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The International Comparative Legal Guide to:

Franchise 2016

2nd Edition

A practical cross-border insight into franchise law

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USA

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1 Relevant Legislation and Rules Governing Franchise Transactions

1.1 What is the legal definition of a franchise?

1. THE FEDERAL TRADE COMMISSION ("FTC") FRANCHISING RULE

The FTC Franchising Rule ("FTC Rule") defines a franchise as having three essential elements:

(i) a franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark [...] or to offer, sell, or distribute goods, services [...] that are identified or associated with the franchisor's trademark;

(ii) the franchisor will exert or has 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

(iii) the franchisee [...] makes a required payment or commits to make a required payment. "Required payment" is defined broadly, and only excludes a *bona fide* wholesale price for goods for resale. For example, the following payments are all considered required payments: royalties; training fees; management and consulting fees; advertising and marketing payments; all fees for services; payments for equipment; payments and royalties for software (except possibly off-the-shelf software for resale to customers).

The coverage of the FTC Rule is as broad as the FTC's authority under the Federal Trade Commission Act. It therefore may cover transactions that are primarily international or intrastate, as long as interstate commerce is affected, as defined under the federal case law under the FTC Act. There are many exemptions under the FTC Rule. See 16 C.F.R. 436.8.

2. THE FEDERAL TRADE COMMISSION ("FTC") BUSINESS OPPORTUNITY RULE

The FTC Business Opportunity Rule covers certain business opportunity ventures, where the seller:

(1) secures retail outlets or accounts for the purchaser;

(2) secures sites or locations for vending machines, rack displays, or any other product sales displays; or

(3) provides services or a person (or company) for securing sites, outlets and accounts; and the franchisee is required to pay a fee. 16 C.F.R. 437.

3. STATES WITH THE "MAJORITY" DEFINITION OF FRANCHISE

In the 11 states of California, Illinois, Indiana, Maryland, Michigan, North Dakota, Oregon, Rhode Island, Virginia, Washington and Wisconsin, a franchise has three essential elements:

(i) a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed (or suggested) in substantial part by a franchisor; and

(ii) the operation of the franchisee's business [...] is substantially associated with the franchise trademark [...] or other commercial symbol designating the franchisor or its affiliate; and

(iii) the franchisee is required to pay a fee.

Many states have unique variations of this definition. For example, in Wisconsin, Virginia and Washington, the terms "or suggested" are added after the term "prescribed".

4. OTHER STATES' DEFINITIONS

A. The states of Hawaii, Minnesota and South Dakota use a definition of franchise that is somewhat broader. In these states a franchise has three essential elements:

(i) a franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name [...] or other commercial symbol or related characteristics; and

(ii) the franchisor and franchisee have a community interest in the marketing of goods or services [...]; and

(iii) the franchisee pays [...] a fee.

The definition of a franchise in Hawaii, Minnesota and South Dakota is broader than in the majority states in two respects. First, the "using the franchisor's trade name" standard is broader than the "substantially associated with the franchisor's trade name" standard. Second, the "community interest" standard is broader than the "marketing plan" standard. A community interest generally exists where there is a continuing financial interest between a supplier and distributor, or a licensor or licensee.

B. New York; State Business Opportunity Laws. New York has a unique definition. For the purposes of New York law, a franchise exists if:

(i) the franchisor is paid a fee by the franchisee; and

(ii) either the franchisee's business is substantially associated with the franchisor's trademark or the franchisee operates under a marketing plan or system prescribed in substantial part by the franchisor.

New York therefore has a definition similar to the majority states, except that either no trademark licence is required, or no market plan is required. State business opportunity registration and disclosure laws are generally broader than franchise laws and generally have no trademark element, but those laws are beyond the scope of this chapter.

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C. Notice Filing States; Business Opportunity Laws. Seven states require notice filings for franchisors (Michigan, Texas, Florida, Utah, Kentucky, Wisconsin and Nebraska). In all but Michigan and Wisconsin, which are discussed above, the definition of a franchise is related to the state definitions of a business opportunity, which are generally broader than those of franchise laws, but which are beyond the scope of this chapter.

