

THE FRANCHISE LAW
REVIEW

FIFTH EDITION

Editor
Mark Abell

THE LAWREVIEWS

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REVIEW

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PREFACE

Since the publication of the first edition of *The Franchise Law Review*, there have been some significant economic and geopolitical developments that have had a significant impact on world trade. However, the apparently inexorable march towards the globalisation of commerce has again continued unabated despite, or perhaps even because of, these changes.

Brexit, the elections of Donald Trump and Emmanuel Macron, the installation of Xi Jinping into the pantheon of Chinese Communist Party gods and the potential fall of Chancellor Merkel in Germany well illustrate the depth and importance of the political changes buffeting the global economy.

Talk of the BRICs is a thing of the past and businesses are often presented with little choice other than to look to more vibrant markets in Asia, the Middle East and Africa for their future growth.

At the same time, trade in the South is on the increase, perhaps at the expense of its North–South counterpart. All of this and the unstable wider geopolitical landscape present business with only one near certainty: there will be continued deleveraging of businesses in the coming years and therefore growing barriers to international growth for many of them. All but the most substantial and well-structured of businesses may find themselves facing not only significant difficulties because of reduced access to funding to invest in foreign ventures, but also challenges arising from lack of managerial experience and bandwidth.

Franchising, in its various forms, continues to present businesses with one way of achieving profitable and successful international growth without the need for either substantial capital investment or a broad managerial infrastructure. In sectors as diverse as food and beverage, retail, hospitality, education, healthcare and financial services, it continues to be a popular catalyst for international commerce and makes a strong and effective contribution to world trade. We are even seeing governments turning to franchising as an effective strategy for the future of the welfare state as social franchising gains still more traction as a way of achieving key social objectives.

Given the positive role that franchising can play in the world economy, it is important that legal practitioners have an appropriate understanding of how it is regulated around the globe. This book provides an introduction to the basic elements of international franchising and an overview of the way that it is regulated in a large number of jurisdictions.

As will be apparent from the chapters of this book, there continues to be no globally homogenous approach to the regulation of franchising. Some countries specifically regulate particular aspects of the franchising relationship. Of these, a number try to ensure an appropriate level of pre-contractual hygiene, while others instead focus on imposing mandatory terms upon the franchise relationship. Some do both. In certain countries, there is a requirement to register certain documents on a public register. Others restrict the manner

in which third parties can be involved in helping franchisors meet potential franchisees. No two countries regulate franchising in the same way. Even those countries that have a well-developed regulatory environment seem unable to resist the temptation to continually develop and change their approach to regulation – as is well illustrated by the new changes to the Australian regulations.

Many countries do not have franchise-specific regulation but nevertheless strictly regulate certain aspects of the franchise relationship through the complex interplay of more general legal concepts such as antitrust law, intellectual property rights and the doctrine of good faith. This heterogeneous approach to the regulation of franchising presents yet another barrier to its use as a catalyst for international growth.

This book certainly does not present the reader with exhaustive answers to all the questions he or she may have about franchising in all the countries covered – that would require far more pages than it is possible to include in a single volume. It does, however, try to provide the reader with a high-level understanding of the challenges involved in international franchising in the first section and then, in the second section, explain how these basic themes are reflected in the regulatory environment within each of the countries covered.

It is hoped that this fifth edition will prove to be a useful and often consulted guide to all those involved in international franchising, but needless to say it is not a substitute for taking expert advice from practitioners qualified in the relevant jurisdiction.

Mark Abell

Bird & Bird LLP

London

January 2018

WHAT IS FRANCHISING?

Mark Abell¹

In 2010, the estimated turnover of franchised businesses in the United States was US\$868.3 billion. However, its importance is not just restricted to the United States. In the EU it was an estimated US\$300 billion.²

For some years, franchising has been ‘playing an ever greater role in a wide range of national economies’³ and institutions, such as the European Commission, have recognised its role in ‘stimulat[ing] economic activity by improving the distribution of goods and/or the provision of services’ by allowing small and medium-sized businesses to ‘establish a uniform network with limited investments’, and ‘to set up outlets more rapidly and with a higher chain of success than if they were to set up without the franchisor’s experience and assistance’,⁴ resulting in them being better able to compete with larger distribution undertakings.

Unfortunately, although franchising enjoys considerable commercial success, legislators and trade bodies around the world have failed to agree on how it should be defined. Perhaps the most complete, non-legal definition is offered by Blair and Lafontaine, who identify the brand, the business format, independence, ongoing support to the franchisee by the franchisor, the economic interests of both parties and the control and enforcement of the brand standards by the franchisor as the defining elements of a franchise.⁵

Despite its current widespread use, the DNA of franchising shows it to be a long-lived and versatile mode of business that throughout history, time and time again, has provided effective solutions to problems thrown up by economic and technological changes. It has played a key role in enabling growing businesses to develop multichannel strategies to meet the challenges presented by changing economic environments and new technologies.

In the 1800s, it enabled brewers to create and sustain a market for their products. In the late 19th and early 20th centuries, companies such as Singer, Ford and Coca-Cola found that their then cutting-edge technology placed demands on market infrastructure that could

1 Mark Abell is a partner at Bird & Bird LLP.

2 PWC 2010 Franchise Business Economic Outlook, www.franchise.org.

3 UNIDROIT, Model Franchise Disclosure Law, Preamble.

4 Commission Regulation (EEC) No. 4887/88.

5 R Blair and F Lafontaine, *The Economics of Franchising* (Cambridge University Press, 2005), p. 294. ‘[T]he franchisor maintains ownership over the trade name and marks and [. . .] develops a complete “recipe” to run each outlet. It then licences the right to operate under the central trade name and business format in a given market for a certain period of time to individuals or small firms in exchange for various fees. The ownership stake of the franchisee in current and future profit leads him or her to put significant effort into the outlet. At the same time, the ongoing fees the franchisee pays to the franchisor ensure that the latter has incentives to maintain the value of the brand by, among other things, screening and monitoring the franchisees and keep abreast of market trends.’

not be met by the then traditional methods of distribution and product support. Franchising enabled them to create a full sales network that provided a requisite level of ongoing customer support across the vast expanse of North America. In the mid 20th century, similar logistical challenges led small family-based fast food businesses with significant growth aspirations, such as McDonald's, KFC and Dairy Queen, to use franchising to achieve those ambitions. In the late 1960s and 1970s, European brands such as Wimpy, Dyno Rod, Ihr Platz and Obi adopted similar growth strategies and by the mid 1970s franchising was being used to facilitate international growth.⁶

This boom in the use of franchising inevitably led to it being regulated and 1971 saw the adoption of the first franchise law, in the form of the California Franchise Investment Law, followed soon after by other US states.

The advent of regulation has not inhibited the growth of franchising. Businesses tend to adopt it as a part of their multichannel strategy to access appropriately qualified managerial resources and capital. There are also other commercial advantages that attract businesses to franchising, such as bulk purchasing, economies of scale and enhanced product development.

Franchisees are attracted to franchising as it increases the chance of success and allows them to be their own boss.

⁶ When the British Franchise Association was established, followed by the French Franchise Federation and the European Franchise Federation.

FRANCHISING AS PART OF AN INTERNATIONAL MULTICHANNEL STRATEGY

*Mark Abell*¹

I SUBSTANCE NOT FORM

Franchising offers a range of exciting strategic possibilities to businesses looking to expand internationally, but its full potential is often not appreciated. To some it is an obvious and ready-made way of internationalising their businesses; others associate it with hamburgers and pizzas, and discount it as an option. Both groups have become too focused on the label they put on the international structure they adopt at the cost of objectively analysing the substance of a particular structure and how it can support and promote their business objectives. When considering how to develop an international business structure involving third parties, it is worth forgetting the form and focusing on the substantive needs of the business and how they can best be met.

Although franchising offers businesses an adaptable mechanism for expanding domestically and internationally, it often comprises one element of a broader multichannel market strategy. As a result, 'vanilla' franchising is increasingly less common than hybrid adaptations tailored to the precise needs of each business. Franchising may or may not be the best word to describe some of these structures, but it is essential that any existing prejudices or misunderstandings about the term do not deflect a business from developing an appropriate structure or misdirect its legal advisers as to how a particular legal structure will be regulated. How a structure is labelled will have no bearing on whether it is regulated by franchise rules or other regulations.

A range of third-party channel and relationship structures are available to companies that wish to re-engineer their approach to their target market. These include corporate or contractual joint ventures, business format franchises, a host of licensing arrangements, exclusive and non-exclusive distribution and agency agreements, and more complex 'hybrid' structures, such as subordinated equity arrangements.

All these third-party channel structures share four common features. To a greater or lesser extent they all involve:

- a* profit sharing;
- b* investment by a third party;
- c* a divestiture of some degree of operational control; and
- d* risk sharing.

¹ Mark Abell is a partner at Bird & Bird LLP.

The structures listed above all present different risk profiles for both parties involved. Franchising and its related hybrid structures present business with a versatile, effective and road-tested route to both domestic and international growth.

II WHY IS FRANCHISING SO POPULAR?

John Y Brown, the former president of KFC, identified one substantial attraction of franchising when he stated that the only way he could access the US\$450 million he needed to establish KFC's first 2,700 stores was through franchising.² Franchising can also provide the management expertise necessary to expand the business. It solves the problems concerning capital and management that often face growing businesses (resource society theory). Franchising also helps to improve managerial performance by establishing a community of interest that incentivises managers to work hard (agency theory).

Aliouche and Schlenrich³ suggest that franchising offers business an efficient way of increasing its value. This 'value creation' or 'transaction cost theory' is demonstrated by their survey of the US restaurant sector during the 10 years from 1993 to 2002. It suggests that franchised businesses create more value than their non-franchising competitors because they have a higher prospect of creating market value and economic value than non-franchisors and generate on average higher added value than non-franchisors.

Economies of scale lead to cost savings, and increased brand recognition is created more cost-effectively.

III INTEGRATED CORPORATE OR FRANCHISE STRUCTURES

Companies such as McDonald's have successfully developed a strategy of operating both company-owned outlets and franchised outlets. Costa Coffee is another example of a franchisor that has very effectively developed a split model of company-owned outlets in major towns and markets, and a 'hub' franchise model enabling it to operate effectively and bring its brand to consumers in smaller regional markets that are operated by franchisees.

This combined approach ensures that the franchisor has continual access to the operational realities of its format and is able to review and develop it on an ongoing basis. Corporate outlets generally yield higher profits for the brand owner than franchised outlets. However, the more rapid rate of growth and need for lower investment per unit gives rise to a 'multiplier effect', which leads to a higher return investment, greater market share and ultimately higher gross earnings for the brand owner.

2 See C Wormald and M Abell, 'Introduction – Alternative strategic techniques for the board agenda', in C Wormald (ed.), *Alternative Corporate Re-engineering* (The European Lawyer Ltd., 2011), p. 9.

3 E Hachemi Aliouche and Udo Schlenrich, 2005. 'Does Franchising Create Value? An Analysis of the Financial Performance of US Public Restaurant Firms.' Manchester, NH: Southern New Hampshire University Working Paper Series, 2005-02, cited in Wormald and Abell, 'Introduction – Alternative strategic techniques for the board agenda', *Ibid.*, p. 9.

IV FRANCHISING AS A PART OF WIDER-RANGING MULTICHANNEL STRATEGIES

There is nothing particularly new about the concept of businesses having a multichannel retail strategy. As noted by the authors of a 2009 Harvard Business School working paper,⁴ retailers have for some time started their businesses by exploiting one particular channel and then expanding it into others. In 1925, the US retailer Sears opened its first store as a way of complementing its existing catalogue business, which had been around since the early 1880s; Eddie Bauer and Spiegel's followed the same path, and more recently, we have seen television retailers HSN and QVC moving into the internet space.⁵ The advent of integrated multichannel retailing is due to the rapid development of the internet as a new selling channel since the dot-com boom in the mid 1990s, when many envisioned consumers abandoning 'bricks' for 'clicks' and buying most products and services over the internet. However, the internet has become a facilitating technology, which enables traditional bricks-and-mortar retailers to broaden their offering by establishing websites and riding the wave of online shopping. This not only gives them access to more customers but also improves operational efficiency. However, the internet does not meet all of every brand's marketing and sales needs, and franchising has evolved to further facilitate growth and development in the way that brands access potential clients, as both retailers and service providers face many new challenges and opportunities in the multichannel retailing environment: in developing international multichannel strategies; in creating synergies across channels; in deciding how to decide product mix; and in understanding how multichannel retailing will evolve over time in different geographic markets.

Perhaps the certainties are that improved financial performance will require continuing flexibility and that cannibalisation between channels and differences in prices and margins across channels will always be a risk. Multichannel retailing is continually developing as new channels, such as m-commerce, evolve into still newer channels. The legal documentation structuring these multichannel approaches to the market needs to provide for these certainties; this presents the draftsman with substantial technical challenges.

Brands generally develop their multichannel strategies by opportunistically adding new channels to existing ways to market. As a result of this fast-changing environment, and although historically it has been used in one of three 'vanilla' forms (namely unit franchising, master franchising and development agreements), over the past few years franchising has increasingly been used as one element in a variety of more complex and sophisticated structures developed in a bespoke manner to meet the exact multichannel, and other, needs of brand owners. These more sophisticated hybrid structures deliver not only an increased range of flexibility for customisation to businesses' individual needs, but also more complex challenges for their lawyers.

4 Jie Zhang, Paul W Farris, John W Irvin, Tarun Kushwaha, Thomas J Steenburgh and Barton A Weitz, 'Crafting Integrated Multichannel Retailing Strategies', Working Paper 09-125 (Harvard Business School, 2009).

5 Ibid.

V VANILLA FRANCHISING

i Unit franchising

This is the most basic form of franchising. It is most often used in domestic franchises. The franchisor directly grants the franchisee a right to operate one unit or a number of units. The burden it places on the franchisor means that it is rarely used internationally.

ii Master franchise agreements

In this relationship the franchisor grants to another party, described as a master franchise (or sometimes a 'sub-franchisor'), the right to open franchise outlets itself, and to franchise third parties, described as 'sub-franchisees', to open franchise outlets within a specified or exclusive territory.

iii Development agreements

In this relationship, the franchisor grants exclusive rights to a party described as the 'developer' to develop a territory by opening a number of franchise outlets itself. Developers must have substantial capital and managerial resources and are usually experienced operators.

VI HYBRID STRUCTURES

i Subordinated equity agreements

Companies are increasingly finding that their longer-term international strategic aims are not always met by vanilla franchising. Their commercial aims require more sophisticated, hybrid structures, often involving taking equity in the corporate vehicle that the franchisee has created to develop the brand in the territory. There is a wide range of such subordinated equity structures available, the appropriateness of which will depend upon the franchisor's commercial priorities, their longer-term market-entry strategy, the franchisor's shareholders' ultimate exit strategy, tax planning and so on.

Joint ventures are sometimes used to try to add further flexibility to traditional franchising structures, but more often than not these result in a head-on clash between the control dynamics present in a traditional shareholders' agreement and the brand owner's need to have unfettered control of the brand. Subordinated equity agreements enable the parties to circumvent these inherent tensions and equity interests to become a part of the brand owner's overall strategy.

In many jurisdictions these can have a substantial impact on the regulatory and tax issues that the franchisor has to deal with. As a result subordinated equity arrangements tend to be tailored to each market, while at the same time not compromising the integral homogeneity of the overall international structure.

Subordinated equity structures are sometimes used in conjunction with other 'extra-franchise' structures, such as management agreements of various types.

ii 'Manchising'

Management agreements tend to be used when the foreign developer has sufficient capital to invest in establishing the brand in the target market, but does not have access to the level and depth of operational expertise and resources required to help ensure its success in that market. It also offers the franchisor a further income stream, allied to, but distinct from, that which

it receives by way of the franchise agreement. Historically, these have been most common in the hotel sector, but more recently they have become part of hybrid franchise structures in a range of sectors, including the retail and restaurant sectors.

iii 'Francubating'

There are two basic barriers to a brand using franchising as a way of growing its profits and market share. One is a lack of talented individuals to become franchisees. The other is a lack of individuals with the capital required to invest in a franchise. Access to an appropriate talent pool is an issue beyond the skills of legal advisers; however, providing undercapitalised potential franchisees with a soft entry to becoming a franchisee is not. A variety of structures 'incubate' talented individuals by allowing them to purchase their franchise from the income they generate as a manager of a corporate store.

VII CONCLUSION

The stereotypical view of franchising as a way of cloning fast food outlets is outdated and reflects the realities of the 1980s far more than those of the current decade.

It is now more often than not just one part of a more sophisticated multichannel approach to the international market. This increases the complexity of the regulatory environment in which franchising operates and raises greater challenges for lawyers practising in the field.

THE REGULATION OF FRANCHISING AROUND THE WORLD

*Mark Abell*¹

As will become apparent from the chapters of this book, franchising is regulated in some countries by specific franchise laws. These can be categorised as competition law regulations, foreign trade or investment regulations and core franchise regulations. Competition law regulations seek to prevent the restriction of trade. They are concerned with issues such as the tying in of peripheral or unconnected goods, price maintenance, exclusivity and so on. The EU (in the form of Article 101 of the Treaty on the Functioning of the European Union and the Vertical Restraints Block Exemption), Japan² and Venezuela³ are examples of countries that regulate franchising in this manner.

Developing markets such as China, Indonesia, Kazakhstan, Korea, Moldova, Russia, Ukraine, Belarus, Barbados and Vietnam use foreign trade and investment regulations to protect their economies and often have political and social aims, such as the creation and distribution of wealth. Core franchise regulations are concerned with the way that franchises are sold, particularly the creation of what might be called pre-contractual hygiene. They do this by a variety of means, including mandating pre-contractual disclosure and the terms of the in-term relationship between the franchisor and its franchisees. More developed franchise markets such as the United States, Australia, Canada, Brazil, Taiwan, Mexico, France, Spain, Italy, Belgium and Sweden tend to take this approach. Some countries have adopted a hybrid approach to the regulation of franchising. For example, the South African Consumer Protection Act 2009 is a cross between competition law regulations and core franchise regulations, while both Malaysia and China have a mixture of foreign trade and investment franchise laws and core franchise regulations. Some countries, such as Croatia, define franchise agreements but do not regulate them.⁴

In addition to the 30 countries that have franchise-specific laws, Tajikistan⁵ is also currently contemplating enacting one. The New Zealand government has recently rejected the need for a franchise-specific law.⁶ The majority of these franchise regulations can be

1 Mark Abell is a partner at Bird & Bird LLP.

2 Japan Fair Trade Commission Guidelines, April 2002. These provide for disclosure and offer guidance on vertical restraints.

3 The Venezuelan Pro-Competition Agency's Guidelines for the Evaluation of Franchise Agreements, 7 January 2000. These are based upon the previous EU Franchise Block Exemption (Reg EU 4087/88).

4 Croatian Regulation on block exemption granted to certain categories of vertical agreements, Article 3(6).

5 Lena Peters of Unidroit in 'Update on Franchising Development outside the United States', 8 July 2009.

6 Stewart Germann, 'New Zealand – Government says no to Franchising Regulation', *International Journal of Franchising Law*, Volume 7, Issue 5, 2009.

best categorised as foreign trade and investment regulations. They are more concerned with regulating foreign investment and trade than ensuring the potential franchise abuses are prevented or at least reduced.

I THE DEFINITION OF FRANCHISING

The search for clarity in legislative definitions of franchising is unfortunately not particularly helped by the United States. The definition of ‘franchising’ used by the Federal Trade Commission for more than 20 years is widely used, although in the 15 states that have their own franchise disclosure and registration laws and the more than 20 states and territories that have their own relationship laws (some states have both, sometimes in the same statute), there is no single definition of the term ‘franchising’.

Nevertheless, the two basic approaches taken by the US legislators when attempting to define franchising have had a significant impact upon many of those jurisdictions that have adopted franchise-specific regulations.

The ‘prescribed marketing plan or system approach’⁷ to defining a franchise is most prevalent in the US states. Other states take a broader approach and refer to a ‘community of interest’ in the marketing of goods or services.⁸ Even within these two general categories, there are noteworthy differences.

The prescribed marketing plan or system approach raises the issues of ‘control and assistance’, and the use of the franchisor’s brand. These are dealt with in differing ways by the various statutes and the Federal Trade Commission.

The state of California’s franchise legislation was the United States’ first franchise law when it was introduced in 1970.⁹ It adopts the ‘prescribed marketing plan or system approach’ and defines a ‘franchise’ as a contract or agreement, either express or implied, whether oral or written, between two or more persons by which:

- a* a franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor;
- b* the operation of the franchisee’s business pursuant to such a plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logo type, advertising or other commercial symbol designating the franchisor or its affiliate; and
- c* the franchisee is required to pay, directly or indirectly, a franchisee fee.

The definition has been extended to include petroleum dealers. There are also definitions of franchisor, franchisee and franchise fee. This fairly general definition is typical of those to be found in many other US state franchise laws.

The Amended Federal Trade Commission Franchise Rule requires the franchisor to exert control over the franchisee’s method of operation or to provide significant assistance in the franchisee’s method of operation.

⁷ See Cl. Corp. Code, Section 31005.

⁸ Haw. Rev. Stat. Ann., Section 482E-2; Minn. Stat. Section 80C.01.4, Wis. Stat., Section 135.05(1).

⁹ Cal. Corp. Code Section 31005(a)(1).

The FTC definition is a broad one and, when originally enacted, its first part related to business format franchises¹⁰ and the second part extended it to business opportunities such as vending machine businesses.¹¹ Certain specific types of relationship are expressly excluded.¹² When the FTC Franchise Rule was amended in 2007, the business opportunity rule was spun off into a separate regulation.¹³

In any event, under the Amended FTC Rule, the franchisee must operate under the franchisor's brand – either by selling goods, commodities or services bearing the brand or operating under the brand and selling goods, commodities or services meeting the franchisor's quality standards.

There is little substantive difference between the FTC Rule and the various state approaches.

The community-of-interest approach is used in states such as Wisconsin¹⁴ and New Jersey.¹⁵ It defines a 'franchise' as an agreement between two or more persons in which:

- a the franchisee is granted the right to engage in the business of offering or distributing goods or services using the franchisor's trade name or marks;
- b the franchisor and franchisee share a community of interest in the marketing of the goods or services; and
- c the franchisee pays a franchise fee.

'Community of interest' generally means a continuing financial interest between the parties in the operation of the franchisee's business or the resale of the franchisor's products. Since most commercial relationships involve some type of continuing financial interest, this definition is potentially broader in application than most 'marketing plan' definitions.

Community of interest is defined by the Wisconsin statute as a 'continuing financial interest between the grantor and the grantee in either the operation of the dealership business or the marketing of such goods or services'.¹⁶ Since most dealership and franchise relationships involve some type of continuing financial interest, the 'community of interest' definition of a franchise has a potentially wider application than the prevailing 'marketing plan' definition.

Most of the cases addressing whether a community of interest exists have arisen under the Wisconsin or the New Jersey statute. The 1987 *Ziegler* decision by the Wisconsin Supreme Court¹⁷ lists factors that should be considered in determining whether a community of interest exists under the dealership law.¹⁸

In determining whether a community of interest exists for purposes of the New Jersey statute, courts have focused on the extent of the alleged franchisor's control over the alleged

10 FTC Rule, Section 436.1(h).

11 FTC Rule, Section 437.2(1).

12 FTC Rule, Section 436.8(a).

13 16 CFR, Part 437.

14 Wisconsin Fair Dealership Law.

15 New Jersey Franchise Practices Act.

16 Wisconsin Statute Chapter 135.02(1).

17 *Ziegler Co. v. Rexnord Inc* [1987] 139 Wis.2d 593 N.W.2d 873.

18 These factors include: (1) the duration of the parties' relationship; (2) the extent and nature of the parties' obligations; (3) the percentage of time or revenue devoted to the grantor's products or services; (4) the percentage of the grantee's gross proceeds or profits derived from the grantor's products or services; (5) the extent and nature of the grantee's territory; (6) the use of the grantor's trademarks or logos; (7) the grantee's financial investment in the inventory, facilities, and goodwill of the alleged dealership; (8) the personnel

franchisee, the franchisee's economic dependence on the franchisor, the relative bargaining power of the parties, and the presence of franchise-specific investments by the franchisee. A primary factor in this equation is interdependence, which generally arises when the franchisee invests heavily in the franchise business such that its economic health hinges on the continuation of that business.

Interdependence has been found where a distributor was contractually obliged to develop demand for a supplier's products, was barred from developing or selling competing products,¹⁹ performed joint sales and marketing activities with the supplier, and derived 97 per cent of its revenue from sales of the supplier's products. The percentage of revenues or sales attributable to the franchisor's products is not dispositive of the interdependence issue, but franchisees and dealers whose revenues attributable to a supplier's products are relatively small generally have a hard time establishing interdependence and a community of interest.

As evidenced by the following sections, the definitions of franchising adopted in other jurisdictions can be categorised as taking either a 'prescribed marketing plan or system' or a 'community of interest' approach.

II INFLUENCE OF THE PRESCRIBED MARKETING PLAN OR SYSTEM APPROACH ON OTHER JURISDICTIONS

The key characteristic of the prescribed marketing plan or system definition is that the business must be 'substantially associated' with the franchisor's trademark, trade name, or other commercial symbols to qualify as a franchise. There is often an element of control to be exercised by the franchisor as well.

A classic example of this is the definition used by the state of Alberta in Canada, which, not surprisingly given its proximity to the United States, focuses on the marketing plan. Its definition of franchising includes a 'marketing or business plan prescribed by the franchisor', a 'substantial association with trademarks' and 'significant operation control' by the franchisor.²⁰

Australia also takes a very comprehensive approach. Clause 5(1) of the Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (New Code) defines a franchise agreement as an agreement:

- (a) that takes the form, in whole or part, of any of the following:*
 - (i) a written agreement;*
 - (ii) an oral agreement;*
 - (iii) an implied agreement; and*
- (b) in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor; and*

devoted to the alleged dealership; (9) the amount of money and time spent on advertising and promotions for the supplier's products and services; and (10) the extent of supplemental services provided by the grantee to purchasers of the grantor's products or services.

19 *Instructional Systems Inc. v. Computer Curriculum Corporation* (NJ S Ct 1992) BFG 1992–1993 Para 10, 119.

20 Alberta Franchises Act, Section 1(d).

- (c) *under which the operation of the business will be substantially or materially associated with a trade mark, advertising or a commercial symbol:*
 - (i) *owned, used or licensed by the franchisor or an associate of the franchisor; or*
 - (ii) *specified by the franchisor or an associate of the franchisor; and*
- (d) *under which, before starting or continuing the business, the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount including, for example:*
 - (i) *an initial capital investment fee; or*
 - (ii) *a payment for goods or services; or*
 - (iii) *a fee based on a percentage of gross or net income whether or not called a royalty or franchise service fee; or*
 - (iv) *a training fee or training school fee;*

but excluding:

 - (v) *payment for goods and services supplied on a genuine wholesale basis; or*
 - (vi) *repayment by the franchisee of a loan from the franchisor or an associate of the franchisor; or*
 - (vii) *payment for goods taken on consignment and supplied on a genuine wholesale basis; or*
 - (viii) *payment of market value for purchase or lease of real property, fixtures, equipment or supplies needed to start business or to continue business under the franchise agreement.*

The definition then goes on to state that a transfer, renewal or extension of a franchise agreement and motor vehicle dealerships²¹ are included within the definition. A list of other relationships, such as employer–employee, landlord and tenant and cooperatives are excluded from the definition.²²

Certain limited types of franchise agreements are also exempted from the Code.²³

This definition is one of the most comprehensive and can be interpreted to cover a broad range of arrangements. Although the term ‘franchise’ is normally used to describe business format franchising, the definition in the Australian Code has the potential to capture a wide range of licensing, distribution and agency arrangements not traditionally considered to be a franchise arrangement. Having an express list of non-qualifying arrangements is also an effective way of excluding non-franchise relationships.

The Australian definition succeeds in being comprehensive, but sacrifices succinctness.

Although Australia and Alberta require ‘substantial association’ with marks, Indonesian franchise law shows interchangeability between the brand and other intellectual property. It defines franchising as ‘an agreement in which one party is given the right to utilise and/or use the right over the intellectual property or invention or unique business characteristics owned by another party against a fee’.²⁴ This interchangeability is unique and sets the Indonesian definition apart from most others.

21 Trade Practices (Industry Codes-Franchising) Regulations, Section 4(2).

22 Id., Section 4(3).

23 Id., Section 5. The two main types of exempted franchise agreement are where the franchisor is resident outside Australia and only grants one franchise or master franchise to be operated in Australia. The other main exemption is ‘fractional franchises’, where the franchise agreement is for goods or services substantially the same as those previously supplied by the franchisee and the sales under the franchise are likely to provide no more than 20 per cent of the franchisee’s gross turnover).

24 The Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated 30 July 1997), Chapter 1, Article 1.1.

Certain jurisdictions stipulate that the franchisor should assist the franchisee in running the business. In Korea the franchisor is required to 'support, educate and control' the franchisee in the ways of its business.²⁵ In Malaysia the definition of franchising includes a responsibility on the franchisor to 'provide assistance to the franchisee to operate his business, including help with the provision or supply of materials, services, training, marketing, business or technology'.²⁶ This is an interesting addition to a market plan definition and acknowledges the fact that most franchisees will need assistance to start up the business. Interestingly, the more detailed definition used in Australia is not as comprehensive in this area.

Most of the definitions mentioned above include the payment of a fee. Mexican law, however, is interesting in that it does not.²⁷ This potentially broadens the impact of the law to include relationships that are between not-for-profit organisations or that are peer networks. Although this extension may be valuable in catching some additional arrangements, the vast majority of franchisees will be paying some sort of fee.

The influence of the prescribed system approach is not restricted to franchise-specific laws. It can be found in case law and non-governmental organisations.

For example, neither the Hungarian Civil Code nor any other piece of legislation in Hungary defines franchising. Instead, definitions have been developed by the courts. One judgment suggests that the main feature of a franchise is, that 'a company (franchisor) transfers the exclusive right of selling goods and services to retail units which were introduced by him onto the market under a trade mark'.²⁸

A more thorough definition is offered in another judgment. It defines a franchise as an atypical, unregulated contract whose main characteristics are that: 'the franchisor has an obligation of transferring a complex system to the franchisee, a system which has been worked out diligently from a professional and trading point of view and has already been effectively tested under market circumstances with the right of usage of a trade name and complete training'.²⁹

It is noteworthy that both of the definitions offered take a prescribed system approach and refer to the marks' trade name.

The International Institute for the Unification of Private Law has drafted a definition that falls into the 'prescribed system' category with the intention of it being compatible with most private law systems.³⁰

The use of the word 'prescribes' and the phrase 'substantially associated' follows the approach seen in the United States, Australia and Alberta. Interestingly there is an element of 'assistance', as seen in the Korean definition, and master franchise agreements are expressly included (as they are in Alberta) to avoid any doubt, so avoiding the risk found in Lithuania that master franchises are not within the definition.

This definition is fairly succinct and accurately describes the franchise relationship. It focuses upon the form of remuneration paid by the franchisee to the franchisor so as to distinguish it from selective distribution channels. However, it seems to simply rearrange

25 Act on Fairness in Franchise Transactions, Chapter 1, Article 2.1.

26 The Franchise Act 1998, Part 1, Section 4(d).

27 Law on Industrial Property, Title 4, Chapter VI, Article 142.

28 Judgment No. BH 2003.269.

29 Judgment No. 1 Gf 40.203/1996.4.

30 Unidroit, Model Franchise Disclosure Law, Article 2.

definitions that are already in existence and offers nothing groundbreaking that captures the imagination. Interestingly, it has not been adopted by any of the legislators that have sought to define franchising.

No countries have adopted a 'pure' community of interest approach, probably because the definitions based on it are broader and lack the detail or accuracy of some of the lengthier marketing plan definitions.

However, many definitions contain certain elements of it mixed in with those of a prescribed system approach.

Italy has a definition of franchising that covers intellectual property (IP) rights, commercial assistance and fees very concisely.³¹ It does not deal with control by the franchisor. It merely describes the business aspect as a 'franchising network' and is therefore not detailed enough to give an accurate description of what a franchise entails. The Romanian version is equally succinct and requires the parties to 'continually cooperate' and be 'financially independent' from each other.³² It requires the parties to be named as franchisor and franchisee, however, and is silent on intellectual property rights, which is far from ideal.

Spanish law³³ offers a very broad definition that relates entirely to the rights granted by the franchisor and apparently the use of the words 'franchisor' and 'franchisee'. It defines a franchise as an activity that 'is carried out by virtue of an agreement or contract by which a company, known as the franchisor, grants to another, known as a franchisee, the rights to exploit its own system of commercialisation of products or services'. Although this can still be classified as a marketing plan or prescribed system approach, it is so broad that it is almost meaningless. Describing the business as a 'system of commercialisation products or services' does not adequately describe the IP rights exploited by the franchisee and there is no mention of a fee. Furthermore, if a strict interpretation is used, the definition will not catch any arrangement where the terms 'franchisor' or 'franchisee' are not used by the parties.

The Lithuanian definition of franchising³⁴ still has its roots in the Russian Civil Code defining the agreement as a contract between the 'right holder' and a 'user' rather than franchisor and franchisee. Reflecting both the country's socialist past and again the Russian pedigree of the Code, it expressly states that the parties to a franchise agreement must be either legal entities or entrepreneurs.³⁵ Presumably this is to avoid a government agency being involved in a franchise.

The definition covers the basic elements of a franchise contract, remuneration and the use of intellectual property rights or trademarks, but limits the latter two to exclusive rights only.³⁶ This ignores the possible existence of master franchise agreements under which the master franchisee does not enjoy exclusive rights and is therefore somewhat rudimentary.

The Brazilian franchise law defines a franchise as:

[A] system whereby a franchisor licenses to the franchisee the right to use a trademark or patent, along with the right to distribute products or services on an exclusive or semi-exclusive basis and,

31 Law of 6 May 2004, No. 129 Article 1.1.

32 Ordinance Regarding the Legal Status of Franchises (Government Ordinance 52/1997) as approved and modified by Law 79/1998, Chapter 1, Article 1(a).

33 Article 62 of the Act 7/1996.

34 Lithuanian Civil Code, Article 6.766(1).

35 Id., Article 6.766(3): 'Parties to the franchise contract may be enterprises (entrepreneurs) only.'

36 Id., Article 6.766(2).

*possibly, also the right to use technology related to the establishment and management of a business or operating system developed or used by the franchisor, in exchange for direct or indirect compensation, without, however, being characterised as an employment relationship.*³⁷

While this has something in common with the community of interest approach, the interchangeability of the brand and a patent is an interesting and unique concept that differentiates it from most other definitions, but draws some comparisons with the interchangeability in the Indonesian system. There are also elements of the prescribed plan approach, as the franchisor's 'operating system' must be used.

Taiwan's 'Standards Governing Disclosure of Information by Franchisors'³⁸ seem to confuse the marketing plan or prescribed system and the community of interest approach and define a 'franchise operating relationship' in terms of a community of interest as 'a continuing relationship in which an enterprise, through contractual means, licenses its trademarks or operating know-how for use by another enterprise and assists or offers guidance to that other enterprise in its operations, and for which the other enterprise provides specific consideration'.³⁹ This shows the kind of relationship required for a community of interest approach but also the assistance and guidance seen in the marketing plan approach.

III THE NEED FOR FRANCHISES TO HAVE BEEN PILOTED

There is sometimes a concern that until a franchise model has been tested in a new market it is not fit to be franchised to third parties. As a result, some countries such as China and Vietnam prohibit franchising until the concept has been piloted in the local market. In China there is a requirement that the franchisor establish and operate two company-owned units for more than one year before granting franchises to third parties.⁴⁰ Although the original regulation required that this pilot had to be in China, this requirement has been modified mirroring the debate in Italy, so that the pilot can be anywhere.

Article 2 of the Vietnamese Commercial Law of 2001 requires that franchisors must hold a Vietnamese business licence⁴¹ and that the franchise system has been in operation for at least a year before a franchise can be granted. The Vietnamese master franchisee of a foreign brand is required to have operated the franchise business for 12 months or more prior to granting sub-franchises to unit franchisees.⁴²

IV DISCLOSURE

Pre-contractual disclosure is the most common form of franchise-specific regulation and all those countries that require this are heavily influenced by the US Uniform Disclosure Document (US UFDD).

37 Brazilian Franchise Law, Article 2.

38 Taiwan's Standards Governing Disclosure of Information by Franchisors.

39 Id., Article 1.

40 Article 7 of the Regulation of Administration of Commercial Franchises 2007.

41 Article 6 of Decree No. 35/2006/ND-CP issued by the government to regulate franchises.

42 Id., Article 5(1).

i Timing of disclosure

Pre-contractual disclosure must usually be given between 10 and 21 days prior to the execution of the franchise agreement. Malaysia, Taiwan and Brazil require disclosure at least 10 days prior to the execution of a franchise agreement. Korea requires only five days, while the Canadian states all require 14 days, Mexico 30 days, China 20 days and Vietnam 15 days.

ii Cooling-off period

A number of countries such as Malaysia, Mexico and Taiwan require a cooling-off period during which the franchisee can withdraw from the relationship without penalty. These range from a 30-day cooling-off period in Mexico⁴³ to five days in Taiwan.⁴⁴

iii Contents

Following the lead of the US UFDD, most countries that require pre-contractual disclosure require the same sort of information to be disclosed to the potential franchisees, although the details tend to vary. The information generally required to be disclosed is discussed below.

Basic details of the franchisor

Every country with franchise-specific disclosure legislation requires the franchisor to give some basic details about its business. The amount of detail that has to be disclosed varies from rudimentary information about the franchisor (like in Indonesia or Japan), to more detailed information about the franchisor's business experience, its history of development and information about the business experience of the main people involved on the franchisor's side such as its directors and manager. Not surprisingly the countries with pure franchise regulations such as Canada and Malaysia require a franchisor to provide more franchise-specific information than others.

Description of the franchise and of the market

Almost all disclosure countries require the franchisor to give a short description of the franchise in question. In addition, some countries such as France, Brazil and Vietnam also require the franchisor to provide details of the territory or the market where the franchise is supposed to operate.

Financial information about the franchisor

Although the requirements regarding this item do not seem to be as strict as those set out in the US UFDD in that the bankruptcy history of the franchisor and its affiliates usually does not have to be disclosed (with the exception of Brazil, Canada, China and Malaysia), most disclosure countries require the franchisor to provide the prospective franchisee with balance sheets and financial statements for the past two years with the exception of Japan, Mexico and Taiwan.

43 Id., Article 142 of Mexico's Industrial Property Law.

44 Article 5 of the Standards Governing Disclosure of information by Franchisors by the Fair Trade Commission.

Details of the franchise network

Most disclosure countries require the franchisor to give details about the franchise network, including providing the prospective franchisee with names and addresses of existing franchisees and information about franchisees who left the franchise network. The period that needs to be covered varies from 12 months before the franchise agreement is signed (in Brazil) to three years in the case of Canada.

Litigation details

Details concerning litigation that has to be provided can be divided into franchise-related litigation and general civil or criminal litigation regarding the franchisor and its directors or managers involved in the sale of the franchise. Some disclosure countries follow this distinction and refer to two separate items (e.g., Canada or China); others simply refer to details about litigation in general, depending how detailed the disclosure laws are.

Initial fee, initial investment and continuing fees

Most disclosure laws list the disclosure of fees and other payments that have to be made in accordance with the agreement as separate disclosure items (with the exception of Indonesia). Nevertheless, all disclosure countries require the franchisor to disclose the amount of initial fees and ongoing fees that are payable to the franchisor. Japan and Taiwan also explicitly require the franchisor to specify under which circumstances the initial fee is repayable to the franchisee. When it comes to giving details about the initial investment the franchisee will have to make, not all countries require the franchisor to do so. Unlike under the US UFDD, no country requires the franchisor to disclose during which period the franchisee's initial investment will be amortised, not even Canada (where it is optional to do so), which most resembles the US franchise-specific legislation. The disclosure laws of Indonesia, Japan and Taiwan do not even require the disclosure of the initial investment.

Earning claims

With the exception of the United States, Canadian and Japanese franchise legislation, no other disclosure legislation mentions earning claims. In Canada and Japan it is optional for the franchisor to make such claims in the disclosure document. The only condition is that if earning claims are made, they have to have a reasonable basis. Franchisors in Canada are also required to include the material assumptions underlying the preparation and presentation of the earnings claim and they have to indicate the place where the prospective franchisee would be able to inspect substantiating documents.

Restrictions on the franchisee

Restrictions on the franchisee during the ongoing relationship consist of restrictions on the goods or services that can be provided by the franchisee, non-competition covenants and restrictions on the sale of the franchisee's business. The general rule is that restrictions on the franchisee's economic freedom of action have to be disclosed in every country. Similar to the litigation item, some countries with more sophisticated disclosure laws list the restrictive covenants that have to be disclosed separately (e.g., Canada or Malaysia); other simply refer to 'the general obligations of the franchisee' (e.g., Indonesia) or 'conditions or limitations on the franchisee's business' (e.g., Korea).

Descriptions of the obligations that the parties owe towards one another

Although there is a primary focus on information that has to be provided about the obligations of the franchisee, the obligations of the franchisor, in particular with regard to training and assistance during the pre-opening, but also regarding continuing support during the ongoing franchise relationship, have to be disclosed to prospective franchisees.

Purchase ties and personal involvement of franchisee

If the franchisee is required to purchase certain goods from the franchisor, then this generally has to be disclosed, even though it might not be specifically mentioned in the disclosure law, but would fall under the broad heading 'obligations of the franchisee'. The Canadian franchise legislation even goes a step further in that a franchisor not only has to disclose whether the franchisee has to purchase certain goods exclusively from it, but also any rebates from its suppliers on products that are sold on to the franchisee this way. In addition, any details about the franchisee's personal involvement have to be given, if required under the franchise agreement (as in Brazil, Canada, Malaysia and Vietnam, where this is a separate disclosure item).

Term, termination, renewal

Surprisingly, two disclosure countries do not require a franchisor to make specific disclosure about the term of the agreement, its termination provisions and a possible renewal (Brazil and China). But it is important to note that some of the countries that do not require this separate information to be given require the franchisor to furnish the franchisee with a copy of the franchise agreement.

Details about franchisor's IP rights

Only the following countries deal specifically with the disclosure of IP-related items: Brazil, China, Indonesia, Malaysia, Mexico, Taiwan and Venezuela.

Details of financing arrangements offered by the franchisor

Japan, Malaysia, Canada and Indonesia require the franchisor to disclose details about any financial arrangement offered to the prospective franchisee. In addition, a franchisor is also required in Japan to disclose whether it is prepared to provide financial assistance to a franchisee that finds itself in a difficult financial position.

Exclusivity

Most disclosure countries require the franchisor to specifically disclose whether the franchise granted is exclusive or non-exclusive and whether the franchisor retains the right to operate corporate units in the territory granted (like in Japan).

Country-specific disclosure items

There are a number of countries that require disclosure of specific items that are unusual and shall therefore be mentioned in this section.

In Brazil, franchisors have to give a profile of the 'ideal' franchisee in the disclosure document, in particular with details of its business experience and educational background.

Under the Mexican franchise law, the franchisor has to provide detailed information about the method of calculation for determining profit margins and franchise commissions. This is a very burdensome requirement for franchisors.

In Taiwan, the franchisor has to give information about its management programme in the franchisee's areas of operation.

iv Consequences of non-compliance

Failure to comply with the disclosure regulations generally results in the franchisee being able to reject the agreement so long as it does so within a reasonable time of entering into the agreement. Fines are also imposed in some jurisdictions.

In Canada, in the provinces of Alberta, Ontario, Prince Edward Island and New Brunswick, a prospective franchisee is able to rescind the franchise agreement on notice either 60 days after receiving the disclosure document or no later than two years after the franchise is granted, whichever is earlier.⁴⁵ A right to damages also arises if the franchisee suffers a loss because of misrepresentation in the disclosure document.

In Brazil, failure to comply with the disclosure requirements entitles the franchisee to request the annulment of the agreement and require the reimbursement of all sums that may have already been paid to the franchisor or to any third party designated by the franchisor as franchise fees or royalties, monetarily corrected by the index of variation applicable to savings deposits, plus damages and losses.⁴⁶

Reflecting the central government control of commercial laws, in China, if the franchisor fails to disclose material information or makes a misrepresentation, in addition to the franchisee being entitled to terminate the contract, the government can also impose fines. These range from 10,000 to 100,000 yuan. In addition, a public announcement of the violation will be made if it is a serious one.⁴⁷

Jurisdictions with antitrust regulations take a slightly different approach to failure to properly disclose. In Japan, for example, failure to provide necessary disclosure amounts to the unfair trade practice of deceptive customer inducement and can result in the Japanese Fair Trade Commission issuing a cease-and-desist order or the franchisee obtaining an injunction in the courts.⁴⁸

In Malaysia, violations of the disclosure law are punishable by the imposition of a fine. The court can also declare a franchise void, order refunds of all payments from the franchisee, and prohibit the franchisor from entering into new agreements.⁴⁹

In Mexico, failure to comply with the disclosure requirements will subject a franchisor to a variety of administrative penalties, including fines, temporary closure of the business for up to 90 days, and administrative arrest for up to 36 hours.⁵⁰

45 Alberta Franchises Act, Section 13, the Arthur Wishart Act (Franchise Disclosure) 6(1) and (2); the Prince Edward Island Franchises Act, Chapter 36, Bill 43, Section 6(1); the New Brunswick Franchises Act, Section 6(1).

46 Law No. 8.955 of 15 December 1994, Article 4.

47 Article 28 of the Regulation on Administration of Commercial Franchises 2007.

48 Act No. 101 of 29 September 1973, as amended in April 2002, Section 12(1).

49 The Malaysian Franchise Act 1998 Part VI.

50 Law on Industrial Property, 23 November 1994, Title Seven, Chapter II, Article 213.

In Vietnam, Section 4 of the Decree provides for penal administrative provisions for, *inter alia*, non-compliance with the disclosure requirements.⁵¹

V MINIMUM TERM

It is unusual for a minimum term to be mandated for the franchise agreement. Nevertheless, in Malaysia the franchise agreement must be for a minimum period of five years.⁵² While in Indonesia, master franchise agreements must be for at least 10 years.⁵³

VI A GENERAL DUTY OF GOOD FAITH

The imposition of a duty of good faith on the franchise relationship is currently being hotly debated in a number of jurisdictions, such as Australia, the United Kingdom and the United States. Some countries such as the Canadian provinces, China, Korea and Malaysia already impose a duty of good faith on both the franchisor and the franchisee.

Although it does not have franchise-specific laws, Germany imposes a heavy duty of good faith on franchisors, including, but not restricted to, the pre-contractual obligation to make proactive and full disclosure (*culpa in contrahendo*).

VII THIRD PARTIES

In Malaysia, Korea and Kazakhstan the role of third parties in franchising is regulated.

Malaysia governs the activities of franchise brokers.⁵⁴ These are defined as persons 'doing business as an agent or representative of a franchisor to sell a franchise to any person for a certain consideration but does not include any director, officer or employee of the franchisor or franchisee'.⁵⁵

In Kazakhstan, licence brokers, which are defined as those 'engaged in mediation activities in the course of concluding and performance of the complex business licence contract',⁵⁶ are regulated by the law, which states that they 'may act both on their own behalf and at their own risk, and on behalf and at the risk of the licensor, licensee or other subjects of franchising relations in consideration for a licence broker's fee, which can be payable in the form of a fixed single or periodic payment, fixed payments or otherwise, as provided by the contract'.⁵⁷

In Korea, the law provides for the registration at the Fair Trade Commission of Franchise Consultants,⁵⁸ who are involved in:

- a* matters related to the business prospects of the franchise;
- b* matters related to the preparation and revision of a franchise agreement and the information disclosure document;

51 Article 24(1) of Decree No. 35-2006-ND-CP.

52 The Franchise Act 1998, Part III, Section 25.

53 Cornwallis, *International Journal of Franchising Law*, 2006, Volume 4, Issue 3, p. 5.

54 The Franchise Act 1998, Part II, Section 14.

55 Id., Part Im Section 4.

56 Law on Complex Business Licence (Franchising) (Law No. 330: 24 June 2002), Chapter 1, Article 1(5).

57 Id., Chapter 3, Article 13.

58 Act on Fairness in Franchise Transactions, Chapter III, Article 28.

- c* matters related to the obligations of the franchisee and the conditions to the business operations of a franchise, etc.; and
- d* matters related to the provision of education and guidance to the franchisee.

Consultants have a duty to act ‘with dignity and honestly’⁵⁹ and can be struck off for inappropriate behaviour.⁶⁰

VIII DISCLOSURE BY POTENTIAL FRANCHISEES

Interestingly, in Vietnam, not only does the franchisor have to disclose information to the franchisee, but so does the franchisee to the franchisor. Article 9 of the Vietnamese Commercial Law states that, if the franchisor reasonably requests the franchisee to make full disclosure to it, the franchisee is under an obligation to do so.

IX REGISTRATION REQUIREMENTS

Some jurisdictions require the franchisor to register relevant details and documentation with a government agency. In developing markets this seems to be to enable the government to monitor franchisors doing business in the market, while in more developed economies (such as the United States and Spain) it is to ensure transparency and maintain a certain level of quality. Franchisors who sell franchises in China need to file relevant information with the competent commercial authority. If a franchisor wants to sell franchises in just one province, the information has to be filed at the local office of the MOFCOM of that province. For cross-province franchising, the application has to be filed with MOFCOM itself.

An application has to be made within 15 days of the execution of the franchise agreement and has to contain the following:⁶¹

- a* basic information about the franchise system;
- b* information about all the franchisees within China;
- c* the market plan of the franchisor;
- d* a copy of the business licence or any other qualification certificate of the franchisor;
- e* a copy of the registration certificate for the registered trademark, patent and other operational resources concerning the franchising activities;
- f* a document issued by the commercial authority at city level certifying that the franchisor owns at least two directly operated outlets that have been in operation for more than one year. For the directly operated outlets located outside China, the notarised and authenticated certificate of incorporation must be provided by the franchisor;
- g* a sample franchise contract;
- h* the index of the franchising operation manual;
- i* if the products or services that are franchised are subject to the approval of relevant authorities, the relevant approval documents shall be provided by the franchisor;
- j* a statement for the authenticity and the veracity of the filed information affixed with the signature of the franchisor’s legal representative and the franchisor’s corporate seal; and

59 Id., Article 30.

60 Id., Article 31.

61 Article 8 of the Administration Regulations and Article 5 of Administration Rules on Commercial Franchise Filing – Decree of Ministry of Commerce 2007 (No. 15).

- k* information regarding the execution, rescission, renewal and modification of franchise contracts within the proceeding year. This information has to be updated by 31 March every year.

In Moldova, the franchise agreement must be registered with the State Agency for the Protection of Industrial Property,⁶² which must be informed when the agreement has ended.⁶³ The Law does not provide for any consequences in the event the parties do not register the franchise agreements with the Agency. 'The franchise agreement is considered to be valid from the day it is signed or the day determined by the parties.'⁶⁴ Thus the validity of the franchise agreement does not depend on its registration with the Agency.

Russian law requires that franchise agreements are registered at the register of commercial concessions, which is maintained by the tax authorities. Failure to register it means that it is not valid as against third parties.⁶⁵ In addition to information about the franchisor and franchisee, three copies of the agreement have to be filed. Termination of a franchise agreement prior to its expiration must be registered by the franchisor.⁶⁶

The Indonesian franchise law takes the unusual step of requiring that it is the duty of the franchisee rather than the franchisor to register the franchise agreement and disclosure statement.⁶⁷ Failure to register results in the revocation of the franchisee's trade licence.⁶⁸ Franchise licences between a foreign franchisor and a master franchisee are registered at the Ministry of Trade, while those between a master franchisee and sub-franchisees are registered at regional or municipal offices. This has led to a considerable reduction of the time for registration, namely from 150 days to around 30 days as many of the applications are now delegated to the regional offices.⁶⁹

Malaysia takes a different approach and the franchisor and the franchisee are jointly required to effect the registration.⁷⁰ The filing of false or inaccurate documents is an offence.⁷¹ The franchisee of a foreign franchisor must also register itself.⁷² Failure to register can result in penalties between 5,000 and 50,000 ringgit and up to five years' imprisonment. In addition to this, the court can declare the franchise agreements null and void, order the franchisor

62 Article 9(4) of the Moldovan Law on Franchising No. 1335 dated 1 January 1997 provides: 'The franchise agreement is registered with the State Agency for the Protection of Industrial Property.'

63 Article 10(3) of the Moldovan Law on Franchising provides: 'If the contract has ended, parties have the obligation to cease their activity and to inform the Agency within one month.'

64 Article 9(3) Moldovan Law on Franchising.

65 Russian Civil Code Part II, Chapter 54, Article 1028(2).

66 Russian Civil Code Part II, Chapter 54, Article 1037.

67 Regulation of the Minister of Trade No. 12/M-DAG/PER/3/2006 dated 29 March 2006, which revoked the Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated 30 July 1997), Chapter III, Article 11.1.

68 *Id.*, Chapter VI, Article 22.

69 Bryan Cave International Trade, Regulatory Development in Asia, Indonesia, May 2007, www.bryancavetrade.com.

70 The Franchise Act 1998, Part II, Section 6(2) provides that failure to register amounts to an offence (unless exempted under Section 58 of the Act).

71 The Franchise Act 1998, Part II, Section 7(6).

72 *Id.*, Part VIII, Section 55.

to refund any payment obtained from the franchisee and prohibit the franchisor from entering into any new franchise agreement. There is provision for an annual update of the documents filed.⁷³

In Mexico, although the disclosure document does not need to be registered with the government authorities, franchisors must record all franchise agreements at the Mexican Institute of Industrial Property on execution.⁷⁴ The franchise agreement will not be registrable unless it is in writing and contains certain minimum provisions.

X COMPULSORY CONTENTS OF FRANCHISE AGREEMENTS

A number of countries insist that a franchise agreement contains certain standard clauses. There is a wide variety of approaches and no general trend or pattern can be identified other than a general desire for comprehensiveness.

In Indonesia, a franchise agreement must contain the following clauses:⁷⁵

- a* the name, address and domicile of the company of each party;
- b* the name and position of each party authorised to sign the agreement;
- c* the name and type of right over intellectual property, invention or a unique business characteristic, for example a management system, a selling or display method or a distribution method that constitutes a special characteristic that is the object of a franchise;
- d* the rights and obligations of each party and the aid and facility given to a franchisee;
- e* the marketing area;
- f* the period of the agreement and the method of and the requirements for the extension of the agreement;
- g* the method for settling a dispute;
- h* mutually agreed basic provisions that may result in the termination or expiration of an agreement;
- i* compensation in the event of agreement termination;
- j* the procedure for the payment of compensation;
- k* the use of domestically produced goods or materials produced and supplied by small-scale enterprises; and
- l* nurturing guidance and training for franchisees.

Malaysia takes a less detailed approach and simply prohibits discrimination between franchisees in respect of the charges offered or made for franchise fees, royalties, goods, services, equipment, rentals or advertising services if such discrimination will cause competitive harm to a franchisee who competes with a franchisee who receives the benefit of the discrimination, unless it can be objectively justified.⁷⁶ It also requires that termination must be for good

⁷³ Id., Part II Section 16.

⁷⁴ Regulations Under the Law on Industrial Property (23 November 1994) Title I, Chapter II, Article 5.

⁷⁵ Regulation of the Minister of Trade No. 12/M-DAG/PER/3/2006 dated 29 March 2006, which revoked the Provisions on and Procedure for the Implementation of Franchised Business Registration (Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997, dated 30 July 1997), Chapter II, Article 7.1.

⁷⁶ The Franchise Act 1998, Part III, Section 20.

cause,⁷⁷ be by written notice, and offer an opportunity to remedy a breach⁷⁸ cited as cause for termination. A franchisor refusing to renew or extend a franchise at the end of its term must compensate the franchisee if it does not waive the post termination restrictive covenants or give the franchisee six months prior notice of the termination or non-renewal.⁷⁹

Russian law stipulates the rights and obligations of both the franchisor and franchisee by providing the essential elements of the relationship. It grants a right of renewal to franchisees,⁸⁰ although case law suggests that this can be circumvented in some circumstances.⁸¹ It also states that either party can terminate the franchise agreement upon six months' notice⁸² and that the transfer of the franchise to another franchisee is not a breach that gives rise to a right to terminate the agreement.⁸³

In Ukraine, the law⁸⁴ imposes statutory liability of the franchisor for defective products sold by the franchisee. This is symptomatic of socialist legal traditions and is also found in Latvian and Estonian franchise law.

The Georgian Civil Code⁸⁵ specifies the obligations of the parties, including confidentiality and the liability of the franchisor.

Article 16 of the Vietnamese law states that a franchisee may terminate the franchise agreement unilaterally if the franchisor is in breach of those obligations imposed upon it by Article 287 of the Commercial Law. The franchisor on the other hand is entitled to unilaterally terminate the franchise agreement in the following circumstances:

- a* the franchisee no longer holds the necessary business licence or equivalent papers required by law;
- b* the franchisee is involved in winding-up or bankruptcy proceedings pursuant to Vietnamese law;
- c* the franchisee commits a serious legal violation that has the potential to harm the reputation of the franchise network; and
- d* the franchisee fails to remedy immaterial breaches of its obligations under the franchise agreement within a reasonable time.

Under the Vietnamese Decree a franchisee may transfer its rights to another franchisee subject to:⁸⁶

- a* the assignee being also in the possession of a valid business licence; and
- b* the franchisor giving its prior consent.

77 *Id.*, Part III, Section 31(2).

78 *Id.*, Part IV, Section 30(1).

79 *Id.*, Part IV, Section 32.

80 Russian Civil Code, Part II, Chapter 54, Article 1035.

81 Decision of the Federal Arbitrazh Court of East-Siberian District (FAS VSO decision) of 16 October 2003, Case No. NA19-3914/03-13-FO2-3459/03-C2.

82 Russian Civil Code Part II, Chapter 54, Article 1035.

83 *Id.*, Article 1037.

84 Ukrainian Civil Code, Chapter 76, Articles 1115 to 1129.

85 Adopted on 26 June 1997, Book Three, Special Part, Title One, Chapter Seven (Articles 607–614).

86 Decree No. 35/2006/ND-CP, Article 15(1).

To obtain consent, the franchisee has to inform the franchisor in writing of its intention to assign its rights to a third party. Within 15 days of receiving the request, the franchisor then has to reply in writing. It may object to the transfer of rights on one of the conditions set out in Article 3 of the Decree, namely because:⁸⁷

- a* the assignee failed to fulfil its financial obligations under the franchise agreement;
- b* the assignee has not yet fulfilled the criteria for being chosen as a franchisee by the franchisor;
- c* the transfer might have an adverse effect on the existing franchise system;
- d* the assignee does not agree in writing to fulfil its obligations under the franchise agreement; or
- e* the franchisee has not yet fulfilled its obligations towards the franchisor.

XI DISPUTE RESOLUTION

Some jurisdictions impose certain requirements concerning dispute resolution. The New Brunswick Franchises Act is the first of the provincial statutes to provide for a comprehensive dispute resolution mechanism. The Franchises Act sets out that any party to the franchise agreement who has a dispute with another party to the agreement may deliver a notice of dispute.⁸⁸ Within 15 days of delivery of the notice of dispute, the parties shall attempt to resolve it.⁸⁹ If the parties fail to resolve the dispute within 30 days of the notice, the Franchises Act provides that any of the parties may deliver a notice to mediate the dispute.⁹⁰ The mediation notice cannot be delivered prior to the expiration of the initial 15-day period. However, neither delivery of a notice of dispute nor a notice to mediate precludes a party from taking any other judicial measures.⁹¹ The Korean franchise law also provides for a dispute resolution mechanism and establishes a Franchise Transaction Dispute Mediation Committee.⁹²

XII DOES REGULATION HAVE A SIGNIFICANT IMPACT ON FRANCHISING?

There is, and has always been, a good deal of debate about the need for, desirability of and impact of regulation on franchising.

The strength of franchising in the world's most heavily regulated jurisdiction (the United States), somewhat undermines the suggestion that regulation *per se* has a significant and adverse impact upon franchising. Clearly, bad regulation will have a negative impact on franchising, but that does not mean that good regulation cannot have a positive impact upon franchising. Indeed the lack of good regulation can have an adverse impact on franchising. Conflict between differing regulatory regimes in a single economic region can have an even greater adverse impact upon franchising. This is what happened in the European Union. For example, the 9,971 or so franchise networks operating in the EU and the 405,000 or so outlets make a substantial contribution to the GDP of a number of Member States, with

87 Id., Article 15(3).

88 Section 8(1) of the New Brunswick Franchises Act 2007 (26 June).

89 Id., Section 8(2).

90 Id., Section 8(3).

91 Id., Section 8(10).

92 Korean Act on Fairness in Franchise Transactions, Chapter IV.

a roughly estimated total turnover of €215 billion. However, closer examination suggests that it is over-concentrated in a small number of EU Member States and a comparison with the size of franchising in the United States and Australia suggests that its potential to contribute to the single market and the growth of trade between Member States is far from being fulfilled at present, an estimated 83.5 per cent of its turnover being concentrated in only 25 per cent of the Member States.

The underachievement of franchising in the Single Market can be attributed, at least in part, to the way in which it is regulated. The regulations fail to protect and re-enforce the business reasons that attract franchisors and franchisees to franchising.

The regulatory environment in the EU comprises franchise-specific laws in six Member States. Each law is different from the others. Franchisors embarking upon a European 'roll out' of their concepts therefore encounter delays and costs that are a direct result of this heterogeneous approach – an artificial barrier to pan-European expansion that actively discourages franchisors to grow their businesses across the European Union.

This impact upon franchising is further exacerbated by non-franchise specific laws that can also be divided into pre-contractual, contractual and post-contractual.

The pre-contractual laws often comprise some or all of the following; a duty not to misrepresent facts, an obligation to disclose relevant information to potential franchisees, an extra-contractual obligation to disclose relevant information to potential franchisees, an extra-contractual obligation of confidentiality, an obligation to enter into the franchise agreement once negotiations have passed a certain point and a right to withdraw from the contract within a limited period. Each country takes a different approach to each of these issues resulting in the lack of any homogenous approach.

The ongoing franchisor–franchisee relationship is often regulated by antitrust, unfair competition and consumer law. A duty of good faith also impacts upon franchising in civil law jurisdictions, although not in common law jurisdictions, which take a very different approach to the concept of good faith. For example, whereas German and French law takes a loose approach based upon the Roman law concept of *bona fides*, English law takes a far more literal approach to contracts, using a variety of legal tools to ensure fairness on the relationship.

This exotic cocktail of laws further strengthens the technical barrier to cross-EU expansion.

XIII CONCLUSION

When seeking to internationalise a franchise, it is important to have a full understanding of the challenges that will be presented by the legal systems of each target market. These challenges must be anticipated and taken into account not only in the drafting of the standard documentation but also in the way in which the roll-out is planned, budgeted and implemented.

Companies using franchising as a vehicle through which they will internationalise their business must expect to encounter a range of different legal challenges in each jurisdiction.

SUSTAINING RELATIONSHIPS

Steven Frost and Mark Abell¹

I SUSTAINING FRANCHISEE RELATIONSHIPS

When franchising works it is magical – franchisors rapidly expand their geographical coverage, franchisees have a proven system that allows them to realise their personal goals and reduce their risk, and consumers benefit from great products and services. Relationships are at the heart of this success. Successful franchise networks are built on an interdependent partnership between franchisor and franchisee, where each plays a key role and achieves more by working together. When you attend a franchise conference for one of these high-performing franchise networks, you feel the spirit of cooperation and commitment to a shared vision for success. Franchisees are proud to be part of the brand and speak highly of the products and services they provide in their local area. And when proven franchise concepts do not flourish, we can normally trace the root of the issue to ineffective franchisee relationships. It is important that lawyers understand this reality and not only draft documentation that positively underpins the relationship, but also ensure that it functions within the regulatory environment to best effect ensuring that the relationship is not ‘holed under the waterline’ by laws that directly or indirectly regulate franchising.

II WHY RELATIONSHIPS MATTER

Having a network of engaged and successful franchisees is not simply an altruistic aim – it makes commercial sense:

- a* engaged franchisees who feel valued, buy into the franchisor’s vision and are committed to the partnership are likely to perform better. Often the face of the brand, they will go the extra mile for customers and maximise their sales territory. In management franchisees, they will better motivate and get the best out of their teams;
- b* investing in franchisee relationships also reduces litigation. Franchisees who feel supported and value the partnership are less likely to bring costly disputes. If they have an issue, they are more likely to talk about this with their franchisor and try to find an amicable solution;
- c* franchisees will embrace change. Franchising is built on trust – if a franchisee does not trust the franchisor, they are likely to be defensive about any changes to the franchise model, even if these are intended to help them be more successful. The leadership team will find itself spending more time communicating the reasons behind changes and overcoming objections than driving the business forward;

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- d* investing in franchisee relationships reduces the risk of an independent franchisee association. If franchisees do not feel valued and listened to, they are more likely to establish an independent franchisee association, similar to a staff union. This can create a ‘them and us’ mentality, and the franchisor could soon find itself negotiating with nominated representatives; and
- e* unhappy franchisees undermine franchise recruitment. One critical step that all prospective franchisees should take before signing the franchise agreement is to speak with existing franchisees. If these are dissatisfied or regret having chosen to invest in the franchise, prospective franchisees may be put off from investing in the franchise. Moreover, in the age of social media and blogging, negative reviews by disengaged franchisees can quickly proliferate across the web, damaging the franchisor’s reputation.

III IT STARTS WITH RECRUITMENT

Good franchisee relationships begin before a franchisee joins the franchise network. The way franchisees are recruited and how expectations are set during the recruitment process will have a long-term bearing on the quality of their relationship with the franchisor.

Franchising is often described as a business marriage because of its long-term nature and the aspect of partnership. The recruitment process is the best time for clarifying the expectations of both parties and ensuring these are realistic. As well as ensuring that the prospective franchisee has what it takes to be successful, the franchisor must set clear expectations and not just about the potential financial rewards, but also the sacrifices that they will need to make. This can include having to follow someone else’s system rather than truly being one’s own boss, and the time and work–life balance sacrifices that may be needed, especially in the early years. If expectations are not aligned, the franchisee can quickly come to resent the partnership, increasing the likelihood of dispute and litigation.

For master franchisees and area developers, there are some additional considerations. While the exporting franchisor will want to set a development schedule or recruitment targets, it is critical that these are realistic. The most successful international franchisors also recognise the importance of adapting their concept for local markets and cultures, before ramping up franchisee recruitment. They listen to feedback from the master franchisee for a better understanding of the local marketplace and culture, and make necessary refinements to the model and products and services.

In a number of jurisdictions, such as the United States, Canada, France, Spain, Italy, South Africa, China, Malaysia and Australia, there are franchise-specific laws that aim to ensure optimal transparency and so minimise any mismatch of expectations. In such jurisdictions, lawyers are bound to advise their franchisor clients on how to comply with these laws. However, it is important to appreciate that mere compliance with these pre-contractual laws does not always, *per se*, guarantee the recruitment of appropriate franchisees. More is required as regards the way in which the ‘sales’ process is managed.

In those jurisdictions where there are no franchise-specific pre-contractual obligations, it is nevertheless advisable for the franchisor to prepare and deliver documentation to its potential franchisees that will help minimise the risk of recruiting inappropriate candidates or encouraging franchisees to become involved in the franchise on the basis of a misunderstanding. Again, a pre-contractual disclosure document by itself is not sufficient. There must be an appropriate pre-sales process implemented, of which the disclosure document is merely one part.

IV UNDERSTANDING EACH OTHER'S ROLE

The power of franchising comes from interdependence: understanding each party's role, and that the parties will be more successful by working together, is the key to sustaining excellent franchise relationships.

i The role of the franchisor

The franchisor's role is to provide the proven system, support and mentoring that enables franchisees to achieve their personal and financial goals, in line with expectations set during the recruitment stage. The franchisor must maintain and enforce system standards to protect the brand, provide leadership and a clear vision for the future, share best practice and innovate to ensure the products and services remain competitive. The franchisor must continue to provide a fair deal through value-for-money management fees and royalties in return for support and brand value. This role must be reflected faithfully in the franchise agreement and indeed in some jurisdictions, such as Indonesia and some of the EU Member States, such provisions are mandatory.

ii The role of the franchisee

If the franchisor's role is to provide a proven system and ways of working, the franchisees' role is to follow this and maximise sales in their territory. They should do this in a way that enhances the brand by providing great customer service, supporting their fellow franchisees and sharing best practice.

Although some franchisees refer to themselves as the franchisor's customer because they pay a management fee or royalties to the franchisor, this does not accurately describe their role. Instead of a supplier–customer relationship, it is a two-way partnership and both franchisor and franchisee have obligations to each other.

In some jurisdictions, such as Vietnam, there are mandatory provisions that must be included in the franchise agreement and that reflect the role of the franchisee.

V MOTIVATING FRANCHISEES

One of the most-quoted benefits of developing a franchise network is being able to tap into the self-motivation of franchisees, who will be more driven and enthusiastic than a company employee. While this can be true, many franchisees reach their comfort zone and fail to develop fully the territory they have been allocated. This will undermine the franchisor's sales. This is something that must be borne in mind when structuring the franchise and drafting its documentation, particularly in respect of cross-border franchising.

A provision granting the franchisee an exclusive territory is usually requested by the franchisee, particularly in international franchises. In view of the substantial investment the franchisee is making, this is understandable. However, it can create problems when the franchisee reaches his or her comfort level. A variety of drafting devices can be used to minimise this risk, such as minimum sales targets, minimum number of outlets, areas of prime responsibility, rather than exclusivity, and so on. However, these are merely ways of reducing the risk, not avoiding it. It is therefore vital to understand what motivates franchisees so the franchisor can help to motivate them to perform better.

It is often and incorrectly assumed that what will motivate a franchisee is maximising the financial returns. Instead, as Abraham Maslow described in his classic 1943 paper 'A Theory of Human Motivation',² human beings have varying and more complex motivations other than simply maximising income or profits.

i Maslow's hierarchy of needs

Applying Maslow's theory to franchisees, their potential needs, from basic to transcendental, include:

- a* physiological: breaking even and paying the bills;
- b* safety: making steady profits with no cash-flow worries;
- c* social: a better work–life balance and support and camaraderie with fellow franchisees;
- d* esteem: recognition as a successful business owner or winning business and franchisor awards; and
- e* self-actualisation: building a business empire (e.g., multiple stores and being in control of one's own destiny).

By understanding franchisees' 'why' – their unique and personal reason for investing in a franchise – the franchisor can tap into this motivation and help fuel their drive to build their business.

ii Understanding the franchisee life cycle

From first becoming a franchisee to eventually selling their successful business, most franchisees experience key stages that affect their levels of motivation and overall relationship with their franchisor. It is important for franchisors to understand these and adapt their approach accordingly. These stages are often referred to as the child, adolescent and adult phases:

- a* Child: during the first few months there is an initial honeymoon period with the franchisee excited but slightly nervous about their new adventure. Many franchisees have never operated their own business before so they are very dependent on the franchisor's initial training and support. Provided the franchisor has delivered on the promises it made during the recruitment process and the franchisee becomes profitable, they are likely to be happy and highly motivated.
- b* Adolescent: as the franchisee gains experience and has absorbed the initial training, they may begin to think they know better and try to change certain processes or ways of doing business. In the industry, we call this 'reinventing the franchise system'. In established franchise networks, this is counterproductive because the franchisor has tested those same ideas in years gone by and found they did not provide an optimal solution. As the franchisees' sales grow, so do their management service fee payments to their franchisor – these are normally a percentage of their turnover. They may begin to question and challenge the value they are receiving from their franchisor in return. This issue is more challenging for franchises built predominantly on know-how rather than a strong brand or franchise system; after this knowledge is transferred, the franchisee has a weak dependency on their franchisor.
- c* Adult: mature franchisees realise that they've signed a long-term agreement with their franchisor and, provided they both fulfil their roles, they can achieve more together.

2 Maslow, *A Theory of Human Motivation* (Merchant Books, 1943).

Successful franchisors can tap into this experience by inviting successful, long-serving franchisees to sit on a franchise advisory council and inviting their opinions and suggestions on key network decisions, while still retaining the final decision. However, at the same time, they need to ensure they are continually innovating and providing good value for these established franchisees, who will have ever higher expectations.

