FTC Act and the Clayton Act prohibit anti-competitive abuses in contract formation as well as general trade and commerce. These laws are also applicable to franchises. Moreover, federal civil rights statutes may apply if the franchisee can show prohibited discriminatory practices in the offer, sale, renewal or termination of a franchise.

There are private franchise associations that have established codes of conduct for their members, but these do not have the force of law (see also question 26).

22 Other than franchise-specific rules on what disclosures a franchisor should make to a potential franchisee or a franchisee should make to a sub-franchisee regarding predecessors, litigation, trademarks, fees, etc, are there any general rules on pre-sale disclosure that might apply to such transactions?

At the federal level, the Federal Trade Commission Act prohibits unfair methods of competition and unfair or deceptive acts or practices. The FTC Rule was adopted pursuant to that authority, but the general prohibition remains available to the FTC in appropriate cases.

At the state level, in addition to several franchise-specific statutes, state law typically imposes a common law duty of good faith and fair dealing on parties to contracts, including franchise agreements. This has been used to provide redress for acts by the franchisor prior to and during the sales process. Statutory fraud principles could also be applied to misrepresentations, for example.

23 What other actions may franchisees take if a franchisor engages in fraudulent or deceptive practices in connection with the offer and sale of franchises? How does this protection differ from the protection provided under the franchise sales disclosure laws?

Aside from the statutory causes of action available to franchisees, which are discussed in question 19, franchisees may also bring common law actions for franchisor violations related to the offer and sale of franchises. Under common law, unlike the franchise statutes, franchisees may not be able to obtain attorneys' fees.

State common law and statutory fraud principles will provide franchisees with a cause of action for misrepresentations or false statements made during the franchise sales process. The remedy for general common law fraud and misrepresentation is usually direct, foreseeable damages, although courts also have the authority to award punitive damages in the case of egregious behaviour.

Legal restrictions on the terms of franchise contracts and the relationship between parties involved in a franchise relationship

24 Are there specific laws regulating the ongoing relationship between franchisor and franchisee after the franchise contract comes into effect?

In the US, 21 states, the District of Columbia, Puerto Rico, and the US Virgin Islands have 'relationship' laws governing the termination or non-renewal of franchise agreements and other aspects of ongoing franchise relationships, but there are no federal franchise relationship laws of general application.

Numerous states have relationship laws providing that a franchisor may not terminate or refuse to renew a franchise agreement without 'good cause', which is typically defined as some type of material default, and provide a minimum number of days or a cure period (or both) before a termination or non-renewal can become effective. These cure periods generally range from 30 to 90 days. Nevertheless, immediate termination is permitted under certain conditions, which vary by state. Such states have franchise relationship laws that also regulate transfers, renewals, discriminatory economic terms, product purchase requirements, and other terms typically addressed in franchise agreements.

The application of state franchise relationship laws creates significant potential liability for franchisors operating in the US. Franchisors have to be careful not to violate them, and they are frequently violated due to lack of understanding or inadvertence. Generally, state administrators in registration states with relationship laws will require, as a condition of registration, that franchisors amend or rewrite certain provisions of their franchise contracts to conform to the minimum protections required under the relationship statutes. They also require that franchisors include in their disclosure documents notice of the existence of such laws and certain 'state-specific' disclosures.

Franchisees who are harmed by violations of state franchise relationship laws may recover damages and costs of litigation, including reasonable attorneys' fees. Franchisees may also be awarded other appropriate remedies, including injunctive and other equitable relief.

Franchisees sometimes bring claims based on 'encroachment', where a franchisor locates a franchised or franchisor-owned outlet in close proximity to an existing franchised outlet and the new outlet has a negative financial impact on the existing outlet. Some franchise statutes expressly prohibit encroachment of the franchisee's trade area, but these claims are usually rather fact-specific and may turn, in whole or in part, on whether or not the franchisee was granted any form of exclusivity.

25 Do other laws affect the franchise relationship?

There are no federal franchise relationship laws of general application. Certain industries (for example, the petroleum industry, with the Petroleum Marketing Practices Act) have successfully obtained legislation addressing specific needs within the particular industry. Business opportunity laws may also apply, and exceptions or exclusions available under them require franchisors' attention. In addition, several common law theories affect the franchise relationship; in the absence of franchise relationship laws, franchisees who suffer wrongful acts by franchisors can bring actions based on theories such as breach of contract, fraud, misrepresentation and antitrust. Finally, courts consistently hold that the implied covenant of good faith and fair dealing that exists in any commercial contract also exists in franchise agreements. All the same, the scope of, and the manner of application of, the implied covenant of good faith and fair dealing has been the subject of much litigation and debate.

