



Franchise

in 30 jurisdictions worldwide

Contributing editor: Philip F Zeidman

2012



Published by
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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
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2011

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ISSN 1752-3338

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

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El Salvador

José Roberto Romero

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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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