Some franchisees of course, never make it all the way through these key stages. Some may get stuck in the adolescent phase, especially if they are not as successful as they expected and look for someone to blame. As well as being aware of these key stages, some franchisors will explain them to new franchisees when they join. By signposting their likely emotions, it helps to build trust, shows they are not alone and helps them progress from adolescent to adult as quickly as possible.

iii Exit planning

Some franchisees may have reached their comfort zone, a level where their income is in line with their desires, so they take their foot off the gas and enjoy more time away from the business. One way to motivate franchisees out of this is through exit planning. Discussing how much they want to earn during their retirement and the desired resale value of their business can help to spur them into action and into growing the current business. If franchisees are also focused on maximising their profitability as reported in their annual accounts, their behaviours may change. For example, they may become more frugal when claiming expenses. If a small minority have also been earning revenue but not reporting this to the franchisor, breaching their agreement, they have an incentive to correctly report this so it can be taken into account when valuing their business.

A sign of a healthy franchise network is resales. This helps to demonstrate the ability for would-be franchisees to invest in the franchise, build their business and realise a healthy resale price several years later. New franchisees will often provide a different perspective and help to inject energy into the franchise network, especially if these can realise big gains in performance, showing incumbent franchisees the hidden potential.

The franchise agreement needs to capture this need for resales, and reflect and provide for it in an appropriate manner, with careful and subtle drafting.

VI ESTABLISHING A FRANCHISEE ADVISORY COUNCIL

A franchise advisory council (FAC) is a group of established franchisees who meet with the franchisor's executives to discuss commercial business issues that are relevant to the majority of franchisees. This could include product development, new marketing campaigns or operational changes designed to help move the franchise system forward.

FACs provide a structured vehicle for constructive two-way communication between the franchisor and franchisees. The FAC serves as a sounding board for the franchisor, before new initiatives are rolled out system-wide. Often, by engaging with the FAC, a new initiative will be better received by the network because the FAC has provided a metaphorical stamp of approval. For franchisees, the FAC provides a forum in which to voice their concerns and suggest ideas – in essence, it fulfils the basic human need to have a say and influence what will affect us. Ultimately the final decision-making authority should remain with the franchisor, but any franchise executive worth their salt will ignore the FAC's advice and feedback at their peril.

It is important to invest time to establish a FAC on solid foundations. A robust and well-thought-out legal structure is essential. A badly structured FAC will most probably have a negative impact on the business. A good FAC must have a carefully crafted constitution that governs how it operates, the frequency of meetings and the scope of what discussion items are acceptable (and unacceptable). What is *ultra vires* and what is *intra vires* must be clearly stated. If management service fees and royalties are not up for discussion, this must be made clear at the start. It can help to clarify that any changes and areas of discussion must be focused on growing the size of the pie, rather than how this is shared between franchisor and franchisee. The resulting discussions are likely to be much more collaborative and beneficial to all involved.

When drafting the constitution, franchisors need to consider how franchisees will be elected to the FAC. This can either be done by democratically electing franchisees or by the franchisor appointing them – both have pros and cons. A survey conducted by the International Franchise Association (Wulff, 2005)³ showed that of its franchisor members that have established franchise advisory councils, more than 90 per cent have their FAC members elected by franchisees, rather than appointed by the franchisor.

This creates a risk that the FAC could be dominated by disgruntled franchisees looking to gain greater stature and vent their frustrations. However, if appointed by the franchisor, other franchisees may feel that the FAC does not represent them, and they may disengage from the process. Nevertheless, with an effective chair and ground rules, a FAC can help to improve communication, give franchisees a voice and reduce the likelihood of franchisees starting an independent franchisee association.

VII LEVERAGING TECHNOLOGY

Effective franchisee relationships are built on information. Embedding a franchise management software solution can underpin this. For franchisees, an effective system can ensure they always have access to a library of the latest documents, procedures and templates from their franchisor. This may also help empower them to conduct their own local marketing, selecting from and tailoring centrally made marketing resources within parameters set by their franchisor. Many systems also include forums, which if properly set up, can aid peer-to-peer sharing of ideas and best practices, as well as discussion groups.

For the franchisor, a franchise management solution will typically be used by franchisee support executives to log key conversations and compliance records; by the legal team to track legal agreements; and by head office teams to communicate with franchisees. The system can also provide a wealth of business intelligence and facilitate franchisee-to-franchisee benchmarking.

3 Wulff (2005), 'Advisory Councils: Effective Two-Way Communications for Franchise Systems', International Franchise Association Franchise Relations Committee. Available at <http://franchise.org/files/Advisory%20Councils.pdf>.

VIII MAINTAINING FRANCHISEE SUPPORT AS YOU GROW

Independent franchisee-satisfaction surveys are a powerful tool in ensuring that franchise systems are in a rude state of health. This involves asking franchisees to provide feedback on the support they receive, the quality of their relationship with their franchisor and their overall satisfaction.

Research by Smith & Henderson shows that as franchisors expand beyond 40 franchisees, for many, their levels of franchise satisfaction decline.

There are two reasons for this. First, in a smaller franchise network, franchisees often have a direct channel through to the managing director or founder of the business. They are on hand if a franchisee has any issues, and their passion and commitment to the business and franchisee support is unmatched. As the franchise network expands, they need to recruit more staff and these may not share their commitment to great franchisee support and communication barriers can set in. Some franchisors may also be reluctant or unable financially to scale their support team in line with the growth of the franchise network, causing this to be diluted. Therefore, many franchisors that reach 40 franchisees struggle to sustain their good franchisee relations.

Such franchise systems either stay at this level, struggling to grow, or they invest time, money and energy improving their support and cultivating strong relationships with their franchisees. This fuels their growth and is the reason why there are many very large franchisors with outstanding levels of franchisee satisfaction and excellent franchisee relations. This is particularly so with franchise systems that have an international presence. Regular communication between franchisors and their franchisees, by way of independent surveys and otherwise, is a key way of enabling the business to update and adapt its legal documentation to effectively protect the best interests of the franchise system and help ensure its healthy growth.

Established franchisors face another challenge. Mature franchisees, who are often paying a significant monthly management service fee to their franchisor but are less dependent on them for training and day-to-day support, begin to question whether they are getting value for money. One way of tackling this is to establish new support initiatives aimed at helping these mature franchisees reach the next level. This can involve 'mastermind' groups, helping the franchisees benchmark their operational costs and advanced leadership training for them or their staff.

IX SUMMARY

When franchising works it is a powerful tool with which to grow a business – it allows companies with products and services that consumers want to rapidly expand their geographic reach while tapping into the entrepreneurial drive of an owner-operator. Relationships are at the heart of this success. The most successful franchise companies understand this – they invest and cultivate their relationships with their franchisees because it helps drive their success and ensure that their legal documentation is constantly developed to reflect their changing needs.

INTELLECTUAL PROPERTY

*Allan Poulter and Robert Williams*¹

I INTRODUCTION

Intellectual property (IP) rights are invariably at the heart of a franchise agreement. It is often the ability, through the ownership of IP rights, to prevent unauthorised third parties from reproducing aspects of the franchised business model that enables the franchisor to demand a royalty payment from prospective franchisees. These IP and related rights include trademarks, patents, trade secrets, confidential information or know-how, copyrights and designs. Some of the key features of these rights are set out below.

II TRADEMARKS

One of the most valuable assets of a franchised business is often the goodwill associated with the brand name. Trademark registrations represent the embodiment of this goodwill in a tangible asset that provides a monopoly right to use a name in relation to the goods and services covered by the registration. This confers the right to prevent the unauthorised use of the name or a confusingly similar name by a potential competitor. In addition to the brand name and logo traditionally associated with a business, there are many other aspects of a company's trade dress or get-up that may be protected through trademark registration. The definition of a trademark in many countries has been extended to include other potentially distinctive elements of a brand such as colours, shapes, sounds, animated marks and even smells, tastes and touch. Recently, the actual get-up of a retail outlet has been the subject of successful trademark applications.

It is important to remember that registered trademark rights are territorial, and a registration in one country will give no rights to the use of that name or get-up in another country. Indeed, the mere fact of having secured a registered trademark in one country will be no guarantee that the same mark will be available for use or registration in any other country. Therefore, where international expansion is anticipated it is essential to conduct initial clearance searches to identify any potential infringement risks and, if available, apply for the appropriate trademark registration to cover that territory. This is dealt with in more detail below.

A potential franchisee considering entering into an agreement to be a user of the brand name in a specific country is likely to require confirmation that appropriate searches have been conducted and registrations applied for. Suitable warranties and indemnities to this effect will be requested from the franchisor.

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i Trademark registration

Most countries of the world have a national trademark register. It is also possible to file for a European Union-wide trademark registration (an EU trademark (EUTM)) and a single registration covering a number of African countries (an African Intellectual Property Organization trademark). There is also an international filing system that provides a cost-effective method of filing national applications in certain countries that are signatories to the Madrid Agreement and Protocol. Following the United Kingdom's decision to leave the European Union (Brexit), it is important to consider securing registration at the UK Intellectual Property Office in addition to an EUTM registration, which is unlikely to cover the United Kingdom when it ceases to be a Member State.

When filing a trademark application, it is necessary to identify the specific goods and services to be covered by the registration, and identify the classes within which the goods and services fall. Most countries have adopted the Nice Classification System, which divides the register into 45 classes. It is usual for a trademark application to go through an examination process, which will assess whether the mark applied for satisfies the criteria for registration within that particular country. There is also, generally, an opposition period when third parties can seek to prevent the registration if they have an earlier conflicting right or if there is some other basis on which the registration should be refused.

One of the key values of a trademark registration is that potentially the rights can last in perpetuity. As long as the registration is renewed (the normal period for registration is 10 years) and the mark continues to be used correctly, then the registration will probably remain valid.

ii Clearance searches

Before launching a brand in a new geographical region or in respect of an extended range of goods and services, it is imperative that trademark clearance searches are first conducted to identify any potential infringement risks. In some cases, when an established brand in Country A takes the decision to expand its commercial activities through a franchise into Country B, the clearance searches will locate a local registration that could be relied upon by its owner to prevent the proposed use of that name in that country. In this situation, it will either be necessary to look at ways of overcoming the local registration (which could be by way of attacking the validity of the registration, acquiring the registration, or agreeing some form of coexistence with the owner of the conflicting right) or to consider adopting a new brand name for that particular country. This is clearly not ideal if the intention is to create a single brand for use within all countries into which the business intends to expand. An alternative, and usually less attractive, option would be to consider a rebrand of the entire business.

It is also important to bear in mind any local cultural or linguistic issues that may arise from the use of the brand name within a new country. A name that is perfectly suited to one country may have negative connotations in another.

iii Unregistered trademarks

In many countries it is possible to acquire enforceable rights in a name even in the absence of a trademark registration. However, relying upon unregistered rights should not be seen as a substitute for securing trademark registrations where these are available. It is generally more expensive and difficult to establish an infringement of an unregistered right than it is to succeed in an infringement action based on a registered trademark. Furthermore, the

existence of the trademark registration itself can prove to be a deterrent to a third party's use of the same or similar name (assuming, of course, that they have bothered to conduct clearance searches before adopting the name).

When conducting clearance searches in countries that recognise unregistered rights it is important, in addition to conducting searches of the trademark registers, to conduct further research to ascertain whether the name is being used in relation to relevant goods and services. This will generally involve internet searches and searches of local domain names and company registers and directories.

III PATENTS

A patent (like a registered trademark), is a territorially limited monopoly right, which enables its proprietor to prevent third parties from exploiting the invention claimed in the patent specification. Patent protection can be sought for products and processes that are both novel and inventive over the 'state of the art' as at the priority or filing date of the application for the patent (i.e., to be patentable the invention claimed in the patent specification must not have been disclosed publicly before the priority or filing date of the application, and must also not be obvious over the 'state of the art' at that date). To be patentable, the claimed invention must also meet a number of other criteria – in particular, it should be borne in mind that there are certain things that are exempt from patent protection in various jurisdictions – for example, computer programs, methods of doing business and mathematical methods. However, these exclusions vary from country to country, and so, for example, an invention that might fall foul of the computer program or method of doing business exceptions in the United Kingdom might nevertheless be patentable in the United States (albeit that the scope for obtaining such patents in the United States has narrowed recently).

In practice, while patents are less likely to form the key IP rights in a franchising model than trademarks, they may, in certain circumstances, form an extremely important part of the package of IP rights that are being licensed by the franchisor to the franchisee. This is particularly the case for businesses that provide technical information or equipment to the franchisee to enable them to operate the franchised business successfully. In such situations, certain processes (e.g., to manufacture the products to be sold by the franchisee) may be patented, and a licence under the relevant patents will need to be granted to the franchisee under the franchise agreement. It may also be the case that the product being sold by the franchisee is itself patented – a historical example of such a situation is that pertaining to Singer sewing machines, which were patented, and which were distributed in the United States via a network of franchisees in the 1850s.

i Patent registration

Most countries in the world grant patents, which must be applied for on a country-by-country basis. However, there is a centralised system for seeking patent protection in a number of European countries (including several that are not EU Member States, such as Turkey, Norway and Switzerland), via the European Patent Office (EPO). Patent applications filed at the EPO are examined centrally, and if the claimed invention is deemed patentable, the application will mature into a bundle of national patents in the various countries in which the applicant chooses to designate and validate the patents. It is hoped that in the not too distant future there will be scope to obtain a 'unitary patent' covering up to 25 of the current members of the EU (not currently including Spain, Croatia and Poland) via a single application at the

EPO. However, the details and implementation date of the system have not yet been finalised. There is also a system operated by the World Intellectual Property Organization, which permits an applicant for a patent in a country that is a member of the Patent Cooperation Treaty (PCT) to designate other PCT member countries. This streamlines the application process (and allows the applicant to rely on the initially filed application for the purposes of the patent's 'priority date', which is the date against which the novelty and inventiveness of the claimed invention is assessed). However, the application will still need to be examined (and if considered patentable, granted) on a national basis.

During the examination process, most patent offices will review the substantive patentability of the claimed invention following the completion of a search for 'prior art', as well as by reference to the relevant exclusions (e.g., for computer programs and methods of doing business, in the EPO). During the examination process, it is possible in some countries for third parties to file 'observations' with the examining patent office to try to persuade them that the patent should not be granted. Additionally, if the claimed invention is deemed patentable, in certain countries (and the EPO), there is an opposition period, during which third parties may challenge the validity of the patent.

Unlike registered trademarks, patents generally have a fixed maximum term of 20 years from the priority date. However, they need to be renewed annually, so it is possible for a patent to lapse in a particular country where it was originally registered, if the relevant renewal fees are not paid.

ii Petty patents or utility models

As a final point, it is worth mentioning that in some countries it is possible to obtain a lower form of patent protection, sometimes referred to as petty patents or utility models. These rights are intended to protect technical advancements (which may be incremental improvements to a previously patented product) that may not be sufficiently inventive to pass the threshold to obtain a full patent. They are generally of shorter duration (most commonly between six and 10 years), and are not formally examined in the same way as 'full' patents. Nevertheless, they may still be of value in the context of a franchising arrangement.

IV TRADE SECRETS, CONFIDENTIAL INFORMATION AND KNOW-HOW

The term 'trade secrets' is often used interchangeably with the terms 'confidential information' and 'know-how', to describe business or commercial information that has not been made public. Such information may be technical in nature (e.g., the specific parameters or tolerances to be employed in a manufacturing process, or the identity and specific amounts of ingredients to be used in a recipe for a food or drink product) or non-technical (supplier or customer data, financial data relating to pricing, etc.). Accordingly, it will be appreciated that in a franchising arrangement there will almost always be information and documentation disclosed by the franchisor to the franchisee that incorporates trade secrets that are necessary to run the franchised business successfully (and in accordance with the franchisor's standards).

While there is no internationally recognised definition of what constitutes a trade secret, there are a couple of overarching principles that are generally applicable. First, the relevant information must be secret, in other words, it must not be generally known or be easily accessible by the public (although it may still be known by a significant number of individuals); and secondly, the information must have been subject to reasonable steps by its 'owner' to keep it secret. There is no method by which trade secrets can be registered, and they

are arguably not a true IP right, in the sense that they cannot be formally assigned. However, in the context of a franchising arrangement, the use of trade secrets is certainly licensed, in the sense that the franchisor agrees contractually to disclose the relevant information to the franchisee, and to permit its use for certain specified purposes as set out in the franchise agreement. An EU directive covering trade secrets (including a definition of what constitutes a trade secret) has recently been passed and its provisions need to be enacted by Member States by June 2018. This should therefore lead to greater consistency of protection for trade secrets and confidential information in the EU in the future.

In theory, and provided the information in question does indeed remain secret (and restrictions on its disclosure are strictly maintained), a trade secret may last forever. For example, the recipe for Chartreuse liqueur is still a secret although the product has been on the market for over 400 years. However, this is an exceptional situation and most trade secrets do not end up retaining that status for even a fraction of that period. Nevertheless, to preserve the status of the franchisor's trade secrets for as long as possible, it is very important for the franchise agreement to set out clearly the details of the trade secrets being disclosed and the obligations on the franchisee to keep those trade secrets confidential. Indeed, it may be necessary, in relation to certain particularly fundamental trade secrets (e.g., the specific ingredients of a secret recipe) to strictly limit the disclosure of the information to a small number of individuals under very restrictive conditions and terms of use.

V COPYRIGHT

Copyright protects the physical embodiment of literary, dramatic, musical and artistic works (and therefore covers a very wide range of subject matter). However, in the context of a franchise arrangement, literary and artistic works are often the most important (literary works include reports, brochures, tables, marketing or training materials, and computer programs, and artistic works include photographs, logos, drawings, diagrams, plans, etc.). The aesthetic or artistic standard required to qualify for copyright protection is generally fairly low, although this does vary somewhat from country to country. Bearing in mind the range of works that are protected by copyright, it should be appreciated that there will always be copyright works the use of which will need to be licensed in a franchise agreement.

Copyright is not a strict monopoly right (like patents and registered trademarks) since the proprietor can only prevent actual copying of the relevant work. Accordingly, if a third party independently creates an identical (or more likely very similar) work, that will not infringe, since it is not the idea underlying the work that is protected, but rather the specific embodiment of that idea by way of the work. The proprietor of a copyright work is generally the person who actually creates the work (and not the person who commissions and pays for the work). The main exception to this arises when a person creates a work during the conduct of their employment. In those circumstances, the copyright in the work will generally belong to the employer (although the specific circumstances do vary from country to country).

There is no requirement to register a work for copyright to subsist, but in certain countries, most notably the United States, it is possible to register copyright works to establish a verifiable record of the date and content of the work in question, which may assist if infringement proceedings need to be pursued at some point in the future. In accordance with an international convention (the Berne Convention), to which the majority of the world are signatories, copyright works first published in any Berne Convention signatory country are also recognised (and hence enforceable) in any other signatory country. The duration of

copyright protection varies from country to country (and in some countries depending on the type of work). However, in most of the world, for literary and artistic works, copyright lasts for the life of the author plus either 50 or 70 years.

In a number of countries, databases are specifically protected by a separate right (in particular, an EU-wide database right exists). These database rights are distinct from copyright and protect against the copying of substantial parts of a database (whereas copyright may protect the selection, arrangement or presentation of the data). Database rights (like copyright) do not need to be registered but are generally of shorter duration than copyright (e.g., the EU database right has a term of 15 years).

VI DESIGNS

Perhaps of less relevance to most franchised businesses is the protection that may be afforded through registration of designs, or in some cases through unregistered design rights.

Design protection may be available in respect of the visual features of a product or, indeed, surface decoration or even other visual images such as logos. However, unlike trademark protection, there has been little by way of international harmonisation in the protection of design rights and local advice will generally be necessary to ascertain the availability and scope of design protection.

As a general rule, it is important to seek this advice and file any appropriate applications for the registration of a design before it is disclosed to the public or made commercially available (although some countries do allow for a limited period after public disclosure when a design application can be filed). As with trademarks, there is an EU-wide design registration system whereby a single design registration can be secured covering the entire European Union. The EU also recognises and protects unregistered designs although these rights confer a lower level and shorter period of protection. There is also an international filing system (the Hague Agreement) that can be utilised to secure cost-effective filings for design protection in those countries that are signatories to that particular agreement. Furthermore, the need to secure UK registrations following the decision of the United Kingdom to leave the European Union has to be considered.

DATA PROTECTION

*Ruth Boardman, Francis Aldhouse and Elizabeth Upton*¹

I THE ORIGINS AND EVOLUTION OF DATA PRIVACY LAWS

In Europe, the right to privacy is primarily intended as a protection from interference by the state so that individuals can develop their personalities in their relations with other human beings. Data protection, conversely, has evolved in parallel to the growth of information technology as a tool to protect individuals from potential abuses related to the processing of an individual's data; however, although these concepts are, in principle, separate and distinct, they both exist to protect fundamental rights, including an individual's right to a private life. Accordingly, there is a considerable overlap between privacy and data protection.

i Origins of privacy instruments

Although the concept of privacy law can be traced back as early as 1890,² modern national privacy laws in Europe only began to take shape after the Second World War, when the General Assembly of the United Nations adopted, on 10 December 1948,³ Article 12 of the Universal Declaration of Human Rights:

No one shall be subjected to arbitrary interference with his privacy, family home or correspondence, nor to attacks upon his honour and reputation.

Since the Second World War, the right to privacy or private life has been enshrined in a number of other regional fundamental rights instruments⁴ in Europe, culminating in Article 8 of the European Convention on Human Rights (ECHR),⁵ which provides that:

- 1 *Everyone has the right to respect for his private and family life, his home and his correspondence.*
- 2 *There shall be no interference by a public authority with the exercise of this right except such as is in accordance with the law and is necessary in a democratic society in the interests of national*

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2 Samuel D Warren and Louis D Brandeis, 'The Right to Privacy', *Harvard Law Review*, Vol. 4, No. 5 (15 December 1890), pp. 193–220.

3 Subsequently embodied in Article 17 of the International Covenant on Civil and Political Rights adopted by the General Assembly of the United Nations 16 December 1966.

4 For example, Article 11 of the American Convention on Human Rights, San José, Costa Rica, 22 November 1969.

5 Convention for the Protection of Human Rights and Fundamental Freedoms, Rome, 1950 Council of Europe European Treaty Series 5.

security, public safety or the economic well-being of the country, for the prevention of disorder or crime, for the protection of health or morals, or for the protection of the rights and freedoms of others.

While some fundamental rights are absolute and unqualified, the right to private life, at least in the European view, is not absolute and must be weighed against other fundamental rights, such as the right to freedom of expression to be found in Article 10 of the ECHR.⁶

The 1980 OECD guidelines on privacy were a powerful stimulus to national legislation outside Europe.⁷ These were developed at the same time as the Council of Europe's 1981 Data Protection Convention⁸ (Convention 108). The OECD's focus was the risk of national privacy laws prejudicing transborder data flows, whereas the Council of Europe emphasised the protection of fundamental rights.

ii Origins of data protection

'Data protection' as distinct from 'privacy' has a shorter legal history. It is a European concept and derives from concerns that rose to prominence in the 1970s⁹ about the power of automatic data processing – especially by state organisations. Following legislation in Sweden, Germany and France, but also building on the work of the Younger Committee¹⁰ in the United Kingdom, the fundamental principles of fairness, lawfulness, accuracy, necessity and security were brought together in Convention 108.

Data protection legislation is largely procedural rather than substantive and was developed to address concerns by legislators about the ease with which data could be transferred across borders. Safeguards were subsequently integrated into data protection legislation alongside the principles described in, *inter alia*, Convention 108, to ensure the protection of citizens' privacy rights, while recognising the speed of developments in technology.

II DATA PROTECTION CHALLENGES FOR INTERNATIONAL FRANCHISE RELATIONSHIPS

Many franchise arrangements will involve the collection and handling of customer data as well as employee and other business contact data. Much of this data will be personal data, the use of which is protected by data protection and privacy laws across the world. Currently, there are at least 100 countries in the world with such laws and Europe has some of the most stringent. Anyone thinking of setting up or expanding their franchise arrangement needs to be aware of these rules as non-compliance can lead to fines, claims for compensation, reputational damage and, in some cases, to prosecution for criminal offences.

6 For guidance on how to weigh one right against another, see *Axel Springer v. Germany* App No. 39954/08 (ECtHR, 7 February 2012) and *Von Hannover v. Germany* (No. 2) App Nos. 40660/08 and 60641/08 (ECtHR, 7 February 2012).

7 *OECD Guidelines on the Protection of Privacy and Transborder Flows of Personal Data*, Organisation for Economic Co-operation and Development, Paris 2002, ISBN 92-64-19719-2.

8 Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data, European Treaty Series 108, Strasbourg 1981.

9 For a history see Chapter 2, Colin J Bennett, *Regulating Privacy: Data Protection and Public Policy in Europe and the United States* (Ithaca, NY and London: Cornell University Press, 1992).

10 Home Office, Lord Chancellor's Office and Scottish Office Report of the Committee on Privacy (Cmd 5012 July 1972).

i Which laws will apply to my franchise arrangement?

One of the key challenges facing any international franchise relationship will be for companies to work out which data protection laws will be applicable to their business arrangements. Outside Europe, privacy laws tend to be country-specific (e.g., Australia, Argentina and Taiwan), state-specific or applied to specific sectors (e.g., financial services, health or marketing services). However, such laws can apply on the basis of where the individual is located rather than where the organisation that is processing their data is based (this is especially true for many Asian countries). Within Europe, the current legislation is the Data Protection Directive 95/46/EC (the Directive), which applies to all Member States of the European Economic Area (EEA) including the EU Member States, Norway, Iceland and Liechtenstein. However, on 25 May 2018, the General Data Protection Regulation (GDPR) comes into force and will be directly effective across all EU Member States, where it will replace existing data protection laws, as well as having broader territorial application. The GDPR has a wide territorial scope and will apply to organisations based outside the EU if they monitor or offer goods and services to individuals in the EU. The GDPR will increase the obligations on those who process personal data, and individuals will have stronger rights. There will also be significantly tougher powers of enforcement for national data protection authorities, with powers to fine organisations up to €20 million or 4 per cent of their total worldwide annual turnover for infringements of the new rules. The remainder of this chapter will focus on the changes that the GDPR will bring compared to the existing Directive.

There are additional privacy rules relating to the use of electronic communications set out in the Privacy and Electronic Communications Directive 2002/58 EC (as amended). This Directive is also under review, and an e-Privacy Regulation, currently in draft form, is expected to be implemented during 2018/2019. Some of these existing rules are specific to certain communications service providers (internet service providers (ISPs) and telecommunications companies (telcos)), such as the rules relating to security and confidentiality, breach notification and restrictions on the use of traffic and location data. The e-Privacy Regulation is expected to have a wider scope, so as to apply to all services functionally equivalent to telcos. There are also current provisions that apply to all organisations making use of electronic communications, including:

- a* requirements for notice and consent to use cookies and similar technologies; and
- b* rules relating to unsolicited marketing by email, fax and text, which can require opt-in consent in some situations.

These rules will be more relevant as franchisors and franchisees look to engage customers across a variety of channels. For example, if a franchisor wants the right to control the e-marketing campaigns to all customers, its franchisees are likely to be required to share access to customer databases with it as a matter of course. If so, the parties will need to think carefully about the relevant consents that may be required. These rules will also be relevant to organisations involved in targeted advertising programmes or who are interested in profiling their customers based on their online behaviour and browsing activities.

Loyalty schemes are another area where the rules may apply. In particular, organisations will need to be clear who is participating in the scheme and whether they have appropriate consents to be able to contact the customers.

While the aim of these rules is to set out certain common privacy standards for individuals across the EEA, it is important to note that they only impose minimum standards and many Member States have currently chosen to add different, and often higher,

standards into their local privacy legislation, which can vary significantly from country to country. This may, therefore, require local advice to be sought in every country relevant to the franchise arrangement. While the intention of the GDPR is to alleviate some of these differences, it still permits Member States to legislate in many areas, which will continue to challenge the GDPR's aim of consistency, and will mean that there continues to be a need for local law advice.

While the Directive only applies to data controllers established in the EEA and that process personal data in the context of that establishment, the GDPR will further extend the reach of EU data protection laws: it will apply to data controllers and data processors that have EU establishments and where personal data are processed in the context of such establishments (whether or not the actual data processing takes place in the EU). The GDPR will apply to controllers and processors that are not established in the EU but where they process personal data about EU data subjects in connection with (1) the offering of goods or services (payment is not required) or (2) the 'monitoring' of their behaviour within the EU (this would include tracking individuals online to create profiles, including where this is used to take decisions to analyse or predict personal preferences, behaviours and attitudes).

ii Who and what is covered by the European data protection rules?

The Directive will apply to personal data held in certain types of records that are processed by a data controller.

The data controller is 'the natural or legal person, public authority or agency or any other body which, alone or jointly with others, determines the purposes and means of the processing'. It is clear that franchisors will be data controllers in respect of the personal data they process. In many cases, the franchisees will also be independent data controllers with separate obligations to meet applicable privacy law requirements as they will also determine the purposes and the means of the processing.¹¹ The roles the parties play, however, is not always clear-cut and there may be circumstances in which the franchisees are acting as data processors (i.e., people – other than employees of a data controller – who process personal data on behalf of a data controller and have no independent control over the personal data). This distinction is important as most obligations in the Directive fall on data controllers. However, even though franchisees may be independent data controllers, franchisors will still need to put controls in place (in the franchise agreement) to protect the customer data belonging to the 'brand'. For example, a franchisor may, while protecting the IP in any customer database, wish to consider ensuring that the customer data are the confidential information of the franchisor and can only be used for the purposes of the franchise business, thereby ensuring that the data are destroyed or returned to the franchisor on termination of the franchise arrangement. Under the GDPR, direct obligations and liability placed will be placed upon data processors for the first time. This will include obligations to: (1) document their processing activities (both with the controller and more generally); (2) cooperate with supervisory authorities; (3) implement appropriate security; (4) designate a data protection officer (if applicable); (5) notify the controller of any security breaches; and (6) comply with the international data transfer rules. Breach of these obligations could expose the processor to

11 Note that the law can apply both to corporate organisations and to sole traders.

compensation claims from individuals and administrative fines under the GDPR. There are also specific provisions relating to joint controllers, requiring them to document arrangements and risk joint and several liability.

Personal data are broadly defined and will include information relating to a directly or indirectly identifiable natural person (i.e., an individual, not a company). This will include details such as name, postal address, email address, as well as facts and opinions held about an individual. Customer data, employee data and business contact data (including details held about franchisees) will all be caught by the definition. However, truly anonymous data, such as aggregated statistics, are not regulated by the Directive or the GDPR. Some data are to be regarded as sensitive and can only be processed under strict conditions. Such data include racial or ethnic origin, political opinions, religious or other beliefs, trade union membership, health, sex life, and the commission of offences and related proceedings. The GDPR retains a similar definition but also makes it clear that certain categories of online data may be personal such as online identifiers, device identifiers, cookie IDs and IP addresses. The categories of sensitive data are also extended to cover genetic and biometric data.

Personal data will be caught by the Directive and the GDPR if they are processed wholly or partly by automated means (broadly speaking, on computer) or in certain structured paper files. This would therefore include personal data captured online via social media and apps. The GDPR defines a 'filing system' as any structured set of personal data that is accessible according to specific criteria, whether centralised, decentralised or dispersed on a functional or geographic basis.

The Directive and the GDPR will apply to any operations performed on personal data, from collection through to transfer, disclosure, storage and destruction.

iii What are the main obligations under European data protection laws for franchisors or franchisees to consider?

Notification

The Directive placed an obligation on data controllers to give notification of their data processing activities to the applicable data protection authority. This obligation will (largely) disappear under the GDPR, although organisations will be required to demonstrate accountability by keeping new records of their processing activities (the type of data processed, the purposes for which they are used, etc.), which will contain similar information to that which under current laws controllers are required to register with data protection authorities.

Compliance with data protection principles

Franchisors and franchisees will need to comply with certain principles whenever they are processing personal data. In summary, these specify: data quality standards; the need for a lawful legitimate basis for processing the data; and security and confidentiality obligations and restrictions on transferring data outside the EEA (except in limited circumstances).

Data transfer restrictions will be of particular significance to international franchise arrangements. In short, if personal data belonging to EEA franchisors or franchisees are being transferred outside the EEA, then the relevant organisations will need to show that there is 'adequate protection' for the data, otherwise the transfer will be prohibited. For example, this will be relevant where an EEA franchisor or franchisee is using a US cloud provider to store its customer data. There are a number of solutions that can currently be relied upon to demonstrate adequacy, which include relying on standard contractual clauses contracts approved by the Commission, binding corporate rules, the EU–US Privacy Shield

framework, and unambiguous consent. Franchisors and franchisees should note that the US Safe Harbor scheme, which was considered to provide adequate protection, was declared invalid in October 2015 following the *Schrems* case. The standard contractual clauses and EU–US Privacy Shield are also being challenged on similar grounds, so this is an area that needs to be kept under review and on which appropriate legal advice should be sought early in the establishment of any international arrangement. Franchisors engaging with cloud providers would also need to ensure that the contract provides sufficient assurances around data security and access to data, particularly in the event that the franchisees are to be given some level of access. The GDPR also requires specific contractual obligations to be imposed on data processors.

The GDPR will also introduce more organisational and documentary measures on organisations. Organisations will have to demonstrate compliance with the GDPR, including by adopting data protection by design and by default, staff training programmes and undertaking audits. They will be required to maintain records of processing activity and to carry out privacy impact assessments in certain circumstances. Data protection officers may also need to be appointed. All data controllers will be subject to a general data breach notification regime.

Compliance with individuals' rights

The GDPR expands the rights granted to individuals to whom information relates (data subjects), including the following:

- a* a right to be provided with specified information about the processing of information relating to them (including the right to a copy of the actual information held, free of charge, if requested);
- b* a right to request an organisation to transfer information relating to them to another organisation;
- c* a right to request correction, deletion or restriction to the processing of their information;
- d* a right to object to certain types of processing; and
- c* rights in relation to significant automated decisions (such as computerised decisions regarding job applications).

An individual is also entitled to compensation if he or she suffers damage because a data controller has breached the provisions of the Directive or the GDPR, and can complain directly to the data protection supervisory authority about such breaches.

iv Cybersecurity

Franchisors and franchisees are becoming increasingly aware of the need to protect essential assets such as customer databases from theft, damage, destruction or unauthorised use and in particular from the threats posed by cyberattacks. Franchisors and franchisees will need to identify what assets need to be protected, identify the impact a cyberattack could have on their business, and have in place measures to protect the business (e.g., increased security controls, malware protection, restrictions on the use of removable media). This is a rapidly evolving field that is increasingly attracting regulatory attention. For example, there are already European laws requiring certain EU telcos and ISPs to notify security breaches to both the regulator and the affected individuals. In July 2016, the Network and Information Security Directive (the NIS Directive) was adopted by the European Parliament, and Member States have until 9 May 2018 to implement its provisions into national laws and a further six

months to identify ‘operators of essential services’. This Directive sets out measures designed to ensure critical IT systems in central sectors of the economy such as banking, energy, health and transport are secure. It will apply to operators of such essential services and to ‘digital service providers’. Each EU country will determine which organisations in their jurisdiction are operators of essential services and subject to the rules in line with criteria set out in the Directive, and will determine its own ‘effective, proportionate and dissuasive’ penalties for infringement. All organisations in these sectors that are identified by the Member States as operators of essential services will have to take appropriate security measures and notify significant incidents to the relevant national authority. The same applies to all entities that meet the definition of digital service providers. Micro and small enterprises are excluded from the scope of the NIS Directive. The NIS Directive also requires Member States to adopt their own cybersecurity and NSI strategies, defining strategic objectives and appropriate policy and regulatory measures, and to designate national authorities competent for monitoring the application of the NIS Directive at national level.

III KEY DATA PROTECTION RISKS

Each Member State has a supervisory authority or authorities that enforce data protection and must ensure that there are remedies and enforcement arrangements. Enforcement can result in administrative and criminal proceedings imposing fines and imprisonment; civil damages claims; and bad publicity, damage to goodwill, brand image and loss of consumer trust. Therefore, it is important for any international franchise arrangement to implement appropriate data protection measures to avoid such enforcement actions. Under the GDPR, the supervisory authorities will have the power to fine organisations up to €20 million or 4 per cent of their total worldwide annual turnover for infringements of the new rules.

TAX CONSIDERATIONS

*Mathew Oliver*¹

I INTRODUCTION

This chapter looks at tax issues relating to franchising. Specifically it focuses on the tax rules that commonly apply to franchising arrangements, the tax parameters under which franchising operations should be structured, the tax structuring options to consider and the anti-avoidance rules, which are increasingly focusing on international tax structuring. In this respect the main rules to be considered are those concerning the tax treatment of trading transactions and intellectual property (IP), as these are at the heart of any franchising arrangement.

In looking at these tax rules, we consider corporate franchisors and franchisees – partly for the sake of brevity and partly because (as far as franchisors are concerned) these are the entities most commonly involved in franchising arrangements.

We also look in this chapter at the rules from a UK perspective. While many of the principles of international taxation can be applied generically in a number of jurisdictions, tax is by its very nature highly jurisdiction-specific. In looking at the UK rules we hope to highlight those principles while grounding them in a real-life legal framework. We hope this approach will give the reader a broad understanding of the tax principles that apply to any situation while leaving him or her free to take more detailed local advice in any specific circumstance. It should be noted, however, that on 23 June 2016 the United Kingdom voted to leave the European Union. Until the terms of Brexit are finalised, it is not possible to clarify how this will impact certain aspects of this chapter, in particular access to EU treaties and those UK tax laws that are based upon EU law, such as value added tax (VAT). Given the uncertainty at time of writing, we have not examined the implications of Brexit in this chapter.

Finally, franchisors and franchisees are businesses and as such are concerned with all the tax issues that any business would be. This is not a tax book and we have therefore focused only on those issues that are specific to franchising businesses, namely the tax issues arising from the assets and services that make up the franchising arrangements. While we have in parts mentioned other tax issues that may be relevant, we have only done so in passing.

In broad outline, this chapter will consider the following tax issues in order:

- a* the general framework for the taxation of companies;
- b* withholding taxes that may be applicable on payment of franchise fees and royalties;
- c* the franchisor's tax position;
- d* franchisor tax planning;

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- e* the franchisee's tax position;
- f* transfer pricing; and
- g* value added tax.

II THE GENERAL FRAMEWORK FOR THE TAXATION OF COMPANIES IN THE UNITED KINGDOM

To understand how corporate franchisors and franchisees are taxed in the United Kingdom requires a broad understanding of the UK corporation tax regime – in particular as it applies to IP-based trading entities. We therefore commence with a very broad overview of the relevant UK corporation tax rules before applying these to the franchising context.

The corporation tax regime in the United Kingdom operates to tax companies. A company is defined as any body corporate or unincorporated association but does not include a partnership, a local authority or local authority association.² The amount on which corporation tax is chargeable is the sum of income computed under the various charging provisions and chargeable gains computed in accordance with the rules in the Taxation of Chargeable Gains Act 1992 (TCGA).

A company is subject to corporation tax in the United Kingdom:

- a* if it is a UK resident – on all its profits and gains regardless of the source of the profits or gains or whether they are remitted to the United Kingdom³ unless such profits or gains arise in a permanent establishment situated outside the United Kingdom in which case they may be exempt from tax under the branch exemption rules contained in Part 2 Chapter 3A of the CTA 2009; or
- b* if it is non-UK resident but carries on a trade through a permanent establishment in the United Kingdom – on all its profits arising from its trade through that establishment⁴ and chargeable gains on assets situated in the United Kingdom and used for the trade or permanent establishment.⁵

Companies that are not within the charge to corporation tax can still be subject to income tax on certain UK-sourced income (generally where tax is deducted at source). However, it was announced as part of the 2016 Autumn Statement that there will be consultation on bringing all offshore companies within the charge to corporation tax on their UK-sourced income.

Broadly speaking, a company is a resident of the United Kingdom if it is either:

- a* incorporated in the United Kingdom;⁶ or
- b* has its central management and control in the United Kingdom.⁷

Where a company is resident in both the United Kingdom and elsewhere (e.g., because it is incorporated in the United Kingdom but managed and controlled in another jurisdiction), it is necessary to consider whether there is a tiebreaker clause in the relevant double-tax treaty. Most treaties use the place of 'effective management' to determine where the company is

2 Corporation Tax Act 2009 (CTA 2009), Section 1121.

3 CTA 2009, 25(1); TCGA, Section 2(1).

4 CTA 2009, Sections 5(2) and (3).

5 TCGA, Section 10B(1).

6 CTA 2009, Section 14.

7 *De Beers Consolidated Mines Ltd v. Howe* 5 TC 198.

resident. This is a similar concept to the UK 'central management and control' test. Treaty non-resident companies are not resident for UK tax purposes.⁸ Following the publication of the final report for Action 6 of the 'Action Plan on Base Erosion and Profit Shifting' (BEPS) project (see Section V.iv), in future it is likely that many treaties will have a tiebreaker for residence based upon mutual agreement between the relevant tax authorities rather than simply place of effective management.

Subject to certain exemptions for preparatory or auxiliary activities, a company will have a permanent establishment in the United Kingdom if it has a fixed place of business in the United Kingdom through which its business is wholly or partly carried on, or its agent (other than an independent agent acting in the ordinary course of its business) has and habitually exercises in the United Kingdom authority to do business on its behalf. Following the publication of the final report for Action 7 of the BEPS project (see Section V.iv) it is likely that in future many treaties and the UK legislation will expand the situations where an agent creates a permanent establishment to include situations where the agent plays the principal role leading to the conclusion of contracts that are routinely concluded without modification, whether the contracts are in the name of the enterprise or for supplies of goods, rights, property or services by the enterprise. A fixed place of business includes a branch, office, factory, workshop, place of management or a building site.⁹

i Profits chargeable to corporation tax

Corporation tax applies to profits of a company. The term profit is defined as income and chargeable gains except insofar as the context otherwise requires¹⁰ and is as adjusted for tax purposes. In the case of a non-resident company with a permanent establishment in the United Kingdom, its chargeable profits will be profits from its trading income arising directly or indirectly through, or income from property or rights used or held by or for, the permanent establishment and chargeable gains subject to corporation tax.¹¹ However, there is an exemption from tax for most dividends or other distributions received from other companies (unless, generally speaking, the dividends or distributions are out of untaxed income).

Under the corporation tax regime, income is classified into different charging provisions, such as:

- a* trading income;
- b* property income;
- c* loan relationships and derivative contracts;
- d* intangible fixed assets;
- e* intellectual property, know-how and patents; and
- f* miscellaneous income.

As profits include chargeable gains, corporation tax applies to chargeable gains rather than capital gains tax¹² (which applies for individuals). Chargeable gains are generally calculated in accordance with the capital gains tax rules. However, the intangible fixed assets regime covers gains from assets included within that regime instead of the chargeable gains rules.

8 CTA 2009, Section 18.

9 CTA 2010, Section 1143.

10 CTA 2009, Section 2.

11 CTA 2009, Section 19.

12 TCGA, Section 8(1); CTA 2009, Section 4.

Expenditure that is allowed for tax purposes to reduce profits is determined in accordance with specific charging provisions. So, any disbursement or expense of an income nature wholly and exclusively laid out or expended for the purposes of trade is deductible against profits of that trade for corporation tax purposes in the same manner as for income tax.

Additionally there are specific rules outside the charging provisions that allow tax deductions against total profits; for example:

- a* capital allowances; and
- b* relief for accounting losses on loan relationships and derivative contracts.

The rules on trading income generally take precedence over other charging provisions.

Trading profits

The taxable profits of a trade must be calculated in accordance with generally accepted accounting practice but are subject to any tax adjustments.¹³ Therefore, the starting point for determining taxable trading profits is to use the profit before tax as disclosed in the accounts and adjust it for tax.

Some income and expenses may be excluded. For example, depreciation will not be allowed as a deduction for tax purposes,¹⁴ although expenditure 'capitalised' in accounts may be deferred revenue expenditure that could be deducted when amortised under generally accepted accounting principles. For capital expenditure, capital allowances relief may be available. Also, capital receipts are not chargeable to tax as income and should, therefore, not be included in calculating the trading profits unless there is a specific rule to the contrary.¹⁵

What is a 'trade'?

There is no statutory definition for 'trade' provided in the legislation and hence the term is interpreted in accordance with its ordinary meaning. The final report of the Royal Commission on the Taxation of Profits and Income in 1955 summarised the most important considerations in determining whether a taxpayer has engaged in trade (termed 'badges of trade'). The main factors to look at to indicate whether a transaction is trading in nature are as follows:¹⁶

- a* frequency of transaction – repeated transactions (as distinct from a one-off transaction) would be indicative of trading;
- b* relationship to the taxpayer's trade – a transaction relating to the trade that the taxpayer already carries on suggests that activity as being in the course of trade;
- c* subject matter – a transaction involving assets that are normally the subject matter of trading would be suggestive of trading (e.g., a bulk purchase of whisky or toilet paper is essentially a subject matter of trade, not of enjoyment);
- d* supplementary work – work done to repair or improve the item prior to sale suggests the transaction as being in the nature of trade; and
- e* profit motive and intention – purchases made with a view to resale at a profit or with the intention to resell in the short term indicates that the transactions are not by way of investment so should be trading.

13 CTA 2009, Section 46.

14 Income Tax (Trading and Other Income) Act (ITTOIA), Section 33; CTA 2009, Section 53.

15 ITTOIA, Section 96(1); CTA 2009, Section 93; and Business Income Manual BIM14060.

16 *Marson (Inspector of Taxes) v. Morton* 59 TC 381 at 393.

In *Ransom (Inspector of Taxes) v. Higgs*¹⁷ Lord Reid observed that the term ‘trade’ is used to ‘denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services’.

Relief for trading expenditure

Expenditure is deductible against trading profits for tax purposes if it is of an income nature and incurred wholly and exclusively for the purposes of trade.¹⁸ If expenditure is incurred for more than one reason, one of which is a non-business reason, then, an identifiable part of the expense that can be attributed as being wholly and exclusively for the purposes of trade will not be disallowed.

ii Intangible fixed assets regime

The intangible fixed assets regime in Part 8 of the CTA 2009 (previously Schedule 29 of the FA 2002) provides a broad base for taxation of IP and relief in respect of IP expenditure. It is based on the accounting treatment, thereby generally eliminating the need to make capital and income distinctions. The regime generally takes priority for corporation tax purposes against other charging regimes.¹⁹

It applies to intangible fixed assets that are:

- a* created by the company on or after 1 April 2002;
- b* acquired by the company on or after 1 April 2002 from an unrelated party; or
- c* acquired by the company on or after 1 April 2002 from a related party and either:
 - the asset was a chargeable intangible asset within Part 8 immediately before acquisition;
 - the seller acquired the asset on or after 1 April 2002 from a person who was not related to the seller or the acquiring company; or
 - the asset was created on or after 1 April 2002.²⁰

It is therefore often referred to as the ‘post-April 2002’ regime for IP.

Broadly speaking, an intangible asset is regarded as created or acquired on or after 1 April 2002 to the extent that expenditure on its creation or acquisition was incurred on or after that date.²¹

If part of the expenditure was incurred prior to and some on or after 1 April 2002, the asset is treated as being two separate assets with apportionment being on a just and reasonable basis.²² Internally generated goodwill is treated as created before 1 April 2002 if the business was carried on before that date.²³

¹⁷ [1974] 3 All ER 949.

¹⁸ ITTOIA, Section 34(1); CTA 2009, Section 54(1).

¹⁹ CTA 2009, Section 906.

²⁰ CTA 2009, Section 882.

²¹ CTA 2009, Section 883, Corporate Intangibles Research and Development Manual (CIRD) 11670.

²² CTA 2009, Section 883(5) to (7).

²³ CTA 2009, Section 884.

An intangible fixed asset is 'an intangible asset acquired or created by the company for use on a continuing basis in the course of the company's activities'.²⁴ The term intangible asset adopts the meaning used in UK generally accepted accounting principles (GAAP).²⁵

For accounting periods beginning 1 April 2015, companies have to adopt the new UK GAAP contained in FRS 101 and 102 (a small-company regime within FRS 102 applies from January 2016, although certain 'micro' entities can account under a new simplified accounting standard, FRS 105). FRS 101 is effectively International Financial Reporting Standards (IFRS) with simplified disclosure. FRS 102 is a new regime based upon IFRS for SMEs. Under both FRS 102 and FRS 105, an intangible asset is an identifiable non-monetary asset without physical substance. Such an asset is identifiable when:

- a* it is separable (i.e., capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability); or
- b* it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Under IFRS, 'intangible assets' are identifiable non-monetary assets without physical substance. Assets are identifiable if they are separable or arise from contractual or other legal rights (regardless of whether those rights are separable from the entity (paragraphs 8 and 12 of International Accounting Standard 38)).

Intangible assets include any IP, which means:

- a* any patent, trademark, registered design, copyright or design right, plant breeders' rights or rights under Section 7 of the Plant Varieties Act 1997;
- b* any right under the law of a country or territory outside the United Kingdom corresponding to, or similar to, a right within paragraph (a);
- c* any information or technique not protected by a right within (a) or (b) but having industrial, commercial or other economic value; or
- d* any licence or other right in respect of anything within paragraphs (a) to (c) inclusive, such as a licence to exploit a patent or copyright material.

The rules also apply to goodwill (which takes its accounting meaning).²⁶

The regime does not apply to an asset held:

- a* for a purpose that is not a business or commercial purpose; or
- b* for the purpose of activities that are not subject to UK corporation tax (other than where held for an exempt foreign branch).²⁷

Even though an asset may fall into the definition, there are exclusions such as assets for which plant and machinery capital allowances have previously been made, rights over tangible movable property, rights enjoyed by virtue of an estate, interest or right in or over land, etc.

²⁴ CTA 2009, Section 713(1).

²⁵ CTA 2009, Section 712; CTA 2010, Section 1127.

²⁶ CTA 2009, Section 715.

²⁷ CTA 2009, Section 803.

Royalties and other credits

The post-April 2002 regime treats all royalties and disposal proceeds (credits) as income and treats most costs (debits) on the acquisition and development of intangible fixed assets as expenses on the same basis as for accounting purposes.

Credits can arise as follows:

- a* receipts or royalties recognised in the company's profit and loss account;²⁸
- b* accounting gains in respect of the revaluation of intangible fixed assets²⁹ (up to the debits previously brought into account). No gain would be brought into account if the asset is depreciated for tax purposes on a fixed 4 per cent basis (see below);
- c* accounting gains in respect of negative goodwill written back following a business acquisition;³⁰
- d* accounting gains in respect of the reversal of previous accounting losses that led to deductible debits;³¹ and
- e* accounting gains in respect of realisation of intangible fixed assets.³² A realisation means an asset ceases to be recognised in the company's balance sheet because it has been sold or there is a reduction in the accounting value of the asset as the result of a transaction (as per UK GAAP). Assets with no balance sheet value are deemed to have one for these purposes.

Debits

Debits are brought into account for tax purposes in respect of expenditure on intangible fixed assets when recognised for accounting purposes. For example, debits can arise:

- a* where expenditure is recognised in the profit and loss account;³³
- b* where an accounting loss arises from capitalised expenditure because of amortisation or an impairment review;³⁴
- c* on the realisation of an intangible asset;³⁵ and
- d* on reversals of previous accounting gains.³⁶

Alternatively, a company may elect to write down an intangible fixed asset for tax purposes at a fixed 4 per cent per annum instead of the accounting rate of amortisation. An irrevocable election must be made in writing to HM Revenue & Customs (HMRC) within two years of the end of the accounting period in which the asset is created or acquired.³⁷ The election will take effect with respect to all capitalised expenditure in respect of that asset.

Following changes made in 2015, it will no longer be possible to obtain a debit for the cost of acquired goodwill or similar IP.

28 CTA 2009, Sections 721–722.

29 CTA 2009, Section 723.

30 CTA 2009, Section 724.

31 CTA 2009, Section 725.

32 CTA 2009, Sections 733–741.

33 CTA 2009, Section 728.

34 CTA 2009, Section 729.

35 CTA 2009, Section 735.

36 CTA 2009, Section 732.

37 CTA 2009, Section 730.

Where transfers of intangible assets take place between related parties, the transfer is generally treated as taking place at market value, either under Section 845 of the CTA 2009 or under transfer pricing rules.

The manner in which debits and credits are brought into account will depend on the use to which the IP is put. Assets held for the purposes of a trade will give rise to trading credits or debits. Assets held for a property business are taxed as profits or losses of that business. Non-trading assets give rise to a separate head of non-trading profits. If there is a non-trading loss then the taxpayer is entitled to deduct the non-trading loss against total profits of the relevant accounting period, surrender it by group relief or carry it forward to relieve in future periods.³⁸

iii Pre-April 2002 regime

For IP that is not within the intangible fixed assets regime (see above), the old corporation tax rules continue to apply, which are in many cases equivalent to income tax rules. We refer to these rules as the 'pre-April 2002 regime'.

Under the pre-April 2002 regime for corporation tax, amounts are generally included in or deducted from income to the extent that such items are not capital in nature and amounts are within the chargeable gains rules to the extent that they are capital in nature. So it is crucial to determine whether a receipt or expense is income or capital in nature. The distinction must be interpreted in accordance with the ordinary meaning of the terms by having regard to case law.

A leading authority on this topic, *Inland Revenue Commissioners v. John Lewis Properties plc*³⁹ provides the following considerations to determine whether a receipt is income or capital in nature:

- a if the payment is for the disposal of an asset that has an enduring or long-lasting quality then the payment is likely to be capital;
- b if the payment is of a single lump sum for the once and all disposal of a particular asset, it is more likely to be a capital payment. If the payment is one of a series of recurring payments made at frequent intervals, it is likely to be income in the hands of the payee; and
- c if the disposal of the asset is accompanied by a transfer of risk in relation to it, this suggests that the sum paid for the asset is capital.

The following receipts were held to be income:

- a payments from a number of overseas companies for the sale of know-how relating to aero-engine manufacture, where the repetitive exploitation of know-how was seen as an extension of trade;⁴⁰
- b payment (comprising lump sum and royalty) for a non-exclusive licence to manufacture not more than 75,000 ammunition boxes on a non-exclusive basis at a specific royalty;⁴¹ and
- c lump sum consideration for information consisting of secret processes and formulae.⁴²

38 CTA 2009, Section 753.

39 [2003] STC 117.

40 *Jeffrey v. Rolls-Royce* (1962) 40TC443.

41 *Rustproof Metal Window Co Ltd v. IRC* [1947] 2 All ER 454.

42 *Coalite & Chemical Products v. Treeby (HM Inspector of Taxes)* 48 TC 171.

The following receipts were held to be capital:

- a lump sum for the grant of a 10-year sole licence in the United Kingdom;⁴³
- b lump sum payments in respect of exclusive licences to foreign companies in various countries in which the taxpayer covenanted to keep out of that country;⁴⁴ and
- c lump sum payment for the taxpayer agreeing not to establish another tyre soling plant, which was effectively an exclusive covenant not to compete.⁴⁵

Expenditure will be classified as capital if it is incurred with a view to bringing into existence an asset or advantage for the enduring benefit of the trade.⁴⁶ For example, a sum paid for the acquisition of a business was held to be capital in nature.⁴⁷ In *Tucker v. Granada Motorway Services Limited*,⁴⁸ the House of Lords determined that expenditure incurred for a variation of a lease was capital in nature even though it had no balance sheet value. Having regard to the case law,⁴⁹ HMRC offers the following guidance to indicate capital expenditure:

- a expenditure on an intangible benefit or advantage (for example, trading agreements, licences or other intangibles) in which the identifiable asset is sufficiently substantial and enduring;⁵⁰
- b expenditure that secures a permanent commercial advantage such as the closing down of a potentially damaging competitor;⁵¹
- c expenditure incurred in connection with the acquisition, alteration, enhancement or defence of the fundamental structure of a business;⁵² and
- d a payment that secures an enduring benefit to the business in terms of a change in organisation or structure is likely to be capital⁵³ as distinct from one that has the effect of preserving the existing business, its goodwill or assets (which would be on revenue account).⁵⁴

Other specific charging provisions

If a company receives income or gains from IP rights, which do not amount to profits of its trade, then there are a number of specific charging provisions that could catch such receipts.

However, as the intangible fixed asset regime also applies to royalties relating to pre-April 2002 IP;⁵⁵ the pre-April 2002 corporation tax regime for intangibles is in almost all circumstances limited to rules relating to capital disposals of such IP and certain specific

43 *British Salmson Aero Engines v. IRC* (1938) 3 All ER 283.

44 *Murray (HM Inspector of Taxes) v. Imperial Chemical Industries Ltd* (1967) 44 TC 175.

45 *Margerison v. Tyresoles Ltd* (1942) 25 TC 59.

46 *British Insulated and Helsby Cables v. Atherton* [1926] AC 205, HL.

47 *Triage Services Ltd v. HMRC* Sp C 519 [2006] SCD 85.

48 [1977] STC 353.

49 See also *Strick v. Regent Oil Ltd* (1965) 43 TC1; *Vallambrosa Rubber Co Ltd v. Farmer* (1910) 5 TC; *Sun Newspapers Ltd v. Federal Commissioner of Taxation* (1938) 61 CLR 337.

50 Business Income Manual BIM35505.

51 Business Income Manual BIM35510.

52 Business Income Manual BIM35525.

53 Business Income Manual BIM35545.

54 Business Income Manual BIM35540.

55 CTA 2009, Sections 882(7) and 896.

circumstances, which are excluded from the regime. The general position would be that capital disposals of pre-April 2002 IP should be within the chargeable gains rules. There are, however, some specific rules that override this treatment. We now consider these specific rules.

Disposals of know-how

There are four specific tax rules that could apply to disposals of pre-April 2002 know-how:

- a* disposals in the course of a trade: Section 177 of the CTA 2009;
- b* disposals of know-how as part of a disposal of trade: Section 178 of the CTA 2009;
- c* other disposals of know-how: Sections 408–410 of the CTA 2009; and
- d* capital allowances charges: Section 462 of the Capital Allowances Act 2001 (CAA 2001).

In respect of the first rule, receipts from the disposal of know-how in the course of trade⁵⁶ are specifically treated as trading income – even if capital in nature – under Section 177 of the CTA 2009 unless brought into account under Section 462 of the CAA 2001. Where the trade is also disposed of, the receipt is treated as a capital payment for goodwill although this may be disappplied by election.⁵⁷ The ability to make such an election and the more general trading treatment under Section 177 of the CTA 2009 is disappplied where the transfer is between connected parties.

Profits arising in a year on the disposal of know-how otherwise than in the course of a trade, or for giving or fulfilling an undertaking in connection with such a disposal that restricts any person's activities (whether or not enforceable), are taxed under Sections 908–910 of the CTA 2009. A deduction is allowed for expenditure wholly and exclusively incurred in the acquisition or disposal of know-how (so long as it is only taken into account once). This tax charge does not apply where:

- a* the disposal is taxed as trading income under Section 177 of the CTA 2009;
- b* the consideration is taxed under Section 462 of the Capital Allowances Act on disposal of the know-how;
- c* where the consideration is treated as a capital receipt for goodwill on the disposal of a trade under Section 178 of the CTA 2009; or
- d* where the disposal is by way of sale between bodies of persons under common control.⁵⁸

The term 'know-how' for the above tax charges is defined as any industrial information or techniques likely to assist in:

- a* manufacturing or processing goods or materials;
- b* working a source of mineral deposits (including searching for, discovering or testing mineral deposits or obtaining access to them); or
- c* carrying out any agricultural, forestry or fishing operations.

There is also a specific capital allowance regime for know-how (see Section VI). Where such capital allowances have been obtained and the know-how disposed of, then the disposal value on such know-how has to be brought into account under Section 462 of the CAA 2001, in which case it will reduce the capital allowances available in the period or, if the company is liable to a balancing charge, be treated as a receipt of the trade.

56 CTA 2009, Sections 176–179.

57 CTA 2009, Section 178.

58 CTA 2009, Section 909.

Disposals of patent rights

Tax is charged on any non-trading profits from the sale of the whole or part of any patent rights.⁵⁹ For non-residents, the tax is charged only on the sale of UK patent rights. The term patent rights means the right to do or authorise the doing of anything that, but for the right, would be an infringement of a patent.⁶⁰ Licences are treated as sales. The grantor of a licence is treated as making a part sale unless the licence is exclusive and for the remaining period of the rights, in which case it is treated as the sale of the whole of those rights.

The profit brought into charge is the difference between any capital sums comprised in the proceeds of sale less any deductible costs.⁶¹ The deductible costs are the capital costs of the rights sold (less amounts met by certain other persons – e.g., public bodies) and incidental expenses incurred by the seller in connection with the sale of the patent rights.⁶²

Under spreading rules, the seller (if UK tax-resident) must spread the profits over six years for tax purposes unless he or she elects to tax it all in the year of receipt.⁶³ Non-residents selling UK patent rights will be taxed in the year of receipt unless they elect to spread the income over six years.⁶⁴ Any such election for income tax purposes must be made on or before the first anniversary of the self-assessment filing date for the year of receipt.

Where non-residents are charged to tax under these rules, the person paying the consideration may have to deduct tax at source.

Capital allowances are available for capital expenditure incurred to acquire patent rights for the purpose of a trade within the charge to UK tax⁶⁵ or for patent rights that give rise to UK taxable income.⁶⁶ Where there is a disposal of patents for which such allowances have been given, then the disposal value will need to be brought into account for capital allowances purposes (limited to the capital expenditure incurred on the patent). If this gives rise to a balancing charge, it would again be taxed as a receipt of the trade (or potentially non-trading income).

Chargeable gains

A company will be within the charge to corporation tax on its chargeable gains if it is resident in the United Kingdom or trading in the United Kingdom through a permanent establishment. If trading in the United Kingdom through a permanent establishment, corporation tax on chargeable gains will apply to any UK-situated assets used in or for the purposes of the permanent establishment.⁶⁷

59 CTA 2009, Section 912.

60 CTA 2009, Section 912(3).

61 CTA 2009, Section 913(1).

62 CTA 2009, Section 913(2).

63 CTA 2009, Sections 914–915.

64 ITTOIA, Section 591; CTA 2009, Sections 916–917.

65 CAA 2001, Section 468(1).

66 CAA 2001, Section 469.

67 TCGA, Section 10B.

The rules as to whether an IP asset is a UK asset or a non-UK asset are summarised below:⁶⁸

Asset type	UK asset if:
Goodwill	Trade, business or profession carried on in the United Kingdom
Patents, trademarks and registered designs	Registered in the United Kingdom
Rights or licences to use a patent, trademark or registered design	Rights exercisable in the United Kingdom
Copyright, design right, franchises	Rights exercisable in the United Kingdom
Rights or licence to use the copyright, work or design in which the design right subsists	Rights exercisable in the United Kingdom

Capital gains tax (and corporation tax on chargeable gains) applies on a disposal of an asset.⁶⁹ Disposals include part disposals⁷⁰ as well as situations where capital sums are derived from assets,⁷¹ which includes capital sums received as consideration for use or exploitation of assets and capital sums received for forfeiture, surrender or refraining from exercise of rights. Similarly the extinction or abrogation of a right or restriction over an asset by the person entitled to enforce it is considered a disposal of such a right or restriction.⁷²

A chargeable gain or loss is calculated as the proceeds received on disposal (consideration) less the base cost (cost of the asset, expenditure wholly and exclusively incurred for the purpose of enhancing the value of the asset, costs incidental to the acquisition and costs incidental to making the disposal).⁷³ For a corporate taxpayer, the base cost can be increased by indexation (i.e., the base cost is increased in line with the retail price index) from the date of acquisition until the date of sale. The consideration will be deemed to be the market value (as distinct from the actual amount received) where the transaction is between connected parties or not at arm's length.⁷⁴ Gains are not chargeable to corporation tax on chargeable gains if they are subject to tax as income.⁷⁵

iv Reorganisations

To allow intra-group transactions to be effected in a tax-neutral manner, there are specific rules that allow assets to be transferred within a UK group without crystallising capital gains tax or a tax charge under the intangible fixed asset rules⁷⁶ subject to 'de-grouping charges' if the transferee leaves the group within six years of the date of the transfer.⁷⁷ A condition of such transfers is that the transferee is within the scope of corporation tax in respect of the asset after the transfer.⁷⁸

To prevent assets being taken out of the UK tax net by migrating companies offshore, there are also charges under capital gains and chargeable intangible asset rules should

68 TCGA, Section 275.

69 TCGA, Section 1.

70 TCGA, Section 21.

71 TCGA, Section 22.

72 TCGA, Section 29(5).

73 TCGA, Sections 37–38.

74 TCGA, Sections 17–18.

75 TCGA, Section 37.

76 TCGA, Section 171; CTA 2009, Section 775.

77 TCGA, Section 179; CTA 2009, Section 780.

78 TCGA, Section 171(1A); CTA 2009, Section 775(1)(c).

a company migrate its tax residence offshore,⁷⁹ albeit with potential to postpone any charge if the company remains a 75 per cent subsidiary of a UK company.⁸⁰ Following ECJ case law⁸¹ and a request from the European Commission to change UK law, the Finance Act 2013 saw an amendment to the migration rules whereby a company can either pay the exit charge in instalments or can pay the tax 10 years after migration or, if earlier, on disposal of the assets.

For chargeable gains assets and for chargeable intangible assets, there are in certain circumstances rules that allow assets to be transferred to companies resident offshore in a tax-neutral manner provided in Section 140, Section 140A, Section 140C, Section 140E and Section 140F of the TCGA and equivalent rules Chapter 11 of Part 8 of the CTA 2009. For example, Section 140 applies to a UK company carrying on a trade outside the United Kingdom through a permanent establishment that transfers the trade for an issue of shares or shares and loan stock whereby it owns after the transaction at least 25 per cent of the transferee's ordinary share capital. Any gain is rolled over into the shares although may still be payable if any of the assets are transferred within six years. The rules in Section 140A to 140F of the TCGA cover situations set out in the EU Merger Directive and EU Tax Merger Directive⁸² as well as the European Directive establishing the European Company and European Cooperative Society. The rules on mergers are outside the scope of this chapter, but a franchisor seeking to migrate part of its trade offshore will need to consider whether it could fall within any of these particular rules. It might also consider transferring assets to a foreign permanent establishment, which could be exempt from tax under the exemption in Chapter 3A of the CTA 2009.

III DEDUCTION OF TAX AT SOURCE

There are a number of provisions that give rise to deduction of tax at source on IP royalties that could apply to franchising arrangements. However, following the Finance Act 2016, the position has simplified where payments are made to a person whose usual place of abode is outside the United Kingdom. Under Section 906 ITA, there is a requirement for a person who pays a royalty or other sum for the use of IP that is within the charge to income tax or corporation tax to a person whose usual place of abode is outside the United Kingdom (or makes a periodic payment to certain persons who have acquired their rights from such a UK person) to withhold tax at the basic rate and to account for that tax to HMRC.

For this purpose IP means:

- a* copyright of literary, artistic or scientific work;
- b* any patent, trademark, design, model, plan or secret formula or process;
- c* any information concerning industrial, commercial or scientific experience; or
- d* public lending right in respect of a book.

There are exclusions for copyright payments relating to cinematographic films or video recordings, or their soundtracks.

If a payment does not fall within the provisions of Section 906, it may nevertheless give rise to an obligation to deduct tax at source under:

79 TCGA, Section 185; CTA 2009, Section 859.

80 TCGA, Section 186; CTA 2009, Section 860.

81 *National Grid Indus BV v. Inspecteur van de Belastingdienst Rijnmond* C-371/10 (NGI).

82 Council Directive 2005/56/EC and Council Directive 2009/133/EC.

- a* qualifying annual payments (ITA, Sections 900 and 901);
- b* patent royalties (ITA, Section 903); and
- c* capital payments made for patents (ITA, Section 910).

We consider these in more detail below.

i Qualifying annual payments

Qualifying annual payments are subject to deduction of tax under Sections 900 (payments by individuals) and 901 (other payers) ITA. Under Section 899 ITA, a qualifying annual payment must meet the following conditions:

- a* it must be an annual payment;
- b* it must arise in the United Kingdom;
- c* the payment must be charged to tax under various provisions, including:
 - to income tax under:
 - ITTOIA, Section 579 (royalties from IP);
 - ITTOIA, Chapter 4 of Part 5 (telecommunications rights);
 - ITTOIA, Chapter 7 of Part 5 (annual payments not otherwise charged); or
 - to corporation tax under Chapter 7 of Part 10 CTA 2009 if the recipient is a company (annual payments not otherwise charged to tax); and
- d* the payment must not constitute interest and must not include certain other payments (e.g., charitable donations).

An annual payment is one that is payable under a legal obligation and is capable of recurring over a period of more than 12 months.⁸³ The amounts must be income receipts, and not a capital receipt, so a capital amount paid in instalments would not constitute an annual payment. The amounts must also be 'pure income profit' in the hands of the recipient. Broadly speaking, pure income profit comes to the recipient without the recipient having to do anything in return. Therefore, payments for goods or services cannot be an annual payment.⁸⁴

An individual who makes a qualifying annual payment will only be required to deduct tax if the payment is made for genuine commercial reasons in connection with the individual's trade, profession or vocation.⁸⁵ There is no similar test for companies.

In the franchising context, this is unlikely to apply following the 2016 changes to the deduction of tax rules, as payments to non-residents will be covered by Section 906 ITA and payments to UK companies will generally be excluded from the obligation to deduct tax (see Section III.iv). These sections will therefore only apply where the franchisor is a UK unincorporated business.

ii Patent royalties

To the extent that a patent royalty is not a qualifying annual payment and is not covered by Section 904 (annual payments made in consideration of dividends or exempt consideration, which is unlikely to be applicable in the context of franchising), it may be subject to deduction of tax under Section 903 of the ITA. This section applies to a royalty or other sum in respect

83 *Moss Empires Ltd v. IRC* (1937) 21 TC 264.

84 *Earl Howe v. CIR* (7 TC 289).

85 ITA, Section 900.

of the use of a patent, which arises in the United Kingdom and is charged to income tax or corporation tax. Again, following the 2016 changes, this will only apply where the franchisor is a UK unincorporated business.

iii Sales of UK patent rights

If a UK person buys rights in a patent from a non-resident seller that is liable for UK tax in respect of the sale under Section 587 of the ITTOIA 2005 or Section 912 of the CTA 2009, then the purchaser is obliged to deduct basic rate tax from the purchase price and account for this to HMRC.⁸⁶ For these purposes 'patent rights' means a right to do or authorise the doing of any thing that, but for the right, would be an infringement of a patent and thus includes licences. For non-resident sellers the charges only apply to patents granted under UK law.

iv Excepted payments

The above requirements to deduct tax under Sections 901 (qualifying annual payments), 903 (patent royalties), 906 (IP royalties) and 910 (proceeds of sale of patent rights) do not apply where the payer is a company, local authority or partnership (with a corporate or local authority partner) if such a payer has a reasonable belief that the payment is an excepted payment and, in the case of deductions under Sections 901 and 903, the payer itself has no 'modified net income' (calculated under Section 1025 of the ITA) that would be subject to income tax.

Excepted payments include payments where the person beneficially entitled to the income is:

- a* a company resident in the United Kingdom;
- b* a company not resident in the United Kingdom that carries on a trade in the United Kingdom through a permanent establishment and the payment will be brought into account in computing the UK chargeable profits of the non-resident company;
- c* a body of the type listed in Section 936 of the ITA (broadly, certain public bodies and entities that are generally tax exempt; e.g., charities); or
- d* a partnership beneficially entitled to the income, each partner in which must be an entity within (a) to (c) or the European Investment Fund.

If the payer 'reasonably believes' that an exemption applies it may pay gross, but if that belief proves incorrect, the withholding obligation is re-imposed so the payer is at risk. There is no general mechanism for HMRC to certify that payments may be made gross under these rules.

v Source of royalty

The Finance Act 2016 also brought in new rules to define the source of royalties or other sums paid in respect of IP where the payer is non-UK resident but the payment is made in connection partly with a trade carried on by a UK permanent establishment of the payer. Under these new rules, the entity will need to apportion on a just and reasonable basis the proportion of the payment that relates to the trade carried on through the UK permanent establishment.