In addition, it should be noted that the franchisor–franchisee relationship can be implicated in disputes involving third parties. Examples include claims by parties who assert injuries suffered by virtue of acts of commission or omission by franchisees or their employees (raising issues of potential vicarious liability of franchisors); claims by putative transferees, who assert injury because the franchisor disapproved a proposed transfer (which may also include an assertion of tortious interference); and suppliers who assert injury because the franchisor refused to approve them, or withdrew approval.

26 Do other government or trade association policies affect the franchise relationship?

The US does not have any trade association codes of conduct that are mandatory to franchisors in their relationships with franchisees, or each other. The International Franchise Association (IFA), of which many – if not most – major US franchisors are members, has a code of conduct. Many franchisees are also members of the IFA. The IFA's code of conduct does not have the force of law, but it could influence a court's decision-making process if the court chooses to view it as evidence of custom and usage. There are also private franchisee associations that have promulgated codes of conduct. They also do not have the force of law.

27 In what circumstances may a franchisor terminate a franchise relationship? What are the specific legal restrictions on a franchisor's ability to terminate a franchise relationship?

The circumstances under which a franchisor may terminate are generally governed by the terms of the franchise agreement, common law, and state franchise relationship laws. Fifteen state franchise relationship laws require the franchisor to have good cause or not act in bad faith as a basis for terminating a franchise agreement. Good cause generally means a franchisee has failed to substantially comply with the requirements imposed by the franchisor and can include damages to a franchisor's reputation, the sale of competing products, a failure to maintain standards, a failure to meet sales goals, a failure to report (or under-reporting of) sales, failure to pay royalties, and the franchisor's complete withdrawal from the franchisee's geographic market. The bad faith standard for termination applies if the franchisee acts in contravention of reasonable commercial standards of fair dealing. Assuming that either the franchisor has good cause for termination or the franchisee has acted in bad faith, the franchisor must also comply with procedural requirements that often include giving the franchisee the required advance written notice of termination, including in the notice the reasons for termination and how much time, if any, the franchisee has to cure the default, and continuing to comply with the franchisor's obligations during the notice period.

28 In what circumstances may a franchisee terminate a franchise relationship?

The circumstances under which a franchisee may terminate the relationship are generally specified in the franchise agreement. Franchisors are free to choose whether they wish for their franchise agreements to expressly allow the franchisee to terminate the franchise agreement if the franchisor fails to cure a material default. Also, some state disclosure laws allow a party to the franchise agreement to rescind the agreement if the other party fails to comply with disclosure requirements. In addition, even if the franchisee's right to terminate is not addressed in the franchise agreement itself, common law may provide the franchisee such a right.

29 May a franchisor refuse to renew the franchise agreement with a franchisee? If yes, in what circumstances may a franchisor refuse to renew?

Most franchise agreements provide conditions with which the franchisee must comply in order for the franchisor to renew the franchise agreement. Furthermore, the franchise relationship laws of certain states require good cause for non-renewal by the franchisor. Some states have notice requirements regarding non-renewal of the franchise agreement (for example, requiring the franchisor to give the franchisee notice of intention not to renew at least 180 days prior to the expiration of the franchise agreement).

30 May a franchisor restrict a franchisee's ability to transfer its franchise or restrict transfers of ownership interests in a franchisee entity?

Most franchise agreements contain provisions requiring the franchisor's prior written approval of a proposed transfer, which approval is subject to the satisfaction of several enumerated conditions. In addition, some state laws give a franchisee certain protections where it wishes to transfer. For instance, Iowa law requires that a franchisor's transfer refusal not be arbitrary compared to the franchisor's actions in substantially similar circumstances. Some states require that the franchisor have a material reason relating to the character, financial ability or business experience of the proposed transferee to reject a proposed transfer. To prevent a potential unwanted transfer, a franchisor can contractually reserve for itself the right of first refusal to purchase the franchise if the franchisee desires to sell it. Several states also require a franchisee to notify the franchisor of its intention to transfer or sell the franchise.

31 Are there laws or regulations affecting the nature, amount or payment of fees?

In the US, no state or federal laws dictate the amounts which can be charged for an initial or ongoing fee. State laws vary as to what constitutes a franchise fee, but it is generally defined as any payment the franchisee is required to provide to the franchisor or its affiliates for the right to do business under the franchise agreement or as a condition to, or practical necessity for, obtaining or commencing operation of the franchise.