5. FRANCHISE RELATIONSHIP LAWS, TERMINATION, RENEWAL, TERRITORIES, ETC.

Approximately ten additional states (in addition to the registration, notice filing, and disclosure states mentioned above, which also have relationship laws) regulate the relationship between a franchisor and its franchisees. Most of these laws have broader definitions of franchising. Often these laws do not contain a fee requirement, and may cover all dealers or licensees, and some business opportunities. Examples of laws that cover most franchisees and dealers include the New Jersey Franchise Act and the Wisconsin Fair Dealer Act.

1.2 What laws regulate the offer and sale of franchises?

As stated above, there are federal and state franchise laws. As to the state laws, they generally concern either registration, disclosure, or relationship of the parties. Federal franchise and business opportunity laws require preparation of a franchise disclosure document. State franchise and business opportunity laws may also require disclosure, plus registration with state authorities before offering, negotiating or selling a franchise or business opportunity. Some state franchise laws also regulate the relationship between franchisors and franchisees. These laws change frequently.

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

As mentioned above, various states have franchise sales regulations that impose on franchisors various filing or registration requirements before offering or selling franchises.

Generally, a state franchise registration or filing law may apply when: (a) an offer (including in some states an advertisement) is communicated to or from parties in the state; (b) a prospective franchisee resides (at least part-time) or plans to operate the franchise business (at least part of a territory or market) in a state; or (c) the franchisor resides or is located in a state. Therefore, these laws could apply to offers or sales to domestic or foreign franchisees. To be safe, a franchisor should comply with the franchise laws of its home state, plus the law of the prospective franchisee's jurisdiction, plus that of any other jurisdiction that has any contact or relationship to the offer, sale or operation of the franchise. Because of these broad jurisdictional provisions, it is not uncommon for a franchisor to be subject to the laws of two or more states.

What constitutes an "offer" varies from state to state, but may include (if a specific offer is communicated) oral or written contact with a prospective franchisee, telephone communications into or from the state, advertising, promotional brochures, or websites. Registration of advertising is discussed later.

Certain registration states' regulatory authorities may impose substantial additional conditions unique to that state, such as imposition of an impound account or deferral of payment of initial fees. Registration states generally take about 30 days to evaluate the FDD, but this varies. States with filing, rather than registration, requirements generally do not evaluate the FDD or impose other conditions.

1.4 Are there mandatory pre-sale disclosure obligations?

Franchisors have a legal duty to fully disclose material facts to prospective franchisees in a franchise disclosure document ("FDD"), under various state and federal franchise laws referred to above. Under certain state franchise laws, franchisors must not omit material facts (facts relevant to a prospective franchisee's decision), in addition to the specific disclosures in the disclosure document. Under these laws, franchisors have a duty to disclose any changes in these facts to prospective franchisees, and to existing franchisees in certain cases.

State and federal law also govern the timing of disclosure, generally requiring delivery at least 14 full days before payment of any money or signing of any contracts (longer in a few states).

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

Yes, there are two forms of master franchising and the disclosure and registration requirements vary between them as follows:

(a) In subfranchising, the subfranchisor has the right to offer and sell franchises and enters into franchise agreements directly with the franchisee. All rights and duties are delegated by the franchisor to the subfranchisor and there is a sublicence of the trademark.

(b) In area representation, all franchisee agreements are entered into directly between the franchisor and the franchisee. However, the area representative, who may or may not be a franchisee, is given the right to solicit for prospective franchisees and to provide certain services, often including training, support, and real estate site selection assistance, to franchisees within a stated territory.

Prior to making an offer to a subfranchisor or to an area representative who pays fees (and is therefore a franchisee), a franchisor must register in all registration states and make appropriate disclosures in an FDD. The FDD must be separate from the FDD used to solicit unit franchisees.

