



GETTING THE  
DEAL THROUGH 

# Franchise 2016

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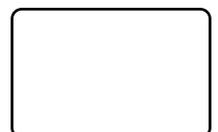


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# United States

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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, as revised by any future government-mandated accounting principles, or as permitted by the Securities and 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. However, 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. However, 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 USA 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 USA 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'. However, in a few isolated situations, franchisees have been found to be 'employees' due to the excessive degree of control that the franchisors exercised. The question of whether an employment relationship exists is typically a matter of state law, unless a claim is brought under the Fair Labor Standards Act (FLSA) and different states apply different formulations of a test to decide the issue. This is an area that is receiving increased scrutiny in franchise systems where franchisors have greater than normal controls over the activities of the franchisee.

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. However, 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 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. However, 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.

For a discussion of recent developments in the employment area, see 'Update and trends'.

#### **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 established 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) that 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. The FTC also has a Business Opportunities Rule that does apply in the relatively rare situation where there is no written franchise agreement or where the total of the required payments or commitments to make a required payment to the franchisor or an affiliate of the franchisor that are made at any time from before to within six months after commencing operation of the franchisee's business is less than US\$540. Since it is rare that a franchise programme falls within the FTC Rule definition of a business opportunity venture, 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.

However, 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. However, 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\$540 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\$1,084,900 exclusive of unimproved land and franchisor financing;
- large franchisee exemption, which exempts franchise sales to ongoing entities with at least US\$5,424,500 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 or 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 Are there any laws, regulations or government policies that restrict the manner in which a franchisor recruits franchisees or selects its or its franchisees' suppliers?**

No, except to the extent implied by the answers to other questions in this chapter.

### **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 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 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 21).

### **17 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
- acknowledgment of receipt of the disclosure document.

### **18 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. However, 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.

**19 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 used.

**20 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 24).

**21 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.

**22 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. However, these do not have the force of law, US law does not have the concept of culpa in, but obligations of good faith could be applied to create a disclosure obligation beyond what is required by statute (see also questions 23 and 27).

**23 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 or master franchisee prior to and during the sales process. Statutory fraud principles could also be applied to misrepresentations, for example.

**24 What 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 franchise sales disclosure laws?**

Aside from the statutory causes of action available to franchisees, which are discussed in question 20, 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 in a franchise relationship**

**25 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. However, 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.

## **26 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. However, 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.

## **27 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 which is available on its website, [franchise.org](http://franchise.org). 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.

## **28 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.

## **29 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.

## **30 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).

## **31 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.

## **32 Are there laws or regulations affecting the nature, amount or payment of fees?**

In the US, no state or federal laws dictate the amounts that 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\$540.

## **33 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.

**34 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.

**35 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.

**36 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.

**37 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.

**38 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.

**39 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. However, 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 the 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. However, 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.

**40 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 treated as 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, although some divergence has emerged regarding the validity of pricing restrictions. Franchisors should be aware of applicable state antitrust laws to ensure that they are in compliance.

**41 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.

**42 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

**Update and trends**

Recently proposed changes to the position of the National Labor Relations Board (NLRB) on when a franchisor will be treated as a joint employer (together with the franchisee) of the franchisee’s employees pose a serious threat to franchising as it has been practised for decades. The NLRB is an agency of the federal government that interprets and enforces the National Labor Relations Act (The Act). The Act protects the right of the unions to recruit members among the employees of private companies. Certain unions have set a goal to recruit franchisees, employees to expand the union’s membership. However, there are many thousands of franchisees in the US and most of their companies are rather small. That makes it impractical for unions to recruit their employees. However, if a franchisor were treated as the employer of all its franchisees’ employees, it would become practical for unions to ‘organise’ those employees as union members across the entire brand.

The proposed new policy of the NLRB would lower the threshold for a determination that a franchisor is the employer of its franchisees’ employees. Under that policy, if the NLRB or account determined that a franchisor exercised excessive controls over the operations of its franchisees, the franchisor would be held to be the joint employer.

The proposed policy has the potential to cause great upheaval in franchised networks and, if taken to an extreme, substantially undermine the foundation of the franchise model. Furthermore, if franchisors were to be found to be joint employers, for purposes of the Act, that could serve as a precedent for holding franchisors responsible under the principles of employment law generally. This is an area where franchisors, franchisees and their advocates can be expected to be very active in their efforts to preserve and protect the viability of the franchise model.

Separately, the lower house of the California Legislature passed a proposed amendment to the California Franchise Relations Act that would, among other things, restrict a franchisor’s termination rights, reduce the franchisor’s flexibility to regulate franchisee transfers, and require franchisors to allow terminated and non-renewed franchisees to ‘monetise’ the equity in their former franchises. Advocates of both franchisors and franchisees will be watching this legislation closely.

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.

**43 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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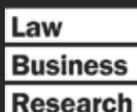
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