A payment for a reasonable quantity of goods for resale at a bona fide wholesale price generally does not fall within the definition of a franchise fee. A number of state franchise laws provide that a payment of less than US$500 does not constitute a franchise fee. The FTC Rule exempts franchises where the total payments to the franchisor at any time prior to the franchisee's seventh month of operations are less than US$500.

32 Are there restrictions on the amount of interest that can be charged on overdue payments?

Most states have usury laws limiting the amount of interest that can be charged on overdue payments. Many franchise agreements include a usury 'savings clause' which limits the amount of interest charged to the highest commercial contract interest rate allowed by law.

33 Are there laws or regulations restricting a franchisee's ability to make payments to a foreign franchisor in the franchisor's domestic currency?

The US has no restrictions on the currency used by the franchisee to make payments to a foreign franchisor. The currency for payment is typically what is agreed on by the parties to the contract.

34 Are confidentiality covenants in franchise agreements enforceable?

Many courts have found that a franchisor's confidential and proprietary information, trade secrets, trade dress and intellectual property may be justifiably protected by the use of reasonable confidentiality covenants.

35 Is there a general legal obligation on parties to deal with each other in good faith? If so, how does it affect franchise relationships?

Courts in most states have consistently held that an implied covenant of good faith and fair dealing exists in commercial contracts, including franchise agreements. How this principle is applied varies from state to state. The covenant generally provides that the parties to a contract must exercise their discretion as to the performance of their contractual obligations in a manner that is not inconsistent with the other party's reasonable business expectations and does not deprive the other party of the benefit of the contract. Franchisees have used the implied covenant to argue that a franchisor has abused its discretion in interpreting the franchise agreement or in introducing new practices or programmes.

36 Does any law treat franchisees as consumers for the purposes of consumer protection or other legislation?

Whether a franchisee is treated as a 'consumer' with respect to the franchisor's dealings with the franchisee for purposes of consumer protection or other legislation varies among the states. Courts in some states have found that a franchisee may be treated as a 'consumer' for purposes of consumer protection or other legislation, whereas other courts in other states have found that a franchisee may not be treated as a 'consumer' for purposes of consumer protection or other legislation.

37 Must disclosure documents and franchise agreements be in the language of your country?

There is no specific requirement under the FTC Rule or state registration laws that disclosure documents, franchise agreements and related documents used in the US should be in English, although it is generally assumed that they will be.

38 What restrictions are there on provisions in franchise contracts?

US franchise laws do not dictate the duration of franchise relationships, nor do they require or prohibit exclusive territories. Nevertheless, in certain states, consequences may arise if the franchisor grants a franchise agreement with too short a duration. For example, Connecticut law imposes negative consequences if the franchise term is less than three years. Covenants that restrict a franchisee from competing with its own franchised unit or other units in the franchise system are common provisions in franchise agreements.

Some states' laws, like California's, will not enforce or will provide only limited enforcement of such restrictive covenants. In most states, if such covenants are reasonable and consistent with public interest (as determined by various factors including geographic scope, time limitations and the scope of activity to be restrained), they are usually enforceable. Note, however, that in some states, a court which concludes that a covenant is too restrictive to be enforced may 'blue-pencil' the provision (eg reduce the geographic or temporal scope) and then enforce it as judicially revised. In other states, however, the excessive scope of a restrictive covenant may cause a court to strike the covenant in its entirety.

Franchisors must decide whether they prefer to arbitrate or litigate disputes with franchisees. If arbitration is chosen, a franchisor may wish to exclude certain matters from arbitration so that those matters may go to court immediately. State franchise authorities have sometimes attempted to restrict arbitration clauses in franchise agreements to some degree as a precondition to registration. Nevertheless, there is case law stating that the Federal Arbitration Act pre-empts any restrictions on arbitration that states purport to impose. Franchise agreements typically contain choice-of-law and forum selection provisions, citing the state where the franchisor's principal place of business is located as the state whose law governs and in which any litigation must be held in case of a dispute arising under the franchise agreement. Several state registration laws prohibit the selection of governing law or venue other than that of the franchisee's state.

Franchisors may not impose restrictions on the customers a franchisee may serve if such restrictions violate civil rights statutes. Otherwise, franchisors are generally free to impose customer restrictions, so long as they are disclosed in the franchise disclosure document.

39 Describe the aspects of competition law in your country that are relevant to the typical franchisor. How are they enforced?

Antitrust laws, such as the Sherman Act and the Robinson-Patman Act, apply to franchise relationships. These laws primarily deal with contracts or conspiracies that restrain trade or discriminate with respect to pricing. Two major types of arrangements can restrain trade in violation of the antitrust laws – horizontal and vertical arrangements. Horizontal restraints involve arrangements that restrain trade among competitors at the same level of market structure. Vertical restraints involve agreements among actors at different levels of a market structure. Allegations of horizontal conspiracies are tested under a more stringent 'per se' approach, while allegations of vertical conspiracies are tested under the rule of reason.