The franchisor and the subfranchisor must each also register and make disclosures to the prospective unit franchisees. Franchisors and subfranchisors are jointly and severally liable for disclosures and registration.

While area representatives must also register as brokers in certain states, and as salespersons in certain states, area reps generally do not need to prepare a disclosure document separate from the franchisors for their own solicitation of unit franchisees as agents for the franchisor. Instead, area representatives use the franchisor's disclosure document and disclose that they will be receiving a payment from initial franchise fees or royalties for providing sales and support services.

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

Yes, the FDD format is governed by detailed federal and state laws and regulations, and contains 23 specific sections. Normally the disclosure portion of the FDD is about 50 pages long. The FDD exhibits often exceed 100 pages, and include an audited financial statement of the franchisor and all of the contracts that will be signed.

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All information in all FDDs must be kept current. The FTC Rule requires amendment of the disclosure document when a "material change" occurs; some changes must be made immediately before any further sales, but others may be made quarterly or annually. The definition of a "material change" is very broad and includes any change that may influence a reasonable prospective franchisee in the making of a decision relating to the franchise. An interim unaudited statement is required to be added to the disclosure document at least every three months if there is a material change from the existing attached statements.

The registration states require more stringent updating requirements and the more stringent requirements prevail over any less stringent requirement in the FTC Rule. These states require the changing of the FDD and the filing of an amendment application in the event of a "material change", promptly and in any event before further offers or sales. A franchisor may not offer to sell or sell a franchise after the occurrence of a material change until an amended disclosure document has been prepared and approved by the state. Any prospective franchisees who received a disclosure document prior to the material change must be re-disclosed with an updated disclosure document at the time required by state or federal law.

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

(a) Filing of Advertisements, Marketing, and Communications to Prospects. Seven registration states require that advertising, promotional materials (such as brochures), and communications with prospects (such as instructions to view and download an FDD) be approved by the state regulatory authority in advance of use. There are various requirements as to the number of days in advance of use that a request for approval must be received, but the longest is ten business days. The state and federal franchise laws also regulate the content of marketing and ads to franchise prospects.

(b) Registration of Salespersons and Brokers. Eleven states require prior registration of persons who will sell or offer the sale of franchises. Two of these states currently require registration of brokers (Washington and New York) and all 12 require salesperson filings. Brokers and salespersons must keep records of offers and sales, under certain state laws.

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

No, membership in an association is not mandatory. Most U.S. franchisors belong to the International Franchise Association ("IFA"). See http://www.franchise.org.

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

The International Franchise Association has promulgated a Statement of Guiding Principles (http://emarket.franchise.org/StatementGuidingPrinciples.pdf); and a Code of Ethics (http://www.franchise.org/mission-statementvisioncode-of-ethics), both mandatory for its members.

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

The FDD must be in "plain English" under state and federal laws; and all registration and filing documents must be made in English.

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

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

There are no universal restrictions. There are, however, filings that must be made in certain sectors to provide information to various government agencies about foreign investment in the U.S. All of these filings have certain dollar thresholds, or are limited to certain national security or technology issues, which result in few foreign franchisors having to make any filings. There are also limits on foreign investment in a few industries with national security implications, which generally do not involve franchising.

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

Entity forms that are common for franchisors, are the same as for many other businesses, and include the corporation and the limited liability company ("LLC"). Both corporations and LLCs are limited liability entities, but there can be differing tax treatment.

Foreign franchisors selling franchises in the USA can sell directly, or can form an affiliate to do so. Advantages in forming an affiliate include a simpler and less expensive audit and the addition of a layer of (partial) liability protection. The affiliate franchisor can be formed either in the USA or outside. If a separate new franchisor entity is used, there are often advantages to using a U.S. affiliate that is not a wholly-owned subsidiary of the foreign entity, which include simplifying the audit and avoiding the parent disclosures in the FDD.