86 ITA, Section 910.

vi Anti-treaty shopping rules

The 2016 changes also introduced anti-treaty shopping rules.⁸⁷ Under these rules double-tax treaty arrangements will not apply to payments to a connected person made under a double-tax treaty tax avoidance arrangement (where obtaining treaty relief is contrary to the object and purpose of the treaty and is the main, or one of the main, purposes of the arrangements) and any tax so deducted is not creditable against corporation tax of a recipient company.

vii EU Interest and Royalties Directive

From 1 January 2004, Council Directive (EC) No. 2003/49 introduced a common system of taxation applicable to interest and royalty payments made between associated companies of Member States. These provisions have force in the United Kingdom (ITTOIA, Sections 757–767 and Section 914 of the ITA) and provide an exemption from income tax on royalties where:

- a* the payer of the royalty is a UK company or a UK permanent establishment of an EU company; and
- b* the person beneficially entitled to the income is an EU company but not such a company's UK permanent establishment or non-EU permanent establishment.

Both companies must be 25 per cent associates, that is, one company holds at least 25 per cent of the capital or voting rights in the other or there must be a parent company of both companies that holds such a share in each.

Payment gross is permitted where the payer reasonably believes the exemption applies, but (as for the excepted payments rules) the payer is at risk if that belief is incorrect. As a practical matter, if the payee is an EU company, the payer's risk can be eliminated as the payee company could make a claim under the applicable double-tax treaty that should result in HMRC issuing a payment directive to the payer to apply a reduced or zero rate of withholding (see further below).

viii Double tax treaties

Royalties paid by a UK resident to a resident of a country with which the United Kingdom has a double-tax treaty may be exempt from withholding taxes as a result of the operation of a royalty article of an applicable double-tax treaty. Even if the royalty article does not extinguish the withholding tax liability it will normally impose a restriction on the amount that can be deducted. There are, broadly speaking, three main types of tax treaty upon which most are based; these are the OECD Model Tax Convention, the UN Model Tax Convention (applicable usually for developing nations) and the US Model Tax Convention.

In respect of royalties, Article 12 of the OECD Model Tax Convention provides as follows:

- 1 Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.*
[The UN Model treaty specifically allows tax to be deducted at source up to a percentage.]

87 Section 917A ITA.

2 *The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.*

[The US Model treaty also covers 'other works' as well as certain gains derived from the alienation of any of the above property. The UN Model treaty also applies the royalty provisions to fees for the use of or right to use industrial, commercial or scientific equipment.]

3 *The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 (business profits) shall apply.*

[The UN Model is similar in this respect save that it also has a carveout for independent personal services supplied in the state and for other business activities carried on in the state of the same or similar kind as those effected through the permanent establishment.]

4 *Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.*

A non-resident licensor must, unless Section 911 of the ITA applies (see below), make an application to its own domestic tax authorities claiming relief under the relevant article of the double-taxation treaty (DTT) and demonstrating that it fulfils the requirements of that article. If the parties are unconnected, these will usually be limited to tax residence and beneficial ownership of the royalty payments. If the recipient is a 'conduit' vehicle, it may struggle to satisfy the beneficial ownership requirement following the case of *Indofood International Finance Ltd v. JPMorgan Chase Bank NA*.⁸⁸ This UK case (the principle in which is being applied generally by many tax authorities – although cf. the Canadian cases of *Prevost*⁸⁹ and *Velcro*⁹⁰) suggests that the meaning of beneficial ownership in tax treaties is more limited than the legal test and will not apply where a conduit vehicle has back-to-back arrangements to pay on receipts of interest or royalties.

Once satisfied the treaty conditions apply, the non-resident's tax authority will certify to HMRC that the licensor is entitled to relief under the relevant DTT and HMRC will then direct the payer to make future payments at the rate specified under the relevant DTT.

Under Section 911 of the ITA, a UK company that makes a payment of royalties otherwise subject to deduction of tax may, if it thinks fit, calculate the sum of income tax to be deducted by reference to the rate applicable in the relevant tax treaty (if lower than the UK rate) and make the payment on that basis (that is, without receiving a payment direction from HMRC following a treaty claim). However, the company must reasonably believe that, at the time the payment is made, the payee is entitled to relief in respect of the payment under

88 [2006] STC 1195.

89 2009 DTC 5053 (FCA).

90 2012 TCC 57.

a relevant tax treaty. As before, the payer is at risk if the payee is not entitled to a reduced rate of withholding under the treaty. However, the payee can make a claim under the treaty that will result in the payer receiving a direction to pay at a reduced rate from HMRC and hence, if there is any doubt, mitigate risk.

ix Issues relating to royalty payments in the franchising context

A major component in any franchising agreement will be a payment of royalties for use of the brand and other IP licensed to the franchisee. As stated above, a franchisee paying a royalty for use of IP may have to deduct tax at source. The manner in which a deduction will be required will depend on the type of IP and the residence of the payee. In the context of a franchising arrangement, payments are likely to be made to a corporate franchisor that will either be UK tax-resident or non-resident. Payments to UK tax-resident corporate franchisors by UK franchisees should not give rise to any withholding tax issues.

If the payment is to a non-UK tax-resident company by a UK-based franchisee, withholding tax will, from 28 June 2016, apply to all royalties and other payments in respect of IP. Assuming that the recipient is not trading in the United Kingdom through a permanent establishment, royalties will give rise to an obligation to deduct tax unless the UK rules are overridden by a tax treaty or the Interest and Royalties Directive.

In any event, the franchisor will be carrying out significant activities under the franchising agreement, including exercising control functions and providing support and assistance services on a recurring basis. The manner in which the franchisor carries out these functions may give rise to a permanent establishment of the franchisor in the United Kingdom. In this event, the payments may be treated as received by such a permanent establishment and therefore as excepted payments.

As the franchisee's obligation to deduct tax at source is heavily dependent on the franchisor's tax status (e.g., whether it has a taxable permanent establishment in the United Kingdom), the franchisee must investigate the treatment of the payments it makes in this respect to ensure that it correctly deducts and accounts for any tax. If the franchisee fails to deduct tax at source, it will still have to account for the tax to HMRC together with interest and penalties. It may, depending on the terms of the agreement, be able to deduct the amount it has failed to deduct at source from future payments, but this is likely to be possible only where there has been a genuine error of fact.⁹¹ Additionally, the franchisee may under the terms of the franchising agreement have a 'gross-up obligation' for any tax deducted on payments. While an agreement to pay royalties without deducting tax under Section 906 is void under Section 909 of the ITA, this is unlikely to apply to a gross-up provision as such a provision will increase the amount payable and therefore also increase the tax deducted at source – so it is not an agreement to pay without deduction of tax.

In practice, even where UK law dictates that there should be a deduction of tax at source for the royalty element of any fees, an appropriate double-tax treaty may well apply to give rise to zero or a reduced rate of withholding tax. Under Section 911 the payer need not deduct tax so long as it reasonably believes that at the time the payment is made the payee is entitled to relief under an applicable double-tax treaty. The franchisee should therefore seek to ensure that the franchisor (or if different, the relevant entity licensing the IP rights) benefits from relief under the applicable treaty. This may include ascertaining its country of

⁹¹ *Countess Shrewsbury v. Earl of Shrewsbury* (1907) 23 TLR 224, CA; *Turvey v. Dentons (1923) Ltd* [1953] 1 QB 218, [1952] 2 All ER 1025.

residence, ensuring it is taxable in that country under relevant rules (e.g., not receiving the income in a branch in a third country that is exempt from tax in the country of residence), ensuring that the royalties are ‘beneficially’ owned by the recipient for treaty purposes and that the franchisor does not have a permanent establishment in the United Kingdom or, if it does, that the royalties are not effectively connected with such a permanent establishment, as well as ascertaining whether anti-avoidance rules, such as Section 917A ITA, apply. As well as investigating the franchisor’s ability to obtain treaty relief, the franchisee may seek to obtain warranty protection in this respect under the franchising agreement.

IV TAX PRINCIPLES FOR FRANCHISORS

i Tax treatment of receipts

Although UK franchisors will be taxable on all fees received or receivable, the nature of such taxation will depend on the type of fee. A UK franchisor will therefore need to know how its fees are to be treated for tax purposes.

In this respect a typical franchise agreement will comprise fees payable for the following:

- a* services;
- b* reimbursement of expenses;
- c* royalties for use of trademarks;
- d* payments for know-how;
- e* payments for show-how;
- f* patent royalties;
- g* payments for copyrighted material (e.g., instruction manuals); and
- h* contributions to advertising materials.

The fees are likely to comprise both an initial fee and regular ongoing payments. In practice, the fees are often not separated out in the above constituent elements in the documentation but are simply an ‘initial fee’ and ongoing ‘service fees’ plus additional amounts for reimbursement of expenditure and contributions to advertising.

As we have seen, a UK franchisor will, broadly speaking, be paying corporation tax on all its profits albeit under different schedules. UK franchisors will generally be carrying on a trade in the United Kingdom and their profits will be subject to corporation tax as trading profits.

For UK franchisors whose IP was created or acquired on or after 1 April 2002, the profits and losses relating to any intangible assets will be calculated under the intangible fixed asset regime whether the receipt is capital in nature or not, but such profits and losses will in any event be taxed as part of the franchisor’s trading profits to the extent that the relevant IP assets are held for the purposes of a trade carried on by the transferor,⁹² which will almost certainly be the case. Therefore, the franchisor should be subject to corporation tax on the profits in its accounts subject to any standard tax adjustments (e.g., for disallowable expenditure or transfer pricing). If the transaction involves a ‘realisation’ of a chargeable intangible asset, then it is possible that a tax charge under the chargeable intangible assets regime could qualify for rollover relief if reinvested in new IP.⁹³ However, realisation for the

92 CTA 2009, Section 747.

93 CTA 2009, Section 754.

purposes of these rules means a transaction resulting, in accordance with generally accepted accounting practice, in the asset ceasing to be on the company's balance sheet or in a reduction in the accounting value of the asset (or would do if it had a balance sheet value).⁹⁴ On this basis it is unlikely in the vast majority of franchising arrangements that a realisation would occur for the purposes of these rules in respect of its activities carried out in the course of its general franchising business.

UK franchisors, whose IP does not fall within the intangible fixed assets regime, may need to analyse transactions in more detail to determine the manner of taxation. For many franchisors, HMRC are likely to accept that all fees simply constitute part of the franchisor's trading profits for corporation tax purposes so in practice, in the vast majority of cases, the tax treatment will be the same as for those in the intangible fixed assets regime. Franchisors may, however, seek to separate the fees into their component parts and tax them accordingly. If HMRC or a taxpayer wish to segregate the income between trading and other elements, the allocation would need to be a reasonable apportionment and justifiable.⁹⁵ If the relevant IP assets are segregated from the trade (e.g., held in a different company from the employees responsible for providing services), then a more detailed analysis of the components of any charge will be necessary.

Should the consideration be split into its component elements these could be taxed as follows.

Initial fee

If payable to a trading company rather than an IP holding company, this is likely to constitute a trading receipt. Arguably there may be a capital sum for a part disposal of goodwill or a capital sum derived from an asset and taxable under Section 22(c) or (d) or Section 29(5) of the TCGA. Where the franchise relates to a new jurisdiction, it will be difficult to say that there has been any disposal of a capital asset; HMRC's view is that there is not generally any reduction in the franchisor's goodwill as a result of entering into any new franchise agreements – on the contrary its goodwill is usually enhanced.⁹⁶ Additionally, under normal principles it would generally be difficult to say for a franchisor that the fees it generates are capital in nature. Therefore, the payment is most likely to be liable to corporation tax on income as a trading profit rather than a capital receipt. HMRC in its guidance cites *Jeffrey v. Rolls-Royce*⁹⁷ as authority for treating the initial fee as a trading receipt in normal circumstances. Specifically it highlights that in this case (concerning disposals of know-how that were treated as income) the circumstances have similarities to many franchising cases, in particular:

- a* the transactions were repeated;
- b* there was a deliberate policy of expansion by granting licences;
- c* benefits other than know-how were provided; and
- d* no capital asset diminished in value.⁹⁸

94 CTA 2009, Section 734.

95 See *Patterson Engineering Co Limited v. Duff* (1943) 25 TC 43 under which the court is not bound to follow contractual allocations if these do not reflect the real nature of payments.

96 Business Income Manual BIM57610.

97 [1962] 40TC443.

98 Business Income Manual BIM57610.

It is irrelevant that the payment is in instalments.⁹⁹

However, if it can be shown that there has been a part disposal of existing goodwill, then this could be taxed within the capital gains rules – for example where the franchisor disposes of existing trading sites to a franchisee. To the extent that there has been a disposal of goodwill subject to capital gains tax (or corporation tax on chargeable gains), then any gain could be subject to rollover relief if the franchisor reinvests the gain in chargeable intangible assets 12 months before or within three years after the disposal.¹⁰⁰ Similarly, if there has been a realisation of goodwill or other IP within the intangible fixed asset regime, the gain can be rolled over into a new chargeable intangible asset.¹⁰¹

Know-how

A disposal of know-how may be taxed as income under Section 908 of the CTA 2009 or as part of the trading profits of the company under Section 177(2) of the CTA 2009 (disposal of know-how where trade continues). This will not, however, be the case where the know-how has qualified for capital allowances and is brought into account under Section 462 of the CAA 201, or it is taxed on disposal of a trade as part of the goodwill of the trade under Section 178 of the CTA 2009 or the disposal is a sale between connected persons.

Show-how

Fees for training the franchisee's staff and ongoing training will normally be part of the trading receipts of the franchisor.

Advertising payments

Where franchisees contribute to central advertising costs incurred by the franchisor, the receipts will typically be revenue receipts taxable as trading profits with a corresponding deduction allowed for the advertising spend. One would expect the income and expenditure to be matched for accounting purposes and generally one would expect advertising expenditure to be an income expense such that there is no net tax payable (unless the franchisor is receiving more than it is spending). To the extent that the expenditure has not been paid, any provision in the accounts will need to be sufficiently accurate to allow a deduction.¹⁰²

Capital payments in respect of patent rights

Where patent rights are transferred, any receipt could give rise to a taxable receipt under Section 912 of the CTA 2009, spread over six years unless tax is elected to be paid earlier.

Royalties

As stated, save for franchisors that may hold the IP separately from the rest of the trade, all receipts are likely to constitute taxable trading profits. Therefore, characterising the receipts as royalties is unlikely to have a practical effect for corporation tax purposes. It may, however, affect whether tax needs to be withheld at source from the payments (as discussed above).

99 *British Dyestuffs Corporation (Blakeley) Ltd v. IRC* (1924) 12 TC 586.

100 Chapter 7 Part 8 of the CTA 2009.

101 CTA 2009, Section 898.

102 For example, *Johnston v. Britannia Airways Ltd* [1994] 67TC99.

Premises

Certain franchisors will seek to provide a franchisee with suitably fitted out and branded premises. The tax treatment of any fees for doing this will depend on the nature of these arrangements.

ii International issues

We now look at the options available for a UK taxpayer when carrying on an international trade. If the franchisor is carrying out its full franchising business, including providing services and licensing all IP from one entity in the United Kingdom, it will be receiving the above mixed supply of services and payments for use of IP. Assuming that the franchisor's activities are not undertaken through a permanent establishment in a different jurisdiction, the fees should all be taxable under the UK corporation tax rules either as trading income, profits from IP or potentially, for the initial fee, chargeable gains (if the franchisor's IP is pre-April 2002 IP).

There used to be a distinction between foreign source income (which was taxed under Schedule D Case V) and UK source income (which was taxed under other schedules – e.g., Schedule D Case I for UK trading income, Schedule D Case III for most UK source royalty payments). This distinction, broadly speaking, disappeared for corporation tax purposes when the tax rules were rewritten into CTA 2009 and CTA 2010. Therefore, all trading income is dealt with under the same provisions of CTA 2009, as is all IP income. There is thus, now, no longer a general distinction between UK and foreign source income save that double-tax relief is available on foreign-sourced income.

Double tax relief in the United Kingdom takes two forms: treaty relief and unilateral relief. Treaty relief is relief granted under an applicable double-tax treaty. Section 2 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) provides for double-tax arrangements in respect of a territory outside the United Kingdom with a view to affording relief from double taxation to have effect by means of an Order in Council. The taxes covered by such arrangements include income tax, corporation tax, capital gains tax and taxes imposed outside the United Kingdom of a similar character to these taxes. As well as invoking the 'royalties' provision of any applicable tax treaty, a number of other provisions may be applicable to a franchisor, such as (in the case of the OECD Model Treaty):

- a* Article 7 (Business Profits) – which, broadly speaking, restricts the right of a territory to tax business profits unless earned through a permanent establishment in that territory (which is in turn defined in Article 5);
- b* Article 13 (Capital Gains) – which again restricts the right of a territory to tax capital gains to those accruing to a permanent establishment in that territory although in this case it can also tax gains from immovable property situated in that territory; and
- c* Article 23 (Double Taxation) – which seeks to avoid double taxation and provide relief through exemption or credit.

Unilateral relief (i.e., double-tax relief given in the absence of any protection under a double-tax treaty) is provided under Section 9 of the TIOPA in respect of income 'arising' and gains 'accruing' in the territory for which tax relief is sought. Unilateral relief is provided

in respect of tax on income or capital gains that corresponds to income tax, capital gains tax or corporation tax and includes state, provincial or local income taxes or taxes levied by a municipality or any other local body.¹⁰³

Double tax relief can be problematic in the following respects:

- a* where the receipts relate to a trade exercised in the United Kingdom, HMRC may seek to argue that the source of the income is the UK trade and not the payments for IP arising offshore. Equally where the IP rights are, say, UK registered rights for which the franchisor could but has not yet made subsequent registrations locally, then arguably the source of the income would be the UK rights. In these circumstances income from overseas franchisees is technically UK source income. However, this is covered by extra-statutory concession B8.¹⁰⁴ This states as follows:

A UK resident may receive income consisting of royalties or 'know-how' payments from a foreign resident. While in particular cases there may be special circumstances that will require to be taken into account, in general such income should be dealt with as follows.

a) Payments made by a person resident in a foreign country to a person carrying on a trade in the UK as consideration for the use of, or for the privilege of using, in the foreign country any copyright, patent, design, secret process or formula, trademark or other like property may be treated for the purpose of credit (whether under double-taxation agreements or by way of unilateral relief) as income arising outside the UK, except to the extent that they represent consideration for services (other than merely incidental services) rendered in this country by the recipient to the payer. b) Traders resident in the UK are not entitled to claim credit for any tax which is levied in the foreign country in respect of payments for services which are rendered in the UK and are not merely incidental services. In any such case the net amount of the payment (after deduction of any foreign tax borne by them on the payments) is included in the computation of profits for UK tax purposes.

The prohibition on credit for foreign tax charged on payments for services rendered in the UK may be overruled by the terms of those double-taxation agreements which have a royalties Article which includes technical services in the definition of royalties (see INTM153130) or a separate technical fees Article (see INTM153140) and those agreements deem the source of such payments to be in the country of which the payer is a resident. In such cases, even though the services are rendered in the UK, credit is due for the foreign tax charged on these payments.

If the owner of a right such as a patent, trademark or copyright is not engaged in any trade to which the right relates but derives income by exploiting that right, the source of the income may be regarded for the purpose of credit as located in the country where the right is enforceable.

- b* Where a franchisor is providing services as well as IP from the United Kingdom, any local tax deducted at source on the service element will not qualify for double-tax relief as a credit unless specifically allowed as technical services under an appropriate double-tax treaty or unless it is merely incidental to the provision of IP. In the absence of a credit relief the foreign tax may be treated as a deduction from income.¹⁰⁵
- c* Where the franchisee has sub-franchisees in a different jurisdiction, then relief may not be available. Unilateral relief for foreign tax in a territory is provided against income 'arising' in the territory. In this case, depending on how the arrangements are structured,

103 TIOPA, Section 9(6).

104 HMRC manuals, International Manual INTM161130.

105 TIOPA, Section 112.

the sub-franchise income may not be income of the franchisor but of the franchisee and it may not arise in the 'territory' but in a third country. This position is relaxed in the rare circumstance that a franchisee is in the Isle of Man or the Channel Islands as there is no requirement for income to arise in these territories to allow credit for tax charged there.¹⁰⁶ Similarly, tax treaties will also provide double-tax relief for losses in the other treaty state. Care should therefore be taken to avoid this situation or to ensure that the appropriate tax leakage is dealt with correctly in the relevant documentation. To the extent that relief is not available, again the tax may be deductible as an expense of the trade.

- d* Unilateral relief provides credit for overseas tax calculated by reference to income arising or a gain accruing against UK tax calculated by reference to that income or gain. Similarly, treaty relief is limited to relief against UK tax arising on the same source of income as bears the tax. Therefore, if a company with foreign source income does not have any UK tax to bear (e.g., because there are deductible expenses or trading losses to set against it), the credits cannot be used against other sources of income (e.g., if the double-tax relief is against trading profits, it cannot be used against investment income).

V FRANCHISOR STRUCTURING

Over the past 30 years, as businesses have become increasingly mobile and international, and particularly since the rise of the internet, multinational operations have increasingly used tax planning as a tool to maximise their after-tax returns. There has been a game of cat and mouse between multinational operations and the revenue authorities as more sophisticated structures have grown up to minimise taxes, tax authorities have introduced rules to block such structures and well-advised businesses have introduced even more sophisticated tax structures and mitigation strategies to overcome such rules.

Today, with a difficult worldwide economic situation and the tight budgetary conditions facing many Western economies, politicians, press and public are increasingly scrutinising the tax affairs of multinational companies. This is particularly the case in sectors of the economy that rely heavily on intangible assets such as brands that are highly mobile and that can, if located in low-tax jurisdictions with minimal substance requirements, have a dramatic downward effect on a group's effective corporate tax rate.

This increasing scrutiny is leading to increased crackdowns on international tax avoidance behaviour and tax arbitrage, with measures such as the BEPS project, which is being run by the OECD and G20 (see Section V.iv). At the same time, however, many governments are seeking to reduce corporate tax rates and provide corporate tax incentives to attract inward investment. In an area such as franchising, where profits substantially derive from IP, there are significant opportunities to locate IP in a low-tax jurisdiction to minimise taxes. In light of these often contradictory demands, the effect that an overly aggressive tax structure may have on reputation is becoming a key business concern, particularly for consumer-facing businesses.

This section gives a general overview of the tax strategies a franchisor may consider in looking to reduce the effective tax rate on its IP income and in broad outline the anti-avoidance rules that have come into play to avoid overly aggressive planning.

106 TIOPA, Section 9(7).

A common form of tax planning for franchisors is to take their IP and operations offshore from the United Kingdom to a jurisdiction that has a lower tax rate. By doing this they would hope that income can be rolled up in a lower taxed jurisdiction thus avoiding or at least deferring UK tax.

For tax purposes a relevant IP holding entity (IP Co) ideally should not be subject to:

- a* profits tax in that entity;
- b* withholding taxes on payments by that entity (e.g., dividends or interest); and
- c* withholding taxes on royalty payments to that entity.

Therefore, tax planning would involve considering which entity would be effective in reducing profits tax and withholding tax, thereby assisting to lower the effective rate.

This entity could either be:

- a* an entity subject to tax (taxable entity) such as a company incorporated in the United Kingdom; or
- b* an entity not subject to tax (non-taxable entity) such as a company incorporated in a tax haven.

As tax havens do not have decent tax treaty networks, withholding taxes may dictate having an entity with a low level of taxation in the structure (and therefore access to a tax treaty network). Examples of relevant jurisdictions that may meet these criteria are the United Kingdom, Luxembourg, Belgium, the Netherlands, Cyprus and Ireland. The availability of certain tax advantages in such jurisdictions could, depending on the circumstances, give rise to a competitive effective tax rate. Such advantages to be considered may include:

- a* a low corporate tax rate on royalty income;
- b* the availability of relief – the ‘taxable’ jurisdiction may offer attractive relief for holding IP or undertaking research and development activities. For example, ‘patent box’-type regimes in the United Kingdom, Netherlands, Belgium and Luxembourg give rise to low tax rates or partial exemption for certain types of IP royalties. The states may also provide taxable amortisation of purchased IP, actual and in certain cases deemed deductions for interest expenses and research and development tax credits; and
- c* the availability of double-tax treaties or the EU Interest and Royalties Directive to reduce withholding taxes and maximise double-taxation relief.

It should also be borne in mind when looking at the location of any vehicle that the vehicle is likely to require ‘substance’ to obtain the relevant tax benefits. It is therefore almost always better to locate companies in jurisdictions where there are people with the requisite skills and experience to manage the business carried on by such a company. This requirement for substance has been particularly enhanced following the BEPS project (e.g., the new transfer pricing regime for intangibles brought in under BEPS).

If IP is held in a taxable structure, tax planning will concentrate around minimising the tax rate (e.g., using special tax regimes applicable in that jurisdiction), maximising reliefs (e.g., amortisation of acquisition cost, research and development reliefs and finance costs) and avoiding withholding taxes.

For an IP Co to be tax-efficient, the licensees would be residents of jurisdictions that do not apply withholding tax on the relevant payments to the IP holding vehicle or that have suitable double-tax treaties, which reduce or eliminate any withholding tax.

One further way to reduce withholding taxes is by using another entity (royalty company) through which the royalties would flow. By flowing the royalties through a royalty company that (1) has a suitable tax treaty with the licensee's jurisdiction (which eliminates or reduces withholding taxes on royalties); and (2) is incorporated in a country that does not levy withholding tax on royalty payments (or has a suitable tax treaty with the jurisdiction in which the IP Co is located), withholding taxes on the royalties could be mitigated (subject to anti-avoidance rules).

However, in this respect, various tax treaty provisions prevent 'treaty shopping'. Again the BEPS project should make planning through 'conduit' and similar structures more difficult, as it has introduced various provisions to be included in tax treaties that prevent treaty abuse. Additionally, anti-avoidance rules may apply to deny treaty benefits or the tax authorities may not view the royalty company as being entitled to the royalties for treaty purposes.¹⁰⁷

If a UK entity were to set up a structure with an offshore subsidiary IP Co or royalty company, the following hurdles would need to be overcome to achieve its aims:

- a* Tax charge on transfer of IP: if any of the IP transferred has a value then this is likely to be taxable; if the franchisor is prepared to accept some tax now to enter into the structure what would be the manner of taxation?
- b* CFC rules: if the IP is in an offshore entity, could its profits in any event be attributed to the United Kingdom under controlled foreign company (CFC) or similar rules?
- c* Substance: will the offshore company be treated as non-resident or trading in the United Kingdom through a permanent establishment in any event and will it have sufficient substance to be seen as the owner of the IP and to benefit from tax treaties etc.?
- d* Diverted profits tax: this was a new tax introduced in 2015 that can apply to structures that do not have sufficient economic substance or that artificially avoid having a permanent establishment in the United Kingdom.

In addition, all relevant anti-avoidance measures would need to be considered in detail and overcome.

i Tax charges on transferring IP to an offshore licensing entity

A taxable gain may be crystallised when a franchisor disposes of the relevant assets to an offshore company. Such a gain could potentially be reduced or avoided with careful planning. In seeking to transfer IP to an offshore entity the franchisor will need to carefully consider the assets to be transferred.

If we consider the nature of the assets to be transferred, each will have a slightly different treatment when seeking to either transfer the asset or simply to register new classes of such IP in an offshore jurisdiction. In this respect it should be borne in mind that different IP has different characteristics. Goodwill can be very local to a business or it can be worldwide; patent rights, however, cannot be enforced outside the jurisdiction of registration but may confer priority registration rights overseas. A franchisor looking to transfer IP offshore will therefore need to carefully analyse each asset from both a legal and an economic perspective

¹⁰⁷ See *Indofood International Finance Ltd v. JP Morgan Chase Bank NA London Branch*; see also the revised commentary on the meaning of 'beneficial ownership' as set out in the 2014 update to the OECD Model Convention.

to determine whether any value is being transferred to the offshore entity and whether such a transfer is therefore taxable (either because the offshore acquirer pays a market price or under transfer pricing or similar rules).

Specifically, different assets will be taxed as follows:

- a* for trading companies subject to the intangible fixed asset regime, disposals of intangibles will be taxed as trading profit under Part 8 CTA 2009. Rollover relief under Chapter 7 of Part 8 may apply if the proceeds of sale (if any) are reinvested in intangibles;
- b* for intangible assets that are not in the above regime, the tax treatment will be as described above, that is:
 - goodwill will be taxed as a capital gains asset and will be taxed under Section 21, Section 22(c) or (d) or Section 29(5) of the TCGA with arm's-length pricing substituted if necessary by Section 17 of the TCGA;
 - patents will be subject to tax either as a trading profit or under Section 912 of the CTA 2009 with tax being potentially spread over six years. Potentially, if capital allowances have been claimed, an amount may need to be brought into account under the capital allowance rules;
 - know-how: Section 177, the ability to elect under Section 178 and Sections 908–910 of the CTA 2009 will not apply to transfers between connected parties. In this event, the transfer will either constitute trading profits, give rise to a chargeable gain or be taxed under the capital allowance rules depending on the circumstances; and
 - copyright, trademarks, designs and design rights will similarly be taxed either as trading income or under chargeable gains rules.

Where a company has a solid UK business but is looking to expand internationally through franchising arrangements, it may seek to split its IP between that which relates to the United Kingdom and that which relates to jurisdictions outside the United Kingdom. It may then seek to transfer the non-UK IP to a tax-friendly jurisdiction and argue that the non-UK IP has no or little value at the time of such a transfer. Whether or not this is justifiable is a question of valuation, which will depend not only on valuation, but also on the extent to which the franchisor has already carried on any trade abroad or has any pre-existing enforcement rights in the relevant offshore jurisdictions, including priority registration rights. This will vary between different classes of IP.

Should there be any taxable profit or gain on the transfer, the franchisor will look to see whether it has any tax assets (such as losses) that it can utilise against a gain. Companies looking to migrate their assets offshore may also consider the reorganisation rules outlined above to determine if they could do so without crystallising a tax charge. It should be borne in mind, however, that many of those rules require a *bona fide* (and not a tax avoidance) intention to fall within the relevant provisions.¹⁰⁸ Alternatively, a franchisor may consider licensing the IP in a manner that does not give rise to a disposal of the asset but that gives rise to tax on the licence fees over a number of years. Whether a licence amounts to a disposal depends on its terms and whether the receipt falls into income or capital as set out above. An exclusive licence for a long period is likely to constitute a disposal whereas a non-exclusive licence for a short period is not.

108 For example, Section 140C, Section 140E(8), 140F(9) TCGA.

ii Controlled foreign company rules

Under the United Kingdom's CFC rules contained in Part 9A of the TIOPA 2010, if a company resident outside the United Kingdom is controlled by persons resident in the United Kingdom, then the profits of the non-resident company (together with any creditable local tax) can be apportioned to UK tax-resident corporate shareholders and charged to UK tax.

Control by UK persons includes cases where a company is controlled by two shareholders each holding 40 per cent or more of the controlling rights and one of which is resident in the United Kingdom.

The rules were substantially amended in FA 2012 following a long period of consultation. The aim of the new rules is to target transactions that artificially divert profits from the United Kingdom.

The rules relating to CFCs are highly technical and detailed (and therefore beyond the scope of this chapter). However, the main entity-level exemptions to a CFC apportionment are:

- a* the exempt period exemption: broadly speaking allowing a period of grace of at least 12 months from coming under UK ownership;
- b* the excluded territories exemption: this exempts companies resident in certain territories from the CFC rules provided:
 - the CFC's 'bad' income (e.g., income that is exempt from tax locally) is not over 10 per cent of its accounting profits or if more, £50,000; and
 - the CFC does not have significant IP income that derives from IP transferred from related persons resident in the United Kingdom (or if not so resident, the IP was held for a permanent establishment of such persons in the United Kingdom) or IP that otherwise derives from IP held by such persons;
- c* the low profits exemption: broadly speaking this applies where the CFC either has:
 - profits of less than £50,000; or
 - profits of less than £500,000 of which no more than £50,000 are non-trading profits;
- d* the low profit margin exemption: where the CFC's profits are not more than 10 per cent of its relevant operating expenditure; and
- e* the tax exemption: where the CFC's tax is at least 75 per cent of what the corresponding UK tax on such profits would have been.

Anti-avoidance rules attach to prevent the exemptions applying in abusive situations.

Even if the CFC is not exempt under the above rules, its profits are only apportioned to relevant UK shareholders and subject to tax under the CFC rules to the extent that those profits fall within one of the 'gateways'. CFC gateways include:

- a* profits attributable to UK activities;
- b* non-trading profits;
- c* trading finance profits;
- d* captive insurance business; and
- e* certain subsidiaries of FSA-regulated companies.

Of most relevance for franchising activities will be the first two of these gateways. If a company's profits meet a number of tests as to non-attribution to the United Kingdom, it will not fall within this first gateway. One of these tests is an IP condition that is similar to the above IP test in the excluded territories exemption.

The intention behind these exemptions and gateways is to stop the CFC rules catching commercially driven structures. However, because of the complexity of these rules they may catch what might seem to be commercial structures and therefore need to be considered in all cases where companies are owned directly or indirectly by UK companies.

iii Diverted profits tax

This tax, which was introduced in Finance Act 2015, with effect from 1 April 2015, applies where:

- a* payments are made by a UK resident (or the UK permanent establishment of a foreign company) to another person that lacks economic substance and there is an effective tax mismatch, and it is reasonable to assume that without the tax benefit the income would not have been diverted from the United Kingdom; or
- b* a foreign company artificially avoids having a permanent establishment in the United Kingdom.

Where the rules apply, a tax charge at 25 per cent applies to the amount of profits that would otherwise have been taxed in the United Kingdom. In the case of the avoided permanent establishment, following the changes to the royalty rules in 2016, the DPT rules also charge to tax any royalties that would have been deemed to be payable had there been a UK permanent establishment. The rules do not apply:

- a* to small or medium-sized enterprises (i.e., where, with certain connected persons there are less than 250 employees and either the annual turnover does not exceed €43 million or an annual balance sheet does not exceed €43 million);
- b* where a permanent establishment is avoided and UK sales do not exceed £10 million and UK-related expenses do not exceed £1 million in a 12-month accounting period; and
- c* where the 'diverted profits' are taxed by an amount equal to at least 80 per cent of the UK tax that would have been payable.

iv Anti-avoidance

It is clear that there would, in the absence of rules to the contrary, be significant scope for tax planning as the nature of IP assets means that they are easy to move across borders.

The historic approach to judicial intervention in tax avoidance cases can be seen in *IRC v. Duke of Westminster*,¹⁰⁹ when Lord Tomlin said: 'Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be.' This approach gave rise to a literal interpretation of tax legislation, allowing structures to be easily devised that circumvented the relevant legislation. However, modern jurisprudence, following a line of cases, including *Ramsay (WT) Ltd v. IRC*,¹¹⁰ *Furniss v. Dawson*¹¹¹ and *Barclays Mercantile Business Finance v. Mawson*,¹¹² has taken a more purposive interpretation of tax legislation. As Lord Nicholls says in *Barclays Mercantile Business Finance v. Mawson*:

109 (1936) 19 TC 490.

110 [1982] AC 300.

111 [1984] STC 153.

112 [2005] STC 1.

The essence of the new approach was to give the statutory provision a purposive construction to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description.

The courts are therefore no longer prepared to take a blinkered look at each transaction but will consider a tax avoidance scheme as a whole. An example of the modern approach in overcoming a tax avoidance scheme can be seen in *Astall & Another v. HM Revenue & Customs*.¹¹³ An example of the limits of such an approach, where it was not possible to interpret the purpose of the legislation, can be seen in the case of *Mayes v. HMRC*.¹¹⁴

Any tax planning and structuring in respect of franchising arrangements and IP licensing structures should therefore always consider whether what is planned falls within the relevant legislation after taking a purposive interpretation of that legislation.

Further specific anti-avoidance rules have been developed to catch the more obvious schemes that have been devised. In any given situation, all relevant specific anti-avoidance rules, sometimes known as targeted anti-avoidance rules (TAARs), will need to be considered. As this is not a tax textbook we will not consider all possible TAARs in this chapter. There are also rules whereby certain types of tax avoidance schemes have to be notified to HMRC.¹¹⁵

Additionally, the United Kingdom has in the Finance Act 2013 introduced a general anti-abuse rule (GAAR) that could apply to any given transaction and would need to be considered seriously by anybody seeking to implement any tax planning after its implementation. The details of the GAAR are set out in Part 5 Finance Act 2013. The GAAR applies to counteract tax advantages arising from tax arrangements that are abusive.¹¹⁶

'Tax arrangements' for the purposes of the GAAR are arrangements of which it would be reasonable to conclude, having regard to all the circumstances, that the obtaining of a tax advantage was the main purpose or one of the main purposes. Such arrangements are abusive if they are arrangements the entering into or carrying out of which cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions having regard to all the circumstances, including whether:

- a* the substantive result of the arrangements is consistent with any principles on which the provisions are based and the policy objectives of the provisions;
- b* there are contrived or abnormal steps; and
- c* the arrangements are intended to exploit shortcomings in the provisions.

Examples are given of things that might indicate that tax arrangements are abusive, including profits being significantly less than economic profits, deductions significantly greater than economic costs or claims for tax credits relating to taxes that are unlikely to be paid. On the contrary, complying with HMRC practice is indicative that arrangements are not abusive.

A number of taxpayer safeguards are built into the GAAR, including:

- a* requiring HMRC to establish that the arrangements are abusive;¹¹⁷

113 [2009] EWCA Civ 1010.

114 [2009] EWHC 2443 (Ch) (8 October 2009).

115 The primary legislation is to be found in Part 7 and Schedule 2 Finance Act 2004.

116 Section 206 FA 2013, Section 206.

117 FA 2013, Section 211(1).

- b* applying a ‘double reasonableness’ test. This requires HMRC to show that the arrangements ‘cannot reasonably be regarded as a reasonable course of action’;¹¹⁸
- c* allowing the court or tribunal to take into account any relevant material as to the purpose of the legislation that it is suggested the taxpayer has abused, or as to the sort of transactions that had become established practice at the time when the arrangements were entered into;¹¹⁹ and
- d* requiring HMRC to obtain the opinion of an independent advisory panel as to whether an arrangement constituted a reasonable course of action, before they can apply the GAAR.¹²⁰

The legislation is also supported by detailed guidance rules issued by HMRC. In respect of international tax planning the guidance notes state:¹²¹

B5.1 There is a network of treaties between States setting out rules that govern the taxation of investment and business activities involving more than one State. These treaties (which are typically based on an OECD Model Treaty) are usually referred to as ‘double-tax treaties’, and their purpose is to avoid subjecting such investments or activities to tax in more than one State and to prevent tax evasion. The United Kingdom has entered into over 100 such treaties, and they are given effect in domestic tax law.

B5.2 Many of the established rules of international taxation are set out in double-taxation treaties. These cover, for example, the attribution of profits to branches or between group companies of multinational enterprises, and the allocation of taxing rights to the different States where such enterprises operate. The mere fact that arrangements benefit from these rules does not mean that the arrangements amount to abuse, and so the GAAR cannot be applied to them. Accordingly, many cases of the sort which have generated a great deal of media and Parliamentary debate in the months leading up to the enactment of the GAAR cannot be dealt with by the GAAR

B5.3 However, where there are abusive arrangements which try to exploit particular provisions in a double-tax treaty, or the way in which such provisions interact with other provisions of UK tax law, then the GAAR can be applied to counteract the abusive arrangements.

The guidance notes also state, in respect of the sorts of cases exciting the media and parliamentary debate, that ‘there is work under way in the OECD on the erosion of the tax base and on profit shifting’.

In this respect, in July 2013 the OECD published a paper entitled ‘Action Plan on Base Erosion and Profit Shifting’,¹²² which has been endorsed by the G20 finance ministers and central bank governors. Under this plan it is recognised that there are weaknesses in the general framework of international taxation. The plan contains 15 action points for further work to

118 FA 2013, Section 207(2).

119 FA 2013, Section 211(3).

120 Schedule 43 FA 2013 and Section 211(2)(b) FA 2013.

121 HMRC’S GAAR Guidance (Approved by the Advisory Panel with effect from 15 April 2013).

122 OECD (2013), ‘Action Plan on Base Erosion and Profit Shifting’, OECD Publishing. See <http://dx.doi.org/10.1787/9789264202719-en>.

help ensure that taxpayers do not abuse international tax rules, to be agreed at an international level. On 5 October 2015, final reports were published in respect of all 15 actions. Of most relevance in the context of franchising, the following reports have been issued:

- a* Addressing the Tax Challenges of the Digital Economy;
- b* Preventing the Granting of Treaty Benefits in Inappropriate Circumstances;
- c* Preventing the Artificial Avoidance of Permanent Establishment Status;
- d* Guidance on Transfer Pricing Aspects of Intangibles; and
- e* Transfer Pricing Documentation and Country by Country Reporting.

In addition, the EU has been working on its own implementation of BEPS through an Anti-Tax Avoidance Directive (ATAD), which should be applied by Member States by 1 January 2019. The ATAD imposes a minimum standard for a number of the matters set out in this chapter, to be applicable at EU level, including exit taxation (i.e., tax on assets transferred across borders); an EU-wide GAAR; and minimum standards of CFC rules. Furthermore, the EU is looking to impose a common corporate tax base under which corporate tax is calculated in each Member State on the same set of rules; followed by a common consolidated corporate tax base under which tax will be payable on an EU-wide basis and then apportioned to relevant Member States. Given the uncertainty of the UK position post Brexit, we have not analysed these proposals in detail.

The OECD has been working on a multilateral treaty that will amend the treaties of members of the BEPS project on signature. However, many of the terms of the multilateral treaty are voluntary and, in addition, many of the changes to treaties will require changes to local law to apply. Therefore the full effect of the BEPS project is yet to be fully determined. Nevertheless, it is expected that many of the rules set out in this chapter could change as a result of these action plans and we have highlighted areas where this may happen. However, given that the UK rules are reasonably sophisticated, many of the action points proposed in the BEPS project are arguably already enshrined in UK law and as such will have a more limited impact in the United Kingdom than in many jurisdictions.

v Company residence

As stated, where an entity is established in any jurisdiction to hold IP rights or carry out any other function, it is likely to require the requisite 'substance' commensurate with its functions. Such substance requirements may arise as a result of a number of factors:

- a* local laws may require specific substance requirements to fall within favourable tax regimes or to benefit from tax treaties or EU directives;
- b* transfer pricing analysis will be undertaken on the basis of a functional analysis that in turn will require continued substance commensurate with such analysis;
- c* residence under local law and tax treaties will usually depend on where the company is managed; and
- d* if the company does not carry out its functions in the local jurisdiction, there is a risk that it may be taxable elsewhere through a permanent establishment.

We set out above the basic legal position for determining whether a company is resident in the United Kingdom. HMRC will apply these tests to determine whether an entity established offshore is actually resident in the United Kingdom. It is usually best practice to ensure

that an entity is appropriately managed in its home jurisdiction to ensure that it meets any required substance tests locally and to ensure that it is not resident in the United Kingdom (or another taxable jurisdiction).

As stated above, for a company that is not incorporated in the United Kingdom, it could be treated as resident in the United Kingdom under UK domestic law if it is centrally managed and controlled in the United Kingdom. The meaning of central management and control is not defined in UK statute and has instead been determined according to UK case law principles. Broadly, the central management and control test is a question of fact that looks at where the highest level of control (i.e., the overall strategic management structure, as opposed to the day-to-day management) of an overseas company is physically conducted. As stated in UK case law,¹²³ the question depends on where the ‘real business is carried on’ and this is ‘where the central management and control actually abides’. It is also stated that ‘it is the actual place of management, not that place in which it ought to be managed, which fixes the residence of a company’.¹²⁴ If this is in the United Kingdom, the company is UK tax-resident (in the absence of any tax treaty provision to the contrary). Cases have attached importance to the place where the company’s board of directors meet, although this is not necessarily conclusive. HMRC sets out detailed guidance in its manuals as to the meaning of central management and control, including a reproduction of the Statement of Practice,¹²⁵ which sets out its view of the factors relevant to determining residence under the common law test.

In some cases, central management and control may be exercised by a single individual. This may happen when a chairman or managing director exercises powers formally conferred by the company’s articles and the other board members are little more than ciphers, or by reason of a dominant shareholding or for some other reason. In those cases the residence of the company is where the controlling individual exercises his or her powers.

In general, the place of directors’ meetings is significant only insofar as those meetings constitute the medium through which central management and control is exercised. In the case of *Wood and another v. Holden*¹²⁶ the Court of Appeal held that an overseas incorporated company, managed by an overseas trust company, which received advice from professional advisers in the United Kingdom, could not be considered to be UK-resident for tax purposes purely because the trust company acted on the recommendations of the professional advisers. This case showed that there must be clear evidence that the central management and control of a non-UK incorporated company is carried out by its directors, and that the authority of the directors has not been usurped by anybody (such as UK-based directors or advisers) in the United Kingdom.

Where a treaty tiebreaker applies, residence is where the company is ‘effectively managed’, although, following the BEPS project, this is likely to change in many treaties to the jurisdiction as agreed by the relevant tax authorities under a mutual agreement procedure. It is usually very difficult to see how the place of the ‘central management and control’ of a company’s business for the purposes of determining its residence under UK domestic law

123 *De Beers Consolidated Mines Ltd v. Howe* 5 TC 213.

124 *Unit Construction Co Ltd v. Bullock* [1960] AC 351.

125 SP1/90 (9 January 1990) now published at INTM120200.

126 [2006] STC 443 (Court of Appeal).

will not be the same as the location of its 'place of effective management' for the purposes of the double-tax treaty. A useful recent case, which considered in detail a company's residence, was that of *Laerstate BV v. HM Revenue & Customs*.¹²⁷

As well as residence issues, companies will be keen not to have taxable permanent establishments in a jurisdiction outside the place of residence. As well as ensuring that the company does not have an overseas office or other fixed place of business, it should not have dependent agents concluding or substantially negotiating contracts on its behalf outside its jurisdiction of residence. Ideally the company should also not have any employees outside such a jurisdiction.

As a practical matter companies should follow clear guidelines to ensure that their decision-making processes do not inadvertently mean that they are resident in a different jurisdiction from that intended – or for that matter trade through a permanent establishment in such a jurisdiction. Examples of matters that could be contained in such guidelines might include:

- a* having a majority of local directors with the necessary requisite skill and knowledge;
- b* holding a minimum number of board meetings each year in the relevant jurisdiction;
- c* making all strategic and other decisions of effective management at those board meetings;
- d* not holding board meetings in any other jurisdiction;
- e* ensuring that there is no or limited participation in board meetings by telephone and no written resolutions;
- f* approval of key contracts should be at board meetings and all contracts should be approved and entered into by local directors;
- g* not substantially negotiating contracts without input from the board. The board should not simply 'rubber stamp' contracts;
- h* having a local company secretary, or similar officer, from which all key documents emanate; and
- i* holding all necessary books and records at the local registered office.

vi Tax issues arising from corporate structuring

As well as the above issues that arise from tax-driven structuring, many tax issues for franchisors can arise from more commercially driven corporate structuring. For example, franchisors may seek equity participation in their franchisees for economic benefits but also often to allow the franchisors to have a degree of corporate control. The tax effects of such joint venture arrangements will depend on the precise circumstances but could involve:

- a* the effect of any control arrangements on the tax residence status of the franchisee;
- b* whether the control arrangements are such as to make the parties connected for any tax purposes (e.g., transfer pricing);
- c* the ability to claim consortium relief for tax losses and the need to deal with surrenders of tax losses under the relevant documentation;
- d* whether the interest acquired by the transferor is sufficient to obtain any tax relief (e.g., exemption from chargeable gains in the United Kingdom under the substantial shareholdings exemption); and
- e* the tax treatment of any financing arrangements.

127 [2009] UKFTT 209 (TC).

VI FRANCHISEE TAX POSITION

While franchisors will generally be companies (and we have therefore concentrated on the corporation tax rules for companies), franchisees may be much smaller businesses and could be run as companies, partnerships or unincorporated small traders. It is beyond the scope of this book to discuss the general tax environment for all such traders. We set out below, however, the tax treatment of the likely payments by corporate franchisees under franchising arrangements. This is generally the reverse of the franchisor treatment. Specifically, a franchisee will want to know:

- a* whether payments are deductible for tax purposes; and
- b* whether it will need to deduct tax at source from payments under the agreements.

For the franchisee, a greater degree of analysis will generally be required as the nature of the payments will vary more dramatically for it.

i Initial fee

The crucial question for the franchisee will be whether the initial fee (or fees) payable by it are income or capital in nature. As the fees will be incurred wholly and exclusively for the franchisee's trade, then if income in nature the fees should be deductible as part of the franchisee's trading profits. If capital in nature, the fees would not be so deductible and the tax treatment will depend on the nature of the fee and the circumstances of the franchisee. Specifically for corporate franchisees:

- a* If the payment is an acquisition of intangible assets (including goodwill), this will for UK corporate franchisees fall within the intangible fixed asset rules (unless the intangible assets are pre-April 2002 IP, which will be the case if it is pre-April 2002 IP for the franchisor and the franchisor and franchisee are connected). If the intangible fixed assets rules apply, the franchisee should, other than in the case of acquired goodwill (or similar IP), obtain a tax deduction for the accounting amortisation of the IP or, if it elects, a fixed writing-down deduction of 4 per cent per annum. The franchisee may also qualify for rollover relief in respect of past gains under Chapter 7 of Part 8 or Section 898 of the CTA 2009.
- b* Payments not covered by the intangible fixed asset rules will need to be analysed on a case-by-case basis and analysed as income or capital depending on the facts (see above for a review of what constitutes income or capital expenditure). Generally, franchisors initial costs are likely to be capital in treatment on the guidelines set out. HMRC confirm this in their manuals on the basis of *S Ltd v. O'Sullivan*¹²⁸ and *Atherton v. British Insulated and Helsby Cables Ltd.*¹²⁹ The costs are to be split as follows:
 - Capital payment for goodwill or franchise rights – for individuals and companies not within the intangible fixed asset rules, goodwill will be an asset for capital gains tax purposes and therefore the acquisition cost will form part of the base cost of the asset but will not give rise to any income tax relief on acquisition. It may be possible to roll over a gain into the expenditure under the rules in Section 152 of the TCGA. However, HMRC takes the view that the amount paid by a franchisee is not for goodwill but for franchise rights, which while being assets

128 Irish Tax Cases 108.

129 (1925) 10TC155; Business Income Manual BIM57620.

for capital gains tax purposes are not assets to which rollover relief applies, and if the licence agreement is less than 50 years, the asset acquired will be a wasting asset for capital gains purposes¹³⁰ the effect of which will be to not only prevent rolling any gains into the asset but also to depreciate its base cost for chargeable gains purposes. Nevertheless, a franchisee can subsequently generate its own goodwill¹³¹ such that it is able to apply rollover relief on a subsequent sale of its franchised purchase. This was the case in *Balloon Promotions* and HMRC's view of this is set out in Tax Bulletin 83. However, in this case the Special Commissioners accepted that there was substantial goodwill in the actual business as run by the franchisee and not in the franchisor's brand (Pizza Express) at that time. It was also a pertinent fact that the franchise agreement had a six-month termination right for either party such that the court held that there were not substantial valuable rights in the agreement.

- Capital payment for know-how or patents – to the extent that any of the initial fee could be attributed to patents or know-how then capital allowances should be available under Parts 7 or 8 Capital Allowances Act 2001.
- Deferred revenue expenditure – just because an initial lump-sum payment is made, it does not mean that this is necessarily capital and general principles should apply to determine if expenditure is income or capital in nature. For example, a prepayment for ongoing staff training may be income in nature albeit paid up front (c.f., an initial one-off training, which is likely to be capital in nature). Such payments for deferred revenue expenditure could be written off in the accounts up front or over a period of years. The accounting treatment will be important in this respect¹³² but not conclusive.¹³³
- Acquisition of trademarks and copyright – these rights would be capital gains assets – possibly wasting assets – and there are no capital allowance rules for such rights.
- Costs of premises are likely to be capital in nature and fit out costs may qualify for relief under the capital allowances code.

HMRC states in its published guidance that:

Whether an apportionment between capital and revenue expenditure is appropriate depends on the facts. The facts may show that no part of the initial lump sum fees can be attributed to services of a revenue nature provided by the franchiser because such services are separately charged for in the annual fees.

In practice, franchisees may put forward an apportionment without reference to the franchisor. An apportionment of this type may be difficult to justify in relation to the services provided. For instance, some franchisors are unwilling to negotiate special terms with individual franchisees and the same lump sum is payable irrespective of the actual services required from the franchisor; for example, the number of staff needing training may be irrelevant.

130 Capital Gains Manual CG68270 and CG76724.

131 *Balloon Promotions Limited v. Wilson* SpC 524/06 [2006] STC (SCD) 167.

132 For example, *Strick v. Regent Oil Limited* (1965) 43 TC 1; *Johnson v. Britannia Airways Ltd* (1994) STC 763.

133 *EEC Quarries Limited v. Watkis* (1975) STC 175.

If the agreement terms are such that no part of the initial fee is specifically attributed to revenue items then the claim for apportionment may need to be critically examined.¹³⁴

ii Capital allowances

A deduction for capital expenditure is available under the capital allowances regime to reduce profits for corporation tax (under the pre-April 2002 regime) and for income tax purposes. Generally, expenditure must be classified as capital and must be incurred on specified assets. Specific rules provide for expenditure on R&D, know-how and patents to be relieved.

The quantum of capital allowance that can be claimed by a taxpayer is provided at a specified rate for each tax year and depends on the type of capital asset and the type of entity incurring the expenditure.

Acquisition of know-how

Where a taxpayer incurs expenditure for the purpose of acquiring know-how from an unconnected person, a capital allowance deduction may be available if the know-how is used in a trade.¹³⁵

‘Know-how’ is defined as ‘any industrial information or techniques likely to assist in manufacturing or processing goods or material; working a source of mineral deposits; or carrying out any agricultural, forestry or fishing operations’.¹³⁶

HMRC takes the view that this definition does not extend to commercial know-how (such as market research, customer lists and sales techniques) because this is not ‘industrial information or techniques likely to assist in the manufacture of goods or materials’.¹³⁷ As such, know-how allowances are unlikely to be of relevance in many franchising situations.

The rate of allowance depends on the tax year in which the relief is sought. Where relief is sought, the allowance is:

- a* all years (except the year in which (b) applies) – 25 per cent of the excess of available qualifying expenditure (AQE) for the pool of assets subject to capital allowance deduction over total disposal value (TDV); and
- b* final tax year (e.g., when trade discontinued) – amount by which the AQE exceeds the TDV.¹³⁸ If the TDV exceeds AQE then an assessable balancing charge will arise to the taxpayer.¹³⁹

Broadly speaking, AQE is capital expenditure on know-how that is incurred for the purposes of the trade and TDV is the net proceeds of sale (which consists of capital sums).

134 Business Income Manual BIM57620.

135 CAA 2001, Section 454(1).

136 CAA 2001, Section 452(2).

137 Capital Allowances Manual CA70030.

138 CAA 2001, Sections 458(1), (6); 457(4), (5).

139 CAA 2001, Sections 457(3); 458(5).

Acquisition of patent rights

A capital allowance deduction is available for capital expenditure incurred to acquire patent rights for the purpose of a trade within the charge to UK tax¹⁴⁰ (or for patent rights that give rise to UK taxable income).¹⁴¹

Patent rights are defined as rights to do or authorise the doing of anything that would, but for that right, be an infringement of a patent.¹⁴²

There is a separate pool of expenditure for each trade and a pool for non-trading expenditure. The writing down allowance available is 25 per cent of the excess of the AQE over total disposal receipts (TDR)¹⁴³ each tax year with similar rules for balancing charges or allowances as know-how. Where the patent rights are not used for a trade, any allowance is given against patent income only.

iii Ongoing fees

In respect of ongoing payments, these will almost always constitute deductible expenses for the purposes of calculating the franchisee's trading profits as they should be income in nature and wholly and exclusively incurred for the purposes of the trade. The key question for such expenses will be whether they are subject to deduction of tax at source – which may also be a question for some capital expenditure included in the initial fee (e.g., if patents have been acquired). Whether or not this is an issue for the franchisee will depend on whether or not the agreement includes a gross-up clause, pursuant to which the fees are increased such that the franchisor stays in the same after-tax position.

As well as the above issues that are specific to the agreement, franchisees will have to contend with all the same tax issues as many other small businesses would have to contend with. For example it would have to consider:

- a* If it is a start-up, should the franchisee establish itself as a sole trader, a partnership or a company?
- b* How are its real estate costs treated? Can it save taxes on its acquisition of any real estate and can it make sure its rental payments are deductible?
- c* Will it obtain tax deductions for depreciating capital items (e.g., under the capital allowances rules)?
- d* Are interest expenses tax deductible for the franchisee? Will it have to deduct tax at source?
- e* Can the franchisee attract investors by offering tax-incentivised equity (e.g., under the UK enterprise investment scheme rules)?
- f* Can it minimise VAT in respect of its supplies to the public?

VII TRANSFER PRICING

Where transactions take place between related, associated or connected companies, there is an incentive for profits to be 'moved' from a company with a relatively high tax rate to another company with a relatively low tax rate. This could be achieved, for example, in the

140 CAA 2001, Section 468(1).

141 CAA 2001, Section 469.

142 CAA 2001, Section 464(2).

143 CAA 2001, Section 472.

context of a trademark licence, by an inflated royalty being charged by a licensor in a low-tax jurisdiction to a licensee resident in a high-tax jurisdiction (thus stripping taxable profits out of the high-tax jurisdiction).

The transfer pricing regime seeks to prevent this type of practice by requiring an arm's-length price to be paid (in the above case, an arm's-length royalty to be paid by the licensee). This is a general rule, which is similar to the specific rules, which impose market value prices on transactions between connected persons (e.g., for capital gains tax, TCGA 1992, Section 17 and for chargeable intangible assets, CTA 2009, Section 845).

Many countries have a transfer pricing regime although the precise mechanics vary from country to country. The United Kingdom's transfer pricing rules are in TIOPA 2010, Part 4. Broadly speaking, the provisions seek to adjust the tax return of a person who obtains a potential UK tax advantage from its non-arm's length dealing with another person. The tax return is adjusted as though the transaction had been at arm's length. Small and medium-sized enterprises (SMEs) may be exempt from transfer pricing rules under Section 166 TIOPA unless the transaction is with a party in a non-qualifying territory (broadly speaking a tax haven), although HMRC may by notice, in the case of medium-sized enterprises (and where the UK Patent Box applies, small enterprises), disapply the exemption. The definition of an SME follows the general EU definition.¹⁴⁴

The provisions apply where provision has been made or imposed between two 'affected persons' by a transaction or series of transactions, the participation condition is met, and the actual provision differs from what would have been the actual provision between independent enterprises dealing on arm's-length terms (the 'arm's-length provision'). The UK rules apply even where the transactions are between two UK parties.

To meet the participation condition, one person must control the other or they must be under control by the same person. 'Control' means voting control or control by virtue of powers conferred by the articles of association or other document regulating the powers of a company whereby the company's affairs are conducted in accordance with the wishes of the controller.¹⁴⁵ In the context of a partnership, control means the right to a share of more than one half of its assets or income. The definition is extended in certain circumstances (e.g., to include rights held by connected persons, rights that will be acquired in the future or persons who own 40 per cent or more of the controlling shares in a company where there is another such 40 per cent or more shareholder).

Where the provisions apply, penalties may be assessed to the extent of tax lost because of fraud or negligent conduct. However, HMRC indicates that where the taxpayer makes an honest and reasonable attempt to comply with the legislation, HMRC will not impose a penalty.¹⁴⁶

In practice, determining the arm's-length value, particularly one that is acceptable to the revenue authorities of two countries, is a difficult exercise. This is particularly the case for intangible assets such as IP, which are often unique to the company or group concerned.

144 As set out in the Annex to Commission Recommendation 2003/361/EC of 6 May 2003 (concerning the definition of micro, small and medium-sized businesses).

145 CTA 2010, Section 1124.

146 International Tax Manual, INTM 483120.

The OECD Transfer Pricing Guidelines¹⁴⁷ describe valuation methods that are generally acceptable to tax authorities around the globe and that have been accepted by HMRC. These are divided into traditional transaction methods and transactional profit methods.

i Traditional transaction methods

Comparable uncontrolled price (CUP)

The CUP method simply compares the price charged between the connected parties (the ‘controlled transaction’) with the price in a comparable uncontrolled transaction (i.e., a comparable transaction between unconnected third parties – an ‘uncontrolled transaction’). The price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction if the two are comparable. The two transactions should be comparable if:

- a* there are no differences between the transactions being compared or between the enterprises entering into the transactions, which could materially affect the price charged in the open market; and
- b* where there are differences, reasonably accurate adjustments can be made to eliminate their effect.

While the CUP method is the most reliable method for transfer pricing, identifying good, reliable comparable uncontrolled transactions can be difficult in practice, as was demonstrated in the case of *DSG Retail Ltd and others v. HMRC*.¹⁴⁸

Resale minus (resale price)

This method is most useful where a company purchases goods for distribution from a connected party (the minus effectively corresponds to a commission and represents the amount out of which the reseller would seek to cover its expenses and, in the light of its functions (taking into account assets used and risks assumed), make an appropriate profit).

Cost plus

This method is most useful for services or where semi-finished goods are transferred between related parties (e.g., a manufacturing company selling to a distribution affiliate), or where joint facility agreements have been concluded. It is in effect the opposite of resale minus, looking at costs incurred and stating that an independent third party would expect to make a fixed profit in addition to such costs. The starting point is therefore the costs incurred by the supplier of the goods or services. A percentage is then added to this to give the supplier a profit appropriate to the functions carried out and the market conditions. The profit element is determined by looking at comparable uncontrolled transactions carried out by the supplier with independent third parties (an ‘internal comparable’). If the supplier does not enter into comparable uncontrolled transactions, the mark-up that would have been earned in comparable transactions by an independent enterprise (an ‘external comparable’) should be considered. As cost-plus generally gives rise to a low fixed profit, it is more suitable to low-risk, low-value functions and is likely to be challenged where the functions or risk involved should give rise to a variable and potentially high level of profits. A risk and functional analysis of what the supplier actually provides is therefore key as to the application

147 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, July 2010.

148 TC00001.

of this (and all transfer pricing methodologies). In looking at comparables it is therefore important to demonstrate similar risk allocations in comparable circumstances. Cost plus can also be used for R&D services, provided that the functional analysis and allocation of risk justify this methodology and any realistically available options or alternative structures in pricing the transaction. In this sense it is sometimes necessary to consider not just who contractually takes the entrepreneurial risk but who would take the entrepreneurial risk were the parties independent.

ii Transactional profit methods

There are two further methods supported by the OECD guidelines that do not look so much at each transaction undertaken by a party but at what level of profit should be allocated to the party. These two methods are the profit split method and the transactional net margin method.

Profit split

This method seeks to determine the division of profits that independent enterprises would have expected to realise from the relevant transactions. It is a 'two-sided' method as it looks at both (or all the) parties to the transaction. The other methods are 'one-sided' in that they only test the appropriate return for a single party without considering the effect on the return of the other party. The method is useful for complex trading relationships where it can be difficult to evaluate transactions separately. The OECD Guidelines make clear that application of a profit split methodology should split the profits on an economically valid basis, which approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length.

Transactional net margin method (TNMM)

The TNMM looks at the net profit relative to a particular base (e.g., costs, sales, assets) that a taxpayer realises from a controlled transaction. In this sense it is similar to cost plus or resale minus. So in this sense internal comparable should be considered in the first instance followed by external comparables. The OECD Guidelines emphasise finding comparable transactions based on functional analysis.

Applying transfer pricing principles to transactions involving intangible assets, including disposals of such assets and royalty payments, is a particularly difficult area because of the uniqueness of most IP and therefore the lack of comparables. There is a specific chapter of the OECD Guidelines dedicated to intangible property. Similarly, there are special chapters dedicated to intra-group services, cost contribution arrangements and business restructurings – all of which may need to be considered in the context of franchising arrangements. The chapter relating to intangible assets has been rewritten as part of the BEPS project.¹⁴⁹ This provides new guidance on defining intangibles, identifying transactions involving intangibles and for determining arm's-length terms for transactions involving intangibles. In a key change resulting from this project, it has been highlighted that IP income should accrue to entities that perform value-creating functions relating to the development, maintenance, enhancement, protection and exploitation of the intangible asset. The net effect of this is that it will be more difficult for multinational enterprises to argue that a company in a low-tax

149 Guidance on Transfer Pricing Aspects of Intangibles, BEPS Action 8: final report dated 5 October.

jurisdiction that simply funds IP development (e.g., R&D or marketing expenses) can accrue the income from the resulting IP, as it will not have sufficient substance in terms of people functions.

Whichever valuation method is chosen, evidence will be needed to justify the value given. Documentation should be kept to evidence the relevant relationship, nature, terms and prices of the relevant transactions, the valuation method used (particularly how the arm's-length price was determined, including any functional analysis or comparable study). The basis for any computational adjustment required to reach an arm's-length value should be retained, and the terms of relevant commercial arrangements with both third-party and affiliated customers. Such documentation should be kept for at least six years from the end of the chargeable period to which it relates.

The extent of documentation should be such 'as is reasonable given the nature, size and complexity (or otherwise) of their business or of the relevant transaction (or series of transactions) but which adequately demonstrates that their transfer pricing meets the arm's-length standard'.¹⁵⁰

It should also be borne in mind that where transfer pricing is relevant to any transaction, a taxpayer may apply pursuant to Section 223 of the TIOPA for an advance pricing agreement (APA) to seek clarity on the terms of a transaction for transfer pricing purposes. Such agreements can be unilateral (i.e., only agreements with HMRC) or bilateral (i.e., where the agreement relates to a cross-border transaction seeking agreement with HMRC and the tax authority in the other jurisdiction).

VIII VALUE ADDED TAX

Broadly speaking, VAT is an indirect tax, chargeable on consumer expenditure. It is based upon EU law, in particular the EU VAT Directive.¹⁵¹ VAT is implemented under the VAT Directive and various other EU regulations thereunder as well as local implementing laws in each jurisdiction. In the United Kingdom, the main implementing law is the Value Added Tax Act 1994 (VATA).

Under the UK rules, VAT applies to any supply where:

- a* there is a supply of goods or services (including anything related to that supply);
- b* the supply is made in the United Kingdom;
- c* the supply is a taxable supply;
- d* the supply is made by a taxable person for consideration; and
- e* the supply must be made in the course or furtherance of a business carried on by the taxpayer.¹⁵²

There are in addition separate VAT charges where goods are 'imported' into the United Kingdom from outside the EU and also where there is an 'acquisition' of goods in the United Kingdom from another EU Member State.¹⁵³

150 INTM 483030.

151 Council Directive 2006/112/EC on the common system of value added tax.

152 VATA, Sections 1(2), 4.

153 VATA, Section 1(1)(b) and (c).

VAT is collected and payable by the supplier or by the person making the importation or acquisition. The 'cost' of VAT is intended to be borne by the end user but the tax is collected at different stages in the supply chain.

A VAT-registered person must charge VAT (output tax) on its VATable supplies and can recover the VAT it pays (input tax) on supplies received by it to the extent that this can be attributed to taxable (i.e., VATable or zero-rated) supplies. It pays to HMRC (generally on a monthly or quarterly basis) the difference between its output and input tax (or receives a repayment where input tax exceeds output tax).

Input tax is generally only recoverable to the extent it is attributable to taxable supplies. Therefore, where a VAT-registered person makes both taxable and non-taxable (i.e., exempt or certain outside the scope of VAT) supplies, only a proportion of his or her input tax will be recoverable.

Businesses that make taxable and exempt supplies are generally referred to as 'partially exempt traders', typical examples of which are banks and insurance companies. The recovery of input tax attributable to 'outside the scope' supplies varies. However, recovery is not blocked in the case of exports of services that would be taxable if made in the United Kingdom.

i Taxable person

VAT applies to supplies made by a taxable person. Therefore, a person who is a taxable person must charge VAT on taxable supplies made by him or her at the appropriate rate and a person who is not a taxable person must not charge VAT in respect of any supply.

A 'taxable person' is essentially a person (including a company or a partnership) who makes taxable supplies in the United Kingdom in the course or furtherance of a business carried on by him or her and the aggregate value of the supplies that have been made by him or her in the previous 12 months or less, or are expected to be made in the forthcoming 12 months (or in the next 30 days alone), exceeds the prevailing registration limit (this is currently £83,000 in the United Kingdom). This threshold has been removed with effect from 1 December 2012 for non-UK, EU-based VAT-registered traders making supplies of goods to UK-based consumers (referred to as distance selling). Businesses may also register voluntarily for VAT (thus becoming taxable persons).

ii Supply of goods and services

A 'supply of goods' means the supply of the whole property in goods but the transfer of an undivided share in property or of the possession of goods is a supply of services (unless possession is transferred under a sale agreement or in certain other circumstances (e.g., hire purchase agreements). Additionally, certain other supplies are specifically treated as supplies of goods (e.g., supplies of power or certain supplies of land).¹⁵⁴

A 'supply of services' is defined as anything that is not a supply of goods but is done for a consideration (including, if so done, the granting, assignment or surrender of any right).¹⁵⁵ Granting IP rights will generally be supplies of services for VAT purposes.

154 VATA, Schedule 4 paragraphs 1–3.

155 VATA, Section 5(2)(b).

iii Time of supply

For goods, the time of supply is when they are removed or otherwise made available. If the goods are removed before it is known whether they are to be supplied, the time of supply is when the supply becomes certain or, if sooner, 12 months after removal.¹⁵⁶

The 'time of supply of services' is when the services are performed.¹⁵⁷ An exception to this general rule is where there is a continuous supply of services, in which case the time of supply is the earlier of when the payment is received by the supplier and when the supplier issues the invoice.¹⁵⁸ In the case of royalties, the time of supply is the earlier of when the royalties are received and a VAT invoice is issued.¹⁵⁹

For both goods and services, it is possible to accelerate the time of supply by the issue of a VAT invoice or receipt of payment.¹⁶⁰

iv Taxable supply

A taxable supply is a supply of goods or services made in the United Kingdom other than an exempt supply.¹⁶¹ There are three rates of VAT on taxable supplies, 20 per cent, 5 per cent (on a limited class of supplies) and nil (on zero-rated supplies).

An 'exempt supply' is a supply specified in Schedule 9 of the VATA. Exempt supplies include financial and insurance services, but supplies of IP are not generally exempt. Zero-rated supplies are set out in Schedule 8 VATA and include, subject to detailed conditions, food, children's clothing, medicines subscribed by pharmacists, etc.

There are two other categories of supply, which are important for VAT purposes: 'outside the scope' supplies and other supplies treated as not involving a supply of goods or services with the result that VAT is not chargeable. Examples of such supplies include the supply of certain international services (e.g., a transfer of IP to a customer outside the United Kingdom) and a transfer of a business as a going concern.

v Place of supply

The complex 'place of supply' rules determine in which Member State, if any, a supply of goods or services should be taxed. The result is that UK VAT is only chargeable where the place of supply under these rules is the United Kingdom. UK VAT is not chargeable if the place of supply is outside the United Kingdom, even if made by a taxable person. If the place of supply is another Member State of the EU, that Member State has the jurisdiction to charge its local equivalent of VAT on the supply. If the place of supply is outside the EU, no Member State has the jurisdiction to charge VAT on the supply although VAT or sales tax may be chargeable outside the EU.

There are detailed rules for both goods and services and the rules vary depending on whether supplies are to 'taxable persons' (broadly speaking, businesses) or not. In the context of franchising we would assume that all supplies by franchisor to franchisee are business-to-business supplies.

156 VATA, Section 6(2).

157 VATA, Section 6(3).

158 SI 1995/2518, Regulation 90(1).

159 SI 1995/2518, Regulation 91.

160 VATA, Section 6(4).

161 VATA, Section 4(2).

From 1 January 2010, the Place of Supply of Services Directive (Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services) has applied in the EU. This has fundamentally changed the place of supply of services (and therefore place of supply of most IP transactions) in the EU. Further changes came into effect in 2011 (certain services supplied where performed) and in 2015 (relating to broadcasting, telecommunications and electronically supplied services).

In summary, the general place-of-supply rule for services is that:

- a* for business-to-consumer (B2C) supplies, the general rule is that the supply is made where the supplier belongs; and
- b* for business-to-business (B2B) supplies, the general rule is that the supply is made where the recipient belongs.

However, this general rule is subject to so many exceptions that it should not be looked upon as the normal position. It is the position should no exception apply.