Most franchise arrangements fall into the 'vertical' category. A franchisor that has company-owned units faces a higher risk of a vertical arrangement being converted to a horizontal arrangement. The provisions of these antitrust laws are enforced by federal and state governments and by private litigants, who may also bring antitrust claims. Moreover, there are state antitrust laws that may apply to franchise relationships. These state antitrust laws are generally consistent with federal antitrust laws. Franchisors should be aware of applicable state antitrust laws to ensure that they are in compliance.

40 Describe the court system. What types of dispute resolution procedures are available relevant to franchising?

In the US, civil litigation (in both federal and state court beginning at the trial level and, in some cases, ending at the appellate level), arbitration and mediation are generally available for dispute resolution. While the federal courts operate under the Federal Rules of Civil Procedure and state courts have similar rules, many procedural rules of court will vary by jurisdiction. Arbitration is only available if the parties agree to use it. Franchise agreements often include arbitration clauses. The Federal Arbitration Act generally provides for enforcement of contractual arbitration provisions in all states and supersedes

state laws governing arbitration. The US is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and will respect and enforce the parties' choice of arbitration by non-US arbitration panels which may include the parties' agreement to conduct the arbitration outside of the US. In addition, some franchise agreements include mediation clauses.

As a practical matter, the rules of many state court systems and many federal trial courts will require the litigants to engage in some form of court-imposed initial mediation or alternative dispute resolution process before a case can proceed to trial.

41 Describe the principal advantages and disadvantages of arbitration for foreign franchisors considering doing business in your jurisdiction.

There are advantages and disadvantages to selecting arbitration in the United States as the method of resolving disputes. In terms of the advantages, perhaps the greatest advantage of arbitration is that it avoids a jury trial and, absent an agreement to allow a class action, generally requires that the proceeding be conducted on an individual basis with a single franchisee. Arbitration is a more informal proceeding than litigation, where the parties have a say in selecting the person who will be the arbitrator and can, to some extent, control the scope of discovery by the terms of the franchise agreement. Arbitration is generally considered to be faster and less expensive than litigation, though that is not always the case. While one other benefit of arbitration for US-based franchisors is that it generally allows the franchisor to choose its home state as the location of the arbitration, that consideration is most likely not as relevant for a foreign franchisor unless it has some connection to a particular state in the United States where it would want the arbitration to be held.

The major disadvantage is probably the inability to obtain a reversal of an incorrect ruling by the arbitrator. One of the benefits of arbitration is its finality, but this can also be a disadvantage – in opting for finality, one is also sacrificing the ability to appeal an adverse ruling by an arbitrator. Another disadvantage of arbitration is that the rules governing discovery and how the proceeding will be conducted are not as well defined as in litigation in the courts.

For example, the rules of evidence applicable in courts do not need to be followed by arbitrators (absent a requirement in the franchise agreement) and hearsay evidence may well be admitted into the proceeding. Similarly, not all arbitrators will rule on pre-hearing motions raising legal defences, but will allow the hearing to go forward before ruling on these types of issues. Arbitrators also tend to favour equities and their ruling may reflect this, even if the law were to require a different result. There are court decisions calling arbitrations a 'court of equity' and thus one may be sacrificing some predictability in the result by choosing arbitration over litigation. In addition, arbitration can become expensive because, unlike in litigation, the parties are paying for the arbitrator's time and, if an arbitration group is administering the proceeding (such as the American Arbitration Association or JAMS), there are administrative costs involved.

42 In what respects, if at all, are foreign franchisors treated differently from domestic franchisors?

Foreign franchisors are not generally treated differently from domestic franchisors. Foreign franchisors must comply with the disclosure requirements under the FTC Rule, as well as any registration or disclosure or relationship laws (or both) promulgated by the states whose laws apply to any particular transaction or relationship (or both). A practical difficulty arises for foreign franchisors because the franchisor's financial statements must be included in the disclosure document and those statements must be prepared according to United States generally accepted accounting principles, or be prepared in a way that is permitted by the United States Securities and Exchange Commission. For this reason, many foreign companies form a US company to offer franchises in the US and have US-style audited financial statements prepared for it and included in the disclosure document. However, foreign parent companies' financial statements must also be included in the disclosure document if the parent commits to perform post-sale obligations for the franchisor or if the parent guarantees the obligations of the franchisor under its franchise agreements.

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FRANCHISE 2012 ISSN 1752-3338