As stated above, the two forms of master franchising (subfranchisor and area rep) are often used in international franchising into the USA. Except franchisors located in Canada, it is rare for foreign franchisors to directly franchise to unit franchisees in the USA without using master franchisees. Reasons include the size and complexity of the U.S. market, local and regional differences that master franchisees are responsible for addressing, and varying state laws and regulations handled by master franchisees.

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

Limited liability entities such as corporations and LLCs must file with a state before conducting business. Such entities are governed by state laws in the state in which they are formed. There are also state, federal and local tax and business licence forms that will need to be filed. Federally, the form is called an S-4 request for employer ID.

3 Competition Law

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

There are no competition (antitrust) laws that uniquely apply to the offer and sale of franchises. There are federal and state competition laws. Federally the laws include the Sherman Act, which prohibits

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restraints on trade, and the Federal Trade Commission Act ("FTC Act"), which prevents unfair and deceptive trade practices. All states have similar laws. Some antitrust laws that apply to all distribution methods, including franchising, are as follows: case law under the FTC Act restricts tying sales as an unfair trade practice, but only where there is market power in the tied product and the result is anti-competitive under a rule of reason, which is rare; unfair trade practices also include restrictions on customers, suppliers, territories and prices, but only where the result is anti-competitive under a rule of reason, which is rare; and under federal law, resale price-setting by a supplier is prohibited only where the result is anti-competitive under a rule of reason, which is rare. A few states have stricter rules on resale price setting, and this is an area in which the laws are changing rapidly.

Under FDD disclosure laws, state and federal, franchisors must disclose "the precise basis" of any compensation or profit that the franchisor or any affiliates receive from suppliers or lessors. These disclosures must be complete and accurate to avoid liability under franchise and consumer protection laws.

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

No, but perpetual agreements are disfavoured in some states, and may not be fully enforced. There is not a normal term either, and franchise agreements may range from one to 20 years or longer. Perpetual renewals are rare, and may not be fully enforced. Commonly franchise terms are relatively long, to allow franchisees to recoup their investment. Many franchise laws prevent a franchisor from terminating a franchise without good cause. A few state franchise laws give some protection to franchise agreements that expire and are not renewed, typically requiring that a franchisor buy back certain assets or give a one-year notice of non-renewal.

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

No, but perpetual agreements are disfavoured in some states, and may not be enforced. There is no customary term of a supply agreement, and terms of one to ten years are found. There is often, however, and ability of either party to terminate without cause upon notice, which might vary from one to six months or longer.

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

Under federal law, resale price-setting is prohibited only where the result is anti-competitive under a rule of reason, which is rare. However, several states have stricter rules on resale price-setting, some allowing only maximum resale price limits, and this is an area in which the laws are changing rapidly.

3.5 Encroachment – are there any minimum obligations that a franchisor must observe when offering franchises in adjoining territories?

No. Under the U.S. competition laws, territorial restrictions are tested under the rule of reason, and are rarely found unlawful. The FDD requires detailed disclosure of the terms of any territory protection and any exceptions or exclusions, but there no required territorial terms. Some franchisors do not grant any territorial protection. If a franchisor misleads a franchisee or breaches its agreement, that would give rise to claims of breach of contract and violation of some state franchise laws.

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

Yes, in most states in-term and post-term non-compete and non-solicitation of customers covenants are enforceable. The exceptions are as follows: post-termination covenants not to compete are unenforceable in California, and of limited enforceability under franchise laws in others (e.g. Indiana, Iowa, Montana, North Dakota, South Dakota, and Oklahoma); other states have varying requirements for enforcement of post-termination covenants (and some for in-term covenants), most commonly that the covenant be reasonably limited in terms of its geographic scope, time, and scope of type of business prohibited.