A crucial question to determine place of supply is normally where the supplier or recipient 'belongs'. For a relevant business person, it is broadly the place where that person has its business establishment or some other 'fixed establishment', or (in the United Kingdom at least) if it has more than one business establishment, that which is most directly concerned with the supply of services in question. Non-business persons are treated as belonging in the country of such a person's usual place of residence.¹⁶²

Business-to-business supplies of services

Supplies of services by a supplier to a relevant business person are treated as supplied in the country in which the recipient belongs. For this purpose, a relevant business person is a person registered for VAT in the United Kingdom, Isle of Man or EU or any person who independently carries out in any place any economic activity.¹⁶³

Again this can be overridden, for example, for telecommunications, broadcasting and electronically supplied services where 'use and enjoyment' provisions may apply.

Business-to-business supplies of goods

These rules are more complicated than the rules for services and we do not go into them in detail here as the heart of a franchising arrangement is the licensing of IP and the supporting services. Nevertheless there can be associated agreements for the supply of goods so the rules cannot be ignored entirely.

Section 7 VATA sets out a priority for the place of supply of goods. If a supply does not involve the removal of the goods to or from the United Kingdom, they shall be treated as supplied in the United Kingdom if they are in the United Kingdom. There is then a complicated hierarchy of rules that follow this to determine place of supply. In any event, if goods are supplied in the United Kingdom, supplies of goods to EU registered businesses are zero-rated provided the goods are removed from the United Kingdom within three months of the supply. Similarly, supplies involving the exporting of goods outside the EU are also zero-rated.

162 VATA, Section 9.

163 VATA, Section 7A(4).

vi Importation of services from other countries

Where a supplier belonging outside the United Kingdom makes a supply to a taxable person in the United Kingdom and such a supply is treated under the above rules as taking place in the United Kingdom, the ‘reverse charge’ rules apply. Under the reverse charge, the recipient of the services (rather than the supplier of the services) is required to account for VAT at the rate applicable in the Member State in which he or she belongs to the relevant tax authority. The rules also allow the recipient an input tax deduction in respect of purchases related to taxable outputs. The effect of the reverse charge in the United Kingdom, therefore, is to treat services brought in from outside the United Kingdom in the same way as services that are actually supplied in the United Kingdom if the recipient of the services is VAT registered but with the recipient applying the relevant VAT formalities. The reverse charge procedure may also be used on intra-EU acquisitions of goods.

Generally, reverse charges have no effect on recipients who are not taxable persons.

vii Effect of the above rules on franchising arrangements

The net effect of the above rules on franchising arrangements is that generally:

- a* UK franchisors will charge VAT to UK franchisees in respect of all services and goods (assuming the goods are in the United Kingdom);
- b* UK franchisors will not charge VAT to non-UK franchisees in respect of services (which includes IP licences). VAT on the services will be accounted for by EU franchises under the reverse charge procedure. The VAT treatment of any goods supplied will depend in more detail on the nature of the supply chain;
- c* non-UK franchisors will not need to charge VAT on services supplied (including on the IP licences). EU-based franchisees would account for VAT under the reverse charge procedure. Again the VAT treatment of any goods supplied will depend in more detail on the nature of the supply chain;
- d* if there is a discrepancy between the VAT treatment of any of the supplies under a franchising agreement then the question would then need to be asked as to whether one apportions the fees between supplies with different VAT treatments or whether there is a single composite supply with VAT determined on the principle element of the supply under the principles established in *Card Protection Plan v. C & E Comrs*;¹⁶⁴ and
- e* to the extent a franchisee is VAT registered and carrying out fully VATable services, it should be able to recover the VAT on the franchising fees.

A recent VAT case involving franchising arrangements, *Kumon Educational Company Limited v. HMRC*,¹⁶⁵ looked at rewards provided to a franchisee by the franchisor. It was held that these rewards were not for a separate VATable supply but were linked to the franchise fee and in effect amounted to a contingent discount. The franchise fee could therefore be reduced for VAT purposes and VAT previously accounted for repaid.

¹⁶⁴ Case C-349/96 [1999] STC 270, ECJ (Part V11), applied by the House of Lords [2001] UKHL/4 STC 174.

¹⁶⁵ [2015] UKFTT 84.

TRADE SECRETS AND FRANCHISING

*Warren Wayne and Mark Abell*¹

The core of franchising as a commercial strategy is its use of a business format – a format that is usually a matrix of commercial know-how, which although perhaps not entirely novel in its individual elements, is commercially distinctive and valuable as a composite. This know-how is generally kept confidential and is what distinguishes the franchise format from its competitors.

As this know-how is not patentable, it can only be protected by way of contract and trying to ensure that it is shared only on a need-to-know basis. The problem with this, however, is that once this confidential know-how is shared with a franchisee or its employees, it is impossible to take it back again.

Each jurisdiction has a different way of dealing with the protection of this valuable secret know-how, which makes adapting a homogenised approach to their protection by franchisors something of a challenge. It is therefore to be welcomed by franchisors that trade secret reform is currently high on the agenda of all the major economic regions.

In the EU, a draft Directive to harmonise and upgrade European laws is currently pending before the European Parliament. France has even gone as far as to introduce new trade secrets laws in advance of the EU Directive being passed. In the United States, draft bills introducing federal-level trade secret protection are pending in Congress, and in China a draft revision to its trade secrets laws has recently been submitted to the state administration. In addition to this, there are ongoing discussions among the ASEAN Free Trade Area nations regarding the establishment of harmonised trade secrets laws in that region.

The EU Directive is expected to be passed during 2015, when the EU Parliament will consider the original wording proposed by the EU Commission together with the latest iteration of a ‘compromise draft’ that was published on 26 May 2014² following consultation and comment by interested parties. After the adoption of the Directive by the EU Parliament, the EU Member States will have two years to implement local laws giving effect to it. Franchisors therefore need to prepare themselves so that they can take best advantage of this new regime.

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2 EC 9870/14.

I THE NEED FOR A TRADE SECRETS DIRECTIVE

The primary driver for an EU Directive is an economic one. As part of the 'EU 2020 Strategy' the European Commission is obligated to create an innovation-friendly environment for business as part of its commitment to ensuring the smooth functioning of a single European market.³

As intangible assets such as trade secrets and confidential information have grown to account for approximately 80 per cent of the market value of publicly traded companies, Europe has increasingly been at risk of becoming an unattractive environment for innovative businesses to locate themselves. Extensive fact-finding work by the Commission revealed that companies of all sizes, in all most every sector of the economy, reported that trade secrets are very important to them. Alongside this, however, it was found that misappropriation of trade secrets is on the rise.

Unfortunately, trade secrets law in the EU is best described as 'patchwork', with different approaches and different levels of protection in Member States creating uncertainty among businesses as to the type of information that is protectable as a trade secret and with, at times, inadequate enforcement mechanisms. Only around two-thirds of EU states currently have specific legislation concerning the misappropriation of trade secrets, offering enforcement environments that differ widely.

In part, this inconsistency in trade secrets regulation reflects both the permeation of trade secrets across a wide range of business activities and the fact that different countries have approached the issue from different starting points without any overarching coordination. For example, in France there is currently legislation to protect against misappropriation of trade secrets in the employment relationship – but not in an intellectual property context, which instead relies on principles derived through case law.⁴ Likewise, in Germany trade secrets are regulated through both competition law and employment law, but enforcement relies on a system that does not provide for mutual disclosure of evidence, which is often critical in such cases. This picture is complicated further by the fact that this *ad hoc* development of the law has led some countries to have more than one definition of a trade secret, depending on the legal context. In France, the United Kingdom and Germany, for example, the legal definition of a trade secret varies depending on whether the information is disclosed in the context of the employment relationship. This is clearly unhelpful for businesses.

Against this backdrop, the EU Commission concluded that there is an obvious public interest in securing fair competition standards and, at the same time, providing a business environment that encourages and rewards investment in research and innovation.

As matters stand, the Directive will harmonise laws across the EU in three main areas:

- a the definition of 'trade secret', and the means by which holders will be protected throughout Europe;
- b the remedies available to trade secret holders when they suffer a theft or unauthorised use of their trade secrets; and
- c the measures the court can use to prevent trade secrets leaking during legal proceedings.

3 EC 9870/14, Section I, paragraph 2.

4 Article L 621-1 of the Industrial Property Code, which protects 'manufacturing secrets' in the context of the employer–employee relationship. The definition included in the draft directive does, however, correspond to that developed by French case law under (1) Article L 621-1 of the Intellectual Property Code and (2) disputes involving contractual matters or unfair competition in which violation of a 'secret de fabrique' or trade secret was alleged.

II DEFINING TRADE SECRETS

Regardless of any other changes to the draft Directive, it is highly unlikely that the definition of a trade secret will undergo any changes. The existing drafts adopt the 1994 WTO TRIPS definition of a trade secret, which is also reflected in the definition adopted by the United States in the Uniform Trade Secrets Act and which will be carried over into any federal law, if enacted.

Article 2 of the draft Directive defines a trade secret as:

[i]nformation which meets all of the following requirements:

- a) is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;*
- b) has commercial value because it is secret;*
- c) has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information to keep it secret.*

While this definition corresponds with the existing definitions in Member States such as Denmark, Spain and Italy, it will mark a change in countries such as the United Kingdom, Germany, Poland and Hungary, where the requirement for a trade secret to have commercial value will narrow existing approaches.

At present, the classic definition of confidential information under English law is founded in equity and requires that the information (1) has the necessary quality of confidence and (2) is disclosed in circumstances importing an obligation of confidence. English law does not currently require information to have ‘commercial value because it is secret’ for it to be classed as confidential.

In the context of confidential information in the employment relationship under English common law, a trade secret is information that an employee is obliged to keep confidential, even after the termination of employment and without any post-termination restrictions. In this context, ‘trade secret’ means information of a sufficiently high degree of confidentiality based on all the circumstances. These include its importance to the business and the measures taken to protect it. Typically, examples of this category have included the legendary ‘Coca-Cola formula’ as a pure trade secret that is protected regardless of any contractual agreement. This is distinguishable from ‘valuable business information’, which only remains protected after the end of employment if it is covered by express contractual wording.

Various issues come to light as a result of this.

- a* The requirement that the information be ‘secret in the sense that it is not [. . .] generally known or readily accessible’ applies not only to single pieces of information, but also to collections of information. This will ensure that manuals, processes and recipes can all be protected, as long their precise configuration is not generally known outside the business or its contractual supply chain. It also means that it will become easier to enforce confidentiality over customer service data and software features and functionality across Europe.
- b* The requirement for ‘commercial value’ raises questions, such as ‘does the information have to have value to the original holder or it is sufficient that it would have value in the hands of another?’ For example, confidential information that is damaging to a company might not have ‘commercial value’ to that company; although it is likely they would take steps to keep the information secret, they cannot exploit it for value. In the hands

of a competitor, however, or a newspaper, the information may have commercial value as it could improve the relative reputation or activities of the competitor or prompt people to buy newspapers.

- c The requirement that the information ‘has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information to keep it secret’ means that as long as a businesses’ supply chain, licensees, franchise holders and other business partners are required to observe its security requirements for the information, then it remains ‘secret’ and protectable.
- d In an employment law context, the definition of ‘trade secret’ under the Directive is broader than the existing English law common law rules. This indicates greater rights for employers in restricting the use of information by their former employees following termination of employment, although this was not the Commission’s intention, as discussed below.
- e The issue above highlights an important question for Member States: whether implementation of the Directive should come in addition to – or instead of – their national legislation and common law rules.
- f The similarities between the proposed European definition and that of the US Uniform Trade Secrets Act should help promote the confidence of international businesses to expand their operations in Europe. The US approach is that a ‘trade secret’ is one that:
 - derives independent actual or potential economic value from not being generally known to, or readily ascertainable by, other persons who can obtain economic value from its disclosure or use; and
 - is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.

III NEW HEADS OF LIABILITY AND REMEDIES

i Unlawful use of trade secrets

Article 3 of the draft Directive sets out the types of liability for infringement of rights in qualifying trade secrets. These relate to the acquisition, use and disclosure of trade secrets and infringing goods. Infringing goods will be those that significantly benefit from trade secrets that have been unlawfully acquired, used or disclosed.

This means that the use or disclosure of a trade secret will be unlawful (1) where the user knows (or should know) that it was obtained unlawfully or (2) where the infringing activity is carried out intentionally or with gross negligence by a person who obtained the information unlawfully or in breach of some other duty of confidence. Where a trade secret is obtained from a third party, its use or disclosure may still be unlawful if the user knew or should have known that the person from whom it was obtained was using or disclosing the trade secret unlawfully.

At the time of writing there are two separate proposals. The original proposal is:

Article 3(1): ‘The acquisition of a trade secret [. . .] shall be considered unlawful whenever carried out intentionally or with gross negligence by:

- a) *unauthorised access to or copying of any documents, objects, materials, substances or electronic files, lawfully under the control of the trade secret holder, contained the trade secret or from which the trade secret can be deduced;*
- b) *theft;*

- c) *bribery;*
- d) *deception;*
- e) *breach or inducement to breach a confidentiality agreement or any other duty to maintain secrecy;*
- f) *any other conduct which, under the circumstances, is considered contrary to honest commercial practices.'*

The latest 'compromise draft' of 26 May 2014 proposes the deletion of 'theft', 'bribery', 'deception' and 'breach or inducement to breach a confidentiality agreement or any other duty to maintain secrecy'.

The issue that has drawn most attention, however, is the proposal to create liability for conduct that is considered contrary to 'honest commercial practices'. While some conduct will clearly contravene this standard, the potential for differing and inconsistent interpretations across Member States will be high until such time as the Court of Justice of the EU decides a case in which it can give guidance on interpretation.⁵

The Directive will also make it unlawful to produce infringing goods or place them on the market. In effect, this will be a strict-liability offence, as no particular state of mind is required and liability will follow even if the manufacturer did not know that the goods were infringing.

One aspect of liability that the EU will not insist on, however, is the criminalisation of trade secret misuse. Although some states, such as Germany, France and Finland, already have varying degrees of criminal sanctions in this area, the EU will not compel or encourage Member States to follow suit.⁶

Reverse engineering is another area where there are no planned remedies. This is a concern in some industries, as highlighted by the Max Planck Institute:

the use without restrictions of trade secrets obtained through reverse engineering appears problematic, in particular in sectors where [. . .] considerable investments are made in the development of new products. Notable examples include the cosmetic industry, which regularly invests quite heavily in the development of perfumes, but where the know-how generated thereby can be decoded with relative ease through reverse engineering. The unrestricted use of such know-how raises concerns that it could pose a substantial threat to the companies concerned, eventually leading to market failure whereby such goods would no longer be produced.⁷

5 Comments of the Max Planck Institute for Innovation and Competition of 3 June 2014 on the Proposal of the European Commission for a Directive on the protection of undisclosed know how and business information (trade secrets) against their unlawful acquisition, use and disclosure of 28 November 2013, COM(2013) 813 final.

6 EC 9870/14, Section II, paragraph 6: 'Member States agreed that the draft directive should not interfere with their national prerogatives regarding criminal law.'

7 Comments of the Max Planck Institute for Innovation and Competition of 3 June 2014 on the Proposal of the European Commission for a Directive on the protection of undisclosed know how and business information (trade secrets) against their unlawful acquisition, use and disclosure of 28 November 2013, COM(2013) 813 final.

ii Limitation periods

Businesses are likely to have up to a maximum of six years to take action for damages, although it remains possible that the European Parliament will opt for a shorter maximum limitation period. The original proposal was for a limitation period of two years and this proposal still forms part of one of the two drafts that will be considered by the European Parliament.

iii Remedies

If a trade secret is used, copied or disclosed in breach of the Article 3 standards (including breaches of contractual restrictions in licences, franchise agreements, or non-disclosure agreements (NDAs), for example), the remedies will include:⁸

- a* injunctions to prevent further use or disclosure of the information;
- b* court orders prohibiting infringing goods from being produced, marketed, sold, stored, imported or exported;
- c* seizure or delivery up of infringing goods (including imported goods) to stop them being circulated in the market;
- d* delivery up of electronic information, even where it is part of a larger file or materials;
- e* court orders compelling product recalls;
- f* orders requiring alteration to the products, so that infringing characteristics are removed (this includes software and electronic data, such as customer databases);
- g* destruction of infringing goods; and
- h* publication of judgments in appropriate cases.

Use in this context also includes using the information to ‘significantly benefit’ the design, functioning or processes used in other products.

IV HARMONISATION OF COURT MEASURES TO PROTECT TRADE SECRETS DURING LEGAL PROCEEDINGS

Article 8 of the Directive will require Member States to introduce measures to preserve the confidentiality of trade secrets during legal proceedings. This includes, at least, the option to restrict parties’ access to hearings and order them to be carried out solely in the presence of legal representatives and authorised experts.

This requirement has the potential to cause a significant change in the law in some Member States, notably Denmark, Poland, France and Belgium. In particular, the potential for hearings to be held in the absence of the parties to the action is unfamiliar to many legal systems and could foreseeably be challenged on human rights grounds.

The introduction of ‘confidentiality clubs’ to control the dissemination of confidential evidence in trade secrets disputes will also be a novel development in many countries. A confidentiality club is an agreement made by parties in litigation that limits access to confidential documents, so that they are only available to specified people. The upheaval to court procedure in countries such as Germany is likely to be dramatic.

⁸ EC 9870/14, Articles 11 to 14.

V PRACTICAL ISSUES

i Insider threat

Franchisees and their employees and contractors, as well as the franchisor's own employees and contractors, can be a particular threat to trade secret security, even if they are not malicious. According to the FBI, just under a quarter of insider incidents each year are due to employee mistakes.⁹

Staff are also often more vulnerable to malicious attacks than they realise. In a 2007 study, Sophos found that phishing attacks from online social networks had a 72 per cent success rate, as opposed to other methods, which only had an average success rate of 15 per cent.¹⁰

The threat is even greater from staff with malicious intent, with some estimates placing 85 per cent of data losses at the door of employees. These activities are generally achieved with normal levels of access to company data and systems:

*You're dealing with authorized users doing authorized things for malicious purposes. In fact, going over 20 years of espionage cases, none of those involve people having to do something like run hacking tools or escalate their privileges for purposes of espionage.*¹¹

The corresponding amendment to Article 13(1) gives Member States the option of effectively forcing employers to prove intent in employee cases to recover damages. If that is adopted, it will reduce the effectiveness of the Directive to properly compensate businesses in cases of employee trade secret theft. This will compel employers to rely more on the employee contract to ensure they are properly protected.

The requirement to take 'reasonable steps' to protect trade secrets will introduce a greater legal impetus for businesses to take more interest in, and place better controls on, the security around their commercially valuable information throughout their supply chains. It will focus similar attention on licensees, franchise holders and other business partners, who will also need to be required to observe mandated security arrangements for the information. This is not always taken seriously by international businesses, however, as confirmed by PwC in its report 'Key Findings from the 2013 US State of Cybercrime Survey' (June 2013):

Previous PwC surveys support the view that the supply chain is a potential weak link in cybersecurity – both in the United States and globally [. . .] Companies often struggle to get their suppliers to comply with privacy policies – a baseline indicator of data protection capabilities.

The Directive also abstains from limiting works council representatives in their use of confidential information, leaving that to local laws, the rules of the specific works council and the employers' contractual rules with the staff representatives.

9 www.darkreading.com/insider-threat/5-lessons-from-the-fbi-insider-threat-pr/240149745.

10 See 'Good Practice Guide: Online Social Networking', www.cpmi.gov.uk/Documents/Publications/2010/2010032-GPG_Online_social_networking.pdf.

11 www.darkreading.com/insider-threat/5-lessons-from-the-fbi-insider-threat-pr/240149745.

ii Supply chain problems

As it is often practically necessary for franchisors to share some of their trade secrets with third parties to enable them to operate an effective international supply chain to their franchisees, it is critical to ensure those arrangements adequately protect trade secrets.

The obvious starting point is through the use of suitable confidentiality or NDAs, but it is clear that a one-size-fits-all approach will not be a safe solution. Practical steps to take in preparing appropriate documents include:

- a* properly investigating the requirements of the arrangement – ascertaining with precision what trade secrets will need to be disclosed, and to whom; and
- b* carrying out due diligence on the proposed third party:
 - to determine whether it is an established or well-respected business with a track record of previous similar relationships known to have been successful; and
 - to determine its corporate status: whether additional NDAs with individual subcontractors, partners or other third parties are required.

It will also be important to monitor the way in which the relationship with any third party develops or changes while it is in possession of trade secrets. Arrangements may need to be refreshed and reinforced, particularly as its personnel changes. Once a third-party arrangement concludes, it will be vitally important to ensure that the post-termination obligations are actually complied with – especially those governing the return of confidential documents and data.

VI IMPLICATIONS FOR FRANCHISING

The advent of this new approach to protecting trade secrets is having both a reactive and proactive impact upon franchising.

On the reactive front, it is essential that franchise agreements are drafted so as to optimise the protection of the franchisor's trade secrets within the context of the relevant jurisdiction – this is, of course nothing new. The need, however, to ensure that new trade secret laws are central to the way that the franchise agreement deals with the issue is novel. On the proactive front, a result of the new trade secret laws is that the information will likely become commercially exploitable in its own right. For example, some franchises are already exploring new charging structures based on their new ability to classify specific sets of data as 'trade secrets'. Franchisors and their advisers need to be alive to the opportunities to exploit previously private processes, recipes or datasets in ways that will generate new income streams.

FRANCHISEES AS CONSUMERS

*Jiri Jaeger and Frederik Born*¹

I INTRODUCTION

Today, more than 12,000 franchise systems with more than 800,000 franchisees exist worldwide.² In some jurisdictions, expanding business operations by way of franchising is a well-established model for facilitating growth, whereas in others it is a pretty modern way for companies to tap into new markets. It is often new for franchisees too. Franchising, therefore, comes with certain risks for franchisees. They might be inexperienced, uninformed and lacking in bargaining power. More often than not franchisees face franchisors who are well informed about their own franchising system, familiar with the risks in their respective markets³ and are strong negotiators. In fact, research shows that between half and two-thirds of all franchisees enter the franchising business coming from a dependent employment.⁴ Franchisors typically hold the bargaining power that enables them to dictate the conditions of the future long-term relationship to the franchisees and ask them to sign their standard terms.

The correspondence between franchisees' 'weakness' and franchisors' strength causes some jurisdictions to regard franchisees as consumers. Usually this is when initially commencing the business by signing the contract, but sometimes, albeit seldom, it is throughout the entire contractual period. Thus, there are (1) some jurisdictions that never regard a franchisee as a consumer; (2) some jurisdictions that apply consumer protection laws where it is found necessary to protect the franchisee, and the franchisee actually acts as a consumer according to the statutory definition of consumer; and (3) even jurisdictions that generally deem a franchisee to be a consumer. This has an impact on various fields of law, such as consumer credit law, doorstep-selling law, law on supply contracts payable by instalments and unfair contract term law. In some jurisdictions, it follows that franchisees may even enjoy protection under laws regarding residential leases.

Whether consumer protection law is a good or a bad thing may differ depending on one's circumstances. On the one hand, obviously, it seems to be in the interests of the franchisee who seeks protection. Franchisors, on the other hand, want to regard franchisees

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2 Source: GTAI (available at: www.gtai.de/GTAI/Navigation/EN/Invest/Industries/Consumer-industries/franchising.html, last visited 7 November 2016).

3 In some jurisdictions, the franchisor is even required to operate a trial franchising outlet before contracting with a franchisee.

4 See the summarised results from Australia, France and the United Kingdom by Buchan, *Franchisees as Consumers*, p. 42 et seq. (2013).

as business partners on an equal footing⁵ and uphold the principle of ‘freedom of contract’. According to the franchisors’ mindset, the franchisee makes a well-informed business decision when entering into the franchising system. Consumer protection laws are considered as ‘overregulation’ by most franchisors as they could lead to an overall decrease of franchising in the relevant market; overregulation is generally a hindrance, at least for innovation.⁶ Regulation – good and poor – increases the transaction costs for franchisors. Ultimately, it can cause the franchisor not to invest in the overregulated market or make it less of a priority. However, the other side of the coin is that good regulation with a modest level of protection of franchisees can encourage more franchisees to invest in franchising, therefore increasing the possibilities for franchisors to expand and also their choice of business partners.

The following chapter shall provide a selective overview of the overlap of franchising and consumer protection and will highlight two examples.

II OBJECTS FOR CONSUMER PROTECTION LAWS

The justification for the consumer laws in each jurisdiction examined here does not necessarily differ. The United Nations Guidelines for Consumer Protection encourage nations to maintain a strong consumer protection policy and recognise that ‘consumers often face imbalances in economic terms, educational levels and bargaining power [. . .] and should have the right of access to non-hazardous products, as well as the right to promote just, equitable and sustainable economic and social development and environmental protection’.⁷ Consumer laws in the various jurisdictions also share a common theme.

In South Africa, for instance, the purpose of the Consumer Protection Act is to promote and advance the social and economic welfare of consumers by, among other things, establishing a legal framework for the achievement and maintenance of a consumer market that is fair, accessible, efficient, sustainable and responsible for the benefit of consumers generally, promoting fair business practices, improving consumer awareness and information, and encouraging responsible and informed consumer choice and behaviour and promoting consumer confidence and empowerment.⁸

Similarly, in Australia, the Australian Government Productivity Commission stated that a consumer policy framework should aim to ensure that consumers are sufficiently well-informed to benefit from competition, prevent business practice that is unfair or contrary to good faith and, ‘meet the needs of those who, as consumers, are most vulnerable

5 However, research from Australia shows that nearly one third of all Australian franchisors do not have experience in starting a business before setting up their franchising network; Frazer, Weaven, Bodey, ‘Franchising Australia 2010’, p. 118, cited by Buchan, *Franchisees as Consumers*, p. 16 et seq. (2013).

6 Financial Services Authority, ‘Financial Services Authority: A New Regulator for the New Millennium’, (January 2000), p. 6 et seq.; Abell, *The Law and Regulation of Franchising in the EU*, 190 (2013).

7 United Nations, Department of Economic and Social Affairs, United Nations Guidelines for Consumer Protection (as expanded in 1999), at I.1.

8 Consumer Protection Bill, Chapter 1, Part B.

or at greatest disadvantage'.⁹ Three years later, in 2010, the Australian Consumer Law (ACL) was enacted, which was designed to protect consumers, ensure fair trading in Australia and simplify existing laws.¹⁰

German consumer protection law is mostly part of the general private law, which has consumer law provisions embedded at various points. It is noteworthy that the various acts implementing the new laws into the German Civil Code are comparatively silent on the motives behind consumer protection; it is left to the courts and academics to fill the gaps and provide the theoretical basis.¹¹

In the United Kingdom, the Law Commission and Scottish Law Commission noted that misleading and aggressive trade practices are common and lead to a high level of consumer detriment, especially for vulnerable consumers.¹² Subsequently, the UK Consumer Rights Act 2015 was enacted with the primary objective of clarifying the pre-existing English laws and implementing Directive 2011/83/EU on consumer rights (the Consumer Rights Directive).¹³

It is uncertain whether the objectives of consumer protection laws can be considered to fit with the franchisees' situation, responsibilities and position in the contractual relationship. While fair trade might be an overall principle for consumer and commercial transactions, what might distinguish consumers from franchisees is their vulnerability, as has been pointed out in general by the Commissions in the United Kingdom and Australia, mentioned above.

III OVERVIEW OF THE APPLICABILITY OF CONSUMER PROTECTION LAW TO FRANCHISEES

i Germany

With the implementation of the Consumer Rights Directive, several provisions concerning consumer rights have been renewed. Consequently, the complete harmonisation of the most important aspects should ensure legal certainty in the relation between the consumer and the entrepreneur, and generate uniform consumer protection throughout the EU. However, the huge impact of consumer protection law in Germany arises from the very legal perspective on the problems concerning the 'cooling-off period';¹⁴ 'very legal perspective' because many statutory provisions are applied to franchising relationships that a fair few people outside Germany would regard as provisions that typically protect consumers (principle of good faith, reasonableness of contractual terms, etc.).

ii United Kingdom

As in Germany, the United Kingdom has no specific franchising laws. Since the Consumer Rights Act 2015 was introduced, there has been an ongoing discussion on whether it could

9 Australia Government Productivity Commission, Review of Australia's Consumer Policy Framework, Inquiry Report, Vol. 1, No. 45, p. 13 (2008).

10 Explanatory Memorandum, Trade Practices Amendment (Australian Consumer Law) Bill (No. 2) 2010, Consumer guarantees, p. 12.

11 Micklitz, Purnhagen, *Münchener Kommentar BGB*, Vor Section 13 at paragraph 65, 36 (7th ed., 2015).

12 Law Commission and Scottish Law Commission, 'Consumer Redress for Misleading and Aggressive Practices' (Law Com No. 332; Scot Law Com No. 226), p. viii. (2012).

13 Explanatory Notes, Consumer Rights Act 2015, paragraph 5 et seq.

14 Cf. Flohr, in *Handbuch des Vertriebsrechts*, Section 29 at paragraph 86 (Martinek, Semler, Flohr, eds., 4th ed. 2016).

apply to franchisees. The Consumer Rights Act sets out a framework that consolidates key consumer rights covering contracts for goods, services, digital content and the law relating to unfair terms. The statute is the result of combining fragmented pieces of legislation protecting consumer rights, which often consisted of existing case law and European directives.

iii South Africa

In South Africa, the Consumer Protection Act 2008 was enacted to provide long-awaited comprehensive legislation for consumers and it is noteworthy also in relation to franchising. Legal commentators have noted that franchisors have faced a huge administrative burden since the Act's enactment. The Consumer Protection Act comes with specific provisions that have been familiar for decades, such as cooling-off periods and the necessity to include mandatory rules in the franchise agreement. However, the new law also goes further and includes rules governing the supply of goods by the franchisor to the franchisee. For instance, according to Section 21 of the Consumer Protection Act, franchisors may not furnish the franchisee with unsolicited goods or services and, according to Section 13 of the Consumer Protection Act, the franchisee has the right to choose a supplier for unbranded goods.

Because of the broad definition of 'consumer', the franchisee is eligible for the wide range of other consumer rights, too. In contrast to other jurisdictions, where franchise law has 'only' turned case law into statutory law, in South Africa, legislation has changed the business model of franchising. The franchise market in South Africa, it is said, is currently on a par with the Australian market, where legislation is very far-reaching.¹⁵

iv Australia

The ACL (see Section II), which is Schedule 2 of the Competition and Consumer Act 2010, is of major importance when it comes to consumer issues with respect to franchisees. The ACL forms part of the Australian national consumer policy framework. The ACL includes core consumer protection provisions prohibiting misleading or deceptive conduct, unconscionable conduct and unfair terms in standard form consumer contracts. More-informed consumers not only make better choices, but also drive competition and innovation in markets.¹⁶

IV WHAT CONSTITUTES A CONSUMER?

While the objectives of consumer protection law across the various jurisdictions might be generally the same, the scope of the law's application differs. The subjective scope is commonly defined by reference to a 'consumer'. But, surprisingly enough, the ideas as to what constitutes a consumer seem to differ even within the European Union.

Under the Consumer Rights Act in the United Kingdom, a consumer is defined as an individual acting for purposes that are wholly or mainly outside that individual's trade, business, craft or profession.¹⁷ Most legal commentators strongly disagree that a franchisee falls into this definition and – as far as can be seen – courts have not yet granted franchisees

15 Zeidman, 'Is a franchisee a consumer or not?', *Franchise Times* March 2016 (available at: www.franchisetimes.com/March-2016/Is-a-franchisee-a-consumer-or-not, last visited 7 November 2016).

16 Explanatory Memorandum, Trade Practices Amendment (Australian Consumer Law) Bill (No. 2) 2010, 'Consumer guarantees', p. 12.

17 Consumer Rights Act 2015, Section 2(3).

rights under this new statute. The United Kingdom thus marks the one side where it is neither ordered nor seems to be intended to treat franchisees as consumers; however, tracing the legislator's will is often not a fruitful task in common law jurisdictions.

Germany takes a somewhat different position, concept-wise. Protection under German consumer law currently depends first on the role people assume in their particular legal interactions with others, regardless of their individual weaknesses and capacities; and second, on the specific situations in which weaker parties might find themselves, such as doorstep transactions. Actually, it is not about whether a person is a consumer according to the statutory definition but, in fact, about whether a person has entered into a consumer business or a non-consumer business. A franchisee is not regarded as a consumer. When the franchisee signs the franchise agreement, this action is already viewed as business conduct and, thus, conducted by an entrepreneur. However, it is a matter of ongoing discussion as to whether the franchisee is entitled to similar protection (a cooling-off period) when it comes to the conclusion of a franchise agreement as a business start-up. Furthermore, consumer protection rights could be invoked if the franchisee is required to make consistent purchases from the franchisor and if the franchisor sells the same products in his or her own franchise outlet.

South Africa is a somewhat different animal. South Africa's Consumer Protection Act seems to recognise the difficulty one has by forcing the franchisee into the common consumer definition. Thus, while defining what a consumer is generally in terms of the application of the Consumer Protection Act 2008, it merely adds basically that a consumer is also 'a franchisee in terms of a franchise agreement'.¹⁸ Thus, a franchisee is deemed a consumer. Furthermore, Section 5(7) seems to suggest that even legal entities qualify as consumers under the act. One is tempted to ask when does the franchisee not act as a consumer? It seems that while, for instance, Germany seeks to regard only the potential franchisee as a consumer before entering into the franchise agreement, South Africa extends the consumer protection even to an ongoing contractual relationship. This concept allows for a broad application of consumer protection law.

Australia marks another extreme from the United Kingdom. The concept under the ACL is that one can (already) be a consumer if one acquires goods or services as a consumer to the extent that the price or cost does not exceed A\$40,000, regardless of purpose or use, or if the goods or services are ordinarily acquired for personal, domestic or household use or consumption. It might be possible – and subject to an ongoing discussion – for franchisees to be treated, and have the same protection, as consumers when it comes to supply of goods or services by the franchisor up to that threshold, or in the case of acquisitions where the person acquired the goods for the purpose of resupply or for the purpose of using them up or transforming them in trade or commerce.

V COOLING-OFF PERIOD

A common element of consumer protection law is the cooling-off period, which can also often be found in franchise-specific laws. For certain transactions, consumers are able to withdraw from a contract within a certain period after signing. The cooling-off period is an exception to the principle of *pacta sunt servanda*, or even a marked easing of the application of this principle, commonly justified by the potential for the distortion of the decision-making

18 Consumer Protection Act, Chapter 1, Part A, Section 1.

process arising from the inferiority of one party.¹⁹ The same weighting is found with respect to dedicated franchising cooling-off periods. However, it is doubtful whether there are a sufficient number of instances (if any) of ‘fly-by-night’ signing of franchise agreements to justify the legal uncertainty of a cooling-off period.

i Germany and the EU

In Germany and other EU Member States, the Consumer Rights Directive has been transposed into national law. The right to withdraw may be available to franchisees, subject to restrictive requirements; for example, if the person enters into certain financial commitments, such as being granted a loan, postponement of payment or delivery by instalments; or is starting a business for the first time or is a consumer. Although this Directive, and its application to franchisees, may differ from Member State to Member State, the impact of the legislation, where applied, does not differ: the consumer is entitled to withdraw from the contract generally within a period of 14 days after conclusion of the contract.²⁰ Although, to the detriment of the franchisor, this period can be easily extended to slightly more than one year in the event of lack of, or insufficient, information about cooling-off rights, prior to the new law, the period was unlimited. Providing the correct information about the right to withdrawal is not necessarily an easy task for the franchisor, however, as the legislation does not provide a pattern but rather (varying) hints for drafting. At least there is a directive now that contains a sample revocation instruction by the German Franchising Association, but obviously it is not mandatory for German courts.

ii South Africa

South Africa is also familiar with the cooling-off period, as it is included in the franchising sections of the Consumer Protection Act. The franchisee has a right to cancel the franchise agreement without cost or penalty within 10 business days of having signed the agreement by giving written notice to the franchisor.²¹ However, unlike in Germany, the law provides guidance for the franchisor on how to inform the franchisee about this right. The exact wording of the applicable section providing this right to the franchisee must be printed at the top of the first page of the franchise agreement, together with a reference to the section and the Act.²²

iii Australia

Australia is familiar with the right to withdrawal too, but the franchisee’s right is not so extensive. On the other hand, provisions are applied widely to all franchisees, not only those to be regarded as consumers, which is similar to the German concept. The Australian Franchising Code of Conduct²³ provides that a prospective franchisee is entitled to a cooling-off period of seven days after entering into a new franchise agreement.

19 For Germany see, e.g., Mörsdorf, in beconline.GROSSKOMMENTAR Section 355 at paragraph 3 (Gsell, Krüger, Lorenz, Mayer, eds., April 2014).

20 German Civil Code, Section 355 paragraph 2.

21 Consumer Protection Act, Section 7(2).

22 Consumer Protection Act, Section 2(2)a Regulation 2.

23 Division 5, Section 26.

VI JUDICIAL CONTROL OF CONTRACT TERMS

If no dedicated franchising legislation exists, the review of the contractual terms of the franchise agreements by the courts often depends on the application of the laws concerning unfair contract terms or standard terms respectively. More often than not, the application of the law (or at least the extent of the application) depends on whether it is a consumer contracting with an entrepreneur. In some jurisdictions, the application of the law depends on whether a standard form contract is used. In such cases, a franchisor's desire to use a consistent agreement pattern for his or her outlets comes at a price: the franchisor's terms will be reviewed by a judge for their fairness or reasonableness. The franchisee, on the other hand, can sit back and trust that terms to their (considerable) detriment will be softened or even removed by the courts.

i Germany

For standard form contracts,²⁴ the German Civil Code contains provisions governing, for example, the content of the contractual terms.²⁵ Even though the basis of the law is laid down in an EU directive that states that EU Member States have certain rules in common, German law on standard terms goes further than legislation in the rest of the world. German law is particularly strict on businesses. Contractual clauses are subject to an in-depth review by the courts and incomprehensible clauses are reversed to the franchisor's detriment. Clauses that are deemed to be contrary to statutory provisions are deemed invalid. Although core provisions regarding business-to-consumer transactions are similar in all EU Member States, one particular difference in Germany is that the courts tend to apply dedicated consumer provisions to business-to-business (B2B) transactions as well if the situation is 'comparable', and this position is often assumed by the courts. Furthermore, provisions identified as invalid by the courts are not reduced to a level at which they are legally valid, they are simply invalid as a whole. No reduction of invalid provisions to preserve validity is conducted.²⁶ Thus, even though a franchisee is not a consumer in terms of German law, his or her protection here comes close.

ii United Kingdom

In the United Kingdom, franchisees entering into a standard terms franchise agreement can invoke the Unfair Contract Terms Act 1977. However, as this Act seeks only to reduce the possibility of limiting one's own liability, the franchisee can only claim further protection if he or she actually falls within the definition of 'consumer', so the Consumer Rights Act applies. However, as this is highly unlikely, and because in the United Kingdom the principle of good faith is applied less to B2B contracts than it is in civil law jurisdictions, franchisees might have a hard time before UK courts, which (still) uphold the principle of 'freedom of contract' to a large extent. However, it is observed that the understanding of good faith with respect to commercial contracts is currently shifting in common law jurisdictions. Whereas before it

24 Exceptions apply.

25 Sections 305 et seq.

26 Settled case law since Federal Court of Justice NJW 1982, 2309.

was often said to apply only to non-business transactions, in common law jurisdictions there now appears to be a tendency²⁷ of easing the principle of freedom of contract and imposing a duty of good faith, or at least honesty and integrity, in commercial contracts as well.²⁸

iii South Africa

South Africa's Consumer Protection Act also offers the franchisee strong protection against unfair contract terms. Part G of the statute (the right to fair, just and reasonable terms and conditions) applies to franchisees too. According to Section 48 of the Consumer Protection Act, it is required, among other things, that pricing, terms of the contract, and marketing of the goods and services are fair, reasonable and just. Furthermore, the franchisor must draw the attention of the franchisee to important terms of the contract;²⁹ other terms are prohibited.³⁰

Interestingly enough, the law also seeks to regulate prices. According to Section 48(1)(a)(i) of the Consumer Protection Act, the supply of goods or services may not be offered for a price that is unfair, unreasonable or unjust. Hence, South Africa even intervenes in price-fixing. In contrast, as a rule, German law on general terms and conditions, despite being extremely comprehensive, never regulates the two core *essentialia negotii* of an agreement: pricing and performance description. The same can be found in UK law.³¹

iv Australia

The Australian Consumer Law, now for the first time in Australian history, regulates unfair terms in standard form contracts, yet it is limited to consumer contracts. There are some requirements that include franchisee as consumers, which means they can be protected against unfair contract terms. Nevertheless, franchise agreements have not been considered as consumer contracts so far. Also, as in Germany, the contract must not be negotiated. If a term is declared unfair, it will be deemed void, but the rest of the contract will continue, which is also similar to the practice in Germany.

The new Law, which entered into force on 12 November 2016, takes the approach of including franchisees under the Unfair Contract Terms provisions. The Law will protect small businesses from unfair terms in standard form contracts, granting the franchisee further protection as consumers. The small businesses are definitely protected if at the time of entering the contract at least one party to the franchise agreement is a business that employs fewer than 20 people; and either the upfront price payable under the contract does not exceed A\$100,000 or the contract has a term of more than one year and the upfront price payable does not exceed A\$250,000. Most franchise agreements are for a five- or 10-year term and the upfront price payable to the franchisor is often less than A\$250,000, depending on the nature of the franchise system. It can be expected that many franchise agreements will fall within the definition of a small business contract.

Another issue that has a bearing on franchising arises in relation to the Australian Competition and Consumer Commission, as the Commission is empowered to issue

27 See, e.g., 'Zhong Xing Tang, Keeping Faith with Good Faith?: The Evolving Trajectory Post-*Ym Seng and Bhasin*', *JBL* (2016), 420.

28 However, with regard to the United Kingdom, a general principle of good faith still does not exist; see *Chitty on Contracts*, at paragraph 1-1 (32nd edn, 2015).

29 Consumer Protection Act, Section 49.

30 Consumer Protection Act, Section 51.

31 Explanatory notes, Consumer Rights Act 2015, paragraph 18.

infringement notices if it determines a violation of the Competition and Consumer Act 2010 (e.g., by an unfair practices provision in the franchise agreement). The Commission can issue a fine and, probably with greater impact, will publish details of paid infringement notices in a publicly accessible³² register. Thus, knowledge of bad business behaviour will potentially be publicly disseminated.

VII SUMMARY

The question of whether to apply consumer protection laws to franchisees hinges on the issues of who should bear the risks and whether franchisees should be protected from their own decisions and conduct.

However, even if this question is to be answered in favour of the franchisee, what is the actual benefit to the franchisee? Inherent and hidden risks will become apparent to the franchisee no earlier than the point at which the franchisee deals with the franchise documentation that he or she seeks to sign; any real risk that the franchise system is faulty in some way will only emerge later. Nonetheless, the franchisee is protected by his or her right to rescind and by ordinary statutory law or franchising legislation requiring, for instance, a model franchise outlet to have been run by the franchisor (although this is rare). Thus, this already mitigates the need for that period of uncertainty, the cooling-off period. Furthermore, it is doubtful whether the availability of a short window in which to exercise the right to withdraw can protect a franchisee from being imperfectly informed (e.g., with respect to the possibility of withdrawing from the contract should a franchisee should sign a ‘fly-by-night’ contract). Any defects in the contractual object are likely to become apparent only much later.

However, where the franchisee relies on the advice, guidance and skills of the franchisor³³ – as is often the case – this structural weakness in the relation might bring the franchisee close to the position of a consumer and therefore justify the application of consumer protection legislation.

32 <http://registers.accc.gov.au/content/index.phtml/itemId/939950>.

33 Georgosouli, ‘Investor Protection Regulation: Economically Rational?’, University of London – Centre for Commercial Law Studies (2006), p. 10 (available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=893451, last visited 7 November 2016), cited by Buchan, ‘Consumer Protection for Franchisees of Failed Franchisors: Is There a Need for Statutory Invention?’, *QUTLJ* 9/2 (2009), 232, 235.

RESOLVING INTERNATIONAL FRANCHISE DISPUTES

*Victoria Hobbs*¹

The franchisor–franchisee relationship is unique. The franchisor is entrusting its franchisees with some of the franchisor’s most valuable intangible assets, including its know-how, operating methods, goodwill and brand reputation. It is essential for every franchisor to enforce the obligations of its franchisees to ensure that brand standards are maintained and the integrity of the brand image is preserved. In an international franchise system, enforcement of the franchisor’s rights and protection of its assets is likely to be far more problematic than a purely domestic franchise system. The risk of non-compliance and the consequential damage to the entire system will probably increase when the franchisor decides to take its franchise system overseas. In an international context, a franchisor is more likely to appoint a master franchisee or area developer rather than individual unit franchisees. For brevity and ease of reference, the word ‘franchisee’ is used in this chapter to cover unit franchisees, masters, developers and joint venture partners and ‘agreement’ is used to refer to agreements that govern all those types of relationships.

In this chapter we will look at the likely causes of dispute, the forms of dispute resolution, termination of agreements, and enforceability of restrictive covenants and non-compete provisions.

I LIKELY CAUSES OF DISPUTE

The majority of disputes that arise fall into the following categories.

i A mismatch of expectations

This is one of the most common forms of dispute and will usually come to light within six to 18 months of the commencement of the agreement when the franchisee is not as successful as either party thought it would be and any failings in relation to how the franchise opportunity was presented by the franchisor are likely to come to light. A mismatch of expectations will range from a general disappointment, which falls short of giving the disappointed party any legal basis for claim, through to giving the innocent party the right to treat the agreement as effectively void and claim damages.

The concept of misrepresentation exists in many jurisdictions. The key elements that will need to be proved for an innocent party to succeed in a misrepresentation claim will vary between jurisdictions but are likely to include evidence that the franchisor (and misrepresentation is normally a claim against the franchisor) made an untrue statement of

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fact or law to the franchisee that induced the franchisee to enter into the agreement thereby causing the franchisee loss. The remedies available to the franchisee who is able to successfully prove a misrepresentation has been made will also vary from jurisdiction to jurisdiction but could include the right to set aside the agreement, recoup all monies paid under the agreement (minus an allowance for any profit made) and claim damages for loss of opportunity.

The risk of misrepresentation can be minimised by ensuring that all recruitment literature and any financials (in those jurisdictions where a franchisor is permitted to provide financial information) that are given are accurate and up to date; the parties carry out proper due diligence in relation to the other; both parties take proper professional advice; the franchise agreement is carefully drafted to ensure that the franchisor's liability for misrepresentation claims is limited or excluded (subject to local laws in relation to exclusion or limitation of liability); a carefully drafted and up-to-date disclosure document is given by the franchisor (the provision and content of which is mandatory in some jurisdictions); and the parties communicate openly and frankly with each other both before and after the agreement is signed to ensure that any mismatch of expectations is dealt with promptly to avoid escalation of issues.

ii Inappropriate choice of franchise partner

When a franchisor decides to expand overseas, they often make the mistake of entering into an agreement with the first partner who shows an interest in their brand. It is vital that proper due diligence is completed and that the franchisor is confident that the choice of partner has experience of the local market (ideally in the particular industry sector in which the franchisor is operating); is properly funded; has experienced and capable staff who speak both the local language and that of the franchisor to ensure open and clear communication; and ideally a proven track record of growing other franchise brands.

In recent years, a number of large organisations have grown and been highly successful from buying up the master franchise rights to brands particularly in the Middle East and East Asia. Often these master franchisees are extremely experienced local operators and very well funded and own a whole stable of Western brands commonly in the food and beverage and retail sectors. The growth of such organisations has shifted the balance of power in the international franchisor–franchisee relationship and it is no longer necessarily the case that the franchisor is the larger or more experienced organisation. The growth of the large master franchisee organisations has resulted in much more sophisticated franchise partners who can make a phenomenal success in their local markets. However, these partners are also more likely to negotiate hard over the wording of the agreements with the result that agreements are a lot more balanced than they have been historically.

iii Failure to reach minimum performance requirements

It is common for agreements to have some sort of minimum performance requirements (MPRs) whether in relation to the number of stores opened, turnover achieved or products purchased. The financial crisis in 2008 and the subsequent impact on consumer spending hit retailers and food and beverage companies hard. While these sectors have recently enjoyed a resurgence in trade, the sectors are highly competitive in Europe and North America and becoming increasingly so in the Middle East and East Asia. This has even resulted in a number of experienced and well-funded franchise partners being unable to reach the MPRs that are imposed. Failure to reach MPRs often entitles the franchisor to terminate the agreement or reduce the size of the franchisee's territory. However, in the current climate, provided

that the master franchisee has had some success, it is common for the franchisor to agree to renegotiate the MPRs so that the relationship can continue, even though growth in the territory will be slower than the franchisor initially anticipated. MPRs should be reasonable and achievable, otherwise both parties will be disappointed.

iv Lack of franchisor support

Lack of support is a common complaint by franchisees. In domestic franchise systems, the express obligations on the franchisor in terms of support levels may be very limited. However, in an international context, they are likely to be more detailed and extensive. Lack of support allegations are often closely aligned with a mismatch of expectations as it may be that the franchisee is not contractually entitled to high levels of support but is not receiving what they expected or had been told they would receive.

v Failure to maintain brand standards

It is a common complaint by franchisors that master franchisees are failing to maintain the brand standards that the franchisor has set in its home country. This may be for genuine reasons such as a requirement for the brand and operating methods to be adapted to be successful in the franchise territory. There is sometimes a fine line between acceptable modifications to the system and undermining the valuable brand reputation that the franchisor has built up.

II FORMS OF DISPUTE RESOLUTION

In the event of a dispute between a franchisor and franchisee the main options open to the parties are (1) discussion, (2) mediation, (3) termination, (4) arbitration, and (5) litigation. Each of these options is considered in turn below.

i Discussion

Most international franchise agreements are long-term and complex arrangements. It is likely that neither of the parties will want the relationship to break down and the agreement to be terminated unless there really is no other option. The legal and commercial implications of termination are considered later in this chapter. Therefore, before taking any enforcement action or considering termination, the franchisor should contact the franchisee and try to discuss the issues involved to see whether an amicable settlement can be reached. There are often practical difficulties to overcome in arranging discussions as the franchisor and franchisee will inevitably be in different countries and potentially different continents but, if possible, a face-to-face meeting should be arranged as it is more likely to be conducive to settlement.

Many franchise agreements will contain a dispute escalation clause, which sets out how the parties must deal with any dispute that arises between them, or a reference to the operations manual, which sets out a detailed dispute escalation procedure. The first step in a dispute escalation clause is likely to be face-to-face discussions between certain representatives of both parties. Some clauses will set out in detail the procedure and timings for such a meeting, including how much notice must be given, where the meeting will be held, who must be in attendance, what language will be used and the information that must be exchanged prior to the meeting. While such detail may, at the outset of a relationship, seem unnecessary, it can help when both parties are embroiled in a dispute for there to be a clear contractual mechanism for seeking to resolve it. While the legal enforceability of

a dispute resolution clause will depend on the law of the agreement, the courts and arbitrators in many jurisdictions are increasingly likely to hold the parties to a contractually agreed dispute escalation process.

If initial discussions do not prove fruitful, the parties may wish to arrange for discussions to take place between their legal representatives, who will be able to assess the relative merits of each parties' case and may be able to negotiate a compromise. The involvement of legal representatives will not necessarily lead to litigation although it does inevitably have an impact on the relationship and can be taken negatively by a franchisee. However, the early involvement of legal representatives can often lead to a speedy settlement thereby avoiding the costs of the litigation and a complete breakdown in relations between the parties.

Discussions are more likely to be successful if the cause of the dispute is issues such as failure to reach MPRs, failure to maintain standards or allegations of lack of support as the parties should hopefully be able to work together to agree a process going forward that is mutually acceptable. In some circumstances, discussions may be entirely inappropriate and the franchisor may need to move straight to litigation or arbitration. Such circumstances would include where there have been breaches of confidentiality or contractual provisions in relation to non-competition or misuse of the franchisor's trademarks or other intellectual property rights.

ii Mediation

If the parties agree to mediation, the dispute is submitted to a single impartial individual who will act as a referee in relatively informal settlement discussions. It is preferable, and nowadays fairly common, for there to be a contractual obligation for the parties to try to resolve their differences via mediation prior to resorting to litigation or arbitration, which will be an enforceable obligation in many jurisdictions. Mediation is a recognised form of alternative dispute resolution in almost all jurisdictions and is becoming increasingly popular because of the fact that the success rates are relatively high and it is a way for the parties to continue the relationship on agreed terms, which is ultimately what most parties wish to do.

As stated above in relation to informal discussions, it is preferable for the mediation clause in the agreement to set out precisely the mechanism for a mediation to avoid satellite arguments holding up the resolution of the main dispute. The clause should set out the mediation body (if any) that will be appointed or an arrangement for the parties to mutually agree the nomination of a mediator; the notice period that must be given; the location and language of the mediation; the length of the meeting (e.g., if it is limited to an eight-hour day or a two-day period); the representatives who must be in attendance (e.g., the CEO or managing director of each company); and how the costs of the mediator will be divided between the parties. In the absence of a mediation clause in the agreement the parties will not have a contractual obligation to mediate but instead must voluntarily and mutually agree to go to mediation.

Mediation is conducted in confidence and, as in arbitration, it should be possible for the parties to avoid any publicity, which can be a major advantage to the franchisor as the brand owner. The main advantages of mediation are as follows:

- a* it is private and flexible;
- b* a mutually acceptable trained professional is selected by the parties who acts as a referee;
- c* mediation is relatively low cost and, if litigation is avoided, is a cost-effective way of dealing with a dispute;

- d* an effective mediator should be able to dissuade a party from pursuing an unreasonable claim or an excessive amount of money;
- e* if there has been poor communication between the franchisor and the franchisee, mediation can bring the parties together to save the relationship;
- f* the parties are able to explore more innovative settlement options that are available to a judge or arbitrator; and
- g* subject to practicalities, a mediation meeting can be set up very quickly thereby saving costs and ultimately the relationship.

The main disadvantages of mediation include the following:

- a* the mediators available may have little experience of franchising and may not understand the key issues;
- b* quick and effective action may be needed to remedy the breach such as applying for an interim injunction (particularly if there has been a breach of confidentiality or intellectual property rights);
- c* mediation does not necessarily produce an enforceable and binding decision. The parties must mutually agree a settlement and time and effort could be wasted while the breach remains unremedied; and
- d* mediating too early in the lifespan of a dispute may mean that the parties are not ready to settle, which can render the mediation unsuccessful.

Mediation is becoming increasingly popular, particularly as a means of resolving international disputes, which can be incredibly expensive to litigate and potentially very damaging to a franchisor's brand reputation, and may have an impact on the rest of the franchise network.

iii Arbitration

The increase in international trade in recent decades has led to a huge upsurge in the use of arbitration as a method of resolving international commercial disputes. Arbitration is essentially a private form of litigation and all parties must agree to the use of arbitration as a means of resolving their dispute. The rights and obligations of the parties to arbitrate their disputes arise from the arbitration agreement that they have agreed. It is common to see an arbitration clause in an international franchise agreement that will form the basis of the agreement to arbitrate. An arbitration clause is a self-contained contract between the parties that is collateral to or ancillary to the main contract, which means that an agreement to arbitrate will not be regarded as invalid, non-existent or ineffective even if the main agreement is defective.

Arbitration has many advantages over litigation in an international franchise context as set out below:

- a* In many jurisdictions, arbitration proceedings are private and confidential, which means that the decision of the arbitrator will not be reported in the same way as a court judgment and the parties should therefore be able to avoid any adverse publicity that often follows litigation. However, this does not apply in all jurisdictions, so local law advice should be taken.
- b* The parties have the power to agree flexible procedures to ensure that the dispute is dealt with efficiently and cost-effectively.

- c The parties can choose a neutral location for the arbitration hearing as opposed to opting for one of the parties' national courts. Jurisdictions such as Hong Kong, Singapore and Geneva have become very popular neutral locations for arbitrating international disputes.
- d Parties can choose an arbitrator with expertise that is relevant to the franchise industry or to the particular issue in dispute. They can also ensure that the arbitrator is neutral and unbiased, which may be an issue in relation to the judges in some local courts.
- e An arbitration award is generally final and binding and the options for challenging an award are very limited, whereas a court judgment is usually subject to rights of appeal to high appeal courts. The process should therefore give more certainty and finality for the parties.
- f It is generally easier to enforce an arbitral award in another jurisdiction than it is a court judgment.

Because of the increase in the popularity of international arbitration and the fact that it encourages trade between continents, national legislators have responded by establishing improved and streamlined arbitration laws and procedures and the national courts of most jurisdictions demonstrate a willingness to provide a hospitable climate for arbitration and to require parties to comply with contractual obligations to resolve disputes by arbitration. In general, national courts will interpret arbitration clauses widely so that they cover all nature of disputes arising out of all in connection with the franchise relationship and will usually make it more difficult for parties to challenge arbitration awards in the courts.

Arbitration can be 'institutional' whereby the parties agree to use the laws of a particular established institution specialising in arbitration proceedings who will also have a list of recommended and approved arbitrators. Alternatively, the parties can choose *ad hoc* arbitration whereby the parties either set out their own rules for the conduct of the arbitration or rely on the rules of the law that govern the procedure of the arbitration. It is normally preferable to choose institutional arbitration to rely on the well-drafted rules administered by one of the international arbitral bodies and also benefit from the administrative assistance that they provide. In addition, institutional arbitration tends to be less expensive as, although the arbitral body will charge a fee, the body will fix the fees of the arbitrator or negotiate hourly rates for the parties, whereas there is no such control with *ad hoc* arbitration. Among the more well-known arbitral institutions are the CIETAC (China International Economic and Trade Arbitration Commission), the ICC (International Chamber of Commerce), the ICDR (International Centre for Dispute Resolution), the HKIAC (Hong Kong International Arbitration Centre), the LCIA (London Court of International Arbitration), the SIAC (Singapore International Arbitration Centre) and the Arbitration Institute of the SCC (Stockholm Chamber of Commerce). The choice of arbitral body will usually be swayed by the location of each of the parties and the choice of the seat of arbitration.

The institutional rules usually contain the basic provisions for commencing arbitration, choosing the arbitrators and the procedures to be followed after the award has been given. In drafting an arbitration clause, parties should state where the arbitration is going to take place (the 'seat' of the arbitration); whether it will be administered by a particular arbitral body or be *ad hoc*; the language that will be used; the number of arbitrators (one or three); and the procedural and governing law.

An arbitration award is equivalent to a judgment in litigation in that it is final and binding. Enforcement of arbitration awards in countries other than the location of the

arbitration hearing should, in theory, be relatively straightforward in view of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). As parties to arbitration normally choose a neutral forum for the hearing, it is unlikely that an arbitration award will be made in the defendant's place of residence or business and therefore it is very common for arbitration awards to be enforced in another jurisdiction in which the property and assets of the losing party are located.

The New York Convention requires the courts of contracting countries to give effect to an arbitration agreement and to recognise and enforce awards made in other member countries subject to only very limited exceptions. Countries that are signatories to the New York Convention are able to limit the applicability to awards made in other contracting countries only. Therefore, when seeking to enforce an award, it is important to check whether both the country where the award was made and the country where enforcement is intended are contracting countries. It is also open to countries to limit the applicability of the New York Convention to awards relating to commercial matters only but that should not present a hurdle in franchise relationships.

Despite being signatories to the New York Convention, the courts of some jurisdictions have remained resistant to enforcing foreign arbitral awards, instead choosing to look at the reasoning behind the award and effectively forcing the parties to relitigate the dispute. It is therefore always advisable to consider where the assets of the counterparty may be held, which will not necessarily be the same jurisdiction as its registered office address, and to take local law advice on the enforceability of foreign arbitral awards before deciding on the location of the arbitration.

The New York Convention provides for very limited grounds on which the enforcement of a convention award can be refused. These grounds include incapacity of the parties, invalidity of the arbitration agreement, denial of a fair hearing, lack of jurisdiction, invalid award, procedural irregularities and public policies. The party seeking to enforce an award should apply to the court of the country in which it wants to enforce, and present the award and the agreement under which it was made. The court is then generally bound by local laws to enforce the award unless one of the grounds for refusal is satisfied. If a party is seeking to enforce an award that was made in a country that is not a signatory to the New York Convention, it will need to establish whether the country where enforcement is sought has entered into any other international treaty.

iv Litigation

The agreement will usually include either a binding arbitration clause or a jurisdiction clause that determines the jurisdiction of the courts that will deal with any litigation between the parties. The two main factors that parties normally take into account when deciding whether to opt for litigation or arbitration are whether there are any reciprocal arrangements between the countries in which both parties are based in relation to enforcement of court judgments and how important it will be to keep the dispute private.

Privacy

One of the major disadvantages of litigation is that it may be reported and can lead to adverse publicity for the franchisor. As explained above, arbitration proceedings are private and therefore are not reported although if there is satellite litigation surrounding an arbitration case that may be reported and it is often very difficult for a franchisee to keep the fact that it is in a dispute with one of its franchisees completely confidential from the rest of the network.

Location of the parties

If both parties are based within the EU for example, the parties may opt for litigation in either party's home country as it is relatively straightforward to enforce a court judgment obtained in one EU Member State in another EU Member State by virtue of the Brussels Regulation No. 1215/2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast), which replaced the 2001 Brussels Regulation (Council Regulation (EC) No. 44/2001) for all legal proceedings instigated after 10 January 2015; and the 2011 Lugano Convention (the Lugano Convention on Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters), which allow a party who has obtained a judgment from any EU Member State to enforce that judgment in all other Member States without issuing separate proceedings there. However, if one party is, for example, based in the EU and the other is based in the United States, enforcement of a court judgment is far more complicated as there are no reciprocal enforcement arrangements between the United States and the EU. In those circumstances, the parties may be better advised to opt for arbitration and seek enforcement under the New York Convention.

v Dubai International Financial Centre

The UAE remains a desirable location for Western franchisors because of its wealth, the continued thirst within the region for Western brands and the barriers for entry resulting from the local shareholding restrictions for certain types of businesses (outside the free trade zones).

The Dubai International Financial Centre (DIFC) is a federal financial free zone, established in 2004 to promote growth and economic opportunities in the region. The DIFC has its own court system, separate from the local Dubai courts, which is a common law system based on English law and all proceedings are conducted in the English language. The judges are highly respected and experienced judges both from within the UAE but also the United Kingdom, Singapore, Australia and Malaysia. While the DIFC courts were originally restricted to cases relating to the DIFC, their success and reputation for quality decisions has led to an extension of their jurisdiction to any civil or commercial case where the parties opt for DIFC jurisdiction in a commercial contract or after the dispute has arisen.

The DIFC courts have become a popular choice of jurisdiction in international franchise agreements where one of the parties (most commonly the franchisee) is based in the UAE, as the courts are preferable to the local Dubai courts, and there have been cases where non-UAE entities have encountered difficulties enforcing an arbitral award obtained outside the UAE in the local courts, despite the fact that the UAE is a signatory to the New York Convention.

The DIFC also has an international arbitration and mediation centre that is run in partnership with the LCIA, the rules of which are closely modelled on those of the LCIA.

III CHOICE OF LAW AND JURISDICTION

In an international context it is preferable to choose the jurisdiction and the governing law (to the extent that the choice will be upheld by local laws) under which any disputes will be resolved to avoid time-consuming and expensive satellite litigation. While many jurisdictions will allow the parties to an agreement to choose a governing law and jurisdiction that is not that of the country in which the franchisee trades, some will not and will impose mandatory local law. The natural tendency is for franchisors to choose the jurisdiction and laws of their home country. However, it is imperative to check local laws in the country in which the franchisee is based and will be trading to determine whether these choices will be upheld. It is

also important to check that there is a reciprocal enforcement of judgments structure in place between the relevant jurisdictions otherwise the franchisor could risk litigating in its home country and then effectively having to litigate the case again in the franchisee's home country where it could achieve a completely different result. The individual country chapters will deal with these issues in relation to each featured jurisdiction.

Choice of jurisdiction clauses can be exclusive or non-exclusive. The main advantage of an exclusive clause is that it gives certainty to the parties. The existence or otherwise of a reciprocal arrangement for enforcement of judgments is an important factor when deciding whether to choose an exclusive or non-exclusive jurisdiction clause. For example, if the franchisee is based in a country that has reciprocal arrangements with the franchisor's country, the franchisor should be able to enforce a judgment obtained in its home state in the franchisee's jurisdiction and an exclusive clause may be preferable. However, if there is no such reciprocal arrangement, a non-exclusive clause may be preferable so that the franchisor has the option of suing the franchisee in the country in which the franchisee's assets are situated rather than attempting to enforce a foreign judgment in that country with all the difficulty that involves.

While a non-exclusive clause does provide flexibility, it also potentially exposes the franchisor to litigation in more than one country. While it may be possible to apply for a stay of proceedings, this will undoubtedly lead to increased costs and uncertainty for all parties. A non-exclusive jurisdiction clause or an exclusive foreign jurisdiction clause has the obvious disadvantage to the franchisor in that it has the cost and inconvenience of instructing foreign lawyers and the uncertainty of litigating abroad.

Even if the parties have opted for arbitration, it is relatively common for the franchisor to carve out a right to apply to the local courts where the franchisee is based or trading to apply for emergency injunctive or other relief (if such relief is available in that jurisdiction) to protect the franchisor's intellectual property rights, know-how and confidential information.

IV TERMINATION

Termination of an international franchise is one of the most difficult issues for a franchisor to face as it can be messy, expensive and commercially disastrous. Not only does the franchisor face often complex legal provisions and potentially risk being sued by the franchisee for compensation, it also faces the daunting task of deciding what should happen to the franchise in the territory following the termination. It is, of course, far preferable to avoid being presented with this problem by taking heed of the common causes of dispute discussed at the outset of this chapter. However, unexpected issues do arise and if a franchisor finds itself in a situation where it is seriously considering terminating an agreement, it is vital to ensure that it carefully considers the ramifications of such a decision to carefully plan the legal and commercial procedures necessary and take good local legal advice before making such a decision.

V COMMERCIAL ISSUES

The main decision facing the franchisor will be how to deal with the territory following termination. The answer will inevitably depend on the value of the market and the potential impact on the franchisor's brand reputation. If the territory already has a number of outlets up and running, the franchisor will usually want to allow them to continue. One way to

achieve this is to terminate only the rights to open new outlets thereby allowing the franchisee to continue to operate any existing outlets and allowing the franchisor either itself or via a third party to exploit the rest of the territory (if the agreement permits the franchisor to do so); however, this can cause complications in that the franchisor and the franchisee are still in a relationship and it may be difficult to rebrand the territory given that existing relationship. It may be that the franchisee's breaches are so serious that the franchisor does not want to continue the relationship at all and therefore the only option is for termination of the entire agreement. In this situation the franchisor has three options: (1) appoint a new franchisee for the territory, (2) take over the franchisee's business and run it itself, or (3) discontinue trade in the territory.

i Appointing a new franchisee

This is likely to be the most attractive option for many franchisors, but it may be difficult to recruit a new franchisee if the former franchisee's actions have damaged the brand's reputation in the territory. Timing is also a big issue – unless the franchisor plans the process carefully, there may be a gap between termination of the old franchise and appointment of a new one. This can of course cause huge logistical problems in an international context. It is therefore more common for a franchisor to seek to appoint a new franchisee prior to terminating an agreement; however, the franchisor in that situation needs to take advice on the legal implications of being in discussions with a new franchisee while the old one is still trading, and delaying a decision to terminate, which could lead to accusations that the franchisor has affirmed the contract and lost its right to terminate.

ii Taking over the franchisee's business and running it

If a franchisor needs to terminate immediately or is having difficulties finding a new franchisee, the franchisor may have no option but to step into the shoes of the former franchisee. It is highly likely that the franchisor will not have any staff on the ground in the territory and this can cause huge logistical problems and be highly time-consuming and very expensive – it is not a decision to be taken lightly. The franchisor also needs to take local advice in relation to the enforceability of any 'step-in' rights that it may have in the agreement and the legal implications of effectively taking over the franchisee's business, which could entail the franchisor also taking responsibility for certain debts, leases, employees, etc.

iii Discontinuing trade in the territory

This may be the most unattractive option but may be necessary to protect goodwill. This will also need to be carefully planned in relation to the sale of any assets and the sale of any existing stock. A well-managed winding down of the operations in the territory may give the franchisor an opportunity to reconsider its strategy for the territory and rebrand at a later stage when trading conditions are more favourable.

The situation may be complicated if the franchisor has granted master franchisee rights as opposed to developer rights. If there is a developer, then it is easier and cleaner for the developer's corporate outlets to be closed down or brought back with relative ease. It is, however, far more difficult to deal with the sub-franchisees left by a terminated master franchisee with whom the franchisor is unlikely to have any contractual relationship. It can be very difficult for the franchisor to have any control over such franchisees and could also result in negative publicity for the franchisor.

VI LEGAL ISSUES

Many countries have quite prescriptive legislation or regulations in relation to the parties' rights to terminate franchise agreements. If a franchisor terminates incorrectly, it could be faced with a substantial damages claim and, just as importantly, may face real issues in relation to controlling its intellectual property rights, in particular trademark rights in the territory. If the trademarks have been properly registered in the franchisor's name, the franchisor should be able to protect them following termination. However, in some jurisdictions, if the franchise agreement was registered with the relevant local agency, it can be more complicated to stop the franchisee from continuing to use the trademarks following termination. These issues are addressed in more detail in the intellectual property rights chapter and the individual country chapters.

If a franchisor terminates for underperformance, it is quite likely that the franchisee will owe the franchisor money for management fees or for stock. If the franchisee company is a vehicle that has been set up specifically to run the franchise, then there is a real risk that it will have little or no assets against which the franchisor may enforce. Unless unpaid debts are fairly substantial and undisputed, the time, cost and effort involved in enforcing against the franchisee in a foreign jurisdiction may outweigh the benefits of doing so. While it is difficult to completely prevent this type of problem arising, the franchisor should try as far as possible to ensure that payments are carefully monitored on a regular basis and that any under payment or non-payment is dealt with swiftly. Particularly in the current climate, it is not uncommon for franchisors to agree payment plans and extended payment terms with franchisees to avoid the difficult question of termination; however, this can be a 'slippery slope' and when the franchisor does make a final decision to terminate, the franchisee may be in a situation where it owes the franchisor substantial sums that are going to be difficult to recover.

Another issue that the franchisor needs to consider is the question of existing stock and whether it should be returned to the franchisor or whether the franchisee can be permitted to sell it through other networks. The question is really a commercial one and will depend on which option the franchisor prefers. It may be that it is not commercially worthwhile for the franchisor to ship the goods back to its home country and it would prefer the stock to be sold on by the franchisee perhaps by way of an agreed method and within an agreed timescale. These types of issue should ideally be dealt with in the franchisor's standard terms and conditions of supply agreed at the outset of the relationship and annexed to the franchise agreement.

Any real estate or leases owned by the franchisee can also cause logistical problems. It may not be possible for the franchisor to take over any leases for local law reasons or the landlord may not wish to contract with a foreign franchisor.

VII NON-COMPETITION COVENANTS

Franchisors will commonly ask their franchisees to give certain contractual undertakings not to be involved in a competing business both during the term of the agreement and for a certain time period after termination. The enforceability of these in-term and post-term obligations will vary greatly depending on the jurisdiction and will be subject to the competition and antitrust laws of the franchisee's jurisdiction.

i In-term obligations

As a general rule, in-term non-compete obligations are more likely to be enforceable as local courts may agree that the franchisee should have an obligation not to compete with its franchisor during the term of the agreement. The franchisee will be party to a great deal of valuable confidential information that belongs to the franchisor during the term of the agreement, particularly in relation to pricing, costs of products and marketing strategy, and it is therefore unreasonable for the franchisee to be involved in a competing business while it is party to such information from the franchisor. In addition, it is also quite common for there to be a provision in the agreement entitling the franchisor to terminate if the franchisee is involved in a competing business in the territory during the term of the agreement. If the franchisee is an existing operator, then it is quite likely that the parties will agree a carve out for the franchisee's existing business interests when the agreement is negotiated.

ii Post-term obligations

These restrictions are more complicated both from a legal and commercial perspective. While the franchisee may be prepared to agree to an in-term restriction, many master franchisees are not prepared to agree to any post-termination restrictions, particularly if they are an existing operator in their jurisdiction. It is more common for post-termination restrictions to be widely used in the franchisor's domestic market in the event that it wants to ensure that a unit franchise operator does not go on to compete in its territory following expiration or termination of an agreement. With a more sophisticated international partner, it will be more difficult for the franchisor to impose post-termination restrictions and obligations. In addition, post-termination restrictions are more difficult to enforce as they are more likely to be anticompetitive and these issues are dealt with in more detail in each country chapter.