4 Protecting the Brand and other Intellectual Property

4.1 How are trade marks protected?

The USA is a party to all of the major international trademark treaties, including the Paris Convention and the Madrid Protocol. Trademark protection can be achieved by use (common law protection), state trademark registration, and federal registration with the U.S. Patent and Trademark Office ("USPTO"). Federal registration is by far the most common and is advisable for franchisors planning to expand beyond one state. This is because common law protection is limited to the time and scope of actual continuing use, whereas federal trademark registration gives nationwide priority and can be filed on an intent-to-use basis, with priority relating back to the date of filing. Federal remedies are also generally better, and include attorneys' fees and treble damages in some cases.

The term of a USPTO registration is ten years, which can be renewed. A statement of use must be filed within six years of the initial filing.

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

Yes, nearly every state has a trade secret law, and all have common law protection, which is the primary means of protection of franchisor-confidential information and trade secrets. Generally these laws protect information that a franchisor takes reasonable steps to protect. Therefore, franchisors should use confidentiality notices, password protection, and a Confidentiality Agreement (Non-Disclosure Agreement or "NDA") to be signed by franchisees and their employees. Federal laws also assist in some situations, such as the Computer Fraud and Abuse Act.

As to culture in the USA, there is strong opposition to the copying or use of confidential information. There have been many arbitration awards, court judgments and jury verdicts against violators; granting injunctions and awarding significant monetary damages.

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

Copyright is a matter of federal law. The USA protects both registered and unregistered copyrights, and is a party to the major international copyright conventions, including the Berne Convention for the Protection of Literary and Artistic Works ("Berne Convention") and

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the Universal Copyright Convention ("UCC"). The U.S. Copyright Act provides strong remedies for breach, including attorneys' fees and statutory damages.

As to culture in the USA, there is strong opposition to the copying or use of copyright-protected works. There have been many arbitration awards, court judgments and jury verdicts against violators; granting injunctions and awarding significant monetary damages.

5 Liability

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

State franchise and business opportunity laws often include remedies such as damages to franchisees, rescission (return of fees and charges paid and voiding of the contract), trebling of actual damages sustained by franchisees in the discretion of the court, and awarding of reasonable attorney's fees and litigation costs. Violation of these statutes is also a crime that could result in imprisonment, and states can fine offenders and require disclosure of orders in the FDD. Personal, civil, and criminal liability usually exists under most state franchise laws for responsible entities, brokers, contractors, subfranchisors, salespersons, agents, officers, directors and managers. Under the FTC Rule, the FTC can seek fines, criminal sanctions, and restitution of losses of franchisees. There is no private right of action under the FTC Rule.

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

Liability for disclosures to unit franchisees is joint and several between franchisor and subfranchisor under most state franchise laws and under the FTC Rule. There are no limitations on enforcement of indemnities as between the franchisor and subfranchisor.

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

Not for most claims. Most state franchise laws and the FTC Rule have anti-waiver provisions that prevent disclaimer clauses in franchise agreements from shielding franchisors from disclosure violations generally. However, some acknowledgment clauses may be useful to support factual matters however, such as a fact that no oral representations were made on a certain topic.

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

Yes, the law generally permits class actions by franchisees and other claimants. Class action waiver clauses are generally enforceable in connection with a franchise agreement arbitration clause. (Class action waivers in arbitration clauses relating to consumer and employee claims have limited enforceability.) Class action waiver clauses in connection with general litigation are of uncertain enforceability, and generally depend on varying state law.

6 Governing Law

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

There is no general requirement that franchise agreements be governed by local law. There is no generally accepted norm in this area, as it is the subject of negotiation in international franchise agreements. A few state franchise laws require that the contract be governed by local law. A governing law clause will not reduce the scope of application of state or federal franchise laws.

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

Most states have statutes that grant reciprocal enforcement of foreign judgments to jurisdictions that enforce U.S. judgments. Defences under these laws generally include lack of due process, lack of jurisdiction or improper service of process. Franchisors, including foreign franchisors, may seek temporary and permanent injunctions against rogue franchisees, for trademark infringement and trade secret infringement, and such injunctions are frequently granted.