VIII CONFIDENTIAL INFORMATION

As mentioned above, a franchisee will be party to a considerable amount of confidential information that belongs to the franchisor during the term of the agreement. The agreement should contain an obligation to keep such information confidential, even following termination or expiration, for as long as the information remains truly confidential.

Therefore, even if the franchisee has not agreed to a post-termination restrictive covenant, it may be possible to prevent the franchisee from continuing to trade in the same line of business if it can only do so by using the franchisor's confidential information. In many franchise systems, however, while the franchisor does have valuable information in relation to operating procedures and systems, in most cases this information is not truly confidential and it will be very difficult for a franchisor to prevent a former franchisee from using fairly general operating methods and procedures. The information being misused must be genuinely secret and such information must be properly safeguarded and protected by the franchisor to have the requisite protection.

IX CONCLUSION

While international franchising can be a very successful way for a brand owner to expand its network with less costs and exposure than corporate expansion, it is not something to be entered into lightly and it is vital that the franchisor takes proper local law advice so that it can anticipate and prepare for potential problems and issues before granting the franchise

rights. The country in which the franchisee is located is going to be a deciding factor in whether to use arbitration or litigation, and what the franchisor's rights and remedies will be if and when disputes do arise. Resolving international disputes can be expensive and therefore should ideally be avoided if at all possible. Franchisors should therefore consider the likely causes of disputes set out above before entering into the agreement and thereafter conduct the relationship in an open and transparent way to deal with issues before they escalate.

E-COMMERCE AND FRANCHISING

*Ben Hughes*¹

I BACKGROUND

Whereas in the previous millennium e-commerce was something akin to science fiction, it is now a fundamental part of any franchise business and the franchise agreement must deal with the way in which it affects the franchisor–franchisee relationship in some detail. For nearly every multichannel retail operation, e-commerce is now a key sales channel, and is increasingly the main sales channel. This transformation from science fiction to viable sales channel began with the dot-com boom of the mid to late 1990s when new and existing retailers began exploiting and developing internet-enabled technologies to market and sell their goods and services to consumers. The intervening years have witnessed correspondingly revolutionary changes in consumer behaviour and in the way that retail businesses operate. The current e-commerce retail market is also increasingly driven by the proliferation of mobile devices and their usage by consumers. Worldwide in 2016, there were an estimated 3.4 billion smartphone subscriptions that could be used to carry out e-commerce activities and this is set to almost double by 2021.²

The real challenge for franchisors, however, is that e-commerce continues to develop apace. With franchise agreements being granted for periods of up to 15 or 20 years it is essential that they are sufficiently flexible to accommodate the further changes that lie ahead as, although the past 25 years have seen a very rapid development in internet-enabled technologies and an equally rapid increase in internet usage by consumers,³ the next 25 are likely to see even more far-reaching changes.

The outlook is that internet-enabled marketing and selling of goods, services and digital content will be even more widespread in future. This means that all retailers – even retailers currently operating as traditional ‘bricks and mortar’ businesses – need to understand e-commerce from a range of perspectives, including technological, operational, commercial and legal.

1 Ben Hughes is a senior associate at Bird & Bird LLP.

2 See Ericsson’s ‘Mobility Report – Mobile Subscriptions Q1 2016’ as published on their website: <https://www.ericsson.com/assets/local/mobility-report/documents/2016/ericsson-mobility-report-november-2016.pdf>.

3 For example, see the rapid growth in fixed (wired)-broadband subscriptions as published on the International Telecommunication Union’s website: www.itu.int/en/ITU-D/Statistics/Pages/stat/default.aspx.

The purpose of this chapter is both to reflect on the key contracting issues that confront franchisors when they seek to agree the e-commerce components of franchising and development agreements and to help franchisors gain a broad overview of the general legal landscape that they will need to deal with when operating e-commerce businesses.

II WHAT IS E-COMMERCE?

The expression 'e-commerce' is used to refer to a wide range of commercial activities, which can involve different combinations of consumers, businesses and other organisations. The common link is that these activities are conducted over computer networks and, more usually, the internet.

In this chapter, 'e-commerce' will refer to commercial activities between consumers and business retailers that take place over the internet and in which the retailers market or sell goods, services or digital content to consumers who are using networked devices – such as personal computers, tablets, smartphones and internet-enabled televisions.

In this sense, as previously indicated, e-commerce is a fast-moving territory. Retailers now routinely use social networks such as Facebook and Twitter to market their products, and consumers are increasingly using social networks to purchase goods and services.⁴ This is sometimes referred to as 'social commerce' or 's-commerce'. Retailers are also tending to optimise their operations so that consumers can learn about and buy goods and services through dedicated applications (apps) installed on their mobile devices (such as smartphones or tablets) rather than through more traditional websites. This allows retailers to learn more and more about their customers through location-based technologies and other marketing automation technologies.

Near-field technologies (and related security functions) now feature in the most up-to-date mobile devices and these are being leveraged to allow consumers to make payments, which looks likely to disrupt the credit and debit card industry. In future, consumers may also make more use of cryptocurrencies such as bitcoin to buy goods and services. If this does happen, it will have profound implications for financial regulators and central banks.

III E-COMMERCE SOLUTIONS

Most owners of major international retail brands now operate a business strategy in which e-commerce activity forms one or more of several channels through which the goods or services associated with the brand are marketed and sold. This involves the brand owner operating a portfolio of e-commerce platforms that, at a minimum, generally include websites, mobile apps and maintaining presence on social media platforms. Each channel generally forms an integral part of the brand owner's business, increasing brand exposure and, ultimately, revenue and profits. Responsibility for operating each e-commerce platform tends, to a greater or lesser extent, to be allocated among the brand owner itself, specialist digital media marketing agencies, e-commerce platform providers or third-party stakeholders (such as franchisees and joint venture partners). Depending on their circumstances, brand owners and retailers are therefore able (to a greater or lesser extent) to outsource responsibility for parts of their overall e-commerce offerings to third-party providers.

⁴ For example, see Visioncritical's white paper 'From social to sale', published on 25 June 2013 and available at <http://teh.net/wp-content/uploads/2015/04/whitepaper-social-to-sale.pdf>.

The problem that brand owners face when operating this type of strategy is that e-commerce channels have an inherent tendency to conflict with other, more traditional channels, particularly 'bricks and mortar' channels that are operated by third parties. This conflict arises because of the borderless nature of the internet, which makes it difficult to impose territorial restrictions on the marketing and sale of goods, services and digitised content through e-commerce channels.

For example, an international UK fashion brand might have long-standing franchising agreements in place with a 'bricks and mortar' franchisee in France. If, separately, the UK brand were to implement a website and mobile app that offers French consumers goods at cheaper prices or better returns policies than being offered by the franchisee's 'bricks and mortar' shops, this would be problematic.

This type of scenario challenges the brand owner and the franchisee to find a way of operating their potentially competing and conflicting channels in harmony. Of course, in essence, this is a commercial challenge that will be resolved through commercial agreement. Ultimately, however, the documentation of that agreement will need to show a full understanding of the different channels and how they interrelate.

IV E-COMMERCE LEGAL LANDSCAPE

It is clearly very important for e-commerce platform operators to ensure they have a comprehensive understanding of the legal framework that applies to their activities in all jurisdictions in which they are using e-commerce to market and sell their products and services.

Broadly speaking, the types of legal issues that arise will be the same in all jurisdictions. In essence, they flow from the fact that the retailer needs to enter into contracts with consumers that it is marketing or selling to, but in a way that complies with local law. Of course, the overall commercial importance to the retailer of each contract that is generated by the retailer's e-commerce platforms can vary enormously, but such contracts tend to fall into two broad categories:

- a* contracts that govern the supply of the relevant goods, services or digital content; or
- b* contracts that govern the use by the consumer of the retailer's e-commerce platform (e.g., website and mobile apps), including contracts that incorporate acceptable use and privacy policies.

If a retailer operates internationally, it will often want to operate identical or near-identical e-commerce platforms across multiple jurisdictions. If so, then the retailer will need to design its platforms and supporting operations so that, when consumers' use of the platforms generates contracts, there is a high probability that those contracts are enforceable and on terms that the retailer can predict. This is important even if the retailer is seeking to specify that its e-commerce contracts have the same governing law irrespective of the country to which they are selling. The reason for this is that, notwithstanding the governing law chosen by the retailer, in many jurisdictions certain mandatory local law provisions will apply to contracts with consumers regardless of the governing law of the contract. In some jurisdictions, a consumer may even have grounds for arguing that the local law of the jurisdiction in which they reside should apply to the contract instead.

Depending on the law of the jurisdictions in which the retailer is seeking to operate and the nature of the goods, services or digital content being sold, creating e-commerce platforms

that generate contracts that predictably comply in all respects with all local contract law can be a challenging (if not impossible) task. Nevertheless, it is often possible for retailers to create and operate platforms across a specific selection of jurisdictions with a reasonable level of confidence that the contracts generated by the retailer's e-commerce platforms will comply with local law in those jurisdictions.

The types of contractual issues that the retailer will need to consider in each jurisdiction are as follows:

- a* Contract formation rules: local rules on contract formation will apply to the retailer's various e-commerce platforms in each of the jurisdictions in which those platforms operate. The retailer will want to ensure that its platforms comply with these rules so that it has enforceable contracts in place with its retail customers.
- b* Contract terms: broadly speaking, there are two areas for retailers to consider. First, ensuring that key commercial terms are properly incorporated into its contracts. For example, terms and conditions relating to pricing, payment and delivery. Second, ensuring that terms and conditions that allocate legal liability between the retailer and the consumer are incorporated and enforceable. Many jurisdictions restrict retailers' ability to enforce terms that seek to exclude or limit their liability and are favourable to consumers. Given the risk that local law may apply to the contracts generated by a retailer's e-commerce platforms, it is generally sensible to get local law advice on the enforceability of any contractual terms that seek to limit or exclude the retailer's liability in the context of consumer claims.
- c* Governing law and jurisdiction: a retailer may be located in a different country from the country in which the consumer is located. As indicated above, this triggers the rules on choice of governing law and jurisdiction, including under the Rome I Regulation⁵ and the Brussels Regulation.⁶ This is a complicated area of law but, in general terms, it is usually prudent for retailers to include terms specifying which governing law and jurisdiction should apply to the contracts generated by their e-commerce platforms.
- d* E-commerce and consumer legislation: it is likely that there will be specific local laws that will apply to consumers generally and more specifically in respect of e-commerce contracts with consumers. In the EU, there are a number of pieces of legislation that cover this area and apply across all Member States. Primarily, these relate to information provision by e-commerce operators and fairness of terms in consumer contracts. A number of EU Directives will impose obligations on the retailer in these areas, such as the Unfair Commercial Practices Directive,⁷ the Unfair Terms Directive,⁸ the E-Commerce Directive⁹ and the Consumer Rights Directive.¹⁰ The retailer will need to ensure not only that its e-commerce platform provides the information required by these Directives and that its contracts with consumers are compliant with these Directives but also, for the reasons discussed above, that it has complied with any specific local laws that apply in this area.

5 Regulation (EC) No. 593/2008.

6 Regulation (EC) No. 44/2001.

7 Directive 2005/29/EC.

8 Directive 93/13/EEC.

9 Directive 2000/31/EC.

10 Directive 2011/83/EU.

- e* Data privacy: the retailer will, in almost all cases, be collecting personal data through the use of their e-commerce platform and is likely to be responsible for compliance with data protection laws in respect of that data. This will involve, *inter alia*, ensuring that they use personal data in a lawful manner, that personal data is appropriately secured and that individuals are informed and give consent to the use of their personal data. As with consumer legislation, a key consideration for the retailer will be assessing which data protection laws apply to their e-commerce platform as their specific obligations will differ between jurisdictions. Please see Chapter 7 (Data Protection) for a more detailed discussion on this.
- f* Competition: the European Commission generally regards internet marketing and sales through websites as ‘passive selling’ for the purpose of the vertical restraints block exemption. Therefore, customers from outside a franchisee’s exclusive territory who place an order with the franchisee as the operator of the website cannot be prevented from making a purchase from the franchisee, and must be free to make purchases over the internet in general.
- g* Tax: local rules on sales tax are likely to apply to sales to consumers in other jurisdictions. Complying with these requirements may require a retailer to be registered with the tax authorities in the jurisdiction to which it is selling. In the course of running its e-commerce platform, the retailer may have to assess whether withholding tax will apply to any of its transactions (see Chapter 8, ‘Tax Considerations’, for a more detailed discussion on this).
- h* E-money: payment over the internet is now ubiquitous. Many of these transactions use e-money, a digital cash equivalent, stored on an electronic device or remotely on a server in an e-wallet. E-money is usually backed by a credit or debit card or a bank account and allows money to be sent instantly and securely. Although these commonly offer a cheaper and more efficient payment system for retailers, caution should be taken as these transactions are likely to trigger the Electronic Money Directive¹¹ and Payment Services Directive.¹²
- i* Virtual currencies: retailers may want to consider accepting virtual currencies such as bitcoin (distinct from e-money, as they are stand-alone currencies, rather than a digital version of fiat money) as a method of payment on their e-commerce platform. The recent emergence of virtual currencies in mainstream commerce (with large companies such as Microsoft and Expedia now accepting bitcoin for online payments) has left the law in this area playing catch-up. While some commentators have suggested that bitcoin should be governed by the Electronic Money Directive, others suggest it should fall under the Payment Services Directive. Despite much debate on the topic, the EU has not passed any specific legislation in relation to the status of bitcoin as a currency.¹³ Consequently, there is much uncertainty surrounding virtual currencies, and more significantly they are not regulated, meaning retailers and consumers alike are not protected and may be at risk of losing their money should something go wrong.¹⁴

11 Directive 2009/110/EC.

12 Directive 2007/64/EC.

13 In October 2012, the European Central Bank issued a report on virtual currency schemes that discusses the bitcoin system and briefly analyses its legal status under existing EU legislation; the report is available at: www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf.

14 www.eba.europa.eu/-/eba-warns-consumers-on-virtual-currencies.

- j* Merchant acquirers: to accept payments by card on their e-commerce platform retailers are likely to contract with a merchant acquirer, who acts as the link between the retailer, the card issuer and the payment networks. Since the merchant acquirer takes on the risk in each transaction, they commonly only contract on their standard terms, with no ability for a retailer to negotiate these.
- k* Payment card industry data security standards (PCI DSS): since an e-commerce platform is likely to deal with credit and debit card data, the retailer must ensure that the platform complies with the requirements of PCI DSS. PCI DSS is a set of requirements on the storage and use of payment card data. Although PCI DSS does not have the force of law, it is administered by payment card schemes such as Visa and MasterCard, and non-compliance can result in fines.

V CONCLUSION

The internet-enabled technologies that have revolutionised the retail landscape over the past 25 years continue to develop at a rapid pace. Global brand owners, seeking to operate their multichannel businesses and exploit the commercial opportunities that these developments present, find themselves needing to overcome the significant commercial challenges that are created by the borderless nature of the internet. This is achieved through careful negotiations with their commercial partners, which can include third-party franchisees. E-commerce retailers also find themselves needing to navigate through a sometimes bafflingly complex multi-jurisdictional legal landscape, which requires them to adopt sophisticated legal risk-mitigation strategies. For both brand owners and retailers, if these issues are successfully surmounted, substantial rewards are available.

THE COMPETITION LAW OF THE EUROPEAN UNION

Mark Abell¹

I INTRODUCTION

Antitrust law has an uneasy relationship with franchising and there is no homogenous approach adopted by regulatory authorities around the world. Some, such as the United States, follow the view of the Organisation for Economic Co-operation and Development and adopt a ‘rule-of-reason’ approach, by which the practical impact of restrictions determines whether or not they are allowed or prohibited by antitrust law. Others, such as the European Union and its 28 Member States, take a less flexible, politically motivated *per se* approach and treat certain restrictions, such as retail price maintenance, as forbidden, regardless of their practical impact on competition. Article 101 of the Treaty on the Functioning of the European Union is the EU’s antitrust law and prohibits:

all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market

This means that franchisors are prohibited from directly or indirectly trying to fix prices, carve up markets or sources of supply and so on. A franchise agreement incorporating such provisions will be void, potentially leading both to the imposition of fines by the regulators and possible claims for damages from aggrieved parties.²

The definitive explanation of how EU antitrust law impacts franchising in the EU can be found in the seminal decision of the European Court of Justice in the case of *Pronuptia de Paris GmbH v. Pronuptia De Paris Irmgard Schilligallis*.³ This case, which concerned the German franchisee of a French bridal wear business, establishes the principle that a franchisor can impose restrictions on its franchisees if those restrictions are ‘indispensable’ to protect the franchisor’s know-how and to maintain the identity and reputation of the franchise network,⁴ but not those restrictions that carve up markets between the franchisor and its franchisees or fix retail prices.⁵

1 Mark Abell is a partner at Bird & Bird LLP.

2 Case C-453/99 *Courage Ltd v. Bernard Creban* [2002] QB, [2001] All ER (EC) 886.

3 Case 161/84 *Pronuptia de Paris GmbH v. Pronuptia De Paris Irmgard Schilligallis* [1986] ECR 353, [1986] 1 CMLR 414.

4 *Id.*, paragraphs 16, 17.

5 *Id.*, paragraph 12(c).

In the wake of the *Pronuptia* decision by the ECJ, the European Commission gave further clarification as regards how competition law regulates franchising in the EU through its decisions in *Pronuptia*, *Yves Rocher*,⁶ *Computerland*,⁷ *Servicemaster*⁸ and *Charles Jourdan*.⁹

To encourage smaller businesses to participate in cross-border trade within the EU¹⁰ the Commission adopted a *de minimis* exemption,¹¹ which states that only those agreements that have an ‘appreciable’ effect on trade (i.e., those that have 15 per cent of the relevant market)¹² infringe Article 101(1). However, because of the difficulties in defining what amounts to a market, relying upon the *de minimis* exemption can be rather imprudent for a franchisor.

Recognising this, and in an attempt to further encourage trade between Member States, the Vertical Restraints Block Exemption¹³ was adopted. This Block Exemption disapplies Article 101(1) to franchise agreements, although franchising is not expressly referred to in the Regulation. The Exemption applies only to those franchisors with a market share of less than 30 per cent and means that franchisors may, *inter alia*, impose maximum price restrictions, but not minimum price restrictions. ‘Hardcore’ restrictions, such as exclusivity, price maintenance and restrictions on cross-supply are not permitted and mean that franchise agreements containing such provisions cannot take advantage of the Block Exemption. Non-compete clauses, although not allowed, can be blue-pencilled out of the agreement, so allowing it to take advantage of the Exemption.

The 28 EU Member States have all adopted competition laws that are exact copies of Article 101, and so there is complete homogeneity among them.

II THE EUROPEAN PARLIAMENT COMMITTEE ON INTERNAL MARKET AND CONSUMER PROTECTION REPORT ON THE ‘LEGAL PERSPECTIVE OF THE REGULATORY FRAMEWORK AND CHALLENGES FOR FRANCHISING IN THE EU’

In September 2016, following a workshop held at the EU Parliament in Brussels, in which a spectrum of stakeholders offered a range of, in some cases rather polemical, ideas on how franchising should be regulated in the EU, the Directorate-General for Internal Policies of the Union issued a report about the way in which the regulation of franchising in the EU might be reconstructed.

The report is not a formal proposal by the Committee on Internal Market and Consumer Protection but is meant to stimulate further discussion among stakeholders. It offers a bold

6 Case C-126/91 *Schutzverband Gegen Unwesen in der Wirtschaft v. Yves Rocher GmbH* [1993] ECR-I-2361.

7 *Computerland Europe SA Franchise Agreements*, Re, Case IV/32.034, [1989] 4 CMLR 259.

8 *Servicemaster*, OJ [1988] L332/38, [1989] 4 CMLR 581.

9 *Charles Jourdan*, OJ [1989] L35/31, [1989] 4 CMLR 591.

10 The *de minimis* principle was first introduced by the ECJ in the case of *Völk v. Établissements Vervaecke Sprl*, Case 5/69 [1969] ECR 295.

11 Notice on agreements of minor importance that do not fall within the meaning of Article 85(1) of the Treaty establishing the European Community OJ [1997] C 372/13.

12 Commission Notice (EC) on agreements of minor importance that do not appreciably restrict competition under Article 81(1) of the Treaty Establishing the European Community (*de minimis*) OJ (2001/C 368/07).

13 Commission Regulation (EC) No. 330/2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of vertical agreements and concerted practices OJ L 102.23.4.2010 pp. 1–7.

vision of an entirely new supportive regulatory environment for franchising in the EU, from the one of the most creative academic and professional legal minds in international franchising. It is therefore important for those involved in franchising in the EU to be aware of the approach that it is advocating.

III THE ADVANTAGES DELIVERED BY FRANCHISING

The report observes that franchising is a specific, distinct and uniform type of commercial activity with a positive influence in the EU. It stimulates economic activity by improving distribution and increasing competition. It delivers economic advantages to all those involved and consumers, by *inter alia*, giving businesses increased access to other EU Member State markets. Arguably, with a looming Brexit, franchising has never been more important in terms of its ability to encourage cross-border EU trade.

IV THE DIFFERENT TYPES OF FRANCHISE REGULATION IN THE EU AND ITS DYSFUNCTIONALITY

The report observes that there are two distinct types of franchise regulation in the EU. Those concerned with macroeconomic issues and those concerned with both the way in which franchisors sell their franchises to potential franchisees and the rights of the two parties during the relationship.

Those regulations that focus on the macroeconomic issues are over-concerned with intra-brand issues and fail to appreciate the value that franchising can contribute to the single market, both by enabling small and medium-sized enterprises (SMEs) to expand effectively throughout the EU, and by unleashing entrepreneurship in individual franchisees throughout the EU.

The various EU Member State sales and relationship regulations lack any real uniformity, increasing cost and causing delays for franchisors seeking to roll out across the single market, thereby creating technical barriers to cross-border franchising within the EU.

To further exacerbate the difficulties, the macroeconomic and sales and relationship-focused regulations been developed in an uncoordinated manner, in isolation from each other. This has contributed to the dysfunctionality of franchise regulation in the EU.

Self-regulation of franchising in the EU lacks both homogeneity and a clear, consistent and effective approach to enforcement, in addition to which there is a significant conflict of interest between the interests of individual franchisors and those of franchising as a way of doing business. In any event, nearly 80 per cent of franchise chains in the EU are not members of national franchise associations and therefore not subject to the self-regulatory regime.

The result of this dysfunctional regulation is that franchising is substantially underperforming in the EU. This is evidenced by the fact that 83.5 per cent of franchising's turnover in the EU is concentrated in only 25 per cent of the Member States and constitutes only 1.86 per cent of the EU's GDP, compared with 5.95 per cent of GDP in the United States and 10.83 per cent of GDP in Australia.

This failure of the regulatory environment to recognise the value that franchising can deliver to the EU and to support and promote it as a way of helping SMEs to grow across the EU can only be remedied by re-engineering the regulatory environment in the EU.

V HOW THE DYSFUNCTIONALITY OF EU REGULATION CAN BE RECTIFIED

Franchising could better fulfil its potential in the EU if the regulatory environment is re-engineered in a manner that:

- a* promotes franchising and market confidence, by underpinning and supporting the commercial advantages that franchising delivers to franchisors, franchisees and the single market;
- b* ensures pre-contractual hygiene in franchising;
- c* ensures a balance between the interests of franchisors and franchisees;
- d* reconciles the priorities and concerns of the two different types of franchise regulation in an appropriate way; and
- e* is harmonised throughout each EU Member State.

The report suggests that this could best be done by adopting a European legal act (ELA) containing provisions regulating specific issues that would increase market confidence in franchising, ensure pre-contractual hygiene and impose a mandatory taxonomy of rights and obligations. The following approach, using an ELA, is proposed:

- a* the ELA should be used to bring a homogenous approach to the regulation of franchising in the EU;
- b* the ELA should enable SMEs to use franchising to better compete with larger corporations through an ‘exchange of benefits’; and
- c* the ELA should promote market confidence in franchising as a way of doing business, ensuring pre-contractual hygiene and ensuring a fair ongoing relationship between franchisors and their franchisees by imposing appropriate rights and obligations on both parties.

VI WHAT LEGAL INSTRUMENT?

The current heterogeneous regulatory environment creates obstacles that prevent franchisors from taking full advantage of the single market. The same problem was encountered in relation to commercial agency and was overcome by the adoption of a directive.

The report suggests that the catalyst for harmonisation should be an ELA containing provisions regulating specific issues.

The report suggests provisions that the EU Commission could include in an ELA to implement these recommendations. The ELA would have the following three main areas of focus.

i Promoting confidence in franchising

The report proposes that franchising should be seen by business, especially SMEs, as offering legal as well as commercial advantages. They should be offered certain benefits in exchange for using franchising and so allowing third parties to operate their own businesses using the franchisor’s brand and know-how. Regulations should enable SMEs to use franchising to better compete with larger corporations. This can be achieved through an ‘exchange of benefits’.

This means that franchising must be clearly defined and be perceived as offering positive advantages to all involved in it. In other words, regulation should maintain and increase market confidence in franchising as a way of doing business, as it encourages entrepreneurship

not only in SMEs that become franchisors, but also in individuals who become franchisees. The following recommendations will achieve this. This is a positive contribution to the single market, franchisors, franchisees and consumers.

This can be achieved by enabling franchisors to require pre-contractual disclosure by franchisees; focusing regulation only where it is required (by excluding fractional franchisees, *de minimis* franchisees, sophisticated investors, large investors, large franchisees and insiders); and allowing franchisees to compete on a level playing field with corporate chains.

It should establish this by changes to antitrust law, namely allowing franchisors to set the prices their franchisees may charge and restricting franchisee sales over the internet.

These changes will increase market confidence in franchising in the EU and so encourage SMEs and other businesses to adopt it as part of their growth strategy.

Fraud and sharp practice should be regulated by criminal law and not by a franchise-focused ELA.

ii Ensuring pre-contractual hygiene

It is suggested by the report that regulation should also ensure pre-contractual hygiene. That is, it should help ensure that when franchisors and their franchisees enter into a relationship there is as little opportunity as possible for misunderstanding or a mismatch of expectations between them. To achieve this, franchisees should not only be strongly encouraged to take and follow expert advice, they should also understand exactly what they are buying – a blueprint for a business, not a guarantee of success, and an obligation to follow the franchisor's system.

To help ensure pre-contractual hygiene potential franchisees must be given access to appropriate information and equipped to interpret it in an appropriate manner. It is therefore proposed that advisers (particularly lawyers) are required to take short online franchise education courses if they are to advise potential franchisees, and potential franchisees investing more than €20,000 must produce a certificate from their advisers to prove that they have taken such advice.

National franchise associations can play an important part in educating potential franchisees that they have to work hard, follow the format, risk failure and take and follow expert advice from appropriately experienced professionals. They should receive financial support from central government to help ensure their independence.

Pre-contractual disclosure should:

- a* be given in a set form 15 working days before execution or payment;
- b* cover details of the identity and experience of the franchisor, the franchise network, the terms of the franchise agreement and any earnings claims;
- c* be in plain language;
- d* contain an appropriate risk statement;
- e* be accompanied by a copy of the franchise agreement in the form in which it is to be executed;
- f* include a five-day cooling-off period after execution;
- g* if not complied with, lead to the right for the franchisee to terminate or claim damages within 12 months of the franchisee becoming aware of the non-compliance or 24 months of the date of execution, whichever is the later, if it resulted in defective consent having been given;
- h* enable the appropriate regulatory authority to rescind the franchise and related agreements, or claim damages;
- i* allow the regulatory authorities to impose penalties, including disqualification;

- j* be allowed electronically;
- k* give rise to personal liability for any individual responsible for the disclosure document being inaccurate; and
- l* apply to foreign franchisors with no presence in the relevant Member State, who should be under an obligation to disclose relevant information about analogous markets.

To ensure that the legal requirement is always in step with market practice, there should be a regular review of the disclosure law every five years.

Misleading and deceptive behaviour (failing to comply with the pre-contractual disclosure obligations and making any statement that, although literally true, misleads or deceives or is likely to mislead or deceive) should be prohibited.

Registration of documentation on a public register creates a catalogue of problems in those jurisdictions where it is required both in the EU and elsewhere. Indeed, it has been wrongly viewed by some potential franchisees as an endorsement by the regulator of franchise systems – some of which have later proved to be unsuccessful. It is therefore inappropriate, not only because of the practical difficulties it would give rise to in EU Member States, but also because of its lack of cost-effectiveness and lack of impact.

iii Ensuring a fair relationship

The report goes on to state that the ELA should ensure that both franchisor and franchisee act fairly towards each other, reflecting the bargain that they have struck with each other. This can best be done by imposing mandatory terms onto the franchisor–franchisee relationship through the franchise agreement.

The report observes that discussion of these issues are often polemical and driven by the vested interests of individuals rather than higher-level balance. For example, the suggestion that franchisees should be free of any post-term restriction on using the franchisor’s know-how is nothing less than theft of the franchisor’s property and, if adopted, would constitute ‘free-riding’, dealing a potentially near-mortal body blow to franchising and the benefits that it delivers to all involved in it.

It is proposed that there must be a quality-based restriction on franchisors that can take advantage of the benefits offered by the regulation. A franchise that has not operated the business format for at least 12 months or which is operating fewer than four outlets will not have to comply with the regulation and cannot enjoy the exchange of benefits.

Consideration of the realities of the franchise relationship and the risks that both franchisor and franchisee accept lead to the following recommendation.

Franchisees must:

- a* not challenge the franchisor’s intellectual property;
- b* implement the business format;
- c* not compete with the franchisor during the term and for a reasonable period thereafter;
- d* allow the franchisor the right to purchase the franchisee’s business on termination;
- e* allow termination for cause without compensation;
- f* allow the franchisor a pre-emptive right of purchase;
- g* impose a duty of confidentiality; and
- h* purchase core goods and services from the franchisor or its nominated suppliers.

The franchisor must:

- a* be the owner of or have the right to license the intellectual property rights on which the franchise is based;
- b* provide a reasonable level of training;
- c* refrain from encroachment;
- d* allow the franchisee the right to sell its business (subject to the franchisor's pre-emptive right); and
- e* not supply goods or services to the franchisee at overinflated prices or that are unfit for purpose.

Each of these can be justified in their own right, the report states, but would require more space than is available in this chapter.

To take account of the franchise agreement's long-term and changing nature, unconscionable behaviour by both parties must be prohibited.

VII CONCLUSION

This report written by Dr Mark Abell on behalf of the Committee on Internal Market and Consumer Protection breaks new ground and proposes that to actively support and encourage franchising within the EU, an ELA should be adopted that aims to:

- a* define franchising;
- b* require disclosure by both franchisors and franchisees;
- c* disapply other duties of care and consumer rights;
- d* allow franchisors to set retail prices and control use of the internet;
- e* prohibit unconscionable behaviour;
- f* impose a specific and exclusive duty of good faith;
- g* support, and establish a clear role for, national franchise associations; and
- h* periodically review the terms of the ELA.

These proposals as to how regulation can be used to promote the interests of franchisors, franchisees and consumers in the European Community in a harmonised and constructive manner amount to a step change in the regulation of franchising in the EU and will no doubt receive serious consideration from all those with an interest in franchising within the EU and beyond.

THE IMPACT OF BREXIT ON FRANCHISING

*Mark Abell*¹

The decision of the United Kingdom on 23 June 2016 to leave the European Union will have a very real, but at present not fully known, impact upon all those franchisors around the world that have a presence in the United Kingdom, and possibly upon many of those that have a presence in the rest of the EU. This will present challenges for franchise lawyers, who will need to understand the potential implications as these change and develop over the coming years, and consequently they will have to advise their franchise clients how best to deal with the developments.

Although the decision in the referendum was a close one, with 51.9 per cent of the voters in favour of leaving and 48.1 per cent in favour of remaining in the EU, Prime Minister Theresa May has made it clear that there will be no second referendum and that 'Brexit means Brexit'.

This unexpected result has caught almost all franchisors on the hop and left them potentially exposed in respect of their business in the United Kingdom and, perhaps, in the rest of the EU.

There is even a body of sentiment in Scotland in favour of remaining in the EU and suggestions that this could lead to another referendum on Scotland leaving the United Kingdom in favour of staying within the EU.

However, the United Kingdom will not be leaving the EU immediately. There is a technical process under Article 50 of the Lisbon Treaty to be complied with, and that will not begin until the United Kingdom gives formal notice to the EU Council of its intention to withdraw.

Wherever that process leads the United Kingdom and the rest of the EU in terms of both the process itself and the ongoing relationship between the EU and the United Kingdom, the withdrawal agreement must be passed by a qualified majority of the Council, with the consent of the European Parliament.

When Brexit does take effect, EU treaties will cease to apply to the withdrawing state from the date the withdrawal agreement comes into force or, failing the conclusion of an agreement, two years after the Council is notified of the withdrawal (unless the Council unanimously agrees to extend this period).

Although no one, including franchisors and their lawyers, has a crystal ball enabling them to predict exactly what will happen as a result of the Brexit decision, it is clear that when the United Kingdom leaves the EU certain things will happen that will have an impact upon franchisors in the United Kingdom and, potentially, franchisors throughout the EU.

¹ Mark Abell is a partner at Bird & Bird LLP.

Regardless of how the English legal system adapts to the change, Brexit may provide grounds for the termination of franchise agreements, depending on the specific facts and drafted terms (e.g., material adverse change or force majeure clauses) in contracts. This is particularly relevant in the case of franchise agreements that have the EU as their territorial scope. Parties might argue that a contract has become frustrated as a result of Brexit. This is of great relevance to any US franchisors that have granted master franchises for the EU rather than for specifically named countries.

Although 'Brexit will mean Brexit', it does not mean that all the laws impacting upon franchisors in the United Kingdom will change overnight.

When the United Kingdom leaves the EU, all directly applicable EU law (including treaty provisions and regulations) will cease to have legal force in the United Kingdom, unless Parliament passes equivalent domestic legislation. Directives (which are only effective once transposed into domestic UK legislation) will continue to operate, but the UK statute will no longer be required to comply with the Directive from which it derives: the UK Parliament will be free to amend the legislation as it sees fit.

Secondary legislation introduced under the powers set out in European Communities Act 1972 (ECA 1972) to implement EU law will lapse when the ECA 1972 is repealed, subject to the enactment of saving provisions. Where ambiguities arise, directives are likely to continue to be relevant to the interpretation of UK statutes that derive from them.

It is likely that, even after Brexit, the decisions of the Court of Justice of the European Union (CJEU) will continue to be persuasive in UK courts, particularly with respect to UK law derived from or harmonised with EU law. This influence will diminish over time as UK law diverges. Some UK statutes contain a requirement to interpret the legislation consistently with CJEU rulings: this requirement will continue to be effective after Brexit unless and until the UK statute is amended. Depending on the United Kingdom's new status in relation to the EU (which is to be negotiated), the United Kingdom may join the European Free Trade Association (EFTA) (and then also the Lugano Convention on Jurisdiction and Judgments) and possibly the European Economic Area (EEA).

If the United Kingdom joins EFTA, and through it joins the EEA, the position in relation to many aspects of legal practice will remain unchanged. This must be a real possibility and, if it is the outcome, there is likely to be less upheaval from a legal point of view.

If the more Eurosceptic view prevails, it is likely that the United Kingdom will negotiate a looser arrangement with the EU via a series of bilateral and multilateral trade agreements, or through reliance on the rules of the World Trade Association, OECD and G20, of which it will remain a member.

One thing that is clear is that should the EU's Directorate-General for Internal Policies of the Union consider there to be a need for further franchise regulation, resulting in some form of new franchise regulation in the EU, this would most probably not take effect in the United Kingdom.

EU competition rules will continue to apply to franchising post Brexit, although the Commission will have reduced powers. However, new block exemption measures will be needed at UK level, as the UK Competition Act currently relies on the EU block exemption regulations (which will no longer apply following Brexit).

Disputes where the franchisor or franchisee is based in the United Kingdom and the other party is based in an EU Member State are likely to be affected by Brexit. However, there

may be an even wider impact. A dispute between a franchisor and franchisee, even if both are based outside the EU and the United Kingdom, may nevertheless be affected by Brexit if the subject matter of the dispute is in the United Kingdom.

The Brussels Regulation currently governs jurisdiction and the enforcement of judgments within the EU. The Lugano Convention sets out very similar rules, so if, post Brexit, the United Kingdom becomes a signatory to this convention, little will change. Otherwise, the position will depend on negotiated bilateral and multilateral agreements with other countries, or the possible ratification by the United Kingdom, in its own right, of the Hague Convention on Choice of Court Agreements (which the EU has ratified).

It is likely that EU rights, such as registered and unregistered community designs and EU trademarks (EUTMs) (formerly referred to as Community trademarks or CTMs), will no longer have effect in the United Kingdom and there will be questions about what will happen to the 'UK portion' of such rights obtained before Brexit. If existing rights automatically reduce in geographical scope to exclude the United Kingdom, their value will diminish, which will have a commercial impact on the rights holder. This is something that US franchisors with EUTMs need to keep an eye on, as it may mean having to reapply for some of their trademarks in the United Kingdom at some point.

Furthermore, some US franchisors have EUTM registrations but only use their marks in the United Kingdom. Once the United Kingdom no longer forms part of the EU, these EUTM registrations could be vulnerable to attack for non-use. US franchisors in this situation would have to consider expanding their use in the EU to defend their EUTM registrations or consider filing independent national UK applications that would survive any possible future demise of their EUTM as a result of non-use.

Franchisors with a presence in the United Kingdom should audit the immigration status of their workforce, consider applications that could be made now (e.g., for permanent residency and communicate with concerned employees. In the longer term, if and when the government proposes that laws be amended or repealed, employers should also review employment contracts (with a view to addressing any enforceability risks that might arise), policies, procedures and benefit schemes, and check any European Works Council arrangements.

Changes to immigration laws in relation to EU citizens currently living and working in the United Kingdom could have a substantial impact on your franchisee's employees, particularly in the food and beverage and hospitality industries.

Various EU provisions are likely to come into force in the United Kingdom before Brexit takes place. These include the General Data Protection Regulation (GDPR), due to come into force on 25 May 2018, the Network and Information Security (NIS) Directive, likely to be implemented by Spring 2018, and a new directive for the police and criminal justice sector that must be transposed by Member States by 6 May 2018.

Post Brexit, any US franchisor that processes or monitors EU citizens' personal data in connection with its offer of goods, services or monitoring activities, or has a group company or staff operating within the EU, will still have to comply with the GDPR. The extent to which the GDPR will be adopted in the United Kingdom will depend heavily on the type of relationship with the EU that the United Kingdom adopts. However, it seems likely that either the GDPR or a law that looks very like it will be required in the United Kingdom, given that the current UK law is in need of refreshment (it is nearly 20 years old) and given the way that EU data transfer laws operate.

The United Kingdom will wish to continue to trade with the EU post Brexit, therefore closely comparable data protection and cybersecurity laws in many areas will be necessary to avoid barriers to trade.

US franchisors with franchisees in other EU Member States will have to be very careful to ensure they comply with EU data protection and cybersecurity laws even after Brexit.

Franchisors with a large number of commercial contracts, particularly with entities within the EU, should consider auditing these contracts in due course to determine the effect Brexit will have on rights and obligations under these agreements.

The commercial impact of the cost of increased trade barriers between the EU and the United Kingdom could have an adverse impact on franchisors with networks based in the United Kingdom and covering other EU Member States because of, for example, the impact of the restriction of free movement of persons and monitoring of currency fluctuations.

The one thing that is certain about Brexit and its impact on franchisors at the moment is that nothing is certain. However, franchisors must keep a watching brief as various areas of law develop in response to the political changes that look likely to take place over the next two years or so. Bird & Bird will be providing an ongoing review of the impact of Brexit on franchising as matters develop.

EDITOR'S GLOBAL OVERVIEW

*Mark Abell*¹

AFRICA OVERVIEW

Chapter written by Nick Green

The past 12 months have seen a great deal of franchise investment into the African continent, North, South, East, West and Central Africa are all attracting a great deal of attention from franchisors. The regulatory regimes can be challenging and procedures time-consuming and expensive. Accessing knowledgeable legal advice on franchising can be a challenge.

GCC OVERVIEW

Chapter written by Melissa Murray

The Gulf Cooperation Council (GCC) countries comprise six distinct nations, each with similar but distinct legal systems. For example, while Dubai (part of the UAE) has a legal system that has many similarities with Western nations, Saudi Arabia has a legal system firmly based on shariah law. However, there is such a degree of commonality in the way these jurisdictions approach franchising that they can sensibly be dealt with together.

There are no franchise-specific laws in any of the GCC countries, although there has been talk of Abu Dhabi possibly adopting one in the future.

There is a restriction on direct foreign investment in all GCC countries and as the region is often granted by foreign franchisors as a single territory, this has an obvious impact upon the way in which franchisors and their developers or master franchisees structure their approach to the region.

All of the GCC countries have commercial agency laws that can apply to foreign franchises entering the market, with substantial negative consequences from the franchisor's point of view.

ARGENTINA

Chapter written by Florencia Rosati and Gustavo Papeschi

Argentina is an increasingly vibrant economy and franchising is making headway there. There are no franchise-specific regulations, but the usual civil law approach is evident in the way that the courts deal with franchising.

¹ Mark Abell is a partner at Bird & Bird LLP.

AUSTRALIA

Chapter written by Philip Colman

Australia has one of the most developed franchising laws in the world in the form of the Federal Trade Practices (Industry Codes – Franchising) Regulations 1998, which is prescribed as a mandatory industry code by the Competition and Consumer Act 2010 (Cth). Since 2008, this federal law has applied not only to domestic Australian franchises but also to foreign franchises entering the Australian market.

In addition to imposing mandatory pre-contractual disclosure requirements, misleading and deceptive conduct and unconscionable behaviour are also prohibited and there is currently a proposal that a statutory good faith obligation be imposed upon both franchisors and franchisees.

Australia's legal system has its roots in English common law and these are still evident in its jurisprudence, but the state and federal laws are steadily developing into a legal system that has much in common with US law.

AUSTRIA

Chapter written by Eckhard Flohr and Alfons Umschaden

Austrian law closely resembles that of Germany in respect of its impact upon franchising and so good faith is of great importance.

BARBADOS

Chapter written by Giles A M Carmichael

This Caribbean island state has a legal system with its origins in English law and does not have franchise-specific regulations.

CANADA

Chapter written by Paul Jones and Katya Logunov (Stepanishcheva)

Canada does not have national franchise legislation. Many Canadian provinces have adopted franchise-specific laws. Unfortunately each province has adopted slightly differing laws, introducing additional red tape and uncertainty for franchisors entering Canada.

CHILE

Chapter written by Cristóbal Porzio

Chile is seeing an increasing amount of growth in the franchise sector but does not have a franchise-specific law. The concept of duty of good faith is used to impose both a degree of pre-contractual disclosure and a restraint upon how franchisors exercise their contractual rights.

CHINA

Chapter written by Sven-Michael Werner

China's franchising law was adopted in a hurry to satisfy the conditions imposed upon China as regards its accession to the World Trade Organization. As a result, it was not as well considered as it might have been, and has since been amended several times.

The law imposes pre-contractual disclosure, registration and mandatory terms, and the registration process can be challenging and time-consuming. Chinese law also imposes a duty of good faith upon franchise relationships.

As China is a signatory to the New York Convention, foreign arbitration in international franchise agreements tends to be the norm. There is a growing body of Chinese jurisprudence about franchising, but there is yet to be any real evidence of consistency between the various courts.

CZECH REPUBLIC

Chapter written by Vojtěch Chloupek

The Czech Republic does not have any franchise-specific regulations and instead relies upon its Commercial Code to deal with issues such as pre-contractual misrepresentations and the like.

DENMARK

Chapter written by Jacob Ørskov Rasmussen

Like the other Nordic members of the EU, Denmark has a civil legal system that is markedly less interventionist than the German-influenced systems.

It does not have a franchise-specific law.

FRANCE

Chapter written by Raphaël Mellerio

The Napoleonic Code has had a substantial impact upon the law of other EU Member States.

France was the first European country to adopt a franchise-specific law – the Doubin Law – although paradoxically, it does not actually use the word franchising. Although its requirement for pre-contractual disclosure has many similarities to the United States' franchise laws, it is distinct from them.

Concepts such as good faith impact upon the franchisor–franchisee relationship especially as the French judiciary has over recent years taken a more interventionist approach to commercial relationships.

Article 101 of the TFEU shapes French antitrust law.

GERMANY

Chapter written by Stefan Münch, Alexander Duisberg, Markus Körner and Michael Gaßner

Although Germany does not have any franchise-specific laws, it is probably one of the most heavily regulated franchise markets in the world. The application of the doctrine of good faith on both pre-contractual negotiations (*culpa in contrahendo*) and the franchise relationship

itself can have a severe impact upon the franchisor's ability to exercise its contractual rights against franchisees. Added to this is a tendency of the German courts to treat franchisees as consumers and a willingness in some circumstances to view individual franchisees as 'hidden employees', who are able to take advantage of employment rights.

GREECE

Chapter written by Nancy G Gerakini

Greece does not have franchise-specific laws. The law that has most impact upon franchising is the competition law, which reflects the approach of TFEU 101, the EU antitrust law.

HONG KONG

Chapter written by Michelle Chan

Although a part of China, Hong Kong is a Special Administrative Region and has its own distinct legal system, which still has its roots in English common law. It has no franchise-specific law and, like the English legal system, puts great store in the concept of *caveat emptor* while being reluctant to imply any duty of good faith into the franchise relationship.

HUNGARY

Chapter written by Péter Rippel-Szabó and Bettina Kövecses

Unlike many former Soviet Bloc EU Member States, Hungary has resisted the temptation to specifically regulate franchising.

Its civil system still retains some vestiges of its Soviet past, but generally reflects EU directives and regulations. An overriding duty of good faith is imposed by the Hungarian Civil Code on franchising, but the courts do not look to jurisprudence on agency and distribution cases for guidance by analogy, as is the case in some civil jurisdictions.

INDIA

Chapter written by Nipun Gupta and Divya Sharma

Indian law is heavily based upon English law and exhibits the traditional English doctrine of *caveat emptor* in its approach to pre-contractual dealings between franchisors and other franchisees. Likewise, it is loath to imply a duty of good faith on to the franchise relationship.

However, the Indian legal system is exceptionally slow and franchisors are often sceptical as regards the courts' impartiality. As a result foreign law and jurisdiction is the norm in international franchise agreements with arbitration being preferred to litigation because of India being a signatory to the New York Convention and the difficulty in enforcing foreign court judgments. However, there was some uncertainty about the status of foreign arbitration until the 2012 *Balco* decision.

There are some restrictions upon the ability of foreign parties to acquire more than 49 per cent equity interest of Indian companies and although royalties can now be paid without limit and approval, certain other payments still require the approval of the Reserve Bank of India.

INDONESIA

Chapter written by Risti Wulansari

Indonesia is a large and growing market in which franchising is well established. However, it has what are among the most complex and difficult franchise regulations in the world. They impose significant obligations on both franchisors and franchisees, and the local content requirement can be very difficult to comply with.

IRAN

Chapter written by Shelley Nadler and Farid Kani

Iran has no franchise law and the legal environment is fairly benign for franchisors. However, despite having been partially lifted for non-US companies, the international sanctions have a significant impact upon the way franchisors must structure their market entry.

ITALY

Chapter written by Claudia Ricciardi

Italy adopted its franchise law in 2004 after some 15 years of toing and froing within the legislature. It imposes mandatory pre-contractual disclosure and various mandatory clauses.

The law had originally required that all foreign franchisors operate a pilot in Italy before they could franchise their concept there. However, this was received badly by franchisors and it was soon changed so that it did not become a barrier to foreign franchisors establishing their brand in Italy. As a Member State of the EU, Italy's approach to vertical restraints reflects Article 101 of the TFEU.

JAPAN

Chapter written by Yoshihiko Fuchibe and Kentaro Tanaka

The Japan Franchise Association is active but has little influence on the regulatory framework. Antitrust law has an impact upon franchising and the Fair Trade Commission has a good deal of influence over the way in which franchising is regulated on a day-to-day basis.

KAZAKHSTAN

Chapter written by Nick Green and Saule Akhmetova

Kazakhstan has a sophisticated and in parts complex franchise law, which needs to be carefully considered before executing a franchise agreement in the country.

KOREA

Chapter written by Kenneth T Kim, Jason Sangoh Jeon and Jin Woo Hwang

Korea has a challenging franchise law that delivers an unusually high level of protection for franchisees.

MALAYSIA

Chapter written by Lee Lin Li and Chong Kah Yee

The Malaysian franchise law is somewhat complicated and regulates not only franchisors, but also franchise brokers.

MEXICO

Chapter written by Eduardo Kleinberg

Although there is no franchise-specific law in Mexico, franchises are regulated by the Industrial Property Law. This imposes a duty of pre-contractual disclosure upon franchisors and requires certain mandatory provisions included in the franchise agreement.

Franchise agreements are also generally registered with the Mexican Institute of Industrial Property to enable the franchisor to protect its trademarks.

There is also a limited duty of good faith imposed upon parties to a franchise agreement.

NETHERLANDS

Chapter written by Martine de Koning

The Netherlands' mercantilist traditions and favourable tax regime means that it has a legal system that is supportive of international trade. A civil law system, influenced by both the French and German civil law traditions and a Member State of the EU, its laws reflect the tendency to imply an obligation of good faith into franchise relationships. It does not have a franchise-specific law.

NEW ZEALAND

Chapter written by Stewart Germann

After considering whether it should adopt franchise-specific regulations, New Zealand decided that it would not follow the example of its Australian neighbour and that its common law was sufficiently adaptable to deal with the legal issues that arise as a result of franchising.

NIGERIA

Chapter written by Ngozi Aderibigbe and Chinweizu Ogban

This dynamic but challenging market has a difficult regulatory environment. Franchise agreements have to be approved by governmental agency the National Office for Technology Acquisition and Promotion (NOTAP).

POLAND

Chapter written by Kuba Ruiz

Poland has no franchise-specific law and applies a relatively light touch to its regulation.

PORTUGAL

Chapter written by Magda Fernandes, José Maria Montenegro, Vasco Stilwell d'Andrade Dzhamil Oda and Diogo Pinto

There is no franchise law in Portugal and the EU competition law regime has a substantial impact upon the content of franchise agreements there.

RUSSIA

Chapter written by Sergey Medvedev

Russia has a specific trademark-based franchise law, which requires registration of franchise agreements with the Federal Service for Intellectual Property (Rospatent). This can cause some difficulties in practice for franchisors.

SAUDI ARABIA

Chapter written by Melissa Murray

The impact of shariah law on franchising is very marked, and standard agreements usually need substantial amendment before they are suitable for use in the country.

SINGAPORE

Chapter written by Lorraine Anne Tay and Just Wang

The origin of Singapore's commercial success lies in its geographical position and its entrepôt trade. It has a legal system with its roots firmly planted in both English common law and its international outlook. As a trading nation its laws promote international trade and the concept of *caveat emptor* is a fundamental part of its approach to common law.

There is no franchise-specific law in Singapore and it does not generally imply a duty of good faith into contractual relationships.

SWEDEN

Chapter written by Elisabeth Vestin and Sara Heikfolk

After some 20 years of considering whether to regulate franchising, Sweden adopted a pre-contractual disclosure law in 2006, although its lack of real penalties for non-compliance probably restricts its impact. Like all EU Member States, Article 101 of the TFEU has a substantial impact upon the way that vertical restraints are dealt with.

TURKEY

Chapter written by İlknur Pekşen

There is no franchise-specific legislation in Turkey but the antitrust law can pose some challenges for franchisors entering the market.

UKRAINE

Chapter written by Volodymyr Yakubovskyy and Graeme Payne

Ukraine does not have a franchise-specific law and it falls to the Civil Code and Commercial Code to regulate it. Legal uncertainty about registration of franchises has been settled by the passing of new procedural rules on registration of concession agreements, which came into effect in April 2015.

UNITED KINGDOM

Chapter written by Graeme Payne

The United Kingdom is the cradle of common law and yet it is also a Member State of the EU, which has a legal system dominated by civil law concepts such as good faith.

As a result, the law in the United Kingdom is undergoing constant change as the influence of civil law concepts becomes more and more marked. Its competition law is based on Article 101 of the TFEU.

Scotland has its own legal system, which, although very similar to that of England and Wales as regards corporate and commercial matters, is very different in respect of real estate.

There is no franchise-specific law in the United Kingdom and it is generally one of the more 'pro-franchisor' jurisdictions. Because of its colonial past and mercantilist traditions, English law is highly developed as regards international trade. As a result, English law is often adopted as the governing law in the international agreements of non-UK franchisors.

UNITED STATES

Chapter written by Richard L Rosen, Leonard Salis, John Karol, Michelle Murray-Bertrand and Avi Straus

The United States is the birthplace of franchise regulation, the first such law being passed in California in the early 1970s. A complex network of both state and federal laws that imposes a cocktail of pre-contractual disclosure, registration and mandatory term requirements has led to many foreign franchisors believing that the law has become a near insuperable barrier to market entry. It is certainly a complex and ever-changing jurisdiction as regards franchise law, but with appropriate legal support it is far from impregnable.

AFRICA OVERVIEW

Nick Green¹

I INTRODUCTION

The past 12 months have undoubtedly been challenging for many countries within the African region. Oil prices continued to fall for most of 2016, harming economies such as those of Nigeria,² Angola³ and Algeria,⁴ which depend in large part on oil exports. Many countries have also struggled with their foreign exchange liquidity, with the national currencies in a number of countries including Uganda,⁵ Angola⁶ and South Africa⁷ falling to record lows. Other factors such as political instability, the persisting threat of militant insurgencies and terrorist attacks⁸ and lack of infrastructure continue to create uncertainty in the region and potentially deter investment.

The World Bank and World Economic Forum both predict that growth for the region in 2017 will not match the highs of previous years, anticipating it will fall lower than the 5 per cent average over the past decade.⁹ However, growth in the region is still

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- 1 Nick Green is an associate at Bird & Bird. The author would like to thank Vieira de Almeida & Associados and its network of offices and associated offices in Angola, Cape Verde, Congo, Democratic Republic of Congo, Equatorial Guinea, Gabon, Guinea-Bissau, Mozambique and São Tomé e Príncipe for their valuable contributions to this chapter.
 - 2 'Falling oil prices: How are countries being affected', BBC News (18 January 2016), available at: www.bbc.co.uk/news/world-35345874.
 - 3 Shawn Donnan, 'Angola turns to IMF for bailout amid oil price fallout', *Financial Times* (6 April 2016), available at: www.ft.com/content/732e5b5a-fc24-11e5-a31a-7930bacb3f5f.
 - 4 'Algeria's Economic Outlook – Spring 2016', The World Bank, available at: www.worldbank.org/en/country/algeria/publication/economic-outlook-spring-2016.
 - 5 'BMAU Briefing Paper [12/16]: Uganda Shilling depreciation in FY2015/2016: Can a re-occurrence be mitigated?', Ministry of Finance, Planning and Economic Development (May 2016), available at: www.finance.go.ug/dmdocuments/12-16-PFM.pdf.
 - 6 Rogerio de Almeida Vieira, 'Angola's dollar shortage deepens', This is Africa (11 January 2016), available at: www.thisisafricaonline.com/News/Angola-s-dollar-shortage-deepens?ct=true.
 - 7 Christopher Whittall and Patrick McGroarty, 'South Africa's Rand Falls to Record Low After Finance Minister's Dismissal', *The Wall Street Journal* (11 December 2015), available at: www.wsj.com/articles/south-africas-rand-falls-to-record-lows-after-finance-ministers-dismissal-1449853788.
 - 8 World Bank Group, 'June 2016: Global Economic Prospects : Divergences and Risks', International Bank for Reconstruction and Development/The World Bank (2016), p. 22, available at: http://pubdocs.worldbank.org/mwg-internal/de5fs23hu73ds/progress?id=dYBjI8_fbqZ16H6kg2bDGO2kSXpWXiL6xUfzx6M6Ux4,&dl.
 - 9 'World Economic Forum on Africa', The World Economic Forum, available at: www.weforum.org/events/world-economic-forum-on-africa-2017.

anticipated to exceed the prospects of many other developed and developing countries¹⁰ and a number of countries within Africa will still be growing above 6 per cent. Africa therefore still provides plenty of potential opportunities for franchisors looking to expand their brand internationally. Many African countries are focusing on harnessing the potential for growth from advancements in technology, in particular mobile payment networks, allowing poorer individuals living in both cities and rural areas to have greater access to the wired, global financial economy, and providing faster and more secure payment and money transfer systems.¹¹ Other countries, such as Ivory Coast, Rwanda, Kenya and Tanzania, have invested heavily in infrastructure, helping boost their anticipated growth rates up to 6–7 per cent¹² and ensuring that they are attractive prospects for foreign brands looking to invest in the region. Legislative and economic reforms have also been introduced in several countries to ensure local laws – particularly those relating to repatriation of funds and the protection of trademarks – do not deter foreign brands. The number of countries that have ratified the African Tripartite Free Trade Area agreement (TFTA) continues to grow, with Zambia (number 17) ratifying the agreement in June 2016.¹³ Once the TFTA is fully ratified between its 26 signatory states, it is hoped it will add greater stability to those countries and facilitate economic integration of the region as a whole, providing increased harmonisation in the areas of rules of origin, customs cooperation, non-tariff barriers and dispute settlement.

Franchising continues to be recognised by governments in the region as a fast and effective way to increase employment among local populations. With the price of oil and other major commodities still low, it has also been promoted as a way to help build more sustainable economies based on small and medium-sized enterprises operating in a range of sectors, rather than relying on the traditionally strong industries such as oil and mining. The past few years' high rate of growth across the region has resulted in a burgeoning urban middle class in many countries, with a consequential increase in the demand for western brands. The World Economic Forum also highlights the 'fast growing youth population' and the urbanisation of the region, which is expected to result in over 50 per cent of Africans living in cities by 2050,¹⁴ as key reasons to keep Africa in mind with regards to expansion and investment. Continued improvement in infrastructure and policy across the region will undoubtedly strengthen this growth and ensure brands, both foreign and domestic, remain focused on Africa and its vast potential.

10 Ibid. footnote 8, p. 4.

11 Tarek Sultan Al Essa, '6 reasons to invest in Africa', The World Economic Forum (6 May 2016), available at: www.weforum.org/agenda/2016/05/6-reasons-to-invest-in-africa/.

12 Lee Mwiti, '10 things the IMF wants you to know about Africa's economy', The World Economic Forum (15 April 2016), available at: www.weforum.org/agenda/2016/04/10-things-the-imf-wants-you-to-know-about-africas-economy.

13 'Zambia signs Tripartite Free Trade Area Agreement', Common Market for Eastern and Southern Africa (COMESA) (18 June 2016), available at: www.comesa.int/zambia-signs-tripartite-free-trade-area-agreement/.

14 Ibid. footnote 11.

II FRANCHISE LAW

i Legislation

As in Europe and the United States, there is no unified or consistent approach to franchising in the African region. South Africa and Tunisia have enacted franchise-specific legislation, although each differs in its application. Nigeria, Angola, Kenya, Sudan and Uganda regulate technology transfer and commercial agency agreements, which may impact on franchise agreements depending on how the franchise is structured and the sector it operates in. Other countries rely on their civil codes, foreign investment laws, and competition or consumer protection regimes to regulate franchise arrangements.

ii Pre-contractual disclosure

Few African countries require franchisors to provide franchisees with pre-contractual disclosure. Franchisors entering into agreements in Tunisia and South Africa, however, should be aware that these countries are the two exceptions, requiring a minimum amount of information to be provided a set number of days prior to signing (20 days in Tunisia, and 14 in South Africa). A general duty to act in good faith both prior to signing and during any commercial – including franchise – agreement may be understood to require disclosure in certain countries such as Morocco, Algeria, Angola, Cape Verde, Congo and Mozambique, although the extent to which this is enforced is unclear.

iii Registration

Currently, no African country imposes registration requirements on franchise agreements specifically, although many countries – such as Nigeria, Democratic Republic of Congo and Georgia – require a trademark licence to be registered, and it is recommended (but not mandatory) in Malawi. A notable exception to this rule is Egypt, where a trademark licence may be registered, but it is recommended not to do so because of the difficulty involved in deregistering a licence.¹⁵ Ethiopia has also recently indicated that it may impose registration requirements on franchise arrangements. In August 2016, the Ethiopian Parliament adopted the Commercial Registration and Business Licensing Proclamation No. 980/2016 (CRBLP), which introduced, for the first time, a definition of a ‘franchise agreement’.¹⁶ The CRBLP indicated that ‘the franchise’ must be registered,¹⁷ although the exact requirements of the registration (including confirmation as to whether it is the franchise itself or the franchise agreement that must be registered) were not made clear. Those details will be provided in the implementing regulations issued under the CRBLP by the Council of Ministers. There is no defined timetable for the publication of those regulations, though they could come later this year. As set out above, a number of other countries also regulate technology transfer agreements, which may capture franchise agreements and therefore also require registration.

Any agreement that may result in the payment of money outside Zimbabwe by a business entity operating in Zimbabwe must be registered with and approved by the

15 Kendal H Tyre Jr, ed., *Franchising in Africa 2014: Legal and Business Considerations* (LexNoir Foundation, 2014), p. 26.

16 ‘Proclamation No. 980/2016 Commercial Registration and Business Licensing Proclamation’, Federal Negarit Gazette of the Federal Democratic Republic of Ethiopia (5 August 2016), Part 1, Article 2(33), available at: www.mot.gov.et/trade-proclamations.

17 *Ibid.* footnote 16, Part 5, Article 37.

Zimbabwe Exchange Control Authority. South Africa, Cape Verde and Mozambique impose similar registration requirements in relation to agreements containing foreign payment provisions. While not strictly a registration requirement, central bank approval is necessary for the remittance of payments abroad in a number of African states, including Sudan, Angola, Congo, the Democratic Republic of Congo, Ghana, Gabon, Botswana, Burundi, Rwanda, Cape Verde and Egypt.

Franchisors should also be conscious of any post-signing requirements that exist under local law. For those countries where agreements or trademark licences must be registered, or documents must be provided to central banks for remittance approval, this documentation will generally require some form of notarisation or legalisation, and may need to be provided in the local language. While it is rare for this to be an overly onerous requirement, these formalities can be expensive and cause delays if not planned and provided for in advance.

iv Mandatory clauses

The absence of franchise-specific legislation across the region means that there are few mandatory clauses that must be included in a franchise agreement, beyond those requirements that exist in countries' general contract law or civil codes. Foreign franchisors should, however, be aware of particular restrictions that regulatory or national bodies impose on doing business more generally. In Nigeria, for instance, all foreign technology agreements must be registered with the National Office for Technology Acquisition and Promotion (NOTAP), and a broad range of obligations may be imposed on the agreement before NOTAP will approve its registration. Of particular importance to franchisors, NOTAP may limit royalty payments at 5 per cent of net sales or profit and prohibit any agreement having a term greater than 10 years. In a similarly protectionist manner, Zimbabwe has enacted indigenisation laws that require businesses in particular sectors or of certain types or size operating in Zimbabwe to be controlled by indigenous people.

Franchisors should also be aware of additional tax or foreign exchange restrictions that may apply to franchise agreements deemed to be 'service agreements' on that basis that at least part of the agreement relates to 'services' (such as initial training, guidance on the use of trademarks, etc.) being provided by a franchisor to a franchisee in exchange for a 'service fee' (howsoever named). In Angola, if a franchise agreement contains such service provisions, it is likely to be classified as a Technical Assistance and Management Agreement, which must satisfy certain criteria (including the requirement that the services cannot be obtained within Angola, and that the provision of the services will bring significant benefits to the 'franchisee' and the Angolan economy), must be licensed by the Ministry of Economy, and any fees paid thereunder will be subject to a higher tax burden. Similarly, the lack of foreign currency and struggling domestic economy in Zimbabwe has recently led to the Reserve Bank of Zimbabwe imposing a restriction on the level of any service fee being greater than 3 per cent of gross annual revenue.¹⁸ Franchisors considering these markets will, therefore, have to consider how best to structure their arrangements with their franchisees to ensure they are compliant with all local laws, while also ensuring they receive the full benefits of the anticipated deal.

18 'Exchange Control Operational Guidelines and Compliance Framework to Authorised Dealers on Exchange Control Policies and Compliance Measures Issued in the January 2016 Monetary Policy Statement', Reserve Bank of Zimbabwe (8 February 2016), paragraph 7, available at: www.rbz.co.zw/assets/exchange-control-guidelines-for-authorised-dealers-0ecogad7-2016.pdf.

GCC OVERVIEW

*Melissa Murray*¹

I INTRODUCTION

Franchising within the Gulf Cooperation Council countries of Bahrain, Kuwait, Qatar, Oman, Saudi Arabia and the United Arab Emirates (collectively, the GCC) is a well-known and established method for international franchisors to enter the GCC markets. The local shareholding restrictions for certain types of businesses, discussed further below, have led to franchising being one of the most popular methods for international brands entering these local markets.

The United Arab Emirates is often looked at as being the first market for a franchisee to open in when franchisors grant rights to the GCC and wider Middle East and North Africa region. For this reason, this chapter will focus on the United Arab Emirates, as well as looking at various factors common to franchising in the GCC.

Although historically the franchising market has been dominated by international franchisors granting master franchises to wealthy individuals or family groups who directly open multiple locations, local brands are now beginning to emerge and franchise to multiple individuals. Although these local brands are typically looking for franchisees within the GCC market, some brands are beginning to expand outside the UAE into international markets. Just Falafel, a UAE-based falafel retail brand is one example of such a local brand that has expanded into many countries outside the GCC. The emergence of local brands franchising within the GCC has led to the introduction of various franchising consultancies, brokerages and related businesses also entering the GCC markets.

At this stage there is no national franchise association within each country, but local chamber of commerce departments within each country are taking a keen interest in franchising, along with the commercial departments of various embassies, such as the American Embassy office of the US Commercial Service of the Department of Commerce's International Trade Administration.

Given the private nature of company and individual's information within the GCC, there are limited market reports on franchising within each country, but various news reporting agencies and consultancies release independent estimated market intelligence at varying intervals.

¹ Melissa Murray is a partner at Bird & Bird (MEA) LLP.

II MARKET ENTRY

i Restrictions

Generally speaking, there are no approvals or restrictions on franchisors granting master development rights to local entities.

For most businesses in which franchising has predominantly been used in the GCC, such as retail, a company incorporated with local majority shareholding is required to obtain the appropriate trade licence. For example, in the UAE (but outside the various free zone areas) only a company that has 51 per cent UAE national shareholding or 100 per cent GCC shareholding can obtain a retail trade licence for the sale of clothing. Other types of business – for example, real estate agencies – require a 100 per cent UAE national shareholding.

Notwithstanding the shareholder ownership restrictions, the company's constitution can be drafted such that the economic benefit of the company is allocated in percentages different from the share ownership. In addition, practice has developed to overcome restrictions on foreign ownership of UAE companies whereby side agreements are entered into between the UAE national shareholder and the foreign shareholder pursuant to which the UAE national shareholder assigns its profits to the foreign shareholder.

Although it is common practice to enter into such side agreements in the UAE, their enforceability is not certain and the prudent view is that a UAE court may consider such agreements as an attempt to circumvent UAE restrictions on corporate ownership by non-UAE nationals and as a breach of UAE Federal Law No. 17 of 2004 on the Combating of Commercial Concealment, as amended (the Anti-Concealment Law).² The Anti-Concealment Law aims to criminalise the practice of enabling a non-UAE national to conduct an economic or professional activity that is prohibited by UAE laws and regulations. The Ministry of Economy, however, has not yet provided further clarification on the implementation or further deferral of this Law, and the effective implementation of the Anti-Concealment Law may be deferred to coincide with that of either or both of the planned new Companies Law (which is anticipated to enable foreign ownership in excess of 49 per cent and up to 100 per cent in some business activities) and the Foreign Ownership Law. In reality, these practices are followed widely in the UAE and more recently have led to the emergence of specific businesses offering to be the 'silent' 51 per cent shareholder (for a fee). Although this is general market practice, as there is no other way around the strict interpretation of the law, the commercial risk of the UAE law courts should be taken into consideration. For these reasons most international brands enter the GCC markets through franchising rather than through incorporating a local company with potentially unenforceable side agreements.

In most areas (except specific designated 'freehold for foreigner' areas), foreign nationals cannot be registered as the freehold owner of real property, although again side arrangements similar to the foregoing have been used to circumvent the legislation. Further, when taking a lease on property, the owner or manager of the property will usually wish to see a valid trade licence (or residency visa for individuals), which means many clauses in standard franchise agreements, such as those that discuss the franchisor taking possession of a franchisee's premises upon default, are not practical or easily enforced.

² Entered into force on 31 December 2009.

ii Foreign exchange and tax

All GCC states, except Kuwait, are pegged to the US dollar. Generally, no GCC state has any foreign exchange controls or restrictions on the remittance of funds, and foreign investors can freely transfer funds. Withholding tax considerations are relevant in Saudi Arabia, Oman, Qatar and Kuwait, and are discussed further below. Neither the UAE nor Bahrain imposes withholding tax.

III INTELLECTUAL PROPERTY

i Brand search

Throughout the GCC, searching for protected trademarks and other intellectual property (such as copyright, patents, design rights, etc.) is conducted through registered trademark agents and law firms, who directly approach the relevant trademarks office in each country. In addition to this, some trademark agents have developed their own internal database based on published gazettes and trademark journals, which can provide further details on potential conflicting trademarks. As it is not possible to perform GCC-wide trademark searches, trademark applications, or multi-class searches, the process for searching and registering trademarks can be comparatively very costly. Further consideration should be given to issues with English and Arabic symbols and translations, which can increase the searches and registrations required. The Supreme Council of the Gulf Cooperation Council prepared a GCC Trademarks Law many years ago; however, there are currently no implementing regulations and the law is not yet in force in any of the GCC countries. It is, however, expected that the implementing regulations of the GCC Trademarks Law will not offer a unified filing system (as is the case with the GCC Patent Law) and trademark applications will continue to be filed separately in each GCC Member State for protection.

All GCC countries follow a 'first to file' trademark protection system, as opposed to the US system of 'first to use'. Historically, many franchisees have registered in their own names the franchisor's trademarks and use the trademarks in their registered business or company names. Franchisees often quote the time it takes for trademark registration to complete (which can be up to several years in some countries) along with the costs of registration as reasons why they should be responsible for the trademark registration; however, opposing such a registration or having the registration assigned at a later date can be difficult, time-consuming and costly. Business, trade and company names pose a different challenge as each province or emirate has local municipalities or chambers of commerce responsible for business names, which are often not directly linked to trademark registries. In addition to this, independent free zones within the various GCC countries also maintain company and business name registries. Further issues with translation between Arabic and English usually mean there are many competing trade names that often cannot be challenged.

ii Brand protection

To register a trademark, a legalised and notarised power of attorney (prepared by the trademark agent) needs to be provided by the applicant, although some countries within the GCC have differing requirements as to whether the power of attorney needs to be both legalised and notarised. This power of attorney allows the trademark agent to represent the applicant in registering intellectual property rights with the relevant trademarks office in each country. The trademark agent also requires:

- a* an electronic copy of the mark (usually in black and white unless specific colours are sought to be protected);
- b* a list of goods and services to be protected by the mark;
- c* a certified copy of any previous trademark registrations if priority is being sought; and
- d* a certificate of incorporation, certificate of good standing, or extract of the commercial register or trade licence evidencing the name, address, date of incorporation and objectives of the company.

iii Enforcement

Enforcement of franchise-related intellectual property rights can present a number of challenges within the GCC markets. The courts of each of the GCC countries do not readily allow for injunctions or other discretionary remedies, meaning that it can be extremely difficult to prevent a terminated franchisee from continued use of a franchisor's intellectual property. As arbitration is often chosen as the dispute resolution method for international franchise agreements, the arbitration clause can also be raised in any court proceeding to challenge the jurisdiction of the court in some intellectual property disputes.

Criminal offences for fraud, counterfeiting or imitating a registered trademark can be possible in certain circumstances. Also where a local court has jurisdiction to hear intellectual property disputes, a number of other remedies such as attachment orders, confiscation orders, fines, damages, destruction orders and compensation may be available depending on the nature of the dispute.

iv Data protection, cybercrime, social media and e-commerce

There is no GCC-wide data protection law, nor does any country within the GCC have specific data protection legislation. Some free zones, such as the Dubai International Finance Centre and the Qatar Financial Centre have enacted data protection legislation relating to the collection, use and transfer of data within the relevant free zone. Data protection is covered generally in various parts of the legislation such as in criminal, civil and commercial codes, electronic transactions laws, and industry-specific legislation such as covering protection of patient data in medical contexts. Shariah principles also protect an individual's right to privacy and protection from disclosure of secrets. Sanctions associated with processing personal data outside the scope permitted by the various laws are therefore relatively severe compared with those found in Western jurisdictions. For example, in the UAE there are criminal sanctions associated with disclosing 'secret' information (such as personal data). Generally speaking, however, specific consent to the processing of personal data can help mitigate or avoid potential penalties.

Many GCC countries have enacted updated cybercrime laws in line with the model Cybercrime Law recently drafted by the Gulf Cooperation Council and agreed between all members of the GCC. These updated laws cover internet fraud, hacking, illegal access, system interference and distribution of viruses, and include specific provisions covering state security and political stability. These laws are drafted broadly and cover any publication of information over the internet, including blogging and use of social media. Penalties include imprisonment, fines and deportation. Furthermore, as most GCC states have enacted specific electronic transactions law (that allow for execution of contracts through electronic means and that govern the legal effect of electronic records) most of these laws contain some data protection considerations.

IV FRANCHISE LAW

i Legislation

There is no franchise-specific legislation in any GCC country, although commercial agency laws (as discussed further below) often cover franchise relationships with, in some cases, serious consequences for franchisors. General civil and commercial codes can also apply together with general intellectual property laws, penal codes, cybercrime laws and more specific legislation such as consumer protection laws and food safety laws.

ii Pre-contractual disclosure

As there is no specific franchise legislation in any GCC country, neither are there any specific pre-contractual disclosure requirements. Misrepresentation for pre-contractual statements are, however, covered under provisions contained in the various civil codes but in a much more narrow way than in some Western jurisdictions. For example, under Article 185 of the UAE Civil Code, misrepresentation occurs when one of the parties 'deceives the other by fraudulent means by word or act which leads the other to consent to what he would not otherwise have consented to'. It is important to note that it does not include statements made innocently or negligently; there must be an intention, through deliberate action or inaction, to deceive by fraudulent means. Article 187 of the UAE Civil Code allows the person misled to cancel the contract if it can be shown one of the parties made a misrepresentation to the other and that the contract 'was concluded with gross unfairness'. It is important to note that both misrepresentation and 'gross unfairness' must be proven and therefore a case for misrepresentation can be difficult to prove. Further, a party may be prevented from claiming for misrepresentation if the party continued to act in accordance with the contract, as Article 192 of the UAE Civil Code provides 'the right to cancel for misrepresentation and gross unfairness shall lapse on the death of the person having the right to apply for the cancellation or upon a dealing made in the subject matter of the contract in whole or in part in such a way that implies consent'.

iii Registration

As there is no franchise-specific legislation, there are no registration requirements for franchise agreements (outside those to register 'agency' agreements discussed further below).

iv Mandatory clauses

As there is no specific franchise legislation in any GCC state, the usual elements to provide for a binding contract must be met. As an example, Article 129 of the UAE Civil Code provides that for a contract to be formed:

- a* the two parties to the contract should agree upon the essential elements;
- b* the subject matter of the contract must be something that is possible and defined or capable of being defined and permissible to be dealt in; and
- c* there must be a lawful purpose for the obligations arising out of the contract.

Note that consideration is not a required element for a contract to be binding between the parties.

v Guarantees and protection

Guarantees are provided for under various parts of legislation in each of the GCC states. Most Western drafted forms of guarantee require tailoring for the region to be enforceable and there are provisions and practices that can make enforcement of such guarantees difficult. For example, Article 1092 of the UAE Civil Code provides that ‘if a debt is due, the creditor must claim for it within six months from the date on which it fell due, otherwise the surety shall be deemed to have been discharged’. Further, it can be especially important to undertake the usual due diligence to ensure the proposed company is authorised to provide the guarantee under its memorandum and articles of association, any board or shareholders’ meetings passing relevant resolutions are undertaken, etc., and translation into Arabic and signing in front of a notary public can also be necessary.

V TAX

i Franchisor tax liabilities

The UAE and Bahrain do not impose any company or individual taxes and therefore there is no withholding tax.

Further, there is no withholding tax in Kuwait, but in respect of business entities there are a number of laws that provide for a retention-type tax, where every business operating in Kuwait should retain 5 per cent from all invoices paid to contractors or service providers. These amounts are retained until the Kuwait Tax Authority authorises release. Further, the Department of Income Tax (DIT) seeks to tax any entity ‘doing business in Kuwait’. This historically did not cover franchisors, but more recently the DIT has focused on franchise relationships that could in some situations create a tax liability for franchisors. Specific Kuwait tax and legal advice should be sought in this respect.

Saudi Arabia’s withholding tax applies at different rates depending on the services and depending on payments made to related and unrelated parties. Saudi generally imposes a 15 per cent withholding tax on royalties and a 20 per cent withholding tax on management fees.

Oman does not levy withholding tax on technical services fees, interest or dividends. As for royalties, foreign companies without a permanent establishment in Oman that derive Omani-sourced royalties are subject to a 10 per cent withholding tax on the gross royalty, withheld by the Omani payer and remitted to the tax authorities. The definition of royalties includes, among other payments, those for the use of intellectual property rights, patents and trademarks.

In Qatar, withholding tax on payments to non-residents is charged at 5 per cent on royalties and technical fees and 7 per cent on interest, commissions, brokerage fees, directors’ fees and any other payments for services conducted wholly or partly in Qatar. Withholding tax is levied on amounts paid to non-residents in relation to activities not associated with a permanent establishment in Qatar. As a consequence, withholding tax requirements apply to service providers in Qatar who are unable to produce a tax card as evidence of having a tax file in Qatar.

ii Franchisee tax liabilities

At present, there is no withholding, capital gains, personal or individual income tax imposed in the UAE (however, individuals are charged some taxes, albeit indirectly, such as municipality tax imposed on certain hotel services, as well as business and residential

property rentals). *Zakat*, a religious wealth tax levied pursuant to shariah law in many Islamic countries, is also not presently levied in the UAE. Individual emirates in the UAE have issued tax decrees concerning corporate taxes (some decrees dating as far back as the 1960s) but have not implemented their respective decrees, except that oil and gas-producing companies and foreign banks are taxed.

All GCC states impose custom duties payable for the import and export of goods that may be applicable if any goods are supplied. In addition, there may be some form of value added tax (VAT) introduced either to the GCC as a whole or in individual countries in the future.

In Kuwait, income tax is imposed on non-Kuwaiti and non-GCC owned companies. Corporate bodies incorporated within the GCC and owned by the citizens of those countries are granted the same treatment as Kuwaiti companies and are therefore not subject to income tax at present. As discussed above, income tax is imposed on those 'carrying on business in Kuwait', which is currently interpreted widely by the taxation authorities and can expose some franchisors to Kuwait tax.

In Saudi Arabia, individuals can, in some circumstances, be subject to *zakat* and the non-Saudi's share of companies are subject to income tax. Capital gains tax can also be applicable. In Oman, taxes are levied on income earned by a permanent establishment located in Oman. In Qatar, profits of business establishments that are wholly owned by Qatari individuals are not taxed and income tax applies only to businesses. The Qatari tax law states that taxable income arising from sources in Qatar in excess of 100,000 Qatari riyals in any taxable year is taxed at a flat rate of 10 per cent.

VAT is in the process of being implemented in all GCC countries, with an anticipated start date of 1 January 2018. It is expected that the rate of VAT will be set at 5 per cent, with a limited number of items related to food, healthcare and education being exempt.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

As the laws of the GCC are based on shariah law, which provides for fairness and good faith in contractual arrangements, the principle of 'good faith' is specifically recognised and is an important part of the legal system in each jurisdiction.

The UAE Civil Code³ specifically provides at Article 246 an obligation on contracting parties to perform their obligations in accordance with the agreement 'in a manner consistent with the requirements of good faith'. Furthermore, Article 243(2) provides 'with regard to the rights (obligations) arising out of the contract, each of the contracting parties must perform that which he is obliged to do under the contract'. Article 129 of the Bahrain Civil Code also provides that a 'contract must be performed in accordance with its contents and in compliance with the requirements of good faith and honesty'. There are similar provisions in the Qatar, Kuwait and Oman Civil Codes.

ii Agency distributor model

Each of the GCC states has a commercial agency law that can apply to franchise relationships. Where the relevant agency law does not apply, agency considerations under general law

3 Federal Law 5 of 1985.

(e.g., the civil and commercial codes in the relevant countries) can be relevant as franchising often falls within the ambit of the agency provisions in such laws. In each state, the agency provisions under the agency law and general laws encompass broadly similar principles. As a full discussion of the agency provisions are outside the scope of this chapter, obtaining specific legal advice as to the structure of the proposed arrangements, current arrangements and careful drafting of the franchise agreements can be important given the consequences when the agency laws apply. Dealing with a foreign national (or company owned in the amount of a specific percentage (100 per cent or 51 per cent) by nationals of the relevant country), registration (through providing a legalised and notarised version) and exclusivity (but not in all GCC countries) are the predominant requirements for finding a commercial agency under the specific agency laws in each country. Under both the agency laws and general commercial laws of each jurisdiction, termination of an agent can be difficult and compensation (often in substantial amounts) can be payable upon termination. Registration is therefore often avoided by the specific drafting of clauses within the franchise agreements and through taking procedural steps to mitigate the risk of registration by the agent. Also selecting arbitration and a foreign governing law can help; although most commercial agency laws (where they apply) provide that the sole jurisdiction of the local courts apply, local law applies to the dispute and any arbitration provision is void.

In July 2014, Oman amended its Law of Commercial Agencies⁴ to remove the requirement for a material contractual breach to take place before an agreement could be terminated or not renewed (despite what may be provided in the agreement between the parties). The UAE in 2006 made similar amendments, but, after lobbying by various agents, distributors and franchisees, changed the law back in 2010 to require ‘material justified reasons’ before an agency agreement could be amended. It will, therefore, be interesting to see how these changes will play out in practice and whether, as a consequence of this amendment, franchisors with Omani-registered agents will now look to terminate (or not renew) underperforming franchisees. In 2016, Kuwait and Qatar updated their respective Agency Laws. Of particular note, Kuwait replaced its Agency Law to clarify that franchisees and licensees are specifically covered by the Law, and has removed the requirement of exclusivity for agency agreements.

iii Employment law

To date we are not aware of any cases whereby a court has held franchisees to be employees of the franchisor. The various rules and regulations in each county regarding employment and procedural requirements such as visas and labour contracts would make such a claim difficult.

iv Consumer protection

The various consumer protection laws throughout the GCC focus on the protection of individuals in purchasing day-to-day items. For example, the UAE Consumer Protection Law⁵ defines ‘consumer’ as ‘an individual who purchases goods and/or services with or without consideration for personal use or the use of others’. We are not aware of any situations where a franchisee has been or could be treated as a consumer, and the relevant government

4 Sultani Decree 26 of 1977 as amended.

5 Law 24 of 2006.

authorities in each country are focused on protection of individual consumers' rights such as safety of products, product recalls, clear pricing, protection against unreasonable price increases, refunds, product labelling, etc.

v Competition law

Historically, most GCC countries addressed anticompetitive behaviour through their civil and commercial codes or trademark laws, or both, by means of broad and general provisions that prohibit forms of anticompetitive behaviour. More recently the UAE, Saudi Arabia and Qatar have enacted specific competition law legislation. Bahrain, Kuwait and Oman to date do not have specific anti-competition regimes; however, there is discussion at the GCC level for the preparation of a unified GCC competition law.

The competition legislation for the UAE, Saudi Arabia and Qatar is drafted in broad terms focusing on anticompetitive practices (restrictive agreements and abuse of a dominant position) and economic concentrations. A wide range of common commercial practices could therefore be construed as being non-compliant with the legislation; however, there are a number of exemptions and exclusions. For example in the UAE, the telecommunications, financial and transport sectors are specifically excluded, as are exclusive distribution agreements governed by the Commercial Agencies Law. The Competition Law does not yet have the required implementing regulations, but some provisions of standard franchise agreements, such as price controls, mandatory purchasing of products from authorised suppliers, etc., may require approval of the competition regulation committee once it is formed.

vi Restrictive covenants

Non-compete and restrictive covenants are generally difficult to enforce in each of the GCC states. The courts will assess what is reasonable to protect a legitimate business interest and this is determined on a case-by-case basis. Additionally, even if considered reasonable, there can be enforcement challenges as the courts lack injunctive power in most situations. Furthermore, as generally only direct, proven and actual losses are recoverable, proving actual loss arising from breach of the relevant clauses can be difficult.

vii Termination

As discussed above, given the difficulties in enforcing post-term restrictive covenants, and the inability of the franchisor to take over directly the franchisee's business (because of restrictions in local shareholding and on taking local leases), most franchise disputes are resolved through negotiation or mediation between the parties.

viii Anti-corruption and anti-terrorism regulation

Fraud, anti-corruption and anti-terrorism are covered in both general provisions of civil and commercial codes in each jurisdiction and in specific legislation such as the UAE's Anti-Money Laundering Law,⁶ Fraud and Deception Law and the UAE's updated Cybercrime Law.

As an example, the Anti-Money Laundering Law criminalises money laundering in the UAE and provides supporting mechanisms and structures to enforce the prohibition. In addition to the Anti-Money Laundering Law, the recently updated Cybercrime Law provides further penalties of imprisonment and fines for those who use any computer network,

⁶ UAE Federal Law No. 4 of 2004.

electronic information system or information technology to illegally transfer funds with the intent to conceal or disguise either the source of the funds, the origin, ownership and movement of the funds or illegally attain possession of the funds.

ix Dispute resolution

All GCC states are signatories to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) and most franchise agreements entered into between international franchisors and franchisees within the GCC provide for arbitration as the dispute resolution method. Arbitration, together with a foreign governing law provision, is often the recommended method of proceeding where the franchisor is outside the GCC to attempt to mitigate the risk of the various agency protections provided to franchisees in each jurisdiction. The exemption to this is Saudi Arabia, where the enforcement of foreign arbitral awards has traditionally been challenging and, depending on the circumstances, referral of the dispute to arbitration within one of the GCC states or to a Saudi court may be preferable. In 2012, a new arbitration law was introduced in Saudi Arabia; however, it is yet to be seen how or if this will facilitate the enforcement of foreign arbitral awards in Saudi. The UAE became a signatory to the New York Convention relatively recently, and so at this stage there are only a few instances of the local courts enforcing an arbitration award from another Convention country and to the best of our knowledge no foreign award has yet been enforced in Oman.

All GCC countries allow for contracting parties to choose a foreign law, although this is not always upheld in practice where disputes are brought to the local courts. Where the contract provides for arbitration and the arbitration clause is raised (sometimes for tactical reasons it may be preferable not to raise the arbitration clause), the courts will usually refuse jurisdiction to hear a matter. Where the relevant commercial agency law applies to a dispute, there are set procedures for the dispute contained within the relevant law, such as referral first to an agency committee prior to the courts.

Specific performance and injunctions are discretionary remedies and are not commonly granted in the GCC states; however, attachment orders are common (and often used to seize assets that are the subject of the claim). As a general note, only direct, proven and actual losses are recoverable, and consequential losses are generally not recoverable.

VII CURRENT DEVELOPMENTS

Because of the popularity of franchising in the GCC and wider Middle East region, there have been a large number of conferences and expos held by franchise consultants, brokers and chambers of commerce of relevant emirates and provinces within each of the GCC states. The success of such conferences and expos is yet to be seen, as the most successful brands have historically entered the market outwith such events. Franchising of local brands within the GCC is on the rise and we are seeing the beginning of local brands franchising internationally. Although brands franchising to one company or family, who open all stores directly (or through related entities), is still the most commonly seen method of international brands coming to the region, some brands are allowing sub-franchising of non-exclusive individual locations. In particular with local brands, there is growth in franchising to individual (non-corporate) non-exclusive franchisees.

On the legislation front, there have been calls by some interested parties for the development of a franchising law, but at this stage drafts for such a law have not progressed given the need for other laws, such as that on intellectual property (trademarks, patents,

copyrights), to be updated to keep pace with the advancements in technology and e-commerce. With the increase of franchising of local brands to individuals within the GCC, the number of disputes relating to quality and assistance by franchisors is beginning to rise, which may in due course lead to increased regulation in this area.

ARGENTINA

*Florencia Rosati and Gustavo Papeschi*¹

I INTRODUCTION

Argentina has seen a growth in the franchising market in recent years. By 2016, the market included 858 brands and almost 32,000 stores, and a 20 per cent growth in brands was expected in 2017.²

According to a report prepared by Estudio Canudas, by December 2016 the top 10 included the following trademarks: Lave-Rap (laundry services company), Grido (budget ice cream chain), Dia (discount supermarket chain), Sei Tu (ice cream chain), Colorshop (paint company), Bonafide (coffee and chocolate company), Subway (sandwich company), Cafe Martinez (coffee company), Havanna (cookie³ and chocolate company) and Morita (*empanada*⁴ company).

Some foreign brands, such as McDonald's, Wendy's, KFC, Burger King, 5àsec and Falabella, are also present in Argentina. However, local brands are at least as important in terms of franchising.

The most successful sectors are food and beverages, hospitality, clothing, graphics, services and retailing.⁵

To date there is no national franchise association or similar body, nor a government or public report on franchising in the market.

II MARKET ENTRY

i Restrictions

Article 20 of the Argentine Constitution states that foreigners enjoy in the territory of the nation all the civil rights of a citizen; they can practise their profession, industry and commerce; own, buy and sell real estate; navigate the rivers and coasts; worship freely according to their chosen faith; make a will and marry according to the laws. Foreigners and nationals are equal in the law.

In view of the above, foreigners do not need special approvals when entering the local market, although they will certainly need to comply with local regulations.

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2 *Clarín*, Economía, 31 December 2016 (https://clarin.com/economia/franquicias-preparan-dar-salto-2017_0_HylWXjbmSx.html).

3 *Alfajores*: a type of traditional biscuit or cookie in Argentina.

4 Type of traditional pie or pasty in Argentina.

5 According to the Argentine Franchise Guide (<http://www.gaf-franquicias.com/index.php>) issued by the Argentine Association of Brands and Franchising (<http://www.aamf.com.ar#!/-home/>).

Local regulations on franchising do not set out any restrictions for foreigners granting a master franchise or development rights to a local entity. However, to be shareholders of a local entity, foreign shareholders have to be registered locally with the Public Registry of Commerce.

Notwithstanding the above, Argentine law provides that a franchisor may not hold a direct or indirect controlling share participation in the franchisee's business;⁶ however, the relevant provision does not set out the consequences of doing so. Although this provision has yet to be tested in law, it may be criticised for lacking a proper rationale, particularly as Argentine law expressly provides for 'development franchises', whereby a franchisor grants a franchisee (called a 'developer') the right to open several franchises owned or controlled (if set up as companies) by the developer.⁷

ii Foreign exchange and tax

Although there were many foreign exchange restrictions in place in the past, other than some very simple formal requirements, there are none currently enforceable in Argentina (neither specifically for franchise agreements nor in general).

Furthermore, and notwithstanding the fact that we will address the issue below in Section V, no special tax rules apply to franchise agreements.

III INTELLECTUAL PROPERTY

i Brand search

Brand and other intellectual property searches in Argentina are partially available through the National Institute of Industrial Property (INPI) database.

Trademark searches can involve phonetic and graphic searches, but neither of these is available through the INPI database; only searches for identical marks are available, together with searches based on the name of the applicant or holder of the trademark. A similar situation obtains as regards patent, utility model, or industrial model or design searches.

In view of this, to ascertain whether there may be a conflict between pre-existing trademarks, patents, utility models, industrial models or designs and the ones a franchisor or franchisee wants to exploit in Argentina, it is advisable to obtain the opinion of an expert.

ii Brand protection

Trade names, trademarks, patents, utility models, industrial models or designs, copyrights, trade secrets, confidential information or know-how can (whether all or a combination of these) be part of a franchise agreement.

While trade names, copyrights, trade secrets, confidential information or know-how do not need to be registered to obtain ownership, trademarks, patents, utility models and industrial models or designs do need to be registered.

Trademarks can be applied for by corporations or individuals, both national and foreign. Once the trademark application has been filed, the Trademark Office performs a formal examination and, provided formalities are complied with, orders its publication in the Trademarks Bulletin. After publication takes place, third parties have a 30-day term to file

6 Civil and Commercial Code art. 1512 (Arg., 2015).

7 Id. at art. 1513, para. b.

oppositions based on legitimate interests. If opposition are filed, they block the trademark's registration procedure until either an agreement is reached with the opponent or a lawsuit is filed against the opponent (following a mandatory prior instance of mediation). The Trademark Office does not resolve opposition matters; these must be resolved by the courts. After the period for oppositions, the Trademark Office performs an in-depth examination and decides either to issue an office action, if there are matters to be resolved, or to grant the registration.

Other intellectual property rights have different registration processes, with the patent and utility model registration process being the most lengthy and complex, and the industrial model and design registration process being the shortest and simplest.

The patent and utility model registration process has stages similar to those of the trademark registration process (filing, formal examination, publication, opposition period, in-depth examination, rejection or registration).

The industrial model and design registration process differs from the others mentioned above, since only a formal examination is performed and, provided the formal requirements are met, the industrial model or design is granted for a five-year period, which can subsequently be extended for two additional five-year periods.

Miscellaneous

Current franchising regulations provide that the franchisor must be the exclusive owner of the set of intellectual rights, trademarks, patents, trade names, copyrights and other rights included in the franchise system; or, where appropriate, have the right to their use and transmission to the franchisee under the terms of the agreement.⁸

iii Enforcement

According to Argentine regulations, the franchisor shall defend and protect the use by the franchisee of the intellectual property rights granted under the franchise agreement.

However, in international franchise agreements, the enforcement of those rights is contractually the responsibility of the franchisee, which must be specially empowered to do so, without prejudice to the franchisor's obligation to provide the franchisee with all the documentation and other elements necessary for that purpose.

In any case, the franchisee is entitled to intervene as an interested party, in defence of those rights in any relevant administrative or judicial proceedings, through the channels admitted, and to the extent allowed, by procedural law.

iv Data protection, cybercrime, social media and e-commerce

Data protection

Argentine data protection regulations apply to any processing of personal data that takes place within Argentina.

Personal data is broadly defined as information of any kind referring to identified or identifiable natural or legal persons.

In view of the above, in franchise agreements, the party processing personal data in Argentina will have to comply with all data protection regulations. These include, among others, (1) a requirement for the prior informed and express consent of the data subject for the

8 Id. at art. 1512.

processing of his or her data (with some exceptions specifically set out in the regulations), (2) the grant of a right for data subjects to access, update, amend and delete outdated or incorrect information, (3) the obligation for the data controller and processor to take confidentiality and security measures, (4) the obligation for the data controller to register the databases, (5) the obligation to use the data only in connection with the purpose for which they were collected, and (6) the obligation to delete the data when no longer necessary for the purposes for which they were gathered.

As regards cross-border transfers of data, the Argentine data protection regulations prohibit the transfer of personal data to countries that do not provide an adequate level of protection.⁹ However, the prohibition is not applicable when either:

- a* the data subject has expressly consented to such a transfer; or
- b* data is exported for outsourcing purposes by means of an international data transfer agreement (IDTA) between the transferor and the transferee, under which the latter undertakes to comply with the Argentine data protection regulations.

Failure to comply with Argentine data protection regulations may lead to sanctions being imposed by the data protection authority, currently the Public Information Access Agency, and to civil and, in some cases, criminal liability.

In 2016, with a view to replacing the current Data Protection Law, the National Directorate for the Protection of Personal Data (DNPDP) prepared a draft bill, which has not yet been submitted to the National Congress. This draft bill reproduces some of the principles of the European General Data Protection Regulation.

Cybersecurity

The Argentine Criminal Code currently penalises different cybercrimes. Furthermore, Argentina has recently become a party to the Budapest Convention on Cybercrime.

Social media and e-commerce

Social media and e-commerce are not expressly regulated in Argentina. However, they are subject to general laws, such as criminal law, contract law, data protection law, consumer law, data protection law and unfair-competition law, among others.

IV FRANCHISE LAW

i Legislation

Specific regulation of franchise law has only been enacted recently in Argentina with the introduction of the National Civil and Commercial Code (CCCN), which entered into force in 1 August 2015 and replaced both the previous Civil Code and the previous Commercial Code (which were two different bodies of law).¹⁰ Up until then, neither the Civil Code, the Commercial Code or any special law provided special rules for franchising contracts.

⁹ To date, countries with an adequate level of protection are: the Member States of the European Union and members of the European Economic Area, Switzerland, Guernsey, Jersey, the Isle of Man, the Faroe Islands, Canada (for the private sector only), the Principality of Andorra, New Zealand, the Republic of Uruguay and the State of Israel (only for data receiving automated processing).

¹⁰ Law No. 26994, 8 October 2014, B.O. 32985, 1 (as amended by Law No. 27077) (Arg.).

Despite the absence of special regulation, there were no legal obstacles to the execution and enforceability of franchise agreements. Other than the general restriction prohibiting parties from circumventing mandatory provisions, parties had complete freedom to agree upon any terms. Nonetheless, in the absence of special default rules to fall back on (other than the general provisions applicable to all contracts and those similar in nature), issues of legal certainty would become common if parties failed to anticipate any particular situation.

The new CCCN introduced an entire chapter¹¹ specifically addressing franchise agreements, in line with the regulations for sales representative agreements¹² and concession agreements,¹³ which had not been regulated before either. Given the special nature of these agreements, they share many rules.

The current franchise agreement regime comprises provisions addressing many particular issues (e.g., parties' duties and rights, term and termination, labour and antitrust).

As expected with any new piece of legislation, there is still very little interpretative case law (if any). One of the many general issues that still need to be addressed in case law is the nature of some of the provisions: whether they should be regarded as default provisions (i.e., applicable to the agreement in the event that parties do not agree otherwise) or mandatory provisions and a matter of public policy (i.e., parties to the contract may not agree otherwise).

In addition to the main legal effect of that distinction (i.e., whether parties may legally opt out of the provision), there are two important consequences pertaining to franchising contracts that were entered into before the enactment of the CCCN (we will address this issue immediately below) and to matters of international choice of law (see Section VI.ix).

Are the CCCN's new provisions applicable to ongoing franchise agreements? An important issue that will soon be discussed is whether franchise agreements concluded and effective prior to the entry into force of the CCCN should be affected by the newly enacted rules.

The most relevant rule of contracts applicable to this issue is that default rules enacted after a contract has been concluded are not applicable to that contract; on the other hand, new mandatory rules are applicable.¹⁴

Although the rule appears to be quite simple, its application in real-world situations is not, as the rule depends on whether a legal provision is regarded as default or mandatory and, as discussed above, the CCCN is not consistently clear about that.¹⁵

ii Pre-contractual disclosure

In addition to any of the usual representations and warranties included in business agreements, a particular disclosure requirement is provided in Argentine law. The franchisor must provide, prior to the execution of the franchise agreement, economic and financial information on the

11 Civil and Commercial Code arts. 1512–1524 (Arg., 2015).

12 Id. arts. 1479–1501.

13 Id. arts. 1502–1511.

14 Id. art. 7.

15 For example, the CCCN provides that the franchisor must provide the franchisee with an operation manual (Id. art. 1514, inc. para. c), without stating whether the provision is default or mandatory. However, if the agreement entered into by the parties in 2013 (i.e., before the CCCN entered into force) did not provide for an operation manual, would the franchisor be required to provide the franchisee with a manual as of 1 August 2015? The answer would depend on whether the provision is regarded as a default provision or a mandatory provision. If the former, it would not be deemed applicable; if the latter, it would be applicable.

two-year evolution of units similar to the franchise units offered, and which have operated for a sufficient time in the country or abroad.¹⁶ The rationale behind this is that, before deciding whether to enter into the franchise agreement, the prospective franchisee has a legitimate interest in knowing if the business system has been proven successful. The franchisee has to evaluate example cases to project and calculate whether the business will be profitable.

Furthermore, a general rule of good faith (i.e., applicable not only to franchise agreements) should be followed during the pre-contractual negotiations. In this respect, Argentine law provides that during preliminary negotiations, and even if no contractual offer has yet been made, the parties shall act in good faith to avoid unjustifiably frustrating the negotiations. Failure to comply with this duty shall entail an obligation to repair the damage suffered by the party that has relied (without fault on its part) on the execution of the contract.¹⁷

iii Registration

Argentine law does not have any specific regulatory registration requirement for franchises or franchise agreements. Although there is a particular registration requirement under the Transfer of Technology Act¹⁸ for tax purposes, this does not affect the enforceability of the franchise agreement.

iv Mandatory clauses

As mentioned above, the Argentine franchise agreement regime comprises both mandatory and default provisions. Therefore, any issue not specifically addressed by the parties shall be covered by existing legal provisions, some of which may apply on a default basis (i.e., they apply by default unless both parties agree to opt out), while others are mandatory rules.

Within this legal framework, the Argentine regime does not actually set out which clauses must be included by the parties in the franchise agreement (in fact, it does not even require a written agreement); if the parties were not to set out relevant clauses, or even a written agreement at all, the agreement would simply be governed by the existing legal provisions.

This contractual freedom is limited only by mandatory clauses, from which the parties may not opt out (if they were to seek do so, those provisions would simply be null and void). Although there might be some argument as to whether some provisions should be regarded as mandatory (generally, the issue would be the extent to which a particular duty may be contractually limited), the following are the most relevant mandatory provisions:

- a* the franchisor must provide the franchisee with the technical knowledge to develop the franchise;¹⁹
- b* the franchisor must deliver an operations manual;²⁰
- c* the franchisor must provide technical assistance;²¹
- d* where the franchise implies the provision of goods and services, the franchisor must provide them in sufficient quantities and at reasonable prices;²²

16 Id. art. 1514, inc. a.

17 Id. art. 991.

18 Law No. 22426, 23 March 1981, B.O. 24633 (as amended) (Arg.).

19 Civil and Commercial Code art. 1514, para. b (Arg., 2015).

20 Id. art. 1514, para. c.

21 Id. art. 1514, para. d.

22 Id. art. 1514, para. e.

- e* the franchisor must defend and protect the use of the intellectual property involved in the franchise;²³
- f* the franchise agreement term may be no shorter than four years (except in special situations);²⁴
- g* the franchise agreement may not include the following clauses:
 - the franchisee's waiver on the right to challenge the intellectual property involved in the franchise;²⁵
 - a restriction on the franchisee acquiring franchise-specific goods from other franchisees (provided they meet the required contractual specifications and quality);²⁶ and
 - a restriction on meeting and forming non-economic relationships with other franchisees;²⁷
- h* both parties must provide prior notice of termination;²⁸ and
- i* the parties may not agree upon a non-compete provision, unless it is provided for less than one year (after termination) and within a reasonable territory.²⁹

v Guarantees and protection

Parties to a franchise agreement are free to provide for any type of guarantee to secure their obligations. Other than compliance with general rules on the matter, there are no specific rules for franchise agreements affecting the enforceability of guarantees.

In summary, Argentine law provides for two kinds of guarantee: real guarantees and personal guarantees. Real guarantees involve the provision of collateral (either owned by the debtor or any third party) that cannot be transferred or disposed of by the grantor; personal guarantees involve a third party (either an individual or a company) acting (generally) as a co-debtor on a joint and several basis with all its assets. While the first kind provide a more secure guarantee (given that the grantor is not legally or factually able to dispose of the collateral), the second kind provide a broader collateral that may be legally and factually disposed of by the grantor (regardless of any contractual provision). On the other hand, real guarantees are usually more expensive and burdensome to implement when compared to personal guarantees. The nature of the commercial relation and the amounts involved would greatly affect the type of guarantee, which is usually chosen on a case-by-case basis.

Whatever the commercial agreement may be, when large franchise agreements are involved it is fairly common for the franchisor to require the franchisee to obtain a mortgage to secure any ongoing duties (especially payment obligations) under the franchise agreements. Although in the past there have been some doubts about the enforceability of this type of mortgage,³⁰ the CCCN has expressly provided for open mortgages; (i.e., mortgages securing

23 Id. art. 1514, para. f.

24 Id. art. 1516.

25 Id. art. 1519, para. a.

26 Id. art. 1519, para. b.

27 Id. art. 1519, para. c.

28 Id. art. 1522, para. d.

29 Id. art. 1522, in fine.

30 The reason for those challenges was that these guarantees failed to comply with an important requirement of real guarantees: to determine precisely which obligations were guaranteed. Given that the payment obligations did not exist when the real guarantee was executed, that real guarantee could not cover those obligations.

obligations originated by the parties or a particular commercial relationship, even if not specifically mentioned).³¹ The guarantee would cover any obligations accrued within 10 years of its granting,³² up to the amount provided in the guarantee.

V TAX

There is no special tax regulation specifically applicable to franchise agreements; therefore, the general principles of each tax regulation shall be applicable. The Argentine Congress is currently discussing a general tax reform, which is intended to be passed shortly. If approved, the conclusions below should be reviewed.

i Franchisor tax liabilities

The most relevant federal taxes are income tax and value added tax (VAT). Other local taxes (provincial and municipal) may also be levied on the franchise relationship, such as turnover tax and stamp duty. The taxes differ from province to province.

Income tax

This is a federal tax established on the worldwide income obtained by individuals, legal entities domiciled in Argentina (with a permanent establishment in Argentina) and Argentine branches of foreign entities.³³

Non-resident individuals and legal entities without a permanent establishment are only taxed on income from Argentine sources, such as (1) assets located, placed or used in Argentina, and (2) activities in Argentina that produce an economic benefit.

If the franchisor is a resident entity (such as a corporation or a limited liability company and branches) or has a permanent establishment in Argentina, a 35 per cent rate will apply on the net income generated by the franchise agreement.³⁴

On the other hand, any payment made by a resident to a foreign individual or entity for services deemed to be from an Argentine source is subject to a withholding tax at different rates. Regarding payments to a foreign franchisor (and, of course, depending on the particular circumstances), the following rates should be taken into account (bear in mind, however, that no specific regime for franchise agreements exists):

- a Services that cannot be construed as a transfer of technology are subject to a 31.5 per cent withholding tax on the amount to be paid.
- b Any trademark, know-how or other performance that may be construed as a transfer of technology is subject to a 28 per cent withholding tax on the amount to be paid.
- c Any transfer of technology that is not acquirable in Argentina is subject to a 21 per cent withholding tax on the amount paid.
- d Any goods exported to Argentina by a foreign individual or entity are not subject to withholding tax (however, they are subject to VAT and other customs duties, the rates for which vary according to the particular circumstances).

31 Id. art. 2189.

32 Once that term has elapsed, the obligations accrued during that term shall remain secured by the real guarantee.

33 Gustavo Papeschi, *Law and Business Review of the Americas*, SMU Dedman School of Law, Volume 20, Winter 2014, page 82 (United States).

34 Id. at page 83 (United States).

Finally, Argentina has several double-tax treaties in force that cap rates on withholdings on certain kinds of payment. Therefore, if the franchisor is tax resident in a state that has a double-tax treaty with Argentina, lower rates could apply.³⁵

VAT

This federal tax is levied on the sale of goods, provision of services and importation of goods.³⁶

VAT is assessed on a monthly basis and the general rate is 21 per cent. This rate is reduced to 10.5 per cent for certain taxable events (e.g., sales, manufacturing, fabrication or construction, and definitive imports of assets that qualify as 'fixed assets' according to a tariff number list included in the VAT law).

VAT is applied at each economic stage on a non-cumulative basis. The accumulation of the tax is avoided by deducting the VAT invoiced to the local franchisor by its suppliers (VAT credit), as long as the acquired goods or the contracted services are linked to the franchisor's VAT taxable transactions.

Afterwards, the franchisor has to charge VAT on the total amount invoiced to its customers in each monthly tax period (VAT debit), but it is entitled to set off the invoiced VAT credit against its VAT debits for the same monthly period.

If the franchisor is a foreign resident, its services could be considered service imports subject to VAT, to the extent that:

- a* the services were supplied from abroad;
- b* they are effectively exploited or utilised in Argentina; and
- c* the importer is VAT registered.

In this case the importer (franchisee) should self-assess the tax, which can be computed as a credit in the following month.

ii Franchisee tax liabilities

VAT

If the franchisor is an Argentine resident, the franchisee will have to pay the VAT charged on the invoice to the franchisor. If the franchisor is a foreign resident, the franchisee should self-assess the tax, which can be computed as a credit in the following month.

Tax on debits and credits on bank accounts

The franchisee will be subject to this tax on any debit on its local bank accounts or any movement of funds implemented through organised payment systems in lieu of bank accounts.

iii Tax-efficient structures

Regarding the income tax withholdings to be applied to the payments made by a resident to a foreign individual or entity, we must emphasise that the application of the different rates will depend on the nature of the withholding being paid and the registration of the agreement with the INPI (the Argentine authority governing transfer of technology matters).

35 Id. at page 83–84 (United States).

36 Id. at page 82 (United States).

In this sense, if the agreement is registered with the INPI, and depending on the nature of the withholdings, the applicable rate will be 21 per cent or 28 per cent, and if the agreement is not registered with the INPI a 31.5 per cent rate will apply.

Similarly, and from the franchisee's standpoint, it is important to note that the local regime establishes that to deduct expenses for income tax purposes, the agreement governing the payments must be registered with the INPI. It is, therefore, advisable to register the potential contract with the INPI

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The rule of good faith is present throughout Argentine law. Specifically in the CCCN, the rule of good faith is present in many general and specific rules. Pursuant to the general rules, all rights must be exercised in good faith;³⁷ in view of this, contracts must be interpreted according to the parties' common intention and the rule of good faith.

The most relevant application of the rule of good faith is the Argentine doctrine of the abuse of rights.³⁸ This doctrine is one of the foundations of Argentine civil law. It may be best described as a general principle intended to prevent the exercise of a right in a manner that does not reflect a certain degree of fairness in accordance with the rationale behind a particular legal provision; something akin to an equity principle to help reduce the harshness of written law or legal formalities. Although most Argentine lawyers would praise this principle and consider it a foundational aspect of Argentine law, they also consider it a double-edged sword. Given that there are no definitive guidelines for its application, it is difficult to foresee precisely how it may be applied by a judge and the extent to which it could affect any contractual right or obligation.³⁹

Although judges are usually cautious when applying this doctrine, it is important to recognise that, because of the factual circumstances surrounding the contract, what is written in an agreement may not necessarily be enforceable. Even if this is also true for contracts governed by foreign law (i.e., unconscionable terms), under Argentine law the possibility increases substantially.⁴⁰

According to implied guarantees provided by law, the CCCN provides that the franchisor shall be liable for any design defect of the franchise system that causes damage to the franchisee, provided the damage was not caused by the franchisee's wilful misconduct or gross negligence.

In addition to the specific guarantee referred to above, Argentine law provides for two implied guarantees, which although not specific to franchise agreements may be applicable: the guarantee of good title and the guarantee for hidden defects. Both implied guarantees may be waived in advance by the transferee.

37 Id. art. 9.

38 Id. art. 9.

39 As the original drafter of the (now abridged) Civil Code said when he refused to legislate this doctrine, '[i]f the government acts as a judge of the abuse [. . .] it will not be long until it acts as a judge of the use, and any true idea of property and freedom would be lost'. Civil Code art. 2513 (abridged), Author's note (Arg.).

40 Gustavo Papeschi, *Law and Business Review of the Americas*, SMU Dedman School of Law, Volume 20, Winter 2014, page 76 (United States).

ii Agency distributor model

As discussed above, the newly enacted CCCN regulates franchise agreements, sales representative agreements and concession agreements (the rules for which are applicable to distributor agreements). As a consequence, these three types of agreement, which are dealt with together, share a similar treatment and some common rules (with some variations) under the CCCN.

However, and notwithstanding the common elements that may exist under the three types of agreement, our reasonable understanding is that they are three distinct contracts and, except for those rules that are expressly pointed out as applicable for other contracts, a franchise relationship should not be regarded as an agent or distributor relationship.

Nonetheless, the legal regulation of all three kinds of agreement is similar, with only a few differences.⁴¹

iii Employment law

On this matter, the newly enacted CCCN includes a very special legal rule stating that the franchisor and franchisee are independent, and that no labour relationship exists between them.⁴²

Furthermore, it provides that the franchisee's employees do not have any legal labour relationship with the franchisor, notwithstanding any rules on labour fraud.⁴³ Although the legal provision seems clear, Argentine labour judges have always been inclined to take a very broad view on what constitute a labour fraud. Therefore, it is not advisable for franchisors to rely on this rule. As a consequence, the franchisor should always account for the likelihood of being held liable for any labour claims filed by the franchisee's employees. In this regard, franchisors commonly include two key provisions in the franchise agreement:

- a Indemnity provisions: although there are no legal obstacles to agreeing upon an indemnity clause, such a commitment depends on the franchisee's solvency.
- b Franchisor's powers of inspection and control: in most franchise agreements, the franchisor can inspect the franchisee's activity and records to prevent any future claims (since most claims arise from the inaccuracy of the employees' registration).⁴⁴

iv Consumer protection

According to the legal standard that defines consumers under Argentine law, it is quite difficult for a franchisee to be regarded as a consumer. However, one of the most important innovations of the CCCN has been to distinguish between consumer contracts and contracts of adhesion. Therefore, and regardless of whether an agreement may be regarded as a consumer agreement or not (which seems unlikely in a franchise agreement), the agreement may still

41 For example, while the principal in a distribution agreement is required to purchase from the distributor all the goods the latter was obliged to acquire from the former (Id. art. 1508, para. b), there is no similar requirement for the franchisor.

42 Id. art. 1520.

43 Id. art. 1520, para. b.

44 Gustavo Papeschi, *Law and Business Review of the Americas*, SMU Dedman School of Law, Volume 20, Winter 2014, page 88 (United States).

be regarded as a contract of adhesion. Contracts of adhesion are those wherein one of the contracting parties adheres to the unilaterally established general clauses provided by the other party or a third party, without the adherent participating in its drafting.⁴⁵

The following consequences must be taken into account if an agreement may be regarded as a contract of adhesion:

- a* Prohibition of remissions: any general pre-formatted clauses must be comprehensible and self-sufficient. Those clauses that refer to documents not provided to the adherent party shall be regarded as ineffective.⁴⁶
- b* Pre-eminence of particular clauses: any particular clauses (those individually negotiated) that are incompatible with general clauses prevail over the latter.
- c* Interpretation: any ambiguities in pre-formatted clauses are interpreted with prejudice to the drafting party.⁴⁷
- d* Abusive clauses: the following must be regarded as ineffective:
 - clauses that denaturalise the drafting party's obligations;
 - clauses that waive or limit the adherent's rights, or extend the drafting party's rights in relation to default provisions;⁴⁸ and
 - clauses that, because of the content, wording or presentation, are not reasonably predictable.⁴⁹

In addition to the above, the franchisor may be regarded as jointly and severally liable in relation to the final consumer to the extent that the consumer is harmed because of a defect or risk arising in or from the goods or the service provided.⁵⁰

v Competition law

Notwithstanding antitrust issues generally applicable to all transactions in Argentina (beyond the scope of this analysis), the CCCN expressly states that a franchise agreement (in itself) shall not be regarded as a covenant that limits, restricts or distorts competition.⁵¹

vi Restrictive covenants

Given that the very essence of a franchise agreement is the proprietary identification of a certain franchisee with a certain franchisor, Argentine law expressly provides that franchises are exclusive for both parties. On the one hand, the franchisor may not authorise another franchise unit within the same territory, and on the other, the franchisee may only act within

45 Id. art. 984.

46 Id. art. 985.

47 Id. art. 987.

48 This provision is very similar to the one set out in section 37, para. b) of the Consumer Defence Law. Our understanding of the possible interpretation of that addition is that the CCCN introduces the rule that the drafting party in a contract of adhesion may not include any provision that amends (contrary to the adherent party's interest) the default rules provided in any legal provision. In other words, even default rules are regarded as mandatory provisions.

49 Id. art. 988.

50 Law No. 24240, art. 40, Oct. 15, 1993, B.O. 27744, 34 (as amended) (Arg.).

51 Civil and Commercial Code, art. 1523 (Arg., 2015).

the agreed establishments (or within its influence zone if nothing has been agreed), and may not operate (either directly or indirectly) any franchise or activity that may compete with the franchisor.⁵²

Although the parties may limit or eliminate this exclusivity by special agreement, it serves to show the importance that Argentine law attaches to the issue of exclusivity.

vii Termination

Termination of franchise agreements is probably the most important issue under Argentine franchise law. Most conflicts are generally related to the ability of one of the parties (usually the franchisor) to legally terminate the contract and its liability in relation to the franchisee.

Before referring to the agreement's termination, it is first necessary to discuss its term. The CCCN mandates a minimum term of four years for franchise agreements.⁵³ If a shorter term or an indefinite term is agreed, the agreement shall be regarded as if a four-year term has been agreed.⁵⁴ A shorter term may be agreed upon if the franchise agreement involves activities to be performed at a fair or expo shorter than the four-year term.⁵⁵

Upon expiration of the original term, the agreement will be deemed renewed for an additional year unless any party decides to terminate it with 30 days' prior notice⁵⁶ (note the legal contradiction discussed below). Upon a second renewal, the agreement shall be deemed converted into an indefinite-term agreement.⁵⁷

The CCCN sets out several rules about the termination of franchise agreements. There are a few inconsistencies between provisions, which we address below:

- a* the agreement is terminated upon the death (or dissolution in the case of companies) or incapacity of any of its parties;⁵⁸
- b* during its original term, the agreement can only be terminated for cause (only a material breach would authorise its termination);⁵⁹
- c* any agreement shorter than three years (i.e., those entered into under the special circumstances referred to above) is regarded as terminated on its expiration date (i.e., no further notice is required);⁶⁰ and
- d* whatever the agreement's term, the party wishing to terminate the agreement upon the expiration of its original term or renewal must provide prior notice equal to one month per year of contract up to a maximum of six months.⁶¹ Note the contradiction with the condition listed at (c), which only requires 30 days' notice.

Furthermore, for agreements with an agreed indefinite term, the prior notice must be given in a way in which the agreement's termination occurs after the third year of its execution. Note that this provision seems to contradict the stipulation that an indefinite-term agreement shall be regarded as a four-year contract.

52 Id., art. 1517.

53 Id., arts. 1506, 1516.

54 Id.

55 Id.

56 Id.

57 Id.

58 Id., art. 1522, para. a.

59 Id., art. 1522, para. b.

60 Id., art. 1522, para. c.

61 Id., art. 1522, para. d.

In any case, a cause is required for termination.

If sufficient prior notice is not given, the terminated party may claim for the lost profits that would have accrued during the term of a correctly observed notice period.⁶²

Given the apparent contradiction of the legal provisions, we understand that a conservative approach should be used. In that regard, the general rule should be to grant prior notice of termination equal to one month per year of contract (with a maximum of six months) for all cases in which a termination for convenience is intended, whether it is an indefinite-term agreement (converted after the second renewal as discussed above) or the terminating party intends to prevent renewal upon the expiration of the original term or the subsequent renewal term.

The parties may agree (upon execution or termination of the agreement) a covenant preventing the franchisee from marketing goods or services (either its own or third parties') for a maximum of one year after termination of the agreement, provided the scope of the covenant is limited to a reasonable territory.⁶³

Given that the franchisor may not have a controlling stake in local franchises,⁶⁴ the franchisor should not be able to take over the operation of the franchisee's business.

viii Anti-corruption and anti-terrorism regulation

Under Argentine law, there are no particular compliance rules for franchisors or franchisees.

ix Dispute resolution

Although there are no special rules or procedures specifically provided for franchise agreements, a few general matters have to be addressed.

Parties to a commercial agreement (such as a franchise agreement) are able to agree a particular choice of law and jurisdiction. As regards the first, the CCCN acknowledges the parties' ability to choose the law applicable to the agreement.⁶⁵ This choice of law, however, is generally subject to compliance with certain requirements: (1) the contract should be 'international' as opposed to fully domestic; (i.e., it should have a foreign component);⁶⁶ (2) the foreign component should be real, as opposed to fraudulently established by the parties to avoid the application of Argentine law; and (3) the choice of law should bear some reasonable connection or contact with the agreement.

Despite the general validity of the choice of law, any mandatory provision under Argentine law may be deemed applicable to any franchise agreement, regardless of whether the contractual parties have agreed otherwise or have chosen a foreign law.⁶⁷

62 Id.

63 Id.

64 Id., art. 1512.

65 Id., art. 2561.

66 For example, if the place where the agreement is executed, or is to be performed, or the residence of one of the parties at the time of executing the agreement, is located abroad.

67 In other words, although the parties may choose a law other than Argentine law, such a choice does not preclude the application of the mandatory provisions of the CCCN.

As regards the choice of jurisdiction, the CCCN stipulates that parties can agree to submit their international commercial claims to foreign courts,⁶⁸ provided certain requirements are met (similar to those required for the validity of choice of law provisions, as listed above).

Notwithstanding the general validity of the choice of jurisdiction, Argentine courts may – on an exceptional basis – hear a case in certain disputes to avoid any denial of justice (forum of necessity). In this regard, the local franchisee may argue that filing a claim abroad might mean, in fact, an impediment to access to justice. Although we have no knowledge of judicial precedents regarding this particular legal provision, given its wording, and despite the existence of reasonable arguments against the possibility of such an interpretation, the latter should not be disregarded.⁶⁹

Furthermore, parties to franchise agreements may agree (either as a stipulation in the agreement, or afterwards) to submit any franchise-related disputes to arbitration, whether domestic or international.⁷⁰ However, such a covenant, which must be made in writing,⁷¹ is not admissible in the case of contracts of adhesion.⁷²

Argentina is a signatory to the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention).

VII CURRENT DEVELOPMENTS

Argentina's business community (both in general and with regards to the franchise business) is currently at the dawn of a new age – from a legal, economic and political point of view.

From a legal point of view, the newly enacted CCCN has (despite its shortcomings) provided a more certain and foreseeable legal scenario, for both franchisors and franchisees to develop their businesses. During the coming years, we expect to see more and more case law that will help the legal community interpret the CCCN's not-so-clear provisions.

From an economic and political point of view, a more business-friendly government took office in 2015. In the past two years it has taken many open-business measures (for example, curtailing the foreign exchange restrictions) and many more are expected. This has certainly created a welcoming environment for both domestic and foreign investors and franchise players.

68 Id., art. 2605.

69 Id., art. 2602.

70 Id., art. 1649.

71 Id., art. 1650.

72 Id., art. 1651.

AUSTRALIA

*Philip Colman*¹

I INTRODUCTION

Franchising is a sophisticated and stable sector of the Australian economy. Following the conduct of an extensive survey during 2016 by the Asia-Pacific Centre for Franchising Excellence, it has been reported that:

- a* There are an estimated 1,120 franchise brands operating in Australia compared with 1,160 in 2014.
- b* This gradual reduction in franchise systems is expected as the sector continues to mature.
- c* While the number of brands has declined, individual franchise systems have grown internally with modest increases in the number of franchise units.
- d* There are an estimated 70,700 business-format franchised units and 8,300 company-owned units, producing a total of 79,000 units operating in business-format franchises in Australia. While the number of franchised units has slightly increased and company units have decreased, there has been no net overall change in the number of franchise units since 2014.
- e* Approximately 4 per cent of small businesses in Australia are franchise units.
- f* The absence of real growth in the franchise sector is in alignment with the state of the Australian economy over the past two years.
- g* Franchising is dominated by retailing and this industry segment (particularly non-food retailing) has been faced with intense competition. Food retailing has been more resilient, with consumers responding well to variety and innovation in food concepts.
- h* Of franchise brands responding to the survey, 90 per cent originated in Australia and 32 per cent of these are currently franchising internationally, with New Zealand remaining the most common destination despite its small potential market.

Despite it being reported that 90 per cent of franchise systems in Australia are ‘home-grown’, many foreign-based systems are also well established in Australia. They include KFC, McDonald’s, Subway, 7-Eleven, Marriott, InterContinental Hotels, Specsavers, Pandora Jewellery, Lift Brands, Europcar, Jani-King, Baskin-Robbins and Curves.

Nevertheless, Australia has many home-grown successes, including Bakers Delight, Boost Juice, Hairhouse Warehouse, Jim’s Group, Autobarn, Zambrero, Poolwerx, IGA supermarkets and Priceline Pharmacy.

The Franchise Council of Australia Limited is the peak body for the franchise sector in Australia, representing franchisees, franchisors and service providers to the sector.

¹ Philip Colman is a partner at MST Lawyers.

II MARKET ENTRY

i Restrictions

Subject to the foreign investment laws referred to below, foreign business entities are not precluded from operating a franchise system in Australia (including granting master franchise or development rights to local entities) provided they comply with Australian law (particularly laws governing franchising outlined below). A foreign business entity may establish an Australian subsidiary in accordance with the Corporations Act 2001 (Cth).

If the Australian subsidiary is an Australian private company, at least one director of the company must reside in Australia.

Foreign investment is governed by the Foreign Investment Review Board (FIRB). Whether foreign investment approval is required depends upon the type of investment and whether the investment is above a monetary threshold. Most residential real estate acquisitions require prior FIRB approval, as do certain acquisitions of commercial real estate. Acquisitions of shares in or assets of businesses valued at more than the applicable monetary threshold (which as of 1 January 2016 is A\$252 million for non-US investors) require FIRB approval. For US investors, the free trade agreement between Australia and the United States has established different criteria and threshold values depending on whether the investment is within a 'prescribed sensitive sector' of industry. In most instances, these scenarios will not apply to a prospective foreign franchisor, unless it proposes to enter the Australian market via an acquisition. Further information can be obtained from the FIRB website at www.firb.gov.au.

ii Foreign exchange and tax

There are several key tax considerations relating to cross-border franchising in Australia. These can apply to both inbound and outbound transactions and to franchisors and franchisees:

- a* Residency and double taxation – in which country or countries are you liable for income tax?
- b* Foreign exchange – how are dealings in foreign currency treated and when are they subject to tax?
- c* Withholding tax – is withholding tax payable, what rate applies and is double taxation an issue?
- d* Goods and Services Tax (GST) – is GST payable and if so, who is liable to pay the GST? Is this a cash-flow issue or does this impact your profitability? GST can be a real cost in relation to international transactions.
- e* Transfer pricing – are dealings between parties in different countries at arm's length and is the documentation adequate?

Some of these are discussed in more detail below. Careful planning and experienced tax advice is essential in dealing with these issues.

III INTELLECTUAL PROPERTY²

i Brand search

IP Australia (the Australian government agency responsible for the administration of Australia's intellectual property) maintains databases of all registered trademarks, designs, patents and plant breeders' rights. These databases can assist in determining whether the use of a new brand name, logo, design or patent could infringe another party's rights. These searchable databases are available at www.ipaustralia.gov.au.

However, IP Australia's databases are limited in that they only contain information regarding registered or pending rights. As a result it may difficult to ascertain whether a third party has any unregistered intellectual property rights, particularly in the case of prior use of unregistered trademarks or copyright. Searches of the Australian Securities and Investment Commission's databases of registered company and business names, domain name searches and general internet searches can assist in locating third parties that may have unregistered intellectual property rights, particularly in relation to trademarks.

ii Brand protection

Applications to register an interest in intellectual property must be made through IP Australia either online or in paper form. The registration process differs depending on the particular right you are trying to obtain. Generally, applications will be subject to an examination by IP Australia to determine whether the registration should be accepted. Third parties will have an option to oppose the applications before they are registered.

More detailed information regarding each particular registration process is available at www.ipaustralia.gov.au.

In Australia, there is no system of registration for copyright. If the material satisfies the statute, copyright protection will exist automatically.

iii Enforcement

Australia does not have a regulatory body that enforces a party's intellectual property rights. It is the responsibility of the party with an interest in the intellectual property to enforce its rights, usually by way of court proceedings. A registered intellectual property interest generally gives the registered owner the right to prevent other people from using the intellectual property, or to obtain relief if the intellectual property is infringed. The relief may consist of monetary compensation or the right to seek an injunction whereby the court orders the party to immediately cease its infringing behaviour.

Additionally, both registered and non-registered intellectual property rights may be indirectly enforced with the application of the tort of passing off and the statutory prohibition on corporations engaging in misleading and deceptive conduct.

iv Data protection, cybercrime, social media and e-commerce

In Australia there is no legislation regarding cybercrime, social media and e-commerce that specifically pertains to franchises. However, there is legislation that applies to most organisations in a more general sense.

2 The writer acknowledges the contribution to this section by Louise Wolf, a senior associate at MST Lawyers who specialises in intellectual property law.

Updated privacy protection reforms came into effect in March 2014.³ Under these laws, the Australian Privacy Principles (APPs) significantly affect the way organisations collect, store, use, disclose and dispose of personal information about individuals. For example, organisations may be held accountable for sending personal information offshore if the recipient subsequently breaches the APPs. Additionally, the APPs limit the right to use personal information for direct marketing purposes in certain circumstances.⁴ There is a higher standard of protection afforded to sensitive information, which includes information about a person's racial or ethnic origin, religious beliefs, political opinions or membership of a political party or trade association, sexual practices or preferences, health and biometric data.

The Privacy Commissioner's powers include additional investigation and audit powers and the power to make enforceable undertakings, develop and register binding privacy codes and commence proceedings in the Federal Court or the Federal Circuit Court. Penalties of up to A\$1.8 million can be ordered for serious or repeated breaches of the APPs by corporations and up to A\$360,000 for individuals. E-commerce has become a vital component of most businesses in Australia and as a result cybercrime has become a pertinent issue. The APPs require organisations to take reasonable steps to protect data from theft, misuse, interference, loss, unauthorised access, modification or disclosure.⁵

Currently there is very little legislation that deals directly with e-commerce. However, the Electronic Transactions Act 1999 (Cth) does contain provisions that promote business and community confidence in the use of electronic transactions. The Act states that a transaction is not invalid because it takes place wholly or partly by electronic communications.⁶ The Act sets out when the requirements for a signature are satisfied in relation to electronic communications.⁷ Recent cases have applied traditional common law principles to the making of contracts online but have highlighted the need for clear processes to ensure certainty about terms being incorporated into online contracts, and also the need for clear statements given by the accepting party as to their agreement.⁸ Parties are likely to be bound to terms in online contracts by clicking 'I agree' where such terms were visible and accessible to the accepting party prior to acceptance.

Coupled with the growth of e-commerce trading is organisations' utilisation of social media communication channels. Australian laws will no doubt continue to evolve to govern the commercial use of social media outlets. The courts have recently ruled that companies may be held responsible for third-party comments posted on their social media pages if the comments contravene Australian consumer laws or advertising standards.⁹ As a result, organisations are required to monitor their social media pages frequently to actively remove any defamatory, misleading or abusive comments posted by third parties.

3 The Privacy Act 1988 (Cth), Schedule 1.

4 For example, organisations must not use personal data for direct marketing purposes unless the individual would reasonably expect the organisation to use the information for that purpose and the organisation provides a simple means by which the individual may easily request not to receive direct marketing.

5 The Privacy Act 1988 (Cth), Schedule 1, Australian Privacy Principle 11.

6 The Electronic Transactions Act 1999 (Cth), Section 8.

7 The Electronic Transactions Act 1999 (Cth), Section 10.

8 *eBay International AG v. Creative Festival Entertainment Pty Ltd* [2006] FCA 1768; *Smythe v. Thomas* (2007) 71 NSWLR 537; *Goldstein v. Jumbo Corporation Limited* [2006] VCAT 2472, *Evagora v. eBay Australia & New Zealand Pty Ltd* [2001] VCAT 49.

9 *Australian Competition and Consumer Commission v. Allergy Pathway Pty Ltd* (No. 2) [2011] FCA 74.

IV FRANCHISE LAW

i Legislation

On 1 January 2015, the Competition and Consumer (Industry Codes – Franchising) Regulation 2014 entitled ‘Franchising Code of Conduct’ (the Code) replaced the former Trade Practices (Industry Codes – Franchising) Regulation 1998 (the Old Code). This is the primary franchise-specific law in Australia.

The Code is a prescribed mandatory industry code under the Competition and Consumer Act 2010 (Cth) and is underpinned by that Act by virtue of that Act providing that a person must not, in trade or commerce, contravene an applicable industry code.¹⁰

The stated underlying purpose of the Code is to regulate the conduct of participants in franchising towards other participants in franchising.¹¹

The Code applies to conduct occurring on or after 1 January 2015 (other than to discharge an outstanding obligation that arose under the Old Code) in relation to a franchise agreement entered into on or after 1 October 1998.¹² The application of the Code is dependent upon the existence of a franchise agreement. The Code acknowledges that a franchise agreement may be wholly or partly in writing, wholly or partly oral, or wholly or partly implied.

Hence, in determining Code applicability, one must look at the entire relationship between parties and necessarily ignore the title given to any document. When looking at that entire relationship one must positively answer all the following questions for the relationship to be considered a franchise agreement:

- a* Does one person (the franchisor) grant to another person (the franchisee) the right to carry on a business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate¹³ of the franchisor?
- b* Is the operation of the business substantially or materially associated with a trademark, advertising or commercial symbol owned, used or licensed by the franchisor or an associate of the franchisor or specified by the franchisor or an associate of the franchisor?
- c* Is the franchisee obliged to pay money to the franchisor under its arrangement with the franchisor?

Then, having received positive answers to the above questions, one must consider whether the relationship falls under any of the exceptions. These are:

- a* where the only money payable by the franchisee to the franchisor under its arrangement with the franchisor is either:
 - payment for goods and services on a genuine wholesale basis;
 - repayment of loans from the franchisor to the franchisee;
 - payment for goods taken on consignment on a genuine wholesale basis; or
 - payment of market value for purchase or lease of real property, fixtures, equipment or supplies needed to start the business or to continue the business under the franchise agreement; and

10 Section 51AD of the Competition and Consumer Act 2010 (Cth).

11 Franchising Code of Conduct, Clause 2.

12 Franchising Code of Conduct, Clause 3.

13 Defined in the Franchising Code of Conduct, Clause 4.

- b* employer–employee relationships, partnership relationships, landlord and tenant relationships, mortgagor and mortgagee relationships, lender and borrower relationships, the relationship between members of a cooperative registered and operating under various state and territorial laws and ‘fractional franchises’.¹⁴

The Code imposes obligations on franchisors:

- a* to act in good faith towards franchisees¹⁵ (note that an identical obligation is also imposed on franchisees) – the mutual obligation to act in good faith is dealt with in greater detail below;
- b* to create and update and maintain¹⁶ a prescribed disclosure document¹⁷ (see below as to content);
- c* to provide the disclosure document to franchisees and prospective franchisees;¹⁸
- d* to refrain from entering into a franchise agreement until it has received signed certificates from the franchisee as to the obtaining or non-obtaining of legal, accounting and business advice;¹⁹
- e* to provide a prescribed information statement (containing an explanation of franchising and warnings about business risks) as soon as practicable after a prospective franchisee formally applies or expresses an interest in acquiring a franchised business;²⁰
- f* to provide premises lease documents or information to franchisees, including details of any incentive or financial benefit that the franchisor or an associate of the franchisor might receive from a landlord;²¹
- g* to provide copies of other relevant agreements, such as those relating to intellectual property, security agreements, confidentiality agreements and restraint agreements;²²
- h* to prepare annual financial statements of any marketing or other cooperative fund within four months of the end of a financial year and have the statements audited²³ and to supply to franchisees a copy of the statements and audit report within 30 days of them being completed;²⁴

14 Franchises where the goods and services of the franchise are substantially the same as those sold for the previous two years by the franchisee before the franchise agreement was entered into, and sales of those goods and services are unlikely to provide more than 20 per cent of the franchisee’s gross revenue in the first year of the term.

15 Franchising Code of Conduct, Clause 6.

16 The obligation to create and update so as to be compliant with the Code did not arise until 31 October 2015 if the franchisor has an existing disclosure document created under the Old Code. Otherwise the obligation to update must be met within four months of the end of the franchisor’s financial year; however, the requirement to update does not exist if the franchisor did not enter into more than one franchise agreement in that financial year and the franchisor does not intend to enter into a franchise agreement in the next financial year.

17 This obligation does not exist for master franchisors in relation to sub-franchisees (i.e., where a sub-franchisor or master franchisee is interposed).

18 Franchising Code of Conduct, Clause 9.

19 Franchising Code of Conduct, Clause 10.

20 Franchising Code of Conduct, Clause 11.

21 Franchising Code of Conduct, Clause 13.

22 Franchising Code of Conduct, Clause 14.

23 Unless 75 per cent of franchisees agree that it should not be audited.

24 Franchising Code of Conduct, Clause 15.

- i* to provide a copy of its current disclosure document to existing franchisees upon request;²⁵
- j* to provide ongoing disclosure to franchisees²⁶ in relation to:
- any more recently issued statement of solvency, financial statement and audit report relating to the franchisor;
 - changes in majority ownership or control of the franchisor;
 - certain proceedings brought by public agencies against the franchisor or a director of the franchisor;
 - judgments against the franchisor under independent contractor laws;
 - civil proceedings against the franchisor by more than 10 franchisees or 10 per cent of franchisees;
 - certain judgments against the franchisor unsatisfied for more than 28 days;
 - the franchisor becoming externally administered (for example, because of insolvency);
 - material changes to intellectual property relevant to the franchise; and
 - undertakings given to the competition regulator (the Australian Competition and Consumer Commission (ACCC)) or orders relating to such undertakings;
- k* to advise franchisees within six months²⁷ of the end of the term of a franchise agreement whether or not the franchisor will extend the franchise agreement, or enter into a new franchise agreement;²⁸
- l* to keep proper records;²⁹
- m* to refrain from including in franchise agreements general releases of the franchisor from liability to the franchisee or waivers of verbal or written representation;³⁰
- n* not to include in franchise agreements litigation, arbitration or mediation venue provisions that require these processes to take place in venues outside the state or territory in which the franchised business is based;³¹
- o* not to include in post-1 January 2015 franchise agreements clauses that require the franchisee to pay the franchisor's dispute resolution costs;³²
- p* not to unreasonably withhold consent to a request from a franchisee to a transfer of a franchise agreement where the request is accompanied by all information that the franchisor would reasonably require and expect to be given to make an informed decision;³³
- q* to specify any conditions upon which consent to a transfer of a franchise agreement is given;³⁴
- r* to specify the reasons why consent to a transfer of a franchise agreement has been refused:

25 Franchising Code of Conduct, Clause 16.

26 Franchising Code of Conduct, Clause 17.

27 This period is one month if the term of the franchise agreement is six months or less.

28 Franchising Code of Conduct, Clause 18.

29 Franchising Code of Conduct, Clause 19.

30 Franchising Code of Conduct, Clause 20.

31 Franchising Code of Conduct, Clause 21; also note that this Clause only applies to franchise agreements entered into or varied on or after 1 January 2015.

32 Franchising Code of Conduct, Clause 22.

33 See the Franchising Code of Conduct, Clause 25(2). Clause 25(3) sets out certain circumstances where it would be reasonable to withhold such consent.

34 Franchising Code of Conduct, Clause 25 (1)(b).

- if refused following the initial request;³⁵ or
 - if revoked under a right of revocation that exists for 14 days after the consent was given;³⁶
- s* to allow a franchisee to terminate the franchise agreement within seven days of signing it and paying non-refundable money;³⁷
- t* subject to limited exceptions,³⁸ not to terminate a franchise agreement because of a breach unless a breach notice has been served on the franchisee, the franchisee has been given reasonable time to remedy the breach³⁹ and the franchisee does not remedy the breach within the reasonable time specified in the breach notice;⁴⁰
- u* to give reasonable notice to a franchisee of termination of a franchise agreement and the reasons for termination in circumstances where a franchisor exercises a contractual right to terminate where there is no breach by the franchisee;⁴¹
- v* not to require a franchisee to undertake 'significant capital expenditure'⁴² in relation to the franchised business during the term of the franchise agreement;⁴³
- w* to maintain a separate bank account for marketing fees and advertising fees contributed by franchisees;⁴⁴

35 Franchising Code of Conduct, Clause 25(1)(a).

36 Franchising Code of Conduct, Clause 25(5).

37 Franchising Code of Conduct, Clause 26.

38 The exceptions, described in Clause 29, only apply if the franchise agreement gives the franchisor the right to terminate the franchise agreement. They are:

- a* the franchisee no longer holding a necessary licence to conduct the franchised business;
- b* franchisee insolvency;
- c* a corporate franchisee being deregistered under Australian company law;
- d* voluntary abandonment of franchised business or the franchise relationship by the franchisee;
- e* the franchisee is convicted of a serious criminal offence;
- f* the franchisee operating business in a way that endangers public health or safety; and
- g* the franchisee acting fraudulently in connection with the operation of the franchised business.

If one of these exceptions exists, a franchisor may immediately terminate the franchise agreement, unless the agreement provides otherwise.

39 This need not exceed 30 days.

40 Franchising Code of Conduct, Clause 27.

41 Franchising Code of Conduct, Clause 28.

42 The Franchising Code of Conduct, Clause 30(2) provides that significant capital expenditure does not include:

- a* expenditure disclosed in the disclosure document given on entering into, renewing or extending the term of the franchise agreement;
- b* if the expenditure is to be incurred by all or a majority of franchisees, expenditure approved by a majority of those franchisees;
- c* expenditure incurred by the franchisee to comply with legislative obligations;
- d* expenditure agreed by the franchisee; and
- e* expenditure that the franchisor considers is necessary as capital investment in the franchised business, justified by a written statement given to each affected franchisee of:
 - the rationale for making the investment;
 - the amount of capital expenditure required;
 - the anticipated outcomes and benefits; and
 - the expected risks associated with making the investment.

43 Franchising Code of Conduct, Clause 30(1).

44 Franchising Code of Conduct, Clause 31(1).

- x* to pay marketing and advertising fees in relation to units operated by the franchisor on the same basis as franchisees are required to contribute;⁴⁵
- y* to expend marketing and advertising fees only for expenses of the type disclosed in the disclosure document or otherwise legitimate marketing or advertising expenses, expenses agreed to by a majority of franchisees or the costs of administering and auditing the marketing fund;⁴⁶
- z* not to engage in conduct with the intention of influencing a former franchisee to request that his, her or its details be omitted from the disclosure document;⁴⁷
- aa* not to induce franchisees not to form or participate in a franchise advisory council or like body;⁴⁸ and
- bb* to include in the franchise agreement a complaint-handling procedure that complies with the Code.⁴⁹

The Code also requires franchisors (as well as franchisees) to:

- a* act in good faith (see below);
- b* attempt to resolve disputes; and
- c* attend mediation through a duly authorised person.

ii Pre-contractual disclosure

A linchpin of the Code is the requirement for franchisors to:

- a* create (before entering into a franchise agreement) and update (within four months of the end of each financial year) a disclosure document that accords with the Code in terms of content and layout;⁵⁰ and
- b* to give its disclosure document (and a copy of the Code and the franchise agreement in the form in which it is to be executed) to prospective franchisees (including prospective franchisees who are acquiring an existing franchised business), renewing franchisees and existing franchisees where the term or scope of the franchise agreement is being extended, at least 14 days before the relevant documents are executed by the prospective franchisee or 14 days before a prospective franchisee pays to the franchisor any non-refundable money (whichever is the earlier).

The disclosure document requires franchisors to make disclosure under a number of key topics and subtopics. The key topics cover:

- a* background and relevant business experience of the franchisor, its associates and key personnel;
- b* details of relevant past and current litigation, convictions for serious offences or insolvency relating to or involving the franchisor or its directors;

45 Franchising Code of Conduct, Clause 31(2).

46 Franchising Code of Conduct, Clause 31(3).

47 Franchising Code of Conduct, Clause 32.

48 Franchising Code of Conduct, Clause 33.

49 Franchising Code of Conduct, Clause 34. As to the nature of the complaint handling procedure, see clauses 38 and 39.

50 If, as at 1 January 2015, a franchisor has an existing disclosure document created under the Old Code, it will not be required to update its disclosure document so that it complies with the 2015 Code until the earlier of four months from the expiration of the franchisor's financial year or 31 October 2015.