7 Real Estate

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

Generally, no. The term of a commercial property lease varies widely based on a number of factors, including local market conditions, lender requirements, and type of building. But many landlords have experience with franchise systems and prefer to have the lease term (with extensions) coincide with the franchise agreement term. Retail lease terms of five to ten years are common in most markets.

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

Yes, the concept is generally understood by most landlords and enforceable where the landlord has consented to such rights. Some landlords, however, strongly resist granting these rights and seek significant concessions from the franchisor to consent to such rights, such as a franchisor guarantee of the lease obligations even after assignment to a replacement franchisee. Some landlords will agree

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to release the franchisor from the lease if the landlord has the right to approve the replacement tenant or the replacement tenant meets the landlord's creditworthiness standards.

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

Not in the typical franchise context. There are some restrictions related to foreign ownership of federal oil, gas, and mineral leases, and mergers and acquisitions potentially impacting national security, resources, or critical infrastructure. Foreign owners of U.S. real estate can be subject to U.S. tax on disposition of their ownership interest in the real property, in the same manner as U.S. owners are taxed.

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

The commercial real estate market is improving in most areas of the U.S., especially in the class "A" locations. The secondary market is still challenging and there are still some areas of the country that have not significantly recovered from the 2008-2012 recession. Landlords will often give tenants a period of free rent to complete improvements; depending on the shell condition of the space, that period could be 60-120 days. Restaurants usually need more time. "Key money" demands occur in some larger markets, but they typically come from existing tenants with substantial improvements or below-market rent who are subleasing to a new tenant.

8 Online Trading

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

Yes. Vertical territorial and customer restraints are governed by a "rule of reason" analysis, and today are almost never held to be unlawful. Generally, only where a franchisor has had a very large share or monopoly of the relevant market has it been at risk of an antitrust violation for territorial and customer resale restraints. As a practical measure, franchisors should avoid the word "exclusive" when describing a territory where there are reserved rights for the franchisor or its other franchisees with respect to customers, distribution channels, or other activities in that territory; "protected" is a good substitute term. Franchisors should also expressly reserve in the franchise agreement any exceptions to a franchisee's territorial rights, or risk ceding those rights to the franchisee.

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

No. Franchisors should include an express requirement to do so in their franchise agreements.

9 Termination

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

Yes. Many states have franchise relationship statutes that restrict a franchisor's ability to terminate a franchise agreement. Most of these laws require a franchisor to have good cause before terminating a franchise agreement. "Good cause" is defined differently in each state statute, or not at all and left for the courts to determine. Generally, good cause exists if a franchisee has breached a material term of the franchise agreement. Most of these laws require the franchisor to give the franchisee a certain period of notice and opportunity to cure any defaults that might lead to termination, which period can range from 30 to 90 days. For certain serious defaults – like insolvency, abandonment, or risking public safety – most of these states allow a franchisor to terminate immediately or with a much shorter notice and cure period.

In addition, if a franchisee has filed for bankruptcy protection prior to termination of the franchise agreement, the franchise agreement becomes part of the bankruptcy estate. Whether the franchise agreement can be terminated quickly depends upon the type of bankruptcy. If the bankruptcy is a Chapter 11 reorganisation, rather than a liquidation, the agreement generally cannot be terminated quickly unless the franchisee/debtor rejects the agreement, or upon a court order. If the franchisee/debtor assumes the franchise agreement, a franchisor cannot terminate the franchise agreement without obtaining the approval of the bankruptcy court, which can take months.

10 Joint Employer Risk and Vicarious Liability

10.1 Is there a risk that a franchisor may be regarded as a joint employer with the franchisee in respect of the franchisee's employees? If so, can anything be done to mitigate this risk?

Yes, there is some risk for franchisors that exert an unusual level of control, including through technology that monitors employees. A well-drafted franchise agreement will affirm that franchisees are independent contractors, and the vast majority of cases agree. Recently, however, one large franchisor, McDonalds, has been the subject of joint employer claims by the National Labor Relations Board ("NLRB"), which have yet to be resolved.