- c* payments to agents for the introduction or recruitment of franchisees;
- d* details of existing franchisees and key events⁵¹ that have occurred in the past three years;
- e* certain prescribed information as to the relationship between the franchisor (if the franchisor is a sub-franchisor) and the master franchisor;
- f* relevant information regarding intellectual property, including how and on what basis the franchisor can pass on rights to use the intellectual property to franchisees;
- g* details of exclusivity or otherwise of sites or any territory;
- h* details of franchisor's requirements for supply of goods or services to a franchisee;
- i* details of franchisor's requirements for supply of goods or services by a franchisee;
- j* rights, if any, of the franchisee to sell goods or services online;
- k* rights, if any, of the franchisor to sell goods or services online;
- l* any profit-sharing arrangement between the franchisor and franchisee in respect of online sales of goods or services;
- m* the franchisor's site or territory selection policy;
- n* circumstances surrounding past franchise businesses ceasing to operate in the territory to be franchised;
- o* payments to be made by a franchisee, including prepayments, establishment costs and other recurring or isolated payments;
- p* details relating to contributions to, expenditure from, administration and auditing, a marketing or other cooperative fund;
- q* details of any financing offered by the franchisor;
- r* details of unilateral variations to the franchise agreement in the past three years and circumstances where the franchise agreement may be unilaterally varied in the future;
- s* details of arrangements to apply at the end of the franchise agreement;
- t* details of whether the franchise agreement will be amended on a transfer or novation;
- u* any earnings information that a franchisor wishes to give and the basis for the information;
- v* a statement of solvency signed by a director of the franchisor;
- w* either financial reports of the franchisor for the past two financial years or an audit report supporting the franchisor's director's statement of solvency; and
- x* any other relevant updates pertaining to key changes that may have occurred since the disclosure document was created.

The disclosure document must have attached to it a copy of the Code and the franchise agreement in the form in which it is to be executed by the franchisee. In addition, it must include a form of receipt for signing and return by the franchisee.

If, after the date the disclosure document is given, the franchise agreement is amended to give effect to a request by the franchisee or otherwise by filling in required particulars or correcting mistakes or to clarify minor matters, there is no need to redisclose.

Violations of the Code can give rise to affected parties seeking a wide range of civil remedies, such as damages, injunctions and orders setting aside or varying the franchise agreement or the regulator (the ACCC) issuing an infringement notice (A\$9,000) or issuing legal proceedings seeking a civil pecuniary penalty of up to A\$54,000 per offence.

51 Franchise transfers, businesses closing down, terminations, non-renewals and franchisor buy-backs.

iii Registration

There are no mandatory requirements for the registration of disclosure documents or franchise agreements in Australia.

iv Mandatory clauses

The only mandatory clauses prescribed by the Code are those relating to complaint handling and dispute resolution. These are more fully described below.

However, in practice, franchisors mirror many of the provisions of the Code in their franchise agreements, particularly those relating to the cooling-off rights of a franchisee, termination and the procedure for considering requests for a transfer or novation of a franchise agreement.

v Guarantees and protection

As a general rule, guarantees given by persons to support the obligations of franchisees to franchisors are enforceable against the guarantors. The guarantee must be properly executed and it must not be procured by the fraud, undue influence or unconscionable conduct of the franchisor. Where guarantees are sought from persons who do not have equity in or a financial interest in the franchisee, prudent franchisors should insist that the guarantors obtain independent legal advice before accepting the guarantee.

V TAX

i Franchisor tax liabilities

Franchisors domiciled in Australia are subject to the following Australian taxes:

- a* income tax: Australian franchisors will be subject to Australian income tax on their Australian income, including income from foreign sources. The current company tax rate for small businesses (businesses with a turnover of less than A\$25 million for the year ended 30 June 2018) is 27.5 per cent and for all other companies the current tax rate is 30 per cent; and
- b* GST: GST (currently 10 per cent) must be collected on Australian sales and remitted to the tax office. This is only a timing (cash flow) issue and should have no impact on profits. Exports of goods and services may qualify for a GST exemption if strict conditions are met.

If the franchisor has foreign branch franchisees, they may end up paying double tax even if a taxation treaty exists. Further, payments received from foreign franchisees may be subject to withholding tax in a foreign country.

Foreign franchisors are subject to the following Australian taxes:

- a* income tax: if business is conducted through an Australian subsidiary, the subsidiary is liable for Australian income tax at the same rates specified for franchisors domiciled in Australia. A foreign-owned Australian subsidiary often results in double taxation because the profits are generally also taxable in the head entity's jurisdiction but without credit for any Australian tax paid by the subsidiary, particularly in the absence of a double-taxation treaty. If a foreign entity has a branch in Australia, it is subject to

Australian income tax on its Australian business profits. Franchisors will not ordinarily have a branch simply because they have Australian franchisees. Branches can also result in double taxation even if a tax treaty exists. Careful structuring is the key;

- b* withholding tax: a foreign franchisor receiving fees from Australia may lose some of those fees in withholding tax. Contracts and costing need to account for this. Presently, franchise royalties are subject to a 30 per cent withholding tax, although this is subject to the jurisdiction of the franchisor; and
- c* GST: importers of goods into Australia are generally liable for GST on importation. If not properly structured, importation of goods can result in denial of GST credits leaving the franchisor or their agent out of pocket. ATO public ruling GSTR 2003/15 covers importation and GST.

ii Franchisee tax liabilities

Franchisees are subject to the following taxes:

- a* income tax: Australian-owned franchisees are subject to Australian income tax on their worldwide income. Fees paid to a franchisor will generally reduce the Australian taxable income of the franchisee. This may not be the case for payments such as upfront franchise fees and initial training, which may be seen as capital and hence non-deductible expenses;
- b* withholding tax: if withholding tax applies to payments made to foreign residents, the obligation to withhold tax rests with the franchisee. A denial of franchisees deductions will often occur until the withholding tax is paid;
- c* GST: as with foreign franchisors, the franchisee may be the importer of goods and should be aware of structuring issues, which may lead to the loss of GST credits on imported goods; and
- d* foreign exchange: foreign-denominated transactions must be translated into Australian dollars and gains or losses on currency movements are subject to Australian tax. Foreign exchange gains can sometimes be taxed on an accrued basis and not when received.

iii Tax-efficient structures

The key to cross-border franchising is being able to understand the interaction between the two jurisdictions' tax systems to avoid double taxation. This applies for all inbound and outbound transactions, and for both franchisees and franchisors.

There is no single optimal structure and each situation must be evaluated on its facts. Sometimes the use of trusts, partnerships, limited partnerships or hybrid entities can provide a better result by allowing foreign tax credits to pass through, and by avoiding double tax.

VI IMPACT OF GENERAL LAW

Australia is a federation of six states and two territories and has a common law-based legal system. Franchising primarily involves contractual considerations and, hence, the common law and equitable principles of contract developed or adopted by Australian courts play a significant part in franchising. It is not possible in this chapter to even summarise those principles other than to say that they are in many respects similar to those in the United Kingdom and, to a slightly lesser extent, the United States.

i Good faith

The Code mandates that each party or proposed party to a franchise agreement must act towards each other with good faith in accordance with the common law.⁵² A court, in deciding whether there has been a breach of this obligation, may have regard to whether the party acted honestly and not arbitrarily and whether the party cooperated to achieve the purposes of the franchise agreement. Any clause in a franchise agreement that attempts to limit or exclude this obligation will be void.

Parties who act in their legitimate commercial interests are unlikely to contravene this provision. Likewise the Code expressly provides that a franchisor who does not offer an option to renew or right to extend a franchise agreement will not be deemed to have acted contrary to the good-faith obligation.

The existing common law position in Australia is that:

- a* there is to be implied in every franchise agreement a term of good faith and fair dealing that obliges each party to exercise the powers conferred on it by the agreement in good faith and reasonably and not capriciously or for some extraneous purpose; and
- b* the scope of the duty is fettered in that it cannot operate to deny to a party the right to exercise a power conferred by the contract for the promotion or protection of its legitimate commercial interests.⁵³

The former chief justice of the High Court of Australia (Australia's highest appellate court) Sir Anthony Mason has stated⁵⁴ that good faith comprises three notions:

- a* an obligation on the parties to cooperate in achieving the contractual objects;
- b* compliance with honest standards of conduct; and
- c* compliance with standards of conduct that are reasonable, having regard to the interests of the parties.⁵⁵

The consequences of a failure to comply with the good-faith obligation include potential exposure to pecuniary penalties and civil remedies, such as damages, restitutionary orders, injunctions and the like, as well as orders varying the terms of a franchise agreement.

ii Misleading and deceptive conduct

The Australian Consumer Law, which is part of the Competition and Consumer Act 2010 (Cth), prohibits conduct that is misleading or deceptive or that is likely to mislead or deceive.⁵⁶ Allegations of breach of this law are very common in lawsuits and pre-litigation demands. They are also the most common type of allegation made by a franchisee against a franchisor. It is often alleged that a franchisee has been induced by pre-contractual conduct or representations to enter into a franchise agreement and that the conduct or representations

52 Franchising Code of Conduct, Clause 6.

53 *Far Horizons Pty Ltd v. McDonald's Australia Ltd* [2002] VSC 310; *JF Keir Pty Ltd v. Priority Management Systems Pty Ltd* (administrators appointed) 2007 NSWSC 789.

54 In his article 'Contract, Good Faith and Equitable Standards in Fair Dealing' (2000), 116 *Law Quarterly Review* 66.

55 This approach has been cited with approval in a number of cases including *Burger King Corp v. Hungry Jack's Pty Ltd* [2001] NSWCA 187 and *Hughes Aircraft Systems International v. Airservices Australia* (1997) 76 FCR 151. See also *Garry Rogers Motors (Aust) Pty Ltd v. Subaru (Aust) Pty Ltd* (1999) ATPR.

56 Section 18 of the Australian Consumer Law.

were misleading or deceptive. The Australian Consumer Law deems representations as to future matters (for example, earnings projections) to be misleading and deceptive, unless the maker of the representation can prove that it had reasonable grounds for the representation.⁵⁷

The consequences of a finding of misleading and deceptive conduct in a civil suit include awards of damages (assuming a necessary causal link between the impugned conduct and loss can be established), injunctions, orders for refund of money or orders varying or rescinding a contract. If the regulator, the ACCC, brings proceedings, it can, in addition, seek pecuniary penalties, enforceable undertakings, publication orders and orders requiring the offending party to implement a trade practices compliance programme.

These laws are of wide application and also apply to marketing and credence claims in relation to goods and services that are offered for sale. The regulator, the ACCC, has and remains very vigilant in monitoring such activities and, in appropriate cases, seeking pecuniary penalties often in excess of A\$1 million for breaches of these laws.

iii Unconscionable conduct

The Australian Consumer Law also prohibits unconscionable conduct.⁵⁸ The courts have been reluctant to restrict the definition of unconscionable conduct but seem to have settled that it entails conduct that involves:

- a notions of serious misconduct or something that is clearly unfair or unreasonable where the alleged contravener shows no regard for conscience and has acted in a manner that is irreconcilable with what is right or reasonable;
- b normally, some moral fault or moral responsibility;
- c some deliberate (in the sense of intentional) act or at least a reckless act; and
- d a high level of moral obloquy.⁵⁹

The potential consequences of a finding of unconscionable conduct are the same as those for a finding of misleading and deceptive conduct outlined above.

iv Unfair contract terms

Laws that allow courts to strike down or not enforce unfair contract terms⁶⁰ in consumer contracts⁶¹ apply to both franchisors and franchisees. Traditionally franchise agreements have not been considered to be consumer contracts; hence the unfair contract laws have not applied to franchise agreements.

However, legislation recently passed by the Australian Parliament that amends the Australian Consumer Law has the effect of extending the unfair contract laws to a much wider range of small business contracts, including franchise agreements. This new law will apply to a standard form small business contract entered into, varied or renewed on or after 12 November 2016 where three criteria are met:

57 Section 4 of the Australian Consumer Law.

58 Sections 20 to 22 of the Australian Consumer Law.

59 A useful summary is found in *Body Bronze International Pty Ltd & Ors v. Febcorp Pty Ltd* [2011] VSCA 196 at paragraphs 86 to 94.

60 Part 2.3 of the Australian Consumer Law.

61 A consumer contract is defined in Section 23 as a contract for the supply of goods or services or the sale or grant of an interest in land to an individual whose acquisition is wholly or predominantly for personal, domestic or household use or consumption.

- a* it is for the supply of goods or services or the sale or grant of an interest in land;
- b* at least one of the parties is a small business (employs fewer than 20 people, including casual employees employed on a regular and systematic basis); and
- c* the price payable up front is no more than A\$300,000 or, if the contract is for more than 12 months, A\$1 million.

A court or tribunal can declare that unfair terms are void if the following three tests are satisfied:

- a* it would cause a significant imbalance in the parties' rights and obligations arising under the contract;
- b* it is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and
- c* it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on.

The law presumes that a contract is a standard form contract unless the other person proves otherwise (a reverse onus). A court may take account of the following in determining whether a contract is a standard form contract:

- a* whether one of the parties has all or most of the bargaining power relating to the transaction;
- b* whether the contract was prepared by one party before any discussion relating to the transaction occurred between the parties;
- c* whether another party was, in effect, required to either accept or reject the terms of the contract in the form they were presented;
- d* whether another party was given an effective opportunity to negotiate the terms of the contract; and
- e* whether the terms of the contract take into account the specific characteristics of another party or a particular transaction.

In most instances, franchise agreements would be considered to be standard form contracts.

The new law gives examples of terms that may be unfair such as:

- a* terms that enable one party (but not another) to avoid or limit their obligations under the contract;
- b* terms that enable one party (but not another) to terminate the contract;
- c* terms that penalise one party (but not another) for breaching or terminating the contract; and
- d* terms that enable one party (but not another) to vary the terms of the contract.

Certain terms of contracts are not covered by these laws and, hence, cannot be declared void on the ground of unfairness. They are:

- a* terms that define the main subject matter of the contract;
- b* terms that set the price payable up front; and
- c* terms that are expressly permitted by federal and state legislation (for example, terms permitted under the Franchising Code of Conduct.

v Agency distributor model

In theory, in a given case a franchisee could be subject to the laws of agency, whereby it is said that the franchisee is the agent of the franchisor.

If a franchisee was considered to be an agent of the franchisor, the franchisor would be seen as the party contracting with the customer thereby allowing the customer to exercise contractual rights against the franchisor (for example, if goods are defective or not merchantable). It is also conceivable that the franchisor (as principal) might be liable for some debts incurred by the franchisee (as agent).

It is the prospect of these dire consequences that has resulted in nearly all franchise agreements used in Australia making provision that no agency relationship exists. Courts generally will uphold these provisions.

vi Employment law

At federal and state level workplace relations laws exist that regulate the employment of staff by franchisors and franchisees throughout Australia. The Fair Work Act 2009 (Cth) contains a set of employment standards that apply to all workers in Australia.

Franchisees will not be treated as employees of the franchisor unless the relationship is, in reality, an employer–employee relationship but clothed with a sham description such as a franchise agreement or independent contractor arrangement.

On 14 September 2017, the Fair Work Amendment (Protecting Vulnerable Workers) Act 2017 (Cth) was enacted. This law amends the Fair Work Act in a number of respects, but it is the following critical amendments that impact on franchising.

The new law introduces a new civil penalty liability for franchisors. A ‘responsible franchisor’ will contravene the Fair Work Act if one of its franchisees contravenes a civil remedy provision in the Fair Work Act (see below) and either the franchisor or an officer of the franchisor knew or could reasonably be expected to have known that the contravention by the franchisee would occur or, at the time of the contravention by the franchisee, the franchisor or an officer of the franchisor knew or could reasonably be expected to have known that a contravention by the franchisee of the same or a similar character was likely to occur.

A responsible franchisor is a franchisor that has a significant degree of influence or control over the franchisees’ affairs.

The various civil remedy provisions under the Fair Work Act that can be contravened by a franchisee and that can expose a franchisor to the newly proposed statutory liability include:

- a* contraventions of the National Employment Standards;
- b* contraventions of modern awards;
- c* contraventions of enterprise agreements;
- d* contraventions of workplace determinations;
- e* contraventions of national minimum wage orders;
- f* contraventions of equal remuneration orders;
- g* contraventions of provisions dealing with methods and frequency of payment;
- h* contraventions of provisions dealing with methods of payment specified in awards or enterprise agreements;
- i* contraventions of provisions dealing with unreasonable requirements for the employee to spend or pay an amount;
- j* contraventions of provisions dealing with unreasonable requirements for a prospective employee to spend or pay an amount;
- k* contraventions of provisions dealing with employer obligations in relation to guarantees of earnings;
- l* contraventions of provisions dealing with misrepresenting employment as independent contracting;

- m* contraventions of provisions dealing with dismissing an employee to engage as an independent contractor;
- n* contraventions of provisions dealing with misrepresentations to engage an individual as an independent contractor;
- o* contraventions of provisions dealing with employer obligations in relation to employee records; and
- p* contraventions of provisions dealing with employer obligations in relation to payslips.

The new law appropriately limits the franchisor's exposure to liability if at the time of, or prior to, the franchisee's contravention, the franchisor had taken reasonable steps to prevent the contravention. In determining whether a franchisor took reasonable steps to prevent a contravention, a court may have regard to all relevant matters, including:

- a* the size and resources of the franchise;
- b* the extent to which the franchisor had the ability to influence or control the contravening franchisees' conduct in relation to the contravention;
- c* any action the franchisor took to ensure the franchisee had reasonable knowledge and understanding of the requirements under the applicable provisions of the Fair Work Act;
- d* the franchisor's arrangements for assessing the franchisee's compliance with the applicable provisions of the Fair Work Act;
- e* the franchisor's arrangements for receiving and addressing complaints about alleged contraventions within the franchise; and
- f* the extent to which the franchisor's arrangements with the franchisee encourage or require the franchisee to comply with the Fair Work Act or other workplace law.

The new law also provides that where a franchisor has paid to, or on behalf of, an employee, an amount pursuant to an order relating to a contravention by a franchisee, and the franchisor has not been able to recover that amount from the franchisee, the franchisor may commence proceedings against the franchisee.

vii Consumer protection

Franchisees and franchisors who sell goods and services to consumers must comply with the Australian Consumer Law.

The concept of 'consumer' underpins many of the provisions in the Australian Consumer Law. A person can only be considered to have acquired goods or services as a consumer if:

- a* the goods or services were not acquired for resupply or the purpose of transformation in the course of production or manufacture;
- b* the amount paid for the goods or services does not exceed A\$40,000; and
- c* the goods or services were of a kind ordinarily acquired for personal, domestic or household use or consumption.⁶²

Goods or services (including franchise rights) acquired under a franchise agreement will generally not meet these tests.

62 Section 3 of the Competition and Consumer Act 2010 (Cth).

viii Competition law

Australian competition laws⁶³ are extensive and complex. Penalties for breaches of the 'restrictive trade practices' provisions can result in fines of up to A\$10 million, or fines calculated at three times the benefit obtained by the infringer from its illegal activities.

The most common areas under the restrictive trade practices laws that affect franchising are:

- a the prohibition of cartels and cartel provisions (i.e., contracts, arrangements or understandings between competitors that relate to price-fixing, restricting outputs in the production and supply chain, allocating customers, suppliers or territories or bid-rigging);
- b the prohibition of third-line forcing that has the effect of substantially lessening competition (for example, where a franchisor compels a franchisee to purchase goods or services from a third-party supplier); and
- c the prohibition of resale price maintenance (for example, where a franchisor sells goods to a franchisee on the condition that the franchisee will not resell those goods below a certain price).

This list is by no means exhaustive and best-practice franchisors in Australia undertake extensive trade practices training and create and implement compliance programmes.

All the above examples are capable of being effectively sanctioned by the competition regulator (the ACCC) through processes known as 'authorisations' and 'notifications'. A person seeking an authorisation or notification clearly needs to put forward a legitimate case as to why her or she should be allowed to engage in conduct that is otherwise illegal. At a minimum it must be shown that the proposed conduct creates a public benefit that outweighs the detriment associated with the anticompetitive conduct.

ix Restrictive covenants

Non-compete or restrictive covenants contained in a franchise agreement must be carefully drafted. If they are vague, they may not be enforced or, at the very least, be read down to the least restrictive interpretation.

If the non-compete or restrictive covenant goes beyond what is necessary to protect the legitimate business interests of the franchisor (as they were at the time the franchise agreement was executed), it will not be enforceable.

They may also be unenforceable by virtue of Clause 23 of the Code (which only applies to franchise agreements entered into or varied on or after 1 January 2015), which provides that a restraint of trade clause in a franchise agreement or some other associated document will have no effect after the franchise agreement expires if all the following five circumstances exist:

- a the franchisee has sought in writing to extend the franchise agreement on substantially the same terms as those contained in the franchisor's current franchise agreement and that apply to other franchisees or would apply to prospective franchisees;
- b the franchisee was not in breach of the franchise agreement or any related agreement;
- c the franchisee has not infringed the intellectual property of, or a confidentiality agreement with, the franchisor during the term of the franchise agreement;

63 The Competition and Consumer Act 2010 (Cth).

- d* the franchisor does not extend the franchise agreement; and
- e* either:
- the franchisee claimed compensation for goodwill because the agreement was not extended but the compensation given was merely a nominal amount and did not provide genuine compensation for goodwill; or
 - the agreement did not allow the franchisee to claim compensation for goodwill in the event that it was not extended.

They may also be unenforceable by virtue of the new unfair-contract term laws referred to above.

If a franchisee is in breach of a legitimate and enforceable non-compete or restrictive covenant and refuses to cease that conduct, a franchisor may apply to a court for an injunction restraining the franchisee from continuing with the conduct. An injunction can be obtained fairly quickly (at an interlocutory stage in the proceeding) if the court is satisfied there is a serious question to be tried, the balance of convenience favours the granting of the injunction (which often involves consideration of whether damages can provide an adequate alternative remedy) and the applicant (franchisor) undertakes to the court to compensate the franchisee for any loss it suffers if, at the final hearing, the court holds in favour of the franchisee.

x Termination

Termination of a franchise agreement must be effected according to the franchise agreement, the Code or the common law.

A franchisor who has validly terminated a franchise agreement will be able to enforce provisions in the franchise agreement intended to survive termination, such as non-compete or restrictive covenants (provided they are not too wide – see above), confidentiality obligations, prohibitions on ongoing use of intellectual property, return of confidential information and manuals and de-branding obligations.

The ability of a franchisor to effectively take over the terminated franchisee's business will depend on a number of factors such as:

- a* whether the franchisor has rights to occupy leased premises to the exclusion of the franchisee;
- b* whether the franchisor has the right to use or to acquire the hard assets used by the franchisee in operating the business (well-drafted franchise agreements will contain these rights); and
- c* whether the franchisor has the resources to take over operation of the business.

xi Anti-corruption and anti-terrorism regulation

The laws of Australian States and Territories outlaw what is commonly known as bribery.

The Criminal Code 1995 (Cth), while not applying to bribes in the private sector, creates offences relating to the bribery of local and foreign public officials. A company can be held criminally responsible for the actions of its employees, officers or agents acting within the actual or apparent scope of their employment or authority.

The Anti-Money Laundering and Counter-Terrorism Financing Act 2006 (Cth) contains extensive provisions designed to combat money laundering and the financing of terrorism. This legislation imposes various obligations relating to customer identification,

transaction monitoring and suspicious transaction reporting. The money laundering offences are quite wide and extend to receiving, possessing or disposing of money or property that is reasonably suspected of being the proceeds of crime.

xii Dispute resolution

Very few franchising disputes reach adjudication in Australian courts.

The major reasons for this are:

- a* alternative dispute resolution, such as mediation, is extensively used;
- b* litigation is extremely expensive, slow and uncertain; and
- c* it is very difficult to succeed on summary judgment applications.

Although franchise agreements must contain complaint-handling provisions prescribed by the Code,⁶⁴ the right of a party to commence legal proceedings is not affected by those provisions, unless the franchise agreement says so.⁶⁵

It is extremely rare for local franchising disputes to be referred to arbitration in Australia. It is extremely rare for local franchise agreements to provide for arbitration as a means of adjudicating disputes. Nearly all civil cases in Australia (and all franchising cases) are decided by a judge; juries are not permitted and, hence, the fear of the runaway jury does not exist.

Properly drafted exclusive forum provisions in franchise agreements entered into prior to 1 January 2015 will generally be upheld by Australian courts. It is wise to highlight in a disclosure document, or some other document provided to the franchisee before it signs the franchise agreement, the disadvantages the franchisee might face if it is required to litigate or arbitrate overseas.⁶⁶

In respect of franchise agreements entered into on or after 1 January 2015, the Code makes it unlawful to include a clause requiring a party to bring an action or proceeding or conduct mediation in relation to a dispute under the agreement in any state or territory of Australia or any other country other than the state or territory of Australia where the relevant franchised business is located.⁶⁷ Further, any clause in a franchise agreement entered into on or after 1 January 2015 to this effect will not be enforceable.⁶⁸

The procedure for instigating mediation involves:

- a* a party serving on another party a notice of dispute;⁶⁹
- b* attempts then being made to try to resolve the dispute; and
- c* if the dispute is not resolved in 21 days, either party may refer the dispute to mediation; this is done by notifying the Office of the Franchise Mediation Adviser, which will then liaise with the parties and appoint a mediator from its panel of mediators.

64 Franchising Code of Conduct, Clauses 34, 38 and 39.

65 Franchising Code of Conduct, Clause 37.

66 See *Timic v. Hammock* [2001] FCA 74, where the *Subway* forum provision was upheld primarily because of the clear warnings it gave the franchisee before entering into the franchise agreement.

67 Franchising Code of Conduct, Clause 21(2).

68 Franchising Code of Conduct, Clause 21(3).

69 Setting out the nature of the dispute, what outcome the complainant wants and what action the complainant thinks will settle the dispute.

Once a mediator is appointed, a mediation agreement will need to be signed by all parties (including any non-parties who may attend mediation). This agreement will set the ground rules, which will include confirmation of the without-prejudice nature of the discussions, the critical confidentiality obligations and the mediator's fees and the sharing of fees.

The Code also imposes some rules. It requires:⁷⁰

- a* the parties to attend mediation and try to resolve the dispute;
- b* the person attending on behalf of a party having full authority to settle the dispute;
- c* the parties to make clear what they want to achieve from the mediation process; and
- d* the parties not to do things that might damage the reputation of the franchise system.

As stated above, in the absence of a provision in a franchise agreement to the contrary, a party may head straight down the litigation path. This is common if an urgent injunction is required; for example, in circumstances where a terminated franchisee might be continuing to use the franchisor's intellectual property or breaching a valid non-compete provision. Usually, an interlocutory injunction will be sought, which is one that stays in place until the final hearing and determination of the proceeding and at this point no costs orders are made in favour of a successful applicant – rather, they are reserved for later determination.

Subject to this reservation, in most courts in Australia, costs follow the event (the loser is ordered to pay the winner's costs), with the quantum of costs being determined not by what the lawyer charged his client, but by reference to costing scales or concepts of reasonableness.

Enforcement of judgments and arbitral awards in Australia involve court processes, including asset seizure and sale, attachment of debts or earnings and insolvency proceedings.

As a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention), a foreign award (not an award made in Australia in an international arbitration) may be enforced in the federal, state and territory courts⁷¹ as if the award were a judgment or order of that court.⁷²

VII CURRENT DEVELOPMENTS

There are no significant developments in the laws affecting the franchising sector.

70 See the Franchising Code of Conduct, Clause 29.

71 Under Section 8(2) and (3) of the International Arbitration Act 1974 (Cth).

72 See article by Justice Rares of the Federal Court of Australia at www.fedcourt.gov.au/publications/judges-speeches/justice-ares/Rares-J-20110914.rtf.

AUSTRIA

Eckhard Flohr and Alfons Umschaden¹

I INTRODUCTION

Just as in Germany, franchise systems have developed very slowly in Austria, but Austria now has a flourishing franchise industry. In particular, international franchise systems such as Burger King and McDonald's are very successful in Austria.

Most German franchise systems are likely to move into to Austria as the first step of the international development of their franchise system, so that virtually all the German franchise systems are also present in Austria, such as Fressnapf, Zoo & Co, Studienkreis, Schülerhilfe, ISOTEC or hagebaumarkt.

Austria has not yet enacted a franchise act of its own, so the principle of contractual freedom exists. It must, however, be borne in mind that Commission Regulation (EU) No. 330/2010 on the application of Article 101 of the TFEU to categories of vertical agreements and concerted practices (vertical agreements) also directly applies in Austria, and is national law; however – just as in Germany – the provisions of general civil law, commercial law, corporate law, competition law, antitrust law, consumer protection law and employment law, as well as the corresponding decisions of the Austrian Supreme Court (OGH) must be complied with when franchising agreements are drawn up. Finally, the general contractual provisions, as well as the provisions relating to industrial and intellectual property rights and, in certain circumstances, aspects pertaining to tenancy law or fiscal law, must also be observed.

II MARKET ENTRY

In Austria there are no restrictions on foreign franchisors. Master franchise contracts can be closed directly between a foreign franchisor and the Austrian master franchisee or the Austrian franchisor running the franchise outlet (direct franchising).

No franchise regulation nor any disclosure requirement exists in Austria.

III INTELLECTUAL PROPERTY

Through a franchising agreement, the franchisor grants the franchisee the right of use of its trademark rights. An informal agreement is sufficient to validly grant the licence. It can also be agreed that the franchisee's entitlement to use the trademark is recorded in the trademark

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register.² A registration of the trademark register is, however, not a necessary prerequisite for the franchisee to be entitled to use the trademark. It may be stipulated in the franchise agreement that certain types of use of the mark, for example, in advertising, require the franchisor's consent.

Signage has major economic significance to the success of a franchise system, and the franchisor must vouch for the fact that its rights are being validly maintained. Such signage is a 'property usually required in commerce' within the meaning of Section 922 of the Austrian Civil Code (ABGB), so that if it is lacking, the franchisee may be entitled to assert warranty claims. A complete exclusion of any such claims is generally considered unethical under Section 879 of the ABGB. The franchisor is required to protect the intellectual property rights accordingly. In addition, the franchisee is also entitled to assert the right to pursue infringements of intellectual property rights, as the mark ranks among the trademarks protected under Section 9 of the Austrian Act on Unfair Competition.

The 'trade dress' plays an important role if the franchise system is operated in the form of a retail outlet (e.g., a special interior, choice of colour, staff uniform and packaging). The protection of trade dress is not dependent upon registration; it must, however, have gained public recognition.

The protection of the company or its name begins with its registration in the commercial register.

IV FRANCHISE LAW

i Legislation

As previously mentioned, Austria has no special law on franchising or a disclosure requirement law. Franchise contracts and even master franchise contracts have to be drafted according to the rules of the ABGB, the Antitrust Law, the Enterprise Law (UGB) and the rules of the labour and consumer protection regulations and the rules of the EU block exemption on vertical restraints.³

Of interest in relation to the drafting of franchise agreements are two booklets published by the Austrian Federal Competition Authority: the first one covers franchise systems and price policy, and the second deals with compliance regulations. Both booklets are relevant for franchisees as well as for franchisors.⁴

ii Pre-contractual disclosure

There are no disclosure requirements by law with which a master franchisee is obliged to comply. The main points are set by the jurisdiction of the OGH. A franchisee or master franchisee has to be informed about all points that are relevant to the decision of the franchisee or master franchisee to close the franchise or master franchise contract. This may refer to information concerning:

- a the local market situation;
- b the expected turnover of the franchise outlet;
- c a business plan for building up the franchise system in Austria (optional);

2 Section 25(1) of the Austrian Trademark Protection Act (MaSchG).

3 EU VO 330/2010.

4 www.bwb.gv.at.

- d* the competitors;
- e* the importance of the franchise system in Austria;
- f* number of franchisees (local or international);
- g* franchisees leaving the franchise system, especially for what reason during the final year for closing the franchise contract;
- h* intellectual property rights of the franchise systems; and
- i* information about the master or local franchisee franchise contract.

The type of information that has to be disclosed depends on the franchise contract. Normally, franchisors in Austria have a disclosure requirement document giving the potential franchisee all such relevant information.

Foreign franchisors should look to the guidelines of pre-contractual information by the Austrian Franchise Association (ÖFV), but these guidelines are not binding on the courts in Austria.

Most franchise contracts concluded by a German master franchisor with an Austrian master franchisor, or local franchisees directly with the German franchise headquarters, have a choice of German law. Therefore the most recent decisions of German courts of appeal⁵ are also important in relation to pre-contractual disclosure in Austria and the information to be delivered to potential master franchisees when concluding a master franchise agreement, and to local franchisees concluding a direct franchise contract.

iii Registration

There are no registration requirements for foreign franchisees or Austrian franchisees, and no rule is expected in the future. Membership of the ÖFV is not mandatory but may be useful for recruiting franchisees in Austria.

iv Mandatory clauses

Franchise contracts

A franchise agreement is characterised as a *sui generis* agreement, which incorporates elements of a licence agreement, as well as the types of agreement regulated by national law, such as commercial agency agreements, sales contracts, urban and usufruct leases, loan agreements, and memoranda and articles of association. The main purpose of a franchise agreement is the transfer of expertise developed by the franchisor.

Franchise agreements give rise to ongoing obligations, as they are concluded for a particular period and not just for a one-off performance on the part of the franchisee. This leads to a permanent mutual duty of care, and thus also increased significance is given to good faith.

The conclusion of a franchise agreement is, in principle, not subject to any condition regarding form, and, in certain circumstances, may be assumed through conduct that may imply consent to the terms and conditions suggested. The written form is therefore not a legal prerequisite for the franchise agreement to be considered valid. It is, however, advisable, for reasons relating to evidence, to conclude a franchise agreement in writing.

5 OLG Düsseldorf, ZVertriebsR 2014, 46; OLG Hamburg, ZVertriebsR 2015, 78 – Tom Taylor; OLG Dresden, ZVertriebsR 2016, 320 – Krankendienst; OLG Frankfurt, ZVertriebsR 2016, 313 – Haarentfernung.

Franchisor

The franchisor is to be introduced in the recitals of the franchise agreement. In particular, a brief outline of the history and development of the franchise must be given, as well as a summary of the key elements characterising the particular franchise.

Franchisee

Detailed provisions in regard to the franchisee's legal personality must be included in the franchise agreement. The question of legal personality entails particularly that it has to be checked whether the franchisee is a natural or legal person (partnership or company). A supplementary agreement to the franchise agreement may also be concluded concerning the franchisee's company, if necessary.

The franchisee is not a representative of the franchisor, and also has no authority to transact business on behalf of any third party. For this reason, it should be explicitly regulated in the franchise agreement that the franchisee does not represent the franchisor, and that the franchisor is freed by the franchisee from responsibility for any third-party claims made because of the actions of the franchisee.

Recitals

It is always advisable to precede a franchise agreement with recitals, in which the history of the emergence and basis for the franchise system are explained. Recitals are of legal significance for establishing the inherent purpose of the provisions set out in the agreement (the commercial basis). They may therefore also serve the purpose of examining the question of whether it is possible to adjust the franchise agreement, or even terminate it in accordance with the principles of the commercial basis lapsing.

Franchise systems fees

Most franchise agreements provide for the payment of an initiation fee, a franchise fee and an advertising fee.

The initiation fee is not a fee for ongoing services provided by the franchisor, but a consideration in return for the expertise developed by the franchisor and passed on to the franchisee. It should therefore be laid down in the franchise agreement that, should the agreement be dissolved for any reason, the latter is not returned to the franchisee.

Franchise fees are paid to the franchisor by the franchisee, usually on a monthly basis. They are, in the vast majority of cases, calculated based on the total net sales generated by the franchisee. Since total net sales are usually taken as a basis, spin-off products that the franchisee sells may also be included in the calculation when establishing the figure, unless anything has been agreed in the franchise agreement to the contrary.

The average fee of this type in Austria in 2006 was 5.37 per cent of the corresponding total net sales achieved. In some systems, however, these may as well be significantly above that figure. It is also possible to agree that a fixed monthly amount be paid. Furthermore, it may be laid down in the franchise agreement that, in the event of certain total net sales not being achieved, the franchisee still has to pay a minimum franchise fee.

The obligation to pay fees should be differentiated from the obligation to contribute towards advertising expenses. This entails franchisees making a certain contribution, usually

calculated as a percentage of the total net sales, towards the national or regional advertising to be carried out. Such contributions are earmarked for a specific purpose, and should be used by the franchisor in accordance with the established purpose.

Transfer of expertise (know-how)

The transfer of the relevant expertise is an essential component of the franchise agreement, as the franchisor hands over to the franchisee complete instructions for operations.

In accordance with the guidelines of the EU Commission on vertical agreements, the expertise being imparted to the franchisee is a necessary prerequisite for the agreement to qualify as a franchise agreement. Should no expertise be transferred, it will be considered only a licence agreement.

The ÖFV Code of Ethics defines 'expertise' as a package of non-patented practical information based on experience of and trials conducted by the franchisor, which is secret, substantial and identifiable. According to the statements contained in the ÖFV Code of Ethics, 'secret' means that the substance, structure or precise composition of the components of the expertise is not generally known or not easily accessible, in regard to which the word 'not' is to be understood in the narrow sense, so that each individual part of the expertise ought to be entirely unknown or unavailable outside the franchisor's business. According to the ÖFV Code of Ethics, the expertise is deemed 'material' if it covers knowledge that is indispensable for the franchisee concerning the use, sale or resale of the contractual goods or the provision of the contractually agreed services. The expertise is in particular indispensable for presenting the goods intended for sale, processing products in the context of the provision of services, the manner in which customers are served, and conducting business from an administrative and financial perspective. The expertise moreover has to be useful to the franchisee. A further prerequisite is that the expertise needs to be identified. This means that the expertise must in any case be described in sufficient detail for it to be possible to check whether the features of secrecy and materiality are being fulfilled.

The description of the expertise may be included in either the franchise agreement, the handbook or the guidelines, which usually form part of the agreement.

The expertise should be documented in the 'franchise handbook', which accompanies the franchise agreement. Both are connected by means of dynamic references (i.e., it is laid down in the franchise agreement that the franchisee is required to use the applicable version of the franchise handbook).

Legal succession

In the event of the franchise agreement not containing any provisions on legal succession, it will end upon the death of the franchisee. Just as in the case of an agency agreement or commercial agency agreement, the activity undertaken by the franchisee based on the franchise agreement is personal, and thus relates to an individual. The franchise agreement is concluded based on the personal qualifications of the franchisee, which is why the franchisor has an interest in the franchisee personally fulfilling the obligations arising from the agreement.

Usually a legal succession clause is agreed in franchise agreements, to give the franchisee's heirs the opportunity to continue to carry on the franchise operations. The case may be different, however, if a franchise agreement is concluded with an Austrian private company limited by shares. Should the majority shareholder of the franchisee's company die, the franchise agreement will only lapse if, pursuant to the memorandum and articles of association, the death leads to the dissolution of the franchisee's company, and thus

its liquidation. Notwithstanding the latter, the provision that the death of the majority shareholder is a reason for terminating the franchise agreement can, of course, also be included in the franchise agreement.

Contractual period

Certain limitations in regard to the contractual period in particular arise from Sections 864a and 879 of the ABGB), Section 6(1)(1) of the Austrian Consumer Protection Act (KSchG), and the Commission Regulation (EU) No. 330/2010.

A long contractual period in conjunction with an exclusive obligation to purchase from the franchisor may, in certain circumstances, be deemed unethical gagging. Drawing upon the case law on the beer supply contracts, a contractual period of 20 years appears to come very close to being the upper limit that can be tolerated. Classing an excessive contractual period as gagging is based on the restriction of the economic independence of the purchaser contained therein. According to the requirements of the ÖFV Code of Ethics, the contractual period should be limited in such a way that the franchisee can amortise his or her initial investments. Depending on the circumstances of the case, a contractual period exceeding 20 years may also be justified in franchising. This is particularly the case with investment franchise agreements or master franchise agreements.

Subsidiary provisions

It should be agreed in franchise agreements – in the final or subsidiary provisions – that any amendments and additions or supplementary provisions to the agreement need to be laid down in writing to be legally valid, which is also supposed to apply to setting out a provision dispensing with the requirement for the written form. In addition, there should be no subsidiary verbal agreements supplementing an agreement, to prevent problems to obtain the necessary evidence from occurring should a lawsuit be initiated.

Usually, in the final provisions a severability clause is also agreed upon, which, in the event of any provisions of the agreement being or becoming invalid, should stipulate that the validity of the remaining provisions of the agreement should not be affected, and that the latter will therefore remain valid. It is consequently usually agreed in the agreement that a void or invalid provision be reinterpreted or supplemented in such a way that the economic purpose intended with the void or invalid provision is achieved as precisely as possible, and that the latter is also supposed to apply to any loopholes in the agreement.

V TAX

i Franchisor tax liabilities

Austria has nearly the same corporate income tax system as in Germany, but the rates to be paid by franchisors in the legal form of a corporation differ in Austria. At the moment those rates are under political discussion, and a tax reform is to be expected next year.

The franchisor is not liable for any taxes to be paid by the franchisee. On the entrance fee and the royalties, 20 per cent VAT has to be paid.

For income tax purpose, the entrance fee is usually recognised over the term of the franchise. The part of the fee that represents payment for initial services can be recognised as a business expense in the first year. Franchise fees and royalties are subject to withholding if the franchise agreement does not expressly stipulate which portion of the franchise fee is

a royalty payment and which part is paid for service; the tax authorities will assess the portions according to their experience. Austria has double-taxation treaties with a large number of countries, which often allow exemptions to be applied for.

ii Franchisee tax liabilities

The franchisee is liable for corporate income tax if it is a corporation. If the franchisee is a natural person or a partnership, he or she is liable for income tax.

Franchisees often pay themselves a salary as CEO of the franchisee company to pay income tax rather than corporate income tax. Such a salary needs to reflect the market and the salaries normally paid. If the salary substantially strips out all profits or is otherwise unusual, this can lead to a challenge by the tax authorities.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Good faith and fair dealing is central to Austrian contract law,⁶ similar to the German contract law. As the franchisor and the franchisee are working together on a long-term franchise contract, there is an implied obligation of good faith that applies to both parties. As a result, the franchisor needs to consider the impact on the franchisee before exercising a remedy or imposing a new system standard. The main practical example of how good faith affects franchising is the requirement that changes to the manual are subject to the requirement of good faith: the franchisor may only impose changes while taking into account the reasonable interests of the franchisee – this is the loyalty to which the franchisor is entitled.

ii Agency distributor model

The UGB came into force in Austria on 1 January 2007. According to the provisions of the UGB, ‘enterprise-related transactions’ refers to all transactions of an entrepreneur that form part to the operations of his or her company. Transactions that a natural person concludes before taking up the operations of his or her company to create the prerequisites for the latter do not yet count as enterprise-related transactions.

What is significant when applying the UGB is Section 454 is that when the franchise agreement is terminated a franchisee is entitled to assert a claim to compensation for investment for any investments not amortised as at the agreement being terminated, as long as the latter have been initiated by the franchisor.

iii Employment law

The franchisee has to work as an independent salesman, running the franchise outlet at his or her own risk. Therefore the franchisee must have his or her own:

- a* price policy;
- b* running of the franchise outlet; and
- c* staffing decisions.

⁶ Sections 863 II and 914 of the ABGB.

If franchisees do not have these rights, they are not independent – they are employees of the franchisors. The guiding decisions in Germany of the Labour Supreme Court and the Civil Supreme Court are also the leading decisions in Austria.

iv Consumer protection

In the past, franchisees were supposed to be briefed, if necessary, about their right of withdrawal in accordance with the provisions of the Austrian Consumer Protection Act. On 13 June 2014, the Implementing Act on the EU Directive on Consumer Rights came into force. With this law a uniform right of revocation was introduced in all EU Member States, and thus also in Austria.

In other words, when concluding a franchise agreement the founder of a new business must be briefed on the 14-day right of revocation available to him or her, in Austria as well. Should the information on revocation not be provided or not be in line with the legal requirements, the franchisee may revoke his or her declaration of intent given with a view to concluding the franchise agreement, even after 14 days have expired; however, in the interests of legal certainty, this right of revocation will lapse one year and 14 days after the franchise agreement has been closed.

Following a recent judgment by the OGH,⁷ if the franchise agreement has been concluded by a consumer franchisee and certain franchise-agreement regulations are thus rendered invalid because they are in conflict with consumer protection law, the franchisee and the franchisor have to conclude an amendment stipulating that the required regulations are obligatory as the franchisee has now become an entrepreneur.

v Competition law

Austria is one of the 28 EU Member States and as such European competition law principles apply. There are some local issues around the interpretation of the Vertical Restraints Block Exemption and its impact on franchise agreements. Generally, it is thought that a purchase tie in a franchise system should not exceed the 80 per cent threshold set out in the Vertical Restraints Block Exemption.

Price-fixing is, according to the Vertical Restraints Block Exemption, not allowed and normally franchise contracts last for five years if the franchisee is obliged to sell only products of the franchise system to customers and the purchase and sale of other products is not allowed.

The Austrian antitrust authorities have recently published guidelines for the pricing policy of franchise systems as well as other distribution contracts, but they are not binding on the Austrian courts.

For example, the following are not allowed:

- a* verbal or written agreements fixing prices or minimum prices;
- b* agreements for paying provisions to franchisees if they agree that the recommended prices are fixed prices;
- c* obligations for franchisees to pay penalties if they do not agree that the recommended prices are fixed prices; and
- d* agreements monitoring the pricing policy of a franchise.

⁷ OGH 21 January 2015 – 3 Ob 186/14w ZVertriebsR 2015, 389.

Example clauses are allowed concerning:

- a* recommended prices;
- b* fixed maximum prices; and
- c* price monitoring of franchise competitors.

If a franchisor commits a breach of competition law (e.g., price-fixing in relation to the franchisees), the OGH⁸ has fixed new principles for the determination of the penalties to be paid to the Austrian Competition Authority.

vi Restrictive covenants

Non-compete clauses may only be agreed within the scope of antitrust provisions, and should be restricted by the limit of unconscionability in accordance with Section 879 of the ABGB. Accordingly, a geographically unlimited competition clause would inherently cause concern during the currency of a contractual relationship.

Because of the existing interest in maintaining and extending the franchise system, a geographically unlimited non-compete obligation will also be permitted during the period in which the franchise agreement is being maintained. According to Commission Regulation (EU) No. 330/2010, and the Commission Guidelines, the latter is permissible, subject to certain prerequisites, under antitrust law.

In accordance with the provisions of Commission Regulation (EU) No. 330/2010, if the percentage of goods sold being purchased from the franchisor amounts to over 80 per cent of the amount spent on purchases, non-compete clauses may only be agreed for a maximum of five years, unless the exemption clause of Article 5 of Commission Regulation (EU) No. 330/2010 comes into force. According to this, the five-year limitation does not apply if the contractual goods or services are sold by the franchisee on the premises and in grounds that are the property of the franchisor, or are rented by the latter on either a usufructuary or an urban basis, from third parties not connected with the franchisee, and the non-compete obligation does not extend beyond the period in which the franchisor uses the premises and grounds.

From the sixth year onwards, the franchisee is entitled to sell competing products, at least to the extent of 20 per cent of the initial purchase value. This regulation has led to a situation in which only an initial contractual period of five years may be agreed in the case of a franchise agreement with 100 per cent of the goods sold being purchased from the franchisor, and then the parties subsequently conclude another franchise agreement that is, in turn, of five years' duration.

Furthermore, according to Commission Regulation (EU) No. 330/2010, post-contractual non-compete obligations are only permissible for a maximum period of one year following termination of the franchise agreement, as long as the non-compete obligation refers to goods and services that are in competition with the contractual goods or services, relates to premises and grounds from which the franchisee has operated its business during the contractual period, and is vital to protecting the expertise transferred by the franchisor to the franchisee. In all other cases, post-contractual non-compete obligations under Commission Regulation (EU) No. 330/2010 are not legal.

8 OGH 8 October 2015 – 16 Ok 2/15b ZVertriebsR 2015, 391.

Limitations on the legality of non-compete obligations may also arise from Section 879 of the ABGB. Accordingly, non-compete obligations are generally only permitted to a very limited extent. This is mainly justified by the aim of protecting the free and unimpaired exercise of a profession. To assess the legitimacy of a non-compete obligation, initially the valid interests of both parties need to be determined. The technical, geographical and time limits of the legitimacy of the non-compete obligation will emerge upon weighing up the considerations in this way. These depend substantially on the product and features of the market in question.

vii Termination

Termination of the agreement

Like any agreement, the franchise agreement can be amicably dissolved by agreement between the parties. Franchise agreements are often concluded for a certain period, so that the franchise agreement ends upon the expiry of the agreed period. The parties are essentially free in determining the length of the period.

Even in the event that the application of the KSchG is in principle assumed, the right of termination in accordance with Section 15 does not apply. Section 15 of the KSchG covers sales contracts and comparable agreements. Within a franchise system, the franchisor provides recurring services, in particular consultancy and support services concerning marketing or organisational activities.

In accordance with Section 21(1) of the Commercial Agents' Act (HVertrG), if the agreement has been concluded for an indefinite period it may be dissolved by either party in the first contractual year by giving one month's notice. After the second contractual year has commenced, however, the notice period will be at least two months, and after the commencement of the third contractual year at least three months and so on until the sixth and following contractual years, when the notice period will be six months. When calculating the duration of the notice period, in the case of agreements entered into for a specific period but then extended for an indefinite period in accordance with Section 20 of the HVertrG, the contractual period of the defined-term agreement entered into must be included in the calculation. These legal concepts also apply to the termination of franchise agreements.

The basic concept of not permitting termination out of season may, however, be taken into consideration when making analogies in law concerning the termination of ongoing commitments.

Ongoing commitments of indefinite duration may also be ended by giving notice of termination in the absence of contractual arrangements. This right may generally not be entirely excluded through contractual provisions. This right of termination does not, however, exist if it would conflict with the purpose of the agreement. Whereas it does actually follow on from the legal nature of the franchise agreement that long-term cooperation between the contracting parties is intended, it does, however, not follow on that the latter should only end in cases of extraordinary dissolution.

In principle, parties are at liberty to agree termination dates and deadlines for dissolving a franchise agreement. Essentially, a waiver of termination may also effectively be submitted for a specific period. The limit for the legitimacy of termination agreements is formed, *inter alia*, by immorality. For instance, it may, in certain circumstances, be immoral for the franchise agreement to stipulate that the franchisor has a right of termination in the event of unsatisfactory sales if the same is not also conceded to the franchisee.

The analogue application of commercial agency law to franchise agreements is also affirmed by the OGH, where typical causes concern both the termination of the agreement and the claim to compensation. Section 22 of the HVertrG provides for the dissolution of commercial agency agreements for a significant reason.

According to Section 22 of the HVertrG, the following circumstances are in particular deemed to be important reasons entitling the principal to dissolve the contractual relationship prematurely:

- a* the commercial agent becomes incapable of carrying out his or her activities;
- b* the commercial agent is guilty of an act that makes him or her appear unworthy of the principal's trust, particularly if, contrary to the provision of Section 7 of the HVertrG, he or she accepts a reward when he or she transmits orders to the principal that have not been placed or if he or she otherwise engages in deception in regard to essential business matters;
- c* the commercial agent, after a period deemed considerable according to the circumstances, ceases to work for the principal, or refuses to do so, or if he or she infringes any other essential contractual provisions;
- d* the agent is guilty of violence against or substantial defamation of the principal; and
- e* insolvency proceedings are instituted against the assets of the commercial agent.

The commercial agent in turn is entitled to dissolve the contractual relationship prematurely, if:

- a* he or she is unable to carry out his or her work; or
- b* the principal:
 - unduly curtails or retains commission due to the commercial agent or infringes other essential contractual provisions;
 - is guilty of violence against or substantial defamation of the commercial agent; or
 - gives up carrying on the operations in the line of business in which the commercial agent is primarily involved.

Pursuant to Section 21 of the Austrian Insolvency Code (KO), in the event of mutual agreements not having been entirely fulfilled by both parties, the insolvency administrator will be entitled either to fulfil the contract and demand the consideration or to withdraw from it. In the second case, the other contracting party will actually be entitled to assert a claim for compensation for damages, this may only be filed as a claim against the insolvency estate.

In the event of insolvency, the insolvency administrator is entitled to assert a statutory right of continuation for 90 days from the insolvency proceedings being instituted during which its claims to segregate items from the assets involved in the insolvency proceedings (e.g., to require the handing over of trademarks or machinery of the franchisor) cannot be asserted⁹ and the contractual agreement of a right of withdrawal or the dissolution of the agreement in the event of composition proceedings being instituted is usually inadmissible.¹⁰

Should the franchisee die, the franchise agreement will, in the event of doubt in the matter, lapse upon his or her death, since he or she is usually obliged to be personally involved in the day-to-day operations. The case may be different if a franchise agreement is concluded with an Austrian private company limited by shares. Should the majority shareholder of the franchisee's company die, the franchise agreement will lapse only if, pursuant to the

⁹ Section 11(2) of the KO.

¹⁰ Section 20e(2) of the Code on the Austrian Insolvency and Composition Proceedings.

memorandum and articles of association, death leads to the dissolution of the franchisee's company and its liquidation. Notwithstanding the latter, the provision that the death of the majority shareholder is a reason for terminating the franchise agreement can, of course, also be included in the franchise agreement.

Legal consequences of termination of the agreement

Upon termination of the franchise agreement, the franchisee will lose its right to use the trademarks, business designations, logos and other promotional or business symbols of the franchisor. Any operating resources owned by the franchisor are likewise to be returned. In the event of any doubt, the franchise handbook, as well as any additions, will cover the matter. The franchisee may not continue to use the items once the franchise agreement has been terminated.

According to the case law of the OGH, the provisions on the obligation to disclose customer data laid down within the scope of the franchise agreement are also to be deemed 'justified interests' of the franchisor within the meaning of Section 8 of the Austrian Data Protection Act.

An obligation on the part of the franchisee to cease and desist from selling goods or providing services for payment of the franchisor once the agreement has been terminated may arise from a direct contractual provision, for example, from a post-contractual prohibition of competition,

Abuse of signage under Section 9 of the Austrian Act on Unfair Competition (UWG) is usually not to be seen in post-contractual sales, insofar as original products are concerned, since no likelihood of confusion regarding the origin of the goods exists in that case. It should, however, be set out in the franchise agreement that such products are bought back by the franchisor when the franchise agreement is terminated, if applicable applying a mode of calculation for the purchase price already set out in the franchise agreement (cost price minus X per cent).

Should the former franchisee give the impression that he or she is still the franchisee in his or her sales activities, or at least an authorised dealer or contractual partner of the franchisor, this conduct may, in certain circumstances, be deemed an anticompetitive 'exploitation of third-party reputation' under Section 1 of the UWG.

Any claims to compensation for damage will be governed by the general regulations under the Austrian law of obligations.

An unauthorised termination by the franchisee may lead to claims for compensation on the part of the franchisor. The franchisor will, however, be obliged to keep its losses to a minimum by engaging in an appropriate protective transaction; for example, by concluding a new franchise agreement with a third party. The case law states that, in consideration of the mutual interests of the parties as well as when assessing the question of whether there is a reason for early dissolution, the assessment of the legislator regarding the premature dissolution of an agency agreement is to be taken as the basis of reasoning.

From the perspective of contract law, the question arises whether the franchisor is in a position to relieve itself of liability. In this respect, the limitations of Section 879(3) of the ABGB are to be observed. Liability exemption will always be inadmissible and void if it puts the other party – in this case, the franchisee – severely at a disadvantage.

According to the case law, excluding liability for harm deliberately caused is unethical, and therefore irrelevant, but it is legitimate to exclude liability for slight negligence. The explicit or tacit agreement of the exclusion of liability for gross negligence is admissible

insofar as it is not unethical. Conduct being unethical should be assumed in the event that the negligence taking place is so blatant that, in light of the experience gained from daily life and based on honest commercial practice, the conduct cannot be condoned.

Following termination of the agreement, the former franchisee is required to refrain from disclosing the franchisor's expertise, even without express provision having been laid down. The parties may agree that the prohibition on the disclosure of expertise should apply for an indefinite period, and thus not be subject to any limitations.

Compensation claims

Commercial agency

For the franchisee, there is no separate legal provision regarding the question of whether he or she is entitled to assert a claim for compensation once the franchise agreement has been terminated. Such claims are only regulated for commercial agents in Section 24 of the HVertrG. According to this provision, a commercial agent is entitled to assert a claim to compensation if and to the extent that:

- a it supplies the principal with new customers or has considerably extended already existing business relationships;
- b it is to be expected that the principal or his or her successors in right can also draw benefits from these business relationships, even after the contractual relations have been dissolved; and
- c the payment of compensation, taking into account all the circumstances – in particular the commission payments due to the commercial agent arising from business transacted with the customers concerned – is equitable.

In a decision in April 1991,¹¹ the OGH affirmed the application of Section 24 of the HVertrG to franchisees for the first time. The OGH linked to its previous decisions on the analogous application of Section 24 of the HVertrG to licensed dealers and on the comparability of the tasks of the licensed dealer with those of the franchisee.

In the opinion of the OGH, the legal status of a franchisee can certainly be compared with that of a licensed dealer. In the case of a franchise relationship, the integration into the distribution system could even be closer than between manufacturers or intermediate distributors and their licensed dealers. This is allegedly the case if the franchisee's dependence upon the franchisor extends to virtually all matters of business management, wherein the entire management activities are largely geared towards the instructions of the franchisor, which also has extensive monitoring rights.

Compensation for investment

Section 454 of the UGB determines that, when the contractual relationship with the franchisor is terminated, a franchisee has a claim to compensation for investments that, according to the distribution undertaking (franchise agreement), it was obliged to make to ensure uniform distribution, as long as the latter are neither amortised nor reasonably utilisable once the agreement comes to an end. Both material and staffing expenditure are covered.

¹¹ OGH, 10 April 1991 – 9 Ob A 8.9 /81 *Commercial Law Review* 1991, 332; see also the recent judgment: OGH, 1 March 2017 – 5 Ob 72/16y *ZVertriebsR* 2017, 397.

Section 454 of the UGB covers both investments and expenditure. Both material and staffing expenditure fall under the latter. The following can be compensated:

- a* marketing expenses;
- b* advertising expenditure;
- c* expenses for trade fair presentations;
- d* expenses for maintaining the sales organisation;
- e* expenses for setting up the sales premises;
- f* expenses for developing a warehouse for spare parts;
- g* costs of providing the business with the appropriate special tools;
- h* expenses for designing and redesigning the headquarters;
- i* specific personnel costs (equipping the staff employees); and
- j* the costs of CPD and vocational training.

It is to be borne in mind that investments that exceed the contractual obligation are not covered by the claim to compensation for investments.

A claim to compensation for investment will, in accordance with Section 454(2) of the UGB, not arise in the event that:

- a* the franchisee has terminated the contractual relationship or dissolved it prematurely ('self-termination'), unless there was a significant reason for the latter, attributable to the franchisor;
- b* the franchisor has terminated the contractual relationship or dissolved it prematurely based on a significant reason attributable to the franchisee ('termination without notice for a significant reason'); or
- c* in accordance with an agreement with the franchisor, the franchisee has imposed the rights and obligations to which he or she is subject in accordance with the franchise agreement upon a third party ('transfer of contract' or 'sale of business').

It is, moreover, explicitly regulated in Section 454(5) of the UGB that the claim to compensation under Section 24 of the HVertrG is not affected, since the latter is in fact oriented towards a service that is different from the claim to compensation for investment, and pursues a different aim.

viii Anti-corruption and anti-terrorism regulation

Bribery and corruption are criminal offences in Austria, but there is no requirement for Austrian franchisors to carry out any background checks on potential franchisees.

Anti-terrorism regulation in Austria has no impact on franchise systems or the drafting of franchise contracts.

ix Dispute resolution

The franchise agreement has to set out which court has jurisdiction to decide on any legal dispute, should one arise, so including an agreement conferring jurisdiction is imperative for a franchise agreement. Since franchise agreements with foreign franchisors are also often concluded in Austria, it has to be established in the scope of the agreement that in the event of any dispute the law of the Austria will apply. Although international franchise agreements

usually stipulate that the law of the franchisor's jurisdiction applies, this practice tends to be rejected by Austrians; Austrian franchisees are usually only prepared to sign a franchise agreement – even with foreign franchisors – if the application of Austrian law is agreed.¹²

In franchise agreements, however, and particularly with foreign franchisors, resolving disputes through an arbitration court is generally preferable to pursuing a case through the ordinary courts, so the franchise agreement should be supplemented by an arbitration agreement. Use of the regulations of recognised arbitration institutions is generally recommended.¹³ Whether taking the route to such an arbitration court is expedient has to be decided on a case-by-case basis.

In many cases, it is also laid down in franchise agreements in Austria that resolution of legal disputes should be attempted with the aid of a mediator prior to initiation of a judicial dispute (before the state or arbitration courts). To that extent, it has to be established in the franchise agreement that such mediation is to be undertaken, and that the failure of mediation is a procedural prerequisite to any kind of action being filed. The failure of the mediation, therefore, has to be made explicit by the mediator.

Furthermore, it must also be set out within the franchise agreement that measures of provisional legal protection are excluded from the scope of application of the mediation process, or of the arbitration court, and only the courts of the state court system are competent to deal with such measures.

VII CURRENT DEVELOPMENTS

Currently, no general franchising or special disclosure requirement law is expected.

12 The exception to this is that franchise contracts concluded directly with German franchisors are generally governed by German law.

13 Generally, the regulations of the International Chamber of Commerce, which has its headquarters in Paris.

BARBADOS

Giles A M Carmichael¹

I INTRODUCTION

In 1978, 12 years after the grant of political independence, Barbados in a declaration of its positive interest in itself, proclaimed the island open for business and as such a number of franchises were established. These franchises included the Hilton (1978), the Holiday Inn (1979), Kentucky Fried Chicken (1979), Coca-Cola and Sprite (1978). Today the franchise sector has grown substantially with the presence of numerous American petroleum stations, warehouses, hotel and accommodation chains, business services and a select few American restaurants. Names such as Shell (now Sol), Kentucky Fried Chicken, Hilton, Marriott, Radisson, PriceSmart and Esso are now virtually household names in Barbados.

Within the past 10 years, Barbados has seen a commendable development in the franchise sector with the acquisition of franchise licences by international franchises such as Subway, Burger King, Payless ShoeSource and Cost-U-Less.

The franchise sector in Barbados is governed by the Franchises (Registration and Control) Act, Chapter 179 of the Laws of Barbados. The Act was first established in 1975 and later amended in 1991.

As is the case in many Caribbean countries, Barbados does not have a 'franchisor culture'. Instead, it represents more of an expansion area for foreign franchises, and in most instances, for product or service distribution. Hence, Barbados is more of a franchisee area, where franchise licences are granted for the operation of foreign franchises. In fact, the sole example of a local franchisor is Automotive Art, the leading auto care retailer in the Caribbean. This local success story has 21 franchise stores operating throughout the region and their branded products are distributed in 65 countries across the globe.²

The main thrust of franchising in Barbados lies with product distribution franchises that hold franchise licences to manufacture, process or distribute certain international brands. A relevant example is the Barbados Bottling Company, which is the local franchise holder for international brands Coca-Cola, Coca-Cola Light, Coca-Cola Zero, Powerade, Sprite, Sprite Zero, Fanta, Canada Dry and Schweppes Tonic Water. They distribute these popular brands alongside their own indigenous brands.

1 Giles A M Carmichael is a partner at Chancery Chambers.

2 Phone interview with Mr Dereck Forster, managing director of Automotive Art.

II MARKET ENTRY

i Restrictions

Any non-national or non-CARICOM³ member seeking to operate a business by way of a franchise in Barbados must submit a written application to the Minister of Finance and Economic Affairs, who has sole authority to grant the licence. Upon receipt of the application and all other required documentation, the Minister publishes the application for a licence to operate the business on franchise in the Official Gazette, inviting members of the public to object. These objections play a critical role in the Minister's consideration of the request for a franchise licence.

There are no restrictions on a foreign entity granting a master franchise or development rights to a local entity.

Foreign franchisors are permitted by law to own equity in local businesses and have equal rights as citizens to own real property.

ii Foreign exchange and tax

The Exchange Control Act (Chapter 71 of the Laws of Barbados) provides for the transfer of foreign currency. All incoming funds must be registered with the Exchange Control Authority, a division of the Central Bank of Barbados.

Permission is required from the Exchange Control Authority for the purchase by a non-resident of real property situated in Barbados. This permission is routinely granted if the non-resident purchaser brings funds into Barbados to cover the cost of the property.

The Exchange Control Authority may impose restrictions on repatriation of funds. The major consideration in a request for repatriation is the state of foreign reserves in Barbados at the time of the transaction.

Royalties and other fees paid to a franchisor are subject to a 15 per cent withholding tax.

The Central Bank of Barbados has delegated the authority to the commercial banks to issue drafts to individuals or businesses as payment for goods purchased. The limit is US\$125,000 per transaction, provided the required documents are submitted to the commercial bank. Funds in excess of that amount must be approved directly by the Central Bank.

III INTELLECTUAL PROPERTY

Barbados has demonstrated its commitment to the enforcement of intellectual property rights through its commitments to international agreements, as well as through the enactment of local legislation. The country signed the Paris Convention on intellectual property rights, the Nice Agreement, and is a member of the United Nations World Intellectual Property Organization. There are also specific laws that provide for the protection of intellectual property, namely the Patents Act (Chapter 314), Trade Marks Act (Chapter 319), Industrial Designs Act (Chapter 309), Copyright Act (Chapter 300), and the Protection against Unfair Competition Act (Chapter 329A).⁴

3 The Caribbean Community and Common Market, a regional grouping of 15 Caribbean countries.

4 This Act provides for protection against unfair competition within the context of Barbados's obligations under the Agreement on Trade-Related aspects of Intellectual Property Rights of the World Trade Organization.

i Brand search

A search for protected trademarks and other intellectual property is typically conducted at the Corporate Affairs and Intellectual Property Office (CAIPO),⁵ a division of the Ministry of Industry, International Business, Commerce and Small Business Development. CAIPO is responsible for various aspects of industrial property right affairs such as patents, trademarks and industrial designs.

CAIPO has an electronic intellectual property registry system that allows persons to search a database of all registered intellectual property. After logging into the computerised system, the choice can be made to query trademarks or patents. A trademark query will display a list of search fields such as filing date, registration date, list of Nice⁶ classes of words contained in the trademark and the like. After selecting one or more of the criteria and executing the search, all the items matching the criteria will appear. Upon making the selection choice, all relevant information pertaining to the trademark will appear such as, for example: application number and type, sign type, mark image, colour description, Vienna classes, Nice classes and status. A physical search of written name cards with all relevant information can also be performed as soft copies of intellectual property information are also filed and stored.

ii Brand protection

All trademarks, patents and industrial designs should be registered in Barbados to ensure protection of the rights provided under Barbados intellectual property laws. It is the responsibility of the rights holders to register, protect and enforce their rights.

An application for registration of a trademark or other intellectual property must be filed at CAIPO pursuant to the requirements of Section 19 of the Trade Marks Act. The application form (Form 3) must contain a clear reproduction of the sign that is filed for registration and must list all the classes that apply to the goods or services being offered. The cost of the application is Bds\$75 and five copies of the mark must be submitted along with the application.

iii Enforcement

Protection is afforded for Intellectual Property under the Patents Act (Chapter 314), the Trade Marks Act (Chapter 319) and the Industrial Designs Act (Chapter 309).

Redress for actual or threatened infringement is by way of injunction, damages or an order for the erasure, removal, obliteration, delivery or destruction of the offending material. Penalties for competition offences or infringement range from a fine of Bds\$5,000 or two to six years' imprisonment to Bds\$20,000 or 10 years' imprisonment. Continuing offences attract additional fines of Bds\$500 per day.

iv Data protection, cybercrime, social media and e-commerce

There are no laws specifically governing e-commerce. However, legislation and regulation related to cybersecurity has been enacted through the Privacy and Data Protection Act, which is in the draft stages and should be finalised very soon.

5 CAIPO was established under the Corporate Affairs and Intellectual Property Office Act Chapter 21A.

6 International (Nice) Classification of Goods and Services established by the Nice Agreement of 1957.

Additionally, there has been active dialogue on e-commerce and improving security in Barbados. In April 2015, the island's commerce minister spoke about this move at a seminar entitled 'The impact of e-commerce on entrepreneurs and small businesses: cybercrime, intellectual property rights and maintaining your web presence'.⁷

IV FRANCHISE LAW

i Legislation

Barbados is one of approximately 30 countries across the globe and the only member of CARICOM that has franchise-specific legislation.

The Franchising Sector in Barbados is governed by the Franchises (Registration and Control) Act (Chapter 179A) (The Franchise Act). The Franchise Act was established to 'provide for the licensing, registration and control of businesses which operate on franchise in Barbados and for related matters'. The Barbados legislation has a primary focus on the protection of local business and ensuring that there is no unauthorised use of a franchisor's product, trademark or trade name.

The Franchise Act defines 'franchise' as 'a right granted in writing by the owner of a mark, product, service, technique or device to another person to use the mark, product, service, technique or device whether or not the mark, product, service, technique or device is protected by a trademark or trade secret, or by usage, or otherwise, and includes a licence to use a copyright, an industrial design or an invention'.

ii Pre-contractual disclosure

Barbados follows common law in respect of the tort of misrepresentation, which may be viewed as a false statement of fact addressed to the party misled and which induces the contract. Furthermore, the principle of *memo dat quod non habet* applies to the extent that one is not able to give what one does not own. Hence, prior to contract, the parties are legally protected during negotiations by basic common law principles.

iii Registration

Section 3 of the Franchise Act dictates that any franchise licence application must be in writing and addressed to the Minister of Finance.

Registration of a franchise licence is administered by the tax administration department of the Ministry of Finance and Economic Affairs. According to the regulations of the department, the application must be accompanied by the following: the completed application form (Form 1), a notarised copy of the franchise agreement, incorporation documents, projected profit and loss or income statements for each of the first two years of the proposed operation or, if the enterprise is already in operation, audited balance sheets and profit and loss statements for the past two years of the company's operation.⁸

The application form is divided into four sections: applicant, investment, production and certification. The application must disclose relevant details such as the dates of registration of the company, names and contact information of the chairman, managing

7 Theresa Blackman, 'Businesses Told To Step Up Online Security' (BGIS Media, Top Stories, 2015), www.gisbarbados.gov.bb/index.php?categoryid=9&p2_articleid=13912.

8 Application Form 1 under Section 3 of the Franchises (Registration and Control Act, 1974 as amended).

director, other directors and company secretary, nature of the business, details of any similar project within CARICOM, name and description of products for which the licence is sought for franchise, amount of capital to be invested in the proposed operation (i.e., land, building or leasehold improvements, machinery and equipment and networking capital), number and remuneration of persons expected to be employed in the proposed operation and the proposed address at which the business is to be conducted.

Pursuant to the provisions of the Franchise Act, upon receipt of the application for the franchise licence, the Minister publishes an official notice in the Official Gazette, *The Barbados Advocate* newspaper and the *Nation* newspaper inviting members of the public to object to the granting of such a licence, usually within 60 days.

If the franchise licence is approved, an initial registration fee of Bds\$10,000 is required and there is an annual renewal fee of Bds\$2,000.

iv Mandatory clauses

According to the Franchise Act, no person shall operate a business in Barbados using the mark, product, service, technique, device, copyright, industrial design or invention of another person unless a franchise from the owner is obtained; and no person, other than a citizen or permanent resident, shall operate a business in Barbados using his or her own mark, product, service, technique, device, copyright, industrial design or invention without a franchise licence. Hence, any person who wishes to operate a business in Barbados on franchise must obtain a licence from the Minister of Finance and Economic Affairs before commencing business.

Furthermore, foreign (i.e., non-Barbadian or non-CARICOM) businesses cannot use their own marks, products, services, techniques, devices, copyright, industrial designs or inventions without a franchise licence.

Only legally operating franchises may repatriate profits and capital.

v Guarantees and protection

The Consumer Protection Act (Chapter 326D) came into force on 16 January 2003. The purpose of this Act is to safeguard the rights of consumers in areas such as unfair trade practices, unfair contract terms and misleading and deceptive conduct.

The Consumer Guarantees Act (Chapter 326E) was established in an effort to provide redress for consumers in the event that they receive problematic goods or services. The Act relates to consumer guarantees in relation to the supply of goods and services and rights of redress against suppliers in respect of failure of goods and services to comply with any such guarantees.