A franchisor might be regarded as a joint employer if it exerts too much control over employment-related matters of the franchisee. The NLRB recently expanded its long-standing joint employer test to include some forms of "indirect control", which increases the risk that in the future a franchisor will be considered by the NLRB to be a joint employer with its franchisees. In some states, agencies have similarly increased attempts to hold the franchisor responsible for its franchisees' employer liabilities.

To reduce the risk of being regarded a joint employer, franchisors can: reduce or eliminate unnecessary controls on franchisees; have each franchisee acknowledge that it is independent and fully responsible for compliance with all laws and for employment matters; require employment practices insurance and be named as an additional insured; avoid intrusive monitoring systems that monitor individual employee performance; avoid providing training

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to franchisee employees, advice regarding employment issues, or form employee handbooks; and train their operations and field staff to avoid the foregoing.

10.2 Is there a risk that a franchisor may be held to be vicariously liable for the acts or omissions of a franchisee's employees in the performance of the franchisee's franchised business? If so, can anything be done to mitigate this risk?

Yes, similar to the previous question, a franchisor can be held vicariously liable for the acts of its franchisees and their employees if the franchisor exercises too much control over the day-to-day operations of the franchisee, and more specifically over the activity at issue in the claim. The majority of courts have held that issuing detailed operating standards to franchisees and enforcing those standards are not sufficient by themselves to show the requisite control over day-to-day operations to make franchisors vicariously liable. Nevertheless, occasionally a franchisor will issue mandatory standards that are too detailed or otherwise push beyond the traditional franchisor/franchisee roles, and will be found vicariously liable because of it. To mitigate against these risks, franchisors should reduce or eliminate unnecessary controls on franchisees (while still maintaining essential quality controls), use a broad indemnity provision, and require franchisees to obtain adequate insurance to cover the indemnity.

11 Currency Controls and Taxation

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

There are no restrictions; however, financial institutions performing the transfers may have reporting obligations related to certain transfers.

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

Most types of U.S. source income (including royalties under a trademark licence and a management services fee) paid to a foreign person are subject to a withholding tax of 30%. A reduced rate or exemption may apply if stipulated in an applicable tax treaty. The foreign person certifies its eligibility for a treaty's reduced rate or exemption to the U.S. franchisee by filing an IRS form (e.g. Form W-8BEN).

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

Not generally. U.S. franchisees will conduct their business in local currency, but when sending payments or royalties out to a foreign-based franchisor most major U.S. banks can wire most foreign currencies to major financial centres.

12 Commercial Agency

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

There is a potential risk, similar to the risk of vicarious liability discussed above, related to third party claims against the franchisee that also target the franchisor as a principal. Also, Minnesota has an agency law that requires good cause for termination of an agent; other state laws are not as detailed as many foreign laws protecting agents.

Most franchise agreements mitigate these risks by stating that the parties are independent contractors, and that neither party has the authority to act for the other, to bind the other to any obligation or debt, or to act or represent itself as the agent of the other. The parties must also conduct themselves in accordance with that provision, as courts will look to the substance of the relationship over the form. Therefore franchisees should conduct the franchise business themselves and under their own business name; and whenever possible franchisees should work directly with their customers, whether selling products, providing services, or handling the billing.

13 Good Faith and Fair Dealings

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

Under the common law of most jurisdictions, there is an implied covenant of good faith and fair dealing in every contract, including franchise agreements. In general terms, the covenant requires all parties to a contract to act honestly, observe reasonable commercial standards of fair dealing, and not deprive another party of the benefit of the contract. Courts will use the covenant to interpret a clause in a franchise agreement where it is an open or silent term, but the covenant will not override a clear provision of the contract or require a party to sacrifice its own reasonable self-interest. Occasionally the covenant has been used by a franchisee to prevent abusive or arbitrary franchisor conduct or wrongful termination. But several courts have held there can be no violation of the covenant without a violation in bad faith of a term of the underlying contract.

14 Ongoing Relationship Issues

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

Yes. Many states have franchise relationship laws that regulate the franchisor-franchisee relationship during the term of the franchise. These laws vary considerably from state to state, but can regulate the following substantive areas, among others: cause for termination; notice and opportunity to cure defaults; franchisee renewal rights (see section 15 below); franchisor obligations to repurchase franchisee assets on termination or non-renewal; franchisee rights to transfer the franchise (see section 16 below); franchisor discrimination among franchisees; purchasing restrictions; territorial rights; franchisee rights of association; and waivers of statutory rights.

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15 Franchise Renewal

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

It depends. Generally, under the federal FTC Rule and state franchise disclosure laws, the renewal of an existing franchise agreement by signing a new agreement is considered the offer or sale of a franchise, and therefore the standard disclosure obligations outlined in question 1.4 apply. About nine states with franchise disclosure laws and the FTC Rule (Compliance Guide p.19) provide an exemption for the renewal of an existing agreement. Generally, to qualify for the exemption there must not be any material change in the franchise agreement or franchise relationship, nor any interruption in the operation of the franchise business. Often on renewal a franchisor requires the franchisee to sign a new franchise agreement with materially different terms (i.e. the franchisor's then-current form of agreement), in which case the exemptions are unavailable.

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

Only in a few states. The renewal rights agreed to in the franchise agreement will usually govern, but state franchise relationship laws can restrict a franchisor's ability not to offer renewal. Arkansas, Wisconsin, New Jersey, and Puerto Rico have the strictest laws and essentially give franchisees a right to renew unless the franchisor can show good cause for termination. Other state franchise relationship laws merely require a franchisor to provide a certain amount of notice to the franchisee if the franchisor intends not to renew the franchise, or to repurchase some of the assets of the franchised business at the end of the term (see question 15.3 below).

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

Six state franchise relationship laws require the franchisor to purchase some or all of the franchised business's assets at the end of the term, and in limited situations the goodwill of the business as well (though that term has variable meanings). Also, if the franchisor does not comply with any of the non-renewal requirements mentioned in question 15.2, it may face liability for a wrongful non-renewal.

16 Franchise Migration

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

Yes. A franchise agreement can prohibit transfers without the franchisor's consent, however some state laws restrict a franchisor's ability to withhold consent to transfers. For example, some state relationship laws provide a franchisee's heirs a period of time to continue operating the franchise after the franchisee's death. Other state relationship laws prohibit a franchisor from unreasonably refusing to consent to a transfer. And yet further state relationship laws allow a franchisor to deny a transfer request only if the transferee fails to meet the franchisor's established and consistently-applied standards for approving other franchisees, or if the franchisee fails to comply with the transfer conditions in the franchise agreement (e.g. signing a release or personal guarantee). In addition, under common law in many states, if the agreement is not considered to be for personal services, the franchisor may not unreasonably restrain transfer.

Often a franchisor will reserve a right of first refusal related to any proposed transfer of the franchised business or any interest therein. These rights are generally enforceable.

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

"Step-in" rights are common in U.S. franchise agreements. As a practical matter, however, the need to enforce a step-in right usually occurs with a failing, disgruntled franchisee, or an abandoned outlet, and the franchisee or landlord may be unwilling to let the franchisor step in. A franchisor in that situation would have to seek injunctive relief from a court and be prepared to establish that it will suffer irreparable harm if it is not allowed to exercise its step-in rights. Also, often the franchisor is caught off guard and not able to mobilise fast enough to step in before a bankruptcy filing. In that case, getting a bankruptcy trustee or court to approve the step-in rights can take weeks or months.

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

Powers of attorney are not generally used for a step-in situation and are most often used by franchisors to provide for the orderly transfer of telephone numbers, domain names, and the like, on termination or transfer. This is because a power of attorney does not by itself resolve the potential defences raised by landlords or franchisees, described in question 16.2 above.

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