Barbados's consumer protection and guarantees legislation is geared towards consumers, namely, persons who use goods and services for non-commercial use.

The normal practice relating to guarantees and protection is guided by basic contract law principles. Guarantees given by individuals and companies to the franchisor are enforceable. However, companies are not permitted to give guarantees in limited circumstances that are deemed as prejudicial to the company.

V TAX

i Franchisor tax liabilities

Income tax in Barbados is subject to the provisions of the Income Tax Act (Chapter 73).

As long as the franchisor is tax-resident,⁹ he or she is liable to income tax on his or her worldwide income. Personal tax is based on the PAYE system. The first US\$12,500 is granted as a personal allowance and as a consequence is exempt from tax. Earnings between US\$12,501 and US\$30,000 are taxed at a rate of 16 per cent and income over US\$30,000 is taxed at 33.5 per cent.

Barbados imposes a corporation tax, which varies by income, year and type of company on the worldwide income of all tax-resident business entities.¹⁰ The rate for a franchisor is 25 per cent.

ii Franchisee tax liabilities

Franchisees must pay a 15 per cent withholding tax on all royalties paid to franchisors. This would be subject to the provisions of any applicable double-tax treaty. They are also liable to a corporate tax rate of 25 per cent.

As long as the franchisee is tax resident, the franchisee would be liable to income tax on worldwide income. Personal tax is based on the PAYE system. The first US\$12,500 is granted as a personal allowance and as a consequence is exempt from tax. Earnings between US\$12,501 and US\$30,000 are taxed at a rate of 16 per cent, and income over US\$30,000 is taxed at 33.5 per cent.¹¹

Under the provisions of the National Insurance and Social Security Act of Barbados, all employers are required to register their business with the Director of National Insurance. Therefore, franchisees are required to insure all employees between the ages of 16 and 67. The rates of national insurance contributions for employees are 10.10 per cent and 11.25 per cent for employers. This amounts to a total National Insurance Scheme contribution of 21.35 per cent of an employee's earnings payable by the employer. The maximum insurable earnings are Bds\$4,270 per month.

Franchisees that import products to the island are also liable for import duty. Customs duty is levied on goods imported in accordance with the First Schedule of the Customs Act (Chapter 66). The rate is calculated on an *ad valorem* basis of zero per cent to 20 per cent. Certain goods regarded as luxury items are taxed at a much higher rate.

Franchisees that qualify for Barbados's value added tax (VAT) regime must be registered for VAT.¹² The threshold for VAT registration is Bds\$80,000.¹³ VAT is levied at 17.5 per cent on the value of a wide range of goods and services imported or supplied in Barbados by VAT-registered persons.

9 Under the provisions of the Income Tax Act of Barbados, an individual who spends more than 182 days in Barbados in an income year is considered to be resident in Barbados in that income year, or who is ordinarily resident in Barbados in the relevant income year.

10 A business is tax resident if it is either incorporated, continued or registered as an external company under the Companies Act (Chapter 308 of the Laws of Barbados).

11 Invest Barbados, 'A Guide To Doing Business in Barbados'.

12 Under the VAT provisions, a person is required to register for VAT purposes if they supply goods and services in Barbados in the course of a taxable business and if their annual taxable supplies are Bds\$80,000 or more.

13 As of 1 January 2016, Barbados raised the VAT registration threshold to Bds\$100,000.

iii Tax-efficient structures

Tax efficient structures are available and will vary according to the ultimate beneficial owner of the franchise licence. In this regard, Barbados is party to a number of double-taxation treaties that will reduce withholding taxes on dividends, interest and royalties. Furthermore, the CARICOM double-taxation treaty provides for the payment of dividends at a zero withholding tax rate. Accordingly, the use of a holding company incorporated in a favourable CARICOM jurisdiction will sometimes offer attractive possibilities.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The Consumer Protection Act (Chapter 326D) makes provision for the protection and safety of consumers and for connected purposes. This legislation establishes and safeguards rights for consumers in the area of goods and services. It is administered by the Office of Public Counsel.

ii Agency distributor model

The Franchise Act is very general as it relates to all persons operating a business in the country using the mark, product, service, technique, copyright, industrial design or invention of another person. As a consequence, an agent or distributor of a franchised product, regardless of whether or not the operator is a non-national, is subject to the provisions of the Franchise Act.

iii Employment law

In Barbados, there are a number of labour laws that define the rights and responsibilities of all agents in the workplace, namely employees, employers and any respective representative groups. Principal among these laws is the Employment Rights Act of 2012. However, franchisees cannot be treated as employees by the courts.

iv Consumer protection

The Consumer Protection Act (Chapter 326D) of 2002 precludes franchisees from being treated as consumers in any given circumstance by virtue of the fact that they do not meet the criterion of being a 'consumer'. The Act defines a consumer as an individual who acquires from a supplier goods or services of a kind ordinarily intended for private use or consumption.

The Consumer Guarantees Act (Chapter 326) amends the law relating to consumers upon the supply of goods or services, and the rights of redress against suppliers and manufacturers in respect of a failure of goods or services to comply with any such guarantees.

The Fair Trading Commission Act (Chapter 326B), *inter alia*, provides for the establishment of a Fair Trading Commission to safeguard the interests of consumers, to monitor and investigate the conduct of service providers and business enterprises to promote and maintain effective competition.

The thrust of the Fair Competition Act (Chapter 326C) is to promote, maintain and encourage competition; and to prohibit the prevention, restriction or distortion of competition and the use of dominant positions in trade in Barbados and within the CARICOM Single Market and Economy.

v Competition law

There is currently no antitrust legislation in Barbados.

vi Restrictive covenants

There are no specific laws relating to non-compete arrangements. The law on non-compete arrangements in Barbados is based on common law and developed through judicial precedent.

vii Termination

There are no restrictions on shareholding in local businesses, on taking local leases or owning real property. However, for a company to have a lease or own real property in Barbados, it must first be registered in Barbados.

viii Anti-corruption and anti-terrorism regulation

Under the authority of the Money Laundering and Financing of Terrorism Prevention and Control Act (Chapter 129), the government established the Anti-Money Laundering Authority and its operating arm, the Financial Intelligence Unit, in 2000. Barbados also has a Prevention of Corruption Act (Chapter 144), which provides anti-corruption laws.

ix Dispute resolution

Barbados bases its legal system on the British common law system. The Attorney General, the Chief Justice, judges and magistrates administer justice in Barbados. The Caribbean Court of Justice is the highest court of appeal for Barbados.

Notwithstanding the arrangements put in place for dispute resolution, disputes involving franchises are virtually non-existent in Barbados.

VII CURRENT DEVELOPMENTS

It is interesting to note the re-entry of two large international franchises into the market – Miss Universe (Barbados) in 2016, operated by franchise holder Crown Events Inc, and Miss World (Barbados) in 2017, operated by franchise holder Caribbean Market Centre – after a nine-year and a two-year hiatus respectively. The re-emergence of these international pageantry franchises succinctly illustrates the growing diversification in the local franchise market.

In recent times, Barbados has expanded its protectionist fast-food restaurant market and allowed the entry of the international restaurant franchises Subway and Burger King in 2009 and 2012 respectively. Moreover, with the opening of the Limegrove Lifestyle Centre in 2011, Barbados welcomed retail franchises such as Burberry, Louis Vuitton and Michael Kors.

Additionally, the CARICOM Single Market and Economy (Implementation) (Miscellaneous Provisions) Act No. 24 of 2004 removed the necessity for a national of another member state to apply for a licence to operate a franchise on the island. Hence, a franchisor from Antigua and Barbuda, the Bahamas, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St Lucia, St Kitts and Nevis, St Vincent and the Grenadines, Suriname or Trinidad and Tobago is not subject to Section 3 of the Franchise Act.

In addition, there has been considerable dialogue at ministerial level and plans are under way to amend the franchise legislation to make it more attractive to entrepreneurs and potential investors. It is becoming more generally accepted that the current franchise law is

outdated and ill-suited to the current business climate. The Franchise Act was created and amended at a time when protectionism combined with minimal external competition was deemed to be a necessary strategy to aid local small and medium-sized businesses to develop. However, with the advance of globalisation and Barbados's membership in the World Trade Organization, these policies are continually being amended to keep in line with WTO obligations, as well as with more suitable contemporary economic models.

Moreover, with the introduction of the Computer Misuse Act, the Electronic Regulations Act and the soon-to-be enacted Data Protection Act, Barbados is addressing security and privacy policy issues.

Given the constant refrain that Barbados is 'open for business', it is expected that the current Franchise Act will soon be amended to chime more consistently with this mantra.

CANADA

*Paul Jones and Katya Logunov (Stepanishcheva)*¹

I INTRODUCTION

The Canadian franchise industry is fairly well developed, generating approximately C\$68 billion every year. According to the Canadian Franchise Association (CFA), there are an estimated 1,300 franchise brands operating in Canada² in most sectors of the economy, including restaurant, automotive, hospitality, real estate, professional services industries and many others, with 60 per cent of franchises operating in non-food sectors.³

CFA is a national trade association that represents both franchisors and franchisees. CFA publishes an annual Accomplishments Report, which includes an overview of the franchise market in Canada.⁴

The Province of Quebec has a unique legal environment, a mix of civil law and common law systems. Quebec is also predominantly francophone and has laws mandating the use of French in some aspects of business. It is also culturally distinct from other Canadian provinces. The Quebec Franchise Council is a provincial association representing the franchise industry in Quebec.

II MARKET ENTRY

i Restrictions

Generally, there are no restrictions on a foreign franchisor entering the Canadian market. Because of many similarities in business environment, culture, legal system and consumer preferences, franchisors from the United States often start their international expansion into Canada by unit franchising. Master franchising and area development arrangements are also common, particularly when expanding into Quebec.

It is not necessary for a foreign franchisor to establish a Canadian entity or branch. If a foreign franchisor decides to establish a local entity or acquire equity interest in a master franchisee or area developer, a notification to Industry Canada under the Investment Canada Act will be required. Significant foreign investment into a Canadian business may be subject to review and approval by the federal government; however, investments on this scale are not common in the franchise industry.

1 Paul Jones is a principal and founder, and Katya Logunov (Stepanishcheva) is an associate at Jones & Co.

2 Canadian Franchise Association, 2017 Accomplishments Report, available at: https://www.cfa.ca/wp-content/uploads/2017/04/CFA_AR2017_WEB.pdf, at page 37.

3 2017 Accomplishments Report, note 2.

4 2017 Accomplishments Report, note 2.

Franchisors in the food and restaurant industry may face unexpected restrictions with respect to the supply of some foods and beverages. Imports of milk, cheese, eggs and poultry to Canada are subject to high tariffs. The sale of alcohol is also subject to regulations that are more restrictive than regulations in most of Europe.

Franchisors and franchisees usually do not face restrictions on holding or leasing land, as restrictions mostly concern agricultural and cultural land. However, because of low vacancy rates in large urban centres, it may be challenging to secure a good location for a franchised unit. Canadian franchisors often try to lease the desired property and then sublet it to franchisees.

For franchisors who do not already operate in French, the cost of translating disclosure and marketing materials and the operations manual into French may be a barrier to entry to the Quebec market. There are also significant French-speaking populations in New Brunswick and the eastern part of Ontario.

ii Foreign exchange and tax

There are no foreign exchange restrictions in Canada.

The Canadian dollar trades freely and fluctuates against other currencies. Franchisors, depending on the complexity of their supply systems, may want to consider introducing protections against currency fluctuation, and warn potential franchisees of currency fluctuation risks. Franchisors may also want to consider discounts and other measures to remain competitive to Canadian consumers while the Canadian dollar is weak.

Initial franchise fees and royalties paid by a Canadian franchisee to a non-resident franchisor are subject to a 25 per cent withholding tax. The tax rate is reduced under some tax treaties. For example, the withholding tax rate under the tax treaties with the United States, Australia and the United Kingdom is 10 per cent.

III INTELLECTUAL PROPERTY

i Brand search

Canada is a first-to-use as opposed to first-to-file jurisdiction: trademark rights can be acquired through use, as well as through registration. Therefore, a search in the trademarks database alone is not sufficient; a broader search, including business names, corporate register and domain names, is recommended.

Given that Canada has two official languages, French and English, an English language trademark may be confused with a trademark in French and vice versa. Canadian courts held that the likelihood of a trademark being confused with another mark must be assessed through the eyes of an average francophone consumer, an average anglophone consumer or, in some instances, an average bilingual consumer.⁵ A trademark that is likely to be confused with another trademark in English or French will not be registered by CIPO.⁶

5 *Médicament v. Smithkline Beecham Corp.*, 2004 FC 811.

6 Trade-marks Act, RSC 1985, c T-13, section 12(1)(d).

ii Brand protection

Even though common law rights in unregistered trademarks can be enforced in Canada, registration of a trademark significantly strengthens the level of protection and the value of the mark. Registration provides nationwide protection regardless of whether the mark is actually used in all parts of Canada.

Applicants from a World Trade Organization or a Paris Convention country can claim as a priority filing date the filing date of a foreign application if it was filed within six months prior to the Canadian application.

The process of registering a trademark can take approximately one year to 18 months if no oppositions are filed and the examiner does not raise significant objections. Oppositions and examiner's objections may delay registration significantly. It is therefore recommended to file trademark applications in advance of entering the Canadian market.

As Canada has two official languages, French and English, the registration or use of a mark in one language will to some extent protect the equivalent in the other language. However, translations may vary considerably according to a variety of factors. Where protection of the mark in the other language is clearly desired, it is prudent to apply for and register the mark in both official languages.

The 2014 amendments to the Trade-marks Act will, when proclaimed into force, harmonise Canadian law with the Madrid Protocol, the Nice Agreement and the Singapore Treaty. Among other significant changes, the term of trademark registrations will be reduced from 15 to 10 years and colours, sounds, scents and textures will be registrable as trademarks. The new law will eliminate the requirement that the trademark must have been used in Canada or abroad before registration. The changes are not yet in force.

Canada is a party to all major international treaties on copyright. Copyright can be registered, although it is not required. Registration of copyright will serve as evidence of ownership and will preclude an infringer from relying on a defence of 'innocent infringement' in court.

Canadian residents and corporations may register a '.ca' top-level domain with the Canadian Internet Registration Agency. Non-resident owners of Canadian registered trademarks may also register a .ca domain name that represents or includes the exact word component of their Canadian registered trademark.

iii Enforcement

Trademark rights can be enforced against an infringer by filing a lawsuit in the Federal Court or a provincial superior court. Common law rights in an unregistered trademark can be enforced by a common law claim of passing off, as codified by Section 7(b) of the Trade-marks Act. Preliminary injunctions can be applied for, but are rarely granted. A successful party in the lawsuit may be awarded a permanent injunction, damages or an accounting of the infringer's profits from the infringement, the delivering up or destruction of infringing goods and litigation costs (to a certain extent).

The downside of trademark enforcement in Canada is that the judicial process is slow and expensive. The World Bank Group's Enforcing Contracts⁷ ranking puts Canada on 114th place, well behind Australia, China, the United States and the United Kingdom. In Quebec, the rules of civil procedure codified in the Code of Civil Procedure are different

7 Available at <http://www.doingbusiness.org/data/exploretopics/enforcing-contracts>.

from those in common law provinces but generally would be more familiar to a common law practitioner than a civil lawyer, because of availability of discovery and other rules of common law civil procedure.

The Trade-marks Act also establishes criminal liability for knowingly infringing a trademark on a commercial scale, punishable by a fine of up to C\$1 million and imprisonment for up to five years.

Similarly, claims of copyright infringement can be filed with the Federal Court or, in some instances, a provincial superior court. It is not necessary to register copyright before filing a lawsuit. It is a criminal offence to knowingly infringe copyright, including by making copies, selling or distributing infringing copies, etc.

Know-how and confidential information should be protected by a contract between the parties.

iv Data protection, cybercrime, social media and e-commerce

Canada was an early adopter of privacy legislation that meets standards similar to those of the European Union. The Federal Personal Information Protection and Electronic Documents Act and provincial privacy statutes in Alberta, British Columbia and Quebec regulate the collection, use and disclosure of personal information in Canada. The EU Commission has determined that Canada meets the 'adequate level of protection' standard for cross-border transfer of personal data between Canada and the EU.

Generally, non-governmental organisations in Canada are not required to store personal information within the country. The transfer of personal information abroad for data management or processing purposes is permissible if the transferring organisation retains control of personal data. In Alberta, the transfer of personal information abroad for processing requires prior notification to the individual; the federal Office of the Privacy Commissioner recommends that organisations advise their customers that their personal information can be processed in another jurisdiction.

In 2010, Canada adopted a federal anti-spam law (CASL)⁸ that requires organisations that send 'commercial electronic messages' within, from or to Canada to obtain a prior consent from a recipient. CASL also prohibits false or misleading online promotions and the installation of computer programs without consent. CASL establishes sanctions for non-compliance, including a charge of criminal offence for obstructing an investigation, administrative penalties of up to C\$10 million and personal liability for an organisation's officers and directors. CASL's right of private action has been temporarily delayed. Many lawyers and industry players consider the requirements of CASL to be too onerous.

Every province in Canada has adopted electronic commerce legislation that regulates transactions that occur in electronic form. Provided that certain requirements are met, online transactions and contracts concluded electronically are enforceable.

8 An act to promote the efficiency and adaptability of the Canadian economy by regulating certain activities that discourage reliance on electronic means of carrying out commercial activities, and to amend the Canadian Radio-television and Telecommunications Commission Act, the Competition Act, the Personal Information Protection and Electronic Documents Act and the Telecommunications Act, S.C. 2010, c. 23.

IV FRANCHISE LAW

i Legislation

The regulation of franchising falls within the provincial jurisdiction. To date, six Canadian provinces have enacted franchise statutes: Alberta, British Columbia, Manitoba, New Brunswick, Ontario and Prince Edward Island (the Disclosure Provinces). The respective franchise acts (collectively, the Franchises Acts) of the Disclosure Provinces are fairly harmonised, but not identical.

Provincial franchise statutes focus on pre-contractual disclosure obligations and exemptions, the duty of fair dealing, the franchisees' right to associate, statutory right of damages, rescission rights and the jurisdiction of provincial laws and courts.

The Province of Quebec decided not to adopt franchise-specific legislation. Franchises in Quebec are governed by the Civil Code of Quebec, which imposes rules on many aspects of the franchise relationship, including in relation to pre-contractual disclosure, duty of good faith, franchise agreements, securities interests, leases, etc.

Quebec courts recognised that franchisors are subject to certain implicit obligations that flow from the franchise agreements, including an obligation to use reasonable efforts to 'protect and enhance the brand' (*Dunkin' Brands Canada Ltd v. Bertico Inc*, 2015 QCCA 624 (*Dunkin' Donuts*)). The *Dunkin' Donuts* ruling may also have implications for franchising beyond Quebec's borders.

ii Pre-contractual disclosure

In the Disclosure Provinces, a franchisor must provide a disclosure document to a prospective franchisee at least 14 days prior to entering into a franchise agreement or payment of a franchise fee. Disclosure documents must include information prescribed by the franchise regulations (including information about the franchisor and the system, litigation and administrative orders, territorial rights, description of fees and estimate of initial investment), as well as all 'material facts'. A material fact is any information about the franchise system or the business, operations, capital or control of the franchisor that would reasonably be expected to have a significant effect on the value or price of the grant or on the decision to acquire the franchise.

Information disclosed must be complete and accurate as of the date of the disclosure document (except for certain information, such as financial statements, which must be current as of the end of the previous fiscal year).

Failure to provide disclosure, or delivery of incomplete or inaccurate disclosure gives the franchisee the right to rescind the franchise agreement, demand the return of its investment and claim damages. The rescission period for incomplete disclosure is 60 days, and two years from the date of the franchise agreement if no disclosure was provided.

Franchisors should pay attention to the disclosure of all material facts in addition to the prescribed list of information. Canadian courts have held that failure to disclose certain material facts may result in the disclosure document being so deficient as to amount to no disclosure at all, resulting in a two-year rescission remedy.

The Civil Code of Quebec imposes a duty of good faith on contracting parties.⁹ Courts have established that the duty of good faith under the Code requires a franchisor to inform the franchisee of any relevant information that might have a decisive impact on the prospective

9 Code civil du Québec, CQLR c CCQ-1991, article 1375.

franchisee's decision to buy in.¹⁰ Failure to provide information to a prospect in Quebec may result in the reduction of certain obligations, rescission of the franchise agreement and a damages award.

iii Registration

There is no requirement to register the franchisor or the disclosure document in any province. Provincial corporate statutes require out-of-province corporations to register in the province when the foreign corporation starts to 'carry on business' in the province.

iv Mandatory clauses

There are no prescribed clauses that must be included in the franchise agreements.

v Guarantees and protection

Franchisors in Canada routinely require shareholders and directors or officers of the franchisee entity to personally guarantee the obligations of the franchisee under the franchise agreement.

Alberta's Guarantees Acknowledgement Act renders personal guarantees unenforceable unless the individual guarantor signs the guarantee before a lawyer.

The Civil Code of Quebec contains certain unique provisions applicable to guarantees, which will require revision of a common law standard guarantee agreement for use in Quebec.

V TAX

i Franchisor tax liabilities

Taxes in Canada are levied at the federal, provincial and local levels. Federally, the imposition of tax is governed by the Income Tax Act and is administered by the Canada Revenue Agency (CRA). As a general rule, Canadian residents pay taxes based on their worldwide income and non-residents may be subject to Canadian taxes on income earned in Canada. Provincial and municipal governments have powers to levy local taxes, including provincial income tax, liquor and tobacco taxes and municipal property taxes. Taxation is a complex topic in Canada and professional tax advice must be sought before commencing franchise sales.

The tax liabilities of the franchisor depend on several factors, including whether the franchisor has or is deemed to have established a permanent presence in Canada. As noted above, it is not necessary for a foreign franchisor to establish presence in Canada to sell franchises, although having 'boots on the ground' may be beneficial for some franchisors. In very general terms, a 'permanent establishment' consists in having a Canadian branch, subsidiary, place of business or an agent with authority to sign agreements on behalf of the franchisor in Canada.

If the franchisor grants franchises in Canada without having presence in the country, and is not otherwise carrying on business in Canada, generally there will be no tax liability except for withholding taxes on the franchisor's royalty income, management fees and interest payments, payable by the franchisee (see Section II.ii).

A 15 per cent withholding tax is payable on service fees for services rendered in Canada and an additional 9 per cent if the services are rendered in Quebec. In certain circumstances,

¹⁰ *Bank of Montreal v. Bail Ltée*, [1992] 2 SCR 554; 9150-0595 *Quebec Inc v. Cora Franchises Inc*, 2013 QCCA 531 at para. 18.

a waiver from the CRA may be obtained in respect of the service fee withholding tax. Some service payments may be considered royalties and be taxed accordingly if the payment is made for the use of trademarks or other intellectual property rights.

A non-resident franchisor may be liable to pay Canadian income taxes on income earned in Canada if the franchisor carries on business in Canada. The definition of 'carrying on business' is fairly broad and includes, among other things, packing or improving anything in Canada, whether or not for export, and offering anything for sale in Canada through an agent.

If the franchisor has presence in Canada that qualifies as a 'permanent establishment', the franchisor will be responsible for payment of the federal and provincial income taxes on income attributable to the Canadian business.

A Canadian subsidiary of a foreign franchisor is a Canadian resident and as such is responsible for payment of Canadian federal and provincial taxes.

ii Franchisee tax liabilities

The franchisee will be required to register with the CRA and obtain a business number, which will be used to open one or more accounts to remit sales taxes, payroll taxes, corporate income tax, etc.

The Canadian federal government collects a 5 per cent Goods and Services Tax (GST) on sales of goods and provision of services in Canada. In addition to the GST, other provinces (except Alberta) levy a provincial sales tax (PST) on the retail price of most goods. Businesses that sell taxable goods or services are responsible for collecting and remitting the tax. Some provinces have harmonised the PST with the GST, and the combined Harmonised Sales Tax (HST) is collected by the CRA. British Columbia, Manitoba, Quebec and Saskatchewan collect the PST separately.

Franchisees are also responsible for remitting withholding taxes (see Section II.ii and Section V.i above).

iii Tax-efficient structures

There are a number of ways to structure franchising in Canada and the most tax-efficient option will depend on the franchisor's specific needs and circumstances.

For an international franchisor without presence and business operations in Canada, unit or master franchising may be the most tax efficient option. Tax liability of the franchisor will be limited to withholding taxes, which sometimes may be wholly or partially passed on to franchisees.

If a presence in Canada is desirable, franchisors may choose between operating as a branch or establishing a subsidiary in Canada.

Using a branch in Canada may allow the franchisor to deduct losses incurred by the branch from its home taxes. However, a non-resident franchisor will be subject to a branch tax at the same rate as the income tax rate for a foreign-controlled corporation. Branch tax is reduced under some tax treaties. Also, branch operation will not shield the parent entity from the debts and liabilities incurred by the Canadian operation.

The use of a local subsidiary corporation will limit a foreign parent's exposure to liability for debts and liabilities incurred by local operations. The subsidiary will be taxed on its net worldwide income, at a combined federal and provincial or territorial rate, which varies between 25 and 31 per cent. Dividends to the non-resident parent entity are subject to the withholding tax, subject to relief provided in some tax treaties.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Historically, Canadian common law did not recognise an overarching duty of good faith in contractual relationships. However, the Supreme Court of Canada in 2014 recognised¹¹ that parties owe each other a duty to perform the contract ‘honestly and reasonably and not capriciously or arbitrarily’ and that the duty of good faith is a ‘general organising principle’ of contract law.

Unlike the duty of good faith embodied in the Civil Code of Quebec, *Bhasin v. Hrynew* does not create an obligation of franchise disclosure in common law non-Disclosure Provinces.

Disclosure Provinces impose a duty of fair dealing in the performance and enforcement of the franchise agreement. Failure to act in good faith will give rise to a right to claim damages against the breaching party.

ii Agency distributor model

The definition of a ‘franchise’ in the Disclosure Provinces may include product distribution franchises in addition to business format franchises. Certain agency and distribution arrangements (particularly automotive dealerships) fall under the definition of a ‘franchise’ in the Disclosure Provinces and therefore are subject to disclosure and other obligations imposed by the Franchises Acts. Alberta’s Franchises Act specifically excludes purchase of a ‘reasonable amount of goods at a reasonable *bona fide* wholesale price’ from the definition of a franchise fee; wholesale purchases are also excluded in British Columbia, Manitoba, New Brunswick and Prince Edward Island, but not in Ontario.

Distribution agreements can generally be terminated upon reasonable notice. Canadian law does not require a manufacturer to provide compensation for goodwill to its distributor upon termination.

iii Employment law

Under provincial labour and employment laws, two or more companies may be treated as one employer if they are engaged in related business and are commonly controlled or directed. In some circumstances, franchisor may be deemed a ‘related’ employer of its franchisee’s employees, giving rise to liability for employees’ claims for wrongful dismissal, wage and overtime payments, collective agreements claims and even human rights complaints.

If the franchisor’s operational control ties franchisees’ business to the extent that they become economically dependent on the franchisor, including with respect to pricing for goods and services and ability to market to new customers, franchisees can be deemed franchisor’s employees.¹² Janitorial service franchisors can be particularly vulnerable to the risk of being recognised as employers of their franchisees because of their business model, in which the franchisor contracts with and collects payments directly from customers, remitting money to the franchisees after deducting franchisor’s fees.

11 *Bhasin v. Hrynew*, 2014 SCC 71.

12 *International Brotherhood of Teamsters v. Canada Bread Company Limited*, 2017 CanLII 62172 (ON LRB).

iv Consumer protection

Franchisees are not recognised as consumers under the provincial consumer protection laws. However, the Franchises Acts in the Disclosure Provinces are remedial legislation, intended to protect franchisees from the perceived imbalance of power in a franchise relationship; as such, the Franchises Acts are often interpreted and enforced in favour of franchisees.

Consumer protection in Quebec is governed by the Civil Code of Quebec and the Consumer Protection Act. To our knowledge, Quebec courts have not yet extended provisions of the Consumer Protection Act to franchisees; however, certain consumer protection provisions of the Civil Code of Quebec, such as rules applicable to contracts of adhesion, apply to franchisees.

v Competition law

The Federal Competition Act regulates restraints on trade such as price-fixing, exclusive dealing and refusal to deal. Serious anticompetitive activities, such as price-fixing between competitors and bid-rigging, are criminal offences. Vertical market constrains, such as territorial restrictions, resale price maintenance and exclusive dealing, are reviewable by the Competition Tribunal if they negatively affect competition, which is rare in the franchise industry as a negative effect on competition would require a significant market share.

vi Restrictive covenants

Both in-term and post-term non-competition restrictions are common in Canadian franchise agreements. Canadian courts held that, to be enforceable, non-compete restrictions must be reasonable, specific in terms of geographic boundaries, duration and scope of restrictive activities, and should not constitute an undue restriction on trade.

It is important to draft non-competition covenants carefully, as courts generally will not rewrite the clause to make it enforceable.

Non-solicitation clauses are viewed as a lesser restraint on a person's ability to make a living and may be easier to enforce than a non-competition clause.

vii Termination

Termination of a franchise agreement is governed by the contract's provisions, subject to the duty of fair dealing under the Franchises Acts, common law duty of good faith and duty of good faith under the Civil Code of Quebec.

A well-drafted franchise agreement should contain detailed provisions on the events that give rise to a right of termination. The takeover right of the franchisor in the event of abandonment of the franchise by the franchisee should also be reserved in the agreement.

The Civil Code of Quebec contains unique provisions on taking over security and leases.

viii Anti-corruption and anti-terrorism regulation

The Proceeds of Crime (Money Laundering) and Terrorist Financing Act establishes record-keeping and client identification requirements for certain businesses that are susceptible to being used for money laundering and the financing of terrorist activities (money services businesses, accountants, real estate brokers, dealers in precious metals and stones, etc.), and requires reporting of suspicious financial transactions.

The Corruption of Foreign Public Officials Act (CFPOA) creates a criminal offence of bribing a foreign public official. CFPOA may apply to non-Canadian persons if there is a 'real and substantial link' between the offence and Canadian territory; for example, where the offending organisation is registered in Canada.

ix Dispute resolution

Franchise disputes in Canada fall under the jurisdiction of provincial courts, unless the dispute involves purely a matter of federal jurisdiction (such as a trademark).

Generally, Canadian courts will extend comity and recognise a final foreign judgment rendered by a foreign court that had jurisdiction over the dispute. Canadian courts will recognise jurisdiction of a foreign court if it had 'real and substantial connection' to the dispute.

The Franchises Acts of the Disclosure Provinces do not allow the parties to restrict the application of the respective Franchises Acts or jurisdiction of provincial courts by agreement. Jury trials are not used in franchise disputes.

Recognising that judicial process in Canada is relatively slow and expensive, the Supreme Court of Canada encouraged the use of summary judgment proceedings and these are used, to a certain extent, in franchise disputes.

Damages awards in Canadian courts are generally less generous than in the United States. Punitive damages are rare. Damages in a contractual dispute will generally be awarded to place the non-breaching party in the position he or she would have been in had the contract been performed. The winning party may be awarded part of its legal costs.

Canada is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Foreign and domestic arbitral awards will be recognised and enforced upon an application to the relevant provincial court. The Supreme Court of Canada in *Sattva Capital Corp v. Creston Moly Corp*, 2014 SCC 53 ruled that courts should show deference to arbitrators' decisions and apply the standard of reasonableness rather than a stricter standard of correctness when reviewing arbitral awards, except for matters of a 'pure question of law'. Mediation is also recognised and some franchise agreements require the parties to attempt to resolve the dispute by mediation before commencing arbitration or litigation. In New Brunswick, mediation is mandatory if one of the parties to the franchise agreement requests it.

Arbitration in Quebec is governed by the Code of Civil Procedure.

VII CURRENT DEVELOPMENTS

Although provincial franchise statutes in the Disclosure Provinces were based in part on franchise rules developed in the United States by the Federal Trade Commission and the states, Canadian franchise laws differ from the United States in one significant aspect. In the Disclosure Provinces, in addition to the prescribed information, franchisors must disclose all material facts that can impact the decision to buy a franchise.

Initially, franchisors often overlooked the requirement to disclose material facts. However, courts tend to give considerable weight to this requirement. As a result, failure to disclose material facts may have grave consequences for a franchisor, including rescission of the franchise agreement, refund of franchise fees, compensation of franchisees' losses

or damages. This is particularly true in Ontario, where the Arthur Wishart Act (Franchise Disclosure) 2000 does not contain a 'substantial compliance' provision that may excuse a technical or minor non-compliance.

In November 2017, Ontario passed amendments to the Arthur Wishart Act. When the government makes corresponding revisions to the franchise regulations, Ontario will permit charging deposits and enter into confidentiality and site selection agreements before disclosure.

The Ontario Court of Appeal decisions in the *Trillium Motor* cases¹³ deal with several issues arising in the franchising class action context, including whether out-of-province claimants are covered by the Ontario franchise statute, whether releases signed by franchisees are enforceable and whether a franchisor has a duty to facilitate the franchisees' right of association. The Court also held that a law firm that acted for both the General Motors dealers and the federal government during the wind down of the General Motors dealerships in Canada during the 2008 financial crisis breached duty of loyalty and conflict of interest obligations, as the interests of the dealers and the government were at variance.

13 *Trillium Motor World Ltd. v. Cassels Brock & Blackwell LLP*, 2017 ONCA 0544; *Trillium Motor World Ltd. v. General Motors of Canada Limited*, 2017 ONCA 0545.

CHILE

*Cristóbal Porzio*¹

I INTRODUCTION

The Chilean franchise market has been growing at a steady pace over the past few years. This growth has been strongly linked to the positive and consistent economic results shown by the national economic figures. The slowdown of the Chilean economy that began in the second half of 2014 and has continued up to the present has apparently yet to affect the growth of franchising figures in Chile, certainly in terms of the number of brands present and entering the Chilean market. It is still difficult to anticipate at this stage what will happen in the medium and long term. In addition to the difficulties presented by the international economy – with the slowdown in China and its direct consequences for those countries in which commodities are very economically important, as with Chile and copper – there is also the prospect of how important legal reforms, including fiscal and labour reforms, that have already been approved, and are gradually entering into force, will impact the Chilean economy. It is difficult, therefore, to anticipate the direct impact these changes will have on franchising. In fact, a significant impact is already being felt in some sectors, such as mining and construction. Furthermore, although commerce has slowed down – and as sales have slowed the owners of the stores also complain – as yet unemployment in the sector has not increased, and new franchises continue to appear in the market and are visible in Chile's various cities. Furthermore, while the commerce sector's complaint regarding the slowdown in sales is also heard from franchisees, new malls continue to open their doors, with many hosting new brands.

In spite of the economic slowdown, there still appears to be an active interest in franchising in the Chilean market and articles on the subject continue to appear in local newspapers and magazines. Some of these articles have dealt with particular brands (local and foreign) that have chosen to use the franchising system to grow their business. While other articles have been about the franchising industry in general, some have simply announced or confirmed rumours that certain companies are exploring the Chilean market or are ready to enter the local market.

The interest of the Chilean market in the franchising model is only confirmed by the fact that the International Franchise Fair (FIF) took place once again in 2017, for the fourth consecutive year. The stands were numerous and attendance figures were correspondingly high. The interest of the public was very clear, not only during the fair, but also especially during the conferences, as was evident at the extremely well-attended conference on the legal aspects of franchising, which the author led.

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In terms of the figures concerned, according to an investigation conducted by the Faculty of Economics and Business of the University of Chile² – one of the of the country's main universities – the statistics from 2016 concerning the franchise market are still quite impressive. In fact, the franchise market has generated sales of approximately US\$1,957 million per year, which corresponds to a growth of 31 per cent between 2012 and 2016. This figure is three times the amount it was eight years ago. From a social and employment point of view it is estimated that the franchise market currently employs approximately 53,500 people. This investigation remains probably the most recent and most extensive study made locally on this subject as, at the time of writing, no updates to this report have been published.

The number of brands operated by franchising is over 200.

The services and food sectors remain the most important as far as franchising is concerned. In fact, franchises in those sectors comprise over 78 per cent of existing franchised brands. In addition, while a very large number of foreign brands are present in the Chilean market by means of franchising systems, domestic brands also constitute a significant market presence.

The Chilean franchise market features important international players such as 5àSec, GNC Live Well, Applebee's, Alamo Rent A Car, Sixt Rent a Car, Best Western, Starwood Hotels, Burger King Domino's Pizza, Dunkin' Donuts, Holiday Inn Express, Kentucky Fried Chicken, McDonald's, Movistar, the Wall Street Institute, Engel & Völkers (real estate), Fast Fitness, Fruzco, Papa John's and Johnny Rockets, among others.

Among the most important local franchises operating in Chile are International Center (education services), Fuenzalida Propiedades (real estate agencies), Doggis (restaurants serving mainly hot dogs), Emporio La Rosa (restaurants and ice cream producers), Copec (fuel distribution and petrol stations), Juan Maestro (fast-food restaurants, serving mainly sandwiches), Pedro, Juan y Diego (fast food) and Soquimich Comercial (producer and seller of speciality fertilisers, iodine and derivatives, lithium and derivatives, industrial chemicals and potassium).

Although the franchise market plays an important role in the current economy, there is no official government agency in charge of this matter, nor a public report concerning franchising activity in Chile.

II MARKET ENTRY

i Restrictions

The Chilean Political Constitution provides in Article 19 No. 21 for the right of any person to develop any economic activity, provided the activity is not immoral or contrary to public policy or national security. The Constitution does not differentiate between foreign nationals and Chilean nationals, all of them being equal in the law. In view of this, foreign nationals and foreign companies are entitled to deal with Chilean people (individuals and corporations) and to enter into the Chilean market directly.

The Chilean legal system does not provide for a franchise law. Having said that, at the time of entering the Chilean market, a foreign investor or foreign franchisor will not be

2 Pinaud Verde-Ramo, Nicole, 'Mercado de las Franquicias en Chile 2016', Departamento de Administración, Facultad de Economía y Negocios, Universidad de Chile, 2016.

required to obtain special permission or prior approval but will be required to comply with the Chilean laws that regulate commercial activity, the declaration and payment of taxes, labour relationships, the treatment of foreign investments, etc.

As far as the grant of a master franchise or the grant of development rights to a local entity is concerned, no special restrictions will apply. As mentioned, however, a foreign entity wishing to do business in Chile through a franchise system will have to comply with the applicable Chilean laws.

Depending on the field of activity where the foreign entity will do business in Chile, specific or particular rules may apply, in addition to the normal commercial, labour and tax laws indicated above. This is the case, for instance, in the food industry, for which specific rules will apply, and in the telecommunications sector, among others. With regard to the food industry, 2014 was a year of heated debate following the enactment of the 'Super 8 Law' (a law aimed at limiting children's access to junk food while at school), the enactment of its regulations and the withdrawal of the same from Congress. This debate continued during 2015. A local discussion on plain packaging also started to develop slowly and a draft bill is currently before Congress.

Notwithstanding rules and concerns such as those noted above, which may affect its chosen field of activity, a foreign company is free at the time of deciding to enter into the Chilean market to elect the best route for its project, in accordance with the 'principle of the autonomy of the will', established in the Chilean Civil Code.³ As a result, practice indicates that the solutions chosen are very different from one case to another. Some may consist in the franchisor simply granting a master franchise for the Chilean territory to a Chilean entity, while others may consist in the entry into the Chilean market and incorporation of a local entity that will interact with franchisees, or that will incorporate a joint venture with a local entity, etc. Basically, 'all legal solutions' can at least be explored

ii Foreign exchange and tax

Business entities are, for the most part, legally structured, and in different ways, using the main types of company or corporation provided for by Chilean law. At the time of making a decision to enter the Chilean market, the franchisor will have to decide whether a legal entity is to be incorporated in Chile. If the decision is affirmative, it will then have to determine what kind of legal entity will have to be considered. For that decision, the franchisor will take into account the limitations on responsibility, the tax consequences, the needs of the local entity, the power of leverage with a possible local partner, the possibility of amending the structure quickly, the possibility of withdrawing from the business, etc.

In this regard, Chilean law provides for several types of corporation, such as limited liability companies, stock corporations and corporations, among others. The choice of one of the foregoing alternatives will depend on what the foreign franchisor is looking for in its business (e.g., free transfer of shares, number of partners, administration and tax considerations).

Whatever the solution or model chosen, the foreign investor will consider on the one hand that money can be obtained locally at competitive rates, or brought into Chile easily without major obstacles, and on the other hand that money can be changed at a market exchange rate with no major limitations or boundaries. Finally, and from a strict tax point

3 Article 1545.

of view, the foreign investor will know or will have to know from the beginning that a withholding tax will apply to most of the amounts of money that are to be exported from Chile to the country of origin of the foreign investor.

As the franchising model is not currently regulated as such in Chile, the franchisor and franchisee will be liable to pay Chilean taxes for activity carried on in Chile using this model. There could be an exception in the case of an international franchising contract in which one company (franchisor or franchisee) is Chilean and the other company (franchisor or franchisee) is foreign, if Chile and the country concerned have a treaty to avoid double taxation.

It is important to bear in mind that every time a franchisor who has no domicile in Chile, or has not incorporated a company in Chile, is to export to its country of origin the sums of money consisting in rents or payments made to it by the franchisee, this will be subject to payment of a withholding tax, on the terms mentioned above. The responsible entity for the withholding tax will be the person or company responsible for its payment, such as the franchisee. Said tax will have to be paid by means of a formal deposit of money in the official account of the state of Chile.

III INTELLECTUAL PROPERTY

i Brand search

The Chilean Patent and Trademark Office (INAPI) has an online system that provides most of the information regarding trademark registrations and pending applications. The same information can be obtained in the case of patent applications.

In the case of trademarks, the search engine allows the user to search for phonetical and graphical coincidences, and also to check the classes and goods or services descriptions. All this information is public and can be accessed through INAPI's website. However, although the system is undergoing constant improvements, the information may not be completely accurate and might need completion by means of a material review of some files.

In addition, there are private services that perform more detailed searches and that are in a position to prepare and draft thorough reports on the registrability of a trademark.

ii Brand protection

In Chile, it is possible to obtain trademark protection for goods and services. Applications will need to designate classes (using the Nice Classification) and to contain a description of the products or services that are to be covered by the trademark.

Protection can be sought for word marks and for figurative marks. The same can be done for slogans and for sound marks. Three-dimensional trademarks cannot be registered.

To obtain trademark rights in Chile, a trademark application must be filed with INAPI and prosecuted according to the rules established in the Chilean IP Law and its implementing regulations. Some basics that can be highlighted are as follows:

- a* trademark applications can be filed by individuals or by corporations;
- b* trademark applications can be filed by Chilean persons or entities, or by foreign persons or entities;
- c* trademark applications are the subject of a formal examination and examination as to substance;
- d* trademark applications are published in the Chilean Official Gazette, for third parties to file their possible opposition in writing;

- e* the final decision, independently of whether the application has been the subject of opposition, can be appealed before the Court of Industrial Property; and
- f* the final decision of the Court of Appeals can be the subject of an annulment recourse filed before the Supreme Court of Chile.

Trademark registrations are granted for 10 years. This term can be renewed for further periods of 10 years provided a trademark renewal application is properly filed.

Currently, the IP Law does not provide for mandatory trademark registrations. In other words, the registration of a trademark is not mandatory for its use as a trademark in Chile, provided, of course, it does not interfere with the legally superior rights of third parties. In addition, if a person decides to file an application for the registration of its trademark, and finally a registration is granted by the Chilean authority, said registration will not be subject to cancellation on the grounds of non-use. In fact, the use of a trademark is not mandatory to maintain a trademark registration in force. In this respect, a bill for a new IP law is still being discussed by the Chilean Congress, and this draft contains a provision concerning the mandatory use of trademark registrations.

The Chilean IP Law also provides for the application, prosecution and granting of other IP rights, such as patents, industrial designs (3D), industrial drawings (2D) utility models, geographical indications and integrated circuits.

As far as franchising contracts are concerned, it would be advisable, although not mandatory, for the owner of a trademark and owner of a franchising programme to file for a trademark application for its trademarks before entering the Chilean market and, in some cases, before offering franchises locally or even before starting a search for potential franchisees or a master franchisee.

While it may seem expedient to forego this process, as it is not mandatory, the use of a trademark alone will not give significant rights to its user. Trademark property or ownership is acquired in Chile through filing a trademark application, the prosecution of this application and the final granting of trademark rights by the Chilean authority, INAPI.

iii Enforcement

According to Chilean practice, all franchising agreements contain a trademark licence agreement. In some cases, the licence agreement is part of the main body of the franchise agreement while in other cases it is drafted in an annex or exhibit of the franchising agreement.

On the assumption that the trademark will be registered in the name of the owner of the trademark or the franchisor, for a licence agreement to be enforceable against third parties, it will be necessary to register it with INAPI. Although, according to Chilean law, a licence agreement will be valid between the signatory parties because of the sole fact of their having a valid executed agreement, granted in good faith and with a clear intention to enter into the agreement, for the agreement to be valid or enforceable against third parties, it is necessary to register the contract with INAPI.

iv Data protection, cybercrime, social media and e-commerce

Chilean legislation does not provide for a data protection law as such. Nevertheless the Industrial Property Law⁴ contains provisions regarding protection of ‘industrial secrets’.

⁴ Law No. 19,039.

In addition, Chilean legislation provides for a Law on Protection of Consumer's Rights,⁵ a Law on Electronic Documents and Electronic Signature⁶ and for a Law on Privacy Protection.⁷ The latter regulates the 'adhesion contracts' usually found on internet websites under the title of 'general terms and conditions of use'.

In Chile, the sole visit to a website that offers access to certain services does not impose any obligation on the user, unless the user has unequivocally previously accepted the conditions offered by the provider. Typical clauses such as 'by accessing this website you acknowledge that you have read, understood and accepted these terms and conditions of use' do not obligate users in Chile.

To comply with the legal requirements for the 'electronic formation of consent', users must accept the terms and conditions of a website in writing. This can be achieved by clicking the relevant box to indicate acceptance of the terms and conditions. Once the contract is agreed, the provider must send written confirmation to the consumer.

Law No. 19,799 on Electronic Documents and Electronic Signature and its Certification recognises the validity of the acts and contracts agreed electronically, and gives them the same value as a written document.

Regarding personal data, Law No. 19,628 on Privacy Protection states that the user must authorise in writing the use of its personal information. This written agreement can be replaced by an electronic registration process if the identification of the user can be determined and a record of the authorisation can be kept.

IV FRANCHISE LAW

i Legislation

Chile does not have a law on franchising. Therefore, the main applicable law is the contract, which is considered as law for the parties, according to the provisions of Article 1545 of the Chilean Civil Code. In addition to that, civil and commercial codes will apply, together with the general rules of law and the existing case law on franchising. However, case law will not be binding for a court.

The parties are free to determine both the structure and content of the franchise agreement. In other words, a franchise agreement contract should be subject to general contract rules and certain limitations provided by local law, just as with any other contract.

Practice indicates that most franchising agreements are drafted on the basis of 'international models' and 'current international practice'.

ii Pre-contractual disclosure

Generally speaking, Chilean law considers as equals the parties that enter into a contract. In consequence, it does not impose more pre-contractual obligations than those that are the result of the application of the principle of good faith. The Chilean Civil Code states that 'the contracts must be executed in good faith'.

5 Law No. 19,496.

6 Law No. 19,799.

7 Law No. 19,628.

Under normal conditions, the parties to a contract only have to comply with the requirements of pre-contractual disclosures that are necessary to credit that both parties are in good faith; in other words, to be in a position to prove that the information granted to the other party is the information necessary to execute the contract in its natural meaning.

The obligations of the parties at the time of negotiating the agreement are not specifically established, and therefore franchise contracts are treated as any other contract. Therefore, what was discussed at the time of the negotiations in principle has no value unless it is possible to prove by means of strong evidence that the discussion was not a simple discussion but an agreement that was made before the execution of the document, and the agreement is to be considered as the contract.

In this respect, the Chilean Civil Code, Article 1554, states that:

The promise to enter into a contract does not produce any obligation unless the following conditions are met:

- 1) *That the promise is in writing;*
- 2) *That the contract promised is not one of those that the law declares ineffective;*
- 3) *That the promise contains a term or condition that sets the time of the conclusion of the contract;*
- 4) *That the promised contract is specified therein in such a manner that to be perfect the only thing missing is the tradition of the thing or the solemnities prescribed by law.*

Finally, the Civil Code contains rules for the interpretation of contracts (Articles 1560 to 1566), of which the following are examples: ‘if the intention of the parties is known, it should be given greater consideration than the literal wording of the contract’; ‘the terms of the contract, even if they are general, will be applied only for the contract’; ‘the interpretation of a clause that produces effects will be preferred over an interpretation that does not’; ‘unless there is a clear intention of the parties against it, the contract should be interpreted in the way that best suits its nature’; ‘the clauses of common use are considered part of the contract even when they are not expressly included’; and ‘the clauses should be interpreted in a way that favours the whole execution of the contract’.

The local practice indicates that in the case of franchises, memoranda of understanding (MOU) are common. A document of this sort will be useful to channel the discussions and negotiations of the contract. However, in most cases, practice indicates that they will have little weight from a legal point of view. In any case, such a document will in all probability include clauses regulating points such as confidentiality, transfer of information, ownership of information, a possible non-compete clause in case of not reaching an agreement, etc. While such clauses are normally considered as an enforceable contract, the MOU or letter of intention is not sufficient for the prospective franchisee to force the franchisor to enter into the final agreement.

iii Registration

As mentioned above, Chilean law does not prescribe any formalities regarding the execution of franchise agreements.

Nevertheless, to facilitate the enforcement of franchise contracts, it is very common for these contracts to be executed before a notary public, the involvement of which provides certainty regarding the date of execution and the parties to the contract.

iv Guarantees and protection

Guarantees are valid and often used in Chilean contracts. According to local law, there are the following three guarantees:

- a* mortgage: guarantees involving real estate;
- b* pledge: guarantees involving different kinds of moveable property; and
- c* personal guarantee: guarantee involving the goods of a person, in case the principal debtor does not pay its commitments.

The following formalities are required by law in respect of these different kinds of guarantee:

- a* mortgages: Chilean law requires a public deed, and the registration of this deed in the Registry of Mortgages and Encumbrances of the competent real estate registrar. There are some special cases that require other formalities (i.e., mortgage on certain ships), though these are not common;
- b* pledges: pursuant to local law, there are several kinds of pledge for which the law requires different formalities. The most common pledges are the pledges on shares, credits and the non-possessory pledge, among others. Each of these has its own specific formalities (notarisation, registration, among others); and
- c* personal guarantee: Law No. 18,092 provides that this guarantee shall consist of a written document, signed by the person who grants the guarantee, clearly identifying this document as a 'personal guarantee' to ensure the fulfilment of a specific obligation. This guarantee can be limited to a specific amount. Its notarisation is recommended.

V TAX

i Franchisor tax liabilities

As briefly mentioned above, pursuant to Article 58 et seq. of the Chilean Income Tax Law, foreign nationals with no residence or domicile in Chile, or foreign legal entities incorporated abroad, shall pay a withholding tax on any income produced by a Chilean source before they export that income from Chile.

In addition, franchisor and franchisees will pay tax on profits made in Chile through the franchising activity. In the case of international or cross-border franchising contracts, treaties to avoid double taxation may apply.

ii Franchisee tax liabilities

The local franchisee must collect the withholding tax and pay it to the Treasury. Therefore at the time of negotiating a contract of this nature and at the time of its execution, it is very important for the franchisor and franchisee to be clear on the exact amounts to be paid from one party to the other, and to the state (tax). In other words, at the risk of having a longer clause (which may even repeat that the burden of the withholding tax will be on the franchisee), it may be wise to go into some detail to establish clearly how the calculations will take place, the exact amount to be paid ultimately by the franchisee to the franchisor, and when it should finally be received by the franchisor.

According to Chilean law, there are no currency restrictions that may affect a franchise relationship between a US franchisor and a Chilean franchisee.

Notwithstanding the aforementioned, any operation in which the local franchisee receives payment of an amount exceeding 10,000 Chilean pesos shall be notified to the Central Bank of Chile. (This obligation, however, is generally fulfilled by the corresponding Chilean commercial bank that receives the payment.)

iii Tax-efficient structures

Practice indicates that in the case of franchisors domiciled abroad, it is common to establish in the contract the exact amount to be received abroad by the franchisor. Any deduction or payment to be made is the responsibility of the franchisee and does not affect the final amount received by the franchisor. Therefore, the cost to the franchisee is the total sum due for payment plus the withholding tax.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

As indicated above, the Chilean Civil Code imposes a duty of good faith that applies to all contracts, including franchising.

Furthermore, there are some general provisions that should always be taken into consideration in an agreement subject to local law, such as the rules of the interpretation of contracts already mentioned above.

ii Agency distributor model

As indicated above, Chilean law does not provide for a law on franchising. The same can be said for distribution. Therefore the law of the contract will be the main applicable law for the parties.

iii Employment law

The franchisee will not normally be considered as an employee of the franchisor. In addition, practice indicates that most local franchising agreements contain a special clause by means of which the parties establish that the relationship they have is not a labour-law relationship but a commercial relationship.

On the other hand, franchisees are considered as employers of the employees they hire to run the business. As a consequence, the franchisees must comply with all Chilean labour legislation, which always regulates the relationship between employer and employees in the country.

Jurisprudence has determined that if a franchisee who is an employer breaches Chilean labour law, the affected worker could pursue the fulfilment of the relevant legal obligations against the franchisor, which is considered to have subsidiary liability.⁸

Discussion on the reform of the Labour Code is ongoing, and even if the current situation does not change, it cannot be assessed at present.

8 Chilean Supreme Court, *Ortiz Huaiquil Claudia v. Comercial Proventa S.A.*, No. 4012-2008, decision of 25 September 2008.

iv Consumer protection

Unlike in other countries where the jurisprudence and doctrine have developed a criterion that establishes that under special circumstances franchisees could be treated as consumers (for example, in pre-contractual disclosures), this is not the case in Chile.

v Competition law

Franchise agreements are not subject to special treatment under Chile's competition law. Therefore general rules apply. Particularly relevant among these are the Chilean Antitrust Law⁹ and the Unfair Competition Law.¹⁰ In these matters, and in contrast to what was indicated in Section VI.iv, the Chilean legal system that regulates antitrust and unfair competition gives a very special role to case law, which is examined, studied and applied in court decisions.

Some parts of the legal provisions concerned are worth citing:

Any person that enters into or executes, individually or collectively, any action, act or convention that impedes, restricts or hinders competition, or sets out to produce said effects, will be sanctioned ... notwithstanding preventive, corrective or prohibitive measures that may be applied to said actions, acts or conventions in each case.

The following will be considered as, among others, actions, acts or conventions that impede, restrict or hinder competition or which set out to produce said effects:

- a) Express or tacit agreements among competitors, or concerted practices between them, that confer on them market power and consist of fixing sale or purchase prices or other marketing conditions, limit production, allow them to assign market zones or quotas, exclude competitors or affect the result of bidding processes.*
- b) The abusive exploitation on the part of an economic agent, or a group thereof, of a dominant position in the market, fixing sale or purchase prices, imposing on a sale another product, assigning market zones or quotas or imposing other similar abuses.*
- c) Predatory practices, or unfair competition, carried out with the purpose of reaching, maintaining or increasing a dominant position.¹¹*

In general, an act of unfair competition is any act against good faith or good custom which, by illegitimate means, is carried out with the purpose of diverting the clientele of a market agent.¹²

The Unfair Competition Law contains a, merely illustrative, list of acts considered as 'acts of unfair competition'. These include, among others:

- a* any conduct that takes advantage of another's goodwill, or that aims to confuse a third party's goods, services, activities, distinctive signs or establishment with those of the infringer;
- b* the use of signs or diffusion of facts or assertions, incorrect or false, that lead to misinformation about the nature, provenance, components, characteristics, price, production process, brand, appropriateness to fulfil the objectives, quality or quantity, and, in general, about the advantages that are really provided by the offered goods or services; and

9 DL No. 211 of 1973.

10 Law No. 20,169 of 2010.

11 Article 3, Law No. 20,169.

12 Idem.

- c* any incorrect or false information or assertion about the goods, services, activities, distinctive signs, establishment or commercial relations of a third party that is capable of harming its goodwill or any expression directed to discredit or ridicule such a person without any objective basis.¹³

In principle, the parties to the franchise agreement are free to determine its contents.

Practice indicates that most franchising contracts are drafted in a such a manner as not to impose final prices for the end consumer but instead propose a range in which the price should move, to maintain the international standards and position of the product and brand; not to force the franchisee to buy necessarily very specific amounts of goods but, on the contrary, to try to reach some agreement concerning annual sales, and to give bonuses when the goals are reached; and to establish certain rules on 'how to sell' and 'how to make discounts' without jeopardising the position of the brand in the local market and at international level, etc.

vi Restrictive covenants

In Chile, competition and confidentiality covenants are often agreed by the parties. Pursuant to Chilean law, these are valid and fully enforceable. These covenants are usually either contained within the contracts (specific clauses) or agreed in a specific and separate document (non-competition agreement or non-disclosure agreement). However, case law and practice indicate in a rather consistent manner that non-compete clauses are acceptable and enforceable as they are limited in time and provide that the one benefiting from the clause will somehow compensate the one who bears the burden of not competing.

vii Termination

Once again, and as indicated above, the contract will be the law of the parties. In addition, in practice there is a consistent use of rather detailed termination clauses, since if nothing is said, general rules of commercial and civil law will apply, and in most cases those laws will have to be applied by a court. Also in this context, in cases of termination local franchising contracts are repeatedly seen to be used to regulate the following areas:

- a* protection of trademarks;
- b* pending payments between parties;
- c* the possibility of having the franchisor continue with the business, with the aim of protecting the brand, the employees of the franchisee, the location, etc.;
- d* payment of stock and destination of stocks;
- e* rights of the parties during the time of termination and possible legal actions and waivers within determined conditions; and
- f* confidentiality, etc.

As indicated above, non-competition agreements are usually enforceable. In most cases, specific terms and conditions are agreed upon.

Chilean law does permit placement of restrictions regarding transfers of equity interest in franchisees, to the extent that the parties agree to it. Where the parties have provided for a prohibition on the franchisee assigning the contract, a breach of such a provision will be

13 Idem.

a cause for the franchisor to terminate, in principle, with no doubt. If the parties have not agreed to a clause of this nature, and given that the franchising contract is a contract *intuitu personae*, it is understood that the franchisee will not be entitled to assign its contract or rights without the prior consent of the franchisor.

viii Anti-corruption and anti-terrorism regulation

Prior to joining the Organisation for Economic Co-operation and Development,¹⁴ Chile enacted Law No. 20,393 of 2009 introducing criminal liability for legal entities in cases of money laundering, financing of terrorism and bribery.

The law states that:

Legal entities will be responsible for the crimes that were committed directly and immediately in their interest or to their advantage, by its owners, drivers, managers, executives, representatives or those engaged in administration and supervision, provided that the commission of the offence is the result of the failure by the latter of the management and supervisory duties.

The most relevant consequence for franchising is the obligation for the franchisor and franchisee, to different degrees, to exercise strict control to prevent the situations mentioned above.

ix Dispute resolution

Practice indicates that there is no uniform option chosen by the parties as far as applicable law and forum are concerned. Foreign laws and Chilean law (in spite of the lack of franchise law) are common. The same can be said regarding forum; some parties choose court proceedings while others prefer alternative dispute resolution methods such as arbitration (national or international).

Chilean laws permit the parties to reach an agreement to choose from all these options. In fact, there are no restrictions upon the choice of a foreign law or a venue outside Chile for dispute resolution purposes. However, this choice and, in consequence, foreign law, will be applicable only to the extent that there is no conflict with Chilean public policy. Taking into consideration the foregoing, there are some topics in which the applicable law will necessarily be Chilean law, even if the signing parties have agreed something different. For example, Chilean law will apply to the sale or rent and other transactions made in relation to real estate located in Chile, to employment matters, to tax issues, etc.

Commonly, franchising agreements give a mandate to the Arbitration and Mediation Centre of the Santiago Chamber of Commerce as it has gained a favourable reputation in recent years.

Mediation in these cases is recognised, but it is not mandatory unless the parties to the franchise contract have so agreed.

Both judgments and awards are usually enforceable without many issues. Chile has been a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards since 3 December 1975.

Equitable remedies are available in Chile. The Civil Procedure Code provides several remedies, and specific requirements for each of them. The Industrial Property Law provides

14 7 May 2010.

for the possibility of obtaining an interim or permanent injunction to prevent someone – and, therefore, a former franchisee – from continuing to trade in breach of a non-compete provision or from using the franchisor’s trademarks and other intellectual property rights duly registered in the name of the franchisor.

As far as damages are concerned, liquidated damages are contemplated in the Chilean Civil Code.¹⁵ These clauses are used often in civil and commercial contracts, and they are fully enforceable. Notwithstanding the aforementioned, their amounts are generally reasonable, and therefore they are not understood as punitive. The Civil Procedure Code and the Industrial Property Code contain rules for the calculation of damages, under specific circumstances.

VII CURRENT DEVELOPMENTS

The Chilean economy has been growing consistently for many years. The slowdown that began in 2014 and continues today does not seem to have affected franchise development yet or, at least, does not seem to have affected franchise sales in a different manner from commerce sales in general, if these are compared as distinct areas of economic activity. That said, franchise-specific case law is still rather limited at the moment and it could be argued that we have yet to obtain a clear indication of how the continuing economic slowdown and the tax law reforms will ultimately impact on the franchising business.

Despite franchising being discussed and studied today in some Chilean law schools, we have not yet seen a discussion concerning the need for a specific law on the matter. Current commercial, civil and competition laws seem to provide a good framework for franchising businesses in Chile.

It is hoped that, in the short term, both jurisprudence and doctrine development will give more definitive positions and practical answers regarding those topics that have still not been treated in a detailed or consistent manner.

The success of the franchise model in Chile and the still-growing economy have seen several international brands featured in Chilean newspaper and magazine articles as candidates for entry into the Chilean market by means of a franchise system. Finally, in 2017, the FIF organised by the Chamber of Commerce of Santiago took place successfully once again in Chile, with a significant number of participants, and the 2018 FIF event is already being planned.

15 Article 1535 et seq.

CHINA

*Sven-Michael Werner*¹

I INTRODUCTION

Retail and franchising in China developed very fast in the decade from 2001 to 2012, during which the sales volume of the top 100 chain-store retailers in China increased by 10 times. The total sales of the top 100 franchisors in China reached 428 billion yuan in 2016. In 2014, the franchising growth rates varied from sector to sector; for instance, the automobile sector doubled its sales whereas catering and retail experienced a negative year. Still, 90 per cent of franchisors forecast a sales growth for 2015, of which 43 per cent expect 2015 to show a higher rise compared with 2014.

There are two remarkable trends. First, with the increasing costs on franchising (particularly premises and workforce in the first-tier and the second-tier cities) and the overwhelming competition from the rise of online retail, many franchisors have tended to develop franchises in the fourth-tier cities in 2015, particularly in sectors such as supermarkets, laundry, fast food, accessories and the automotive sector. Second, both online and offline purchasing and sales increased rapidly in the past two years in China, forcing global franchisors to seek suitable approaches and strategies to address this.

Franchising in China covers a wide range of industries and sectors such as food and beverages, retail, catering, education and other services. Franchisors encompass Chinese local retailers and international brands such as KFC and FamilyMart with legal entities in China, most of which are members of the China Chain Store & Franchise Association (CCFA).

CCFA, incorporated as a civil association under the Ministry of Civil Affairs in 1997, is the official industry association for the retail and franchise industry in China. Currently it has over 1,000 enterprise members with more than 356,000 outlets, including domestic and overseas retailers, franchisors, suppliers and relevant organisations. By 30 November 2017, 890 foreign franchisors had registered their franchises with the Ministry of Commerce (MOFCOM), the highest governmental body in charge of franchising in China.

II MARKET ENTRY

i Restrictions

As part of its World Trade Organization commitments, China agreed to eliminate legal restrictions on foreign investment in the area of franchising by 11 December 2004. This commitment was implemented with the enactment of Administrative Measures on

¹ Sven-Michael Werner is a partner at Bird & Bird.

Commercial Franchise Businesses on 30 December 2004 with effect from 1 February 2005.² However, foreign franchisors are still obligated to comply with the restrictions on foreign investment set out in the foreign investment industry guidance catalogue and the various laws and regulations applicable to foreign investment in the distribution sector. For example, foreign companies are not permitted to engage directly in distribution activities (which generally covers retail, wholesale, commission agency and franchising operations) but must engage in such activities by setting up a wholly foreign-owned commercial enterprise (FICE). The types of products or services provided by the FICE must be specified in the statement of its business scope.

There are certain restrictions on granting a master franchise or development rights to a local entity (e.g., registration and other requirements) that apply to all master franchisors, foreign or domestic. Such franchises generally fall into two categories: the first is a two-level franchise, or sub-franchise, whereby the franchisor grants a franchisee the franchise rights to a specific sales region, allowing the franchisee to grant sub-franchises to others. In this instance, the franchisee would have a dual role as a franchisor as well as a franchisee. The master franchisor in this model may be either a foreign or a domestic company. The second model is an agent franchise, whereby the franchisor grants a franchisee the right to recruit other franchisees. In this instance, the franchisee would essentially act as an agent of the franchisor in handling the recruiting and would provide these sub-franchisees with guidance, training, consulting, supervision and support. In the second model, the franchisor would have to be a foreign-invested enterprise rather than a foreign company as it would essentially be conducting franchising activities in China.

Subject to obtaining the relevant governmental approvals, a foreign franchisor can own equity in a local business so long as the local business does not fall within an industry sector where foreign investment is restricted or prohibited.

Owning real property is restricted under People's Republic of China (PRC) law. A foreign-invested enterprise that does not specialise in real estate may only purchase real estate in China for its own use. If the franchisor's overall strategy includes provision of premises to franchisees, one solution may be for the franchisor (or an affiliate) to set up a foreign-invested real estate company in China (which would trigger conditional approvals by several Chinese governmental bodies) to make the relevant real estate purchases and to provide premises for franchises to the franchisees. This, however, is subject to another set of relatively restrictive procedures that the investor must complete prior to any applications made for these approvals.

ii Foreign exchange and tax

The yuan, China's official currency, is not a freely convertible currency; offshore remittances are generally subject to the regulation of the State Administration for Foreign Exchange (SAFE). From the perspective of a foreign master licensor, it would be prudent to insist that the master franchise contract provide for payments to be made in a foreign currency and into an offshore bank account so that the responsibility for making offshore remittances rests with the domestic master franchisee. Remittances of current account payments can usually be handled at banks designated by SAFE to handle such transactions upon presentation of the contract and shipping documents. Since November 2016, reports have confirmed

² The Franchise Measures are no longer valid; they have essentially been replaced by the Administration Rules on Commercial Franchise Businesses enacted on 6 February 2007 with effect from 1 May 2007.

that SAFE is again tightening the supervision of outbound payments for both capital and current account items. It will mean, therefore, that SAFE may require the submission of an application for approval. In addition to what would normally be presented to a bank, the application submitted to SAFE shall contain additional documents and information, including without limitation the detailed reasons for the parties' agreement to the terms. Payments may therefore be rejected repeatedly. In the (unlikely) event that the payment cannot be remitted offshore, the parties may consider adding a provision setting out an alternative arrangement for payment of yuan to an onshore bank account or agent. It would also be prudent to stipulate that failure to pay for any reason (including those relating to government actions) cannot be excused under force majeure.

III INTELLECTUAL PROPERTY

i Brand search

Brands of foreign franchisors would usually enjoy protection by operation of their respective trademark registrations in the relevant countries. Such registrations are generally made in the brand's original language and writing. To market products under such a brand to consumers in China, the franchisor would need to create a recognisable Chinese brand based on Chinese language characters and protect the brand locally in China. The selection of Chinese characters for each transliteration is very important as the choice of characters may flatter or detract from the brand image. To avoid future disputes, the franchisor should conduct all necessary trademark searches to ascertain that the selected Chinese name is not already being used by another entity, or if it is being used, that its use can easily be discontinued; for example, by having an intermediary purchase any existing rights on behalf of the franchisor. It is essential, as mentioned, to conduct the requisite market research to ensure that the name appeals to the Chinese general public, taking into account the visual effect of the Chinese characters in both simplified and classical format as well as its auditory effect in various major Chinese dialects. Once the franchisor determines the Chinese name under which it wishes to be officially known to the Chinese public, if it chooses to do so trademark applications to register the Chinese mark in all relevant trademark classes may be filed with the PRC Trademark Office.

Once the franchisor has determined what marks it plans to use to identify the goods or services that are intended to be offered under the franchise, it should conduct a search of the official database of the PRC Trademark Office to ensure that there are no records of trademark registrations or pending applications for marks identical or similar to its own in the trademark classes covering the goods or services to be offered. If there are registered trademarks or pending applications for marks similar or identical to the marks that the franchisor intends to use in the Chinese market, the franchisor will need to decide whether to try to acquire the relevant rights from the prior rights holders, or to identify alternative marks for use in the Chinese market.

The Chinese brand name may then be used for Chinese domain names and also as part of the name of any entity to be established in China. For the registration of China domain names, searches should also be conducted to determine whether the desired domain names in the relevant domains (.cn, .com.cn, .net.cn, etc.) are available. The same applies for company names, as regards company name searches with the relevant Administration of Industry and Commerce to ensure that these names are available for use as part of a company name in the jurisdictions where the franchisor intends to establish its affiliates.

If franchisors are to be allowed to use this name in China, the granting of the relevant use rights would need to be made part of the legal franchise documentation. Franchisors, however, are advised not to license the brand to the franchisee for use as part of the franchisee's company name as it will be difficult to reclaim the rights for its use in the event that the franchise relationship terminates.

ii Brand protection

A franchisor that wishes to do business in the domestic Chinese market is strongly advised to register its key marks in the People's Republic of China. The PRC registrations can be done as part of an international application under the Madrid Convention or by filing separate applications with the PRC Trademark Office. Although filing applications under the Madrid system is a simpler process, in-country applications filed with the Trademark Office will provide the applicant with greater flexibility as it will be able to craft its own specification of goods and services, tailored to accommodate local requirements as well as the needs of the domestic market.

China is a first-to-file jurisdiction and trademarks are protected in China upon registration with the PRC Trademark Office in accordance with the procedures set forth by relevant laws and regulations. That is to say, even though a trademark has been registered in the home country, it is not protected in China until the registration application is approved. Therefore, it is very important for foreign companies to ascertain whether its specific mark is still available in China as it makes plans to enter the Chinese market.

In respect of what can be registered as a trademark, PRC law recognises three-dimensional symbols and combinations of colours as well as any visual sign if it can be used to distinguish the goods or service of a natural person, legal entity or any other organisation from that of others, including any word, design, letters of an alphabet, numerals, etc. Under the Trademark Law, non-visual trademarks such as sound trademarks are registrable in China.

A trademark registration is valid for 10 years, starting from the date the registration receives approval, and may be renewed for subsequent 10-year terms. Renewal applications should generally be made 12 months prior to the expiration date, although, subject to a related application, the application may still be accepted up to six months before the expiry date.

In the PRC, trademarks are not only categorised in the international trademark classes but are further categorised into subclasses. It is possible that the PRC Trademark Office may allow a registration for the same mark from another applicant if it covers goods or services that are not in the same subclass as the goods and services listed in the franchisor's registrations.

Therefore, as a defensive measure to prevent others from registering a certain mark for other related goods, the franchisor may also consider whether it wishes to include additional goods or services in each subclass or register its mark in other classes. As a matter of first priority, the franchisor should register any and all marks in the relevant classes of goods and services that it will be using in China or to promote its products to Chinese customers.

iii Enforcement

The franchisor should monitor, whether on its own or through a designated intermediary, the domestic market on an ongoing basis so that possible problems may be addressed as they arise or as early as possible; for example, any unauthorised use of its trademarks and trade dress in China. This may entail working with law firms, investigation firms and agents as necessary to monitor use of any intellectual property (IP) of the franchisor, identify infringers and collect evidence. If the franchisor is considering sending cease-and-desist letters to infringers, it must

be prepared to follow through on any threats made therein, if only to maintain its credibility as a company that is serious about protecting and enforcing its intellectual property. Pursuit of an aggressive enforcement strategy is key to discouraging potential infringers.

In addition to IP litigation in the PRC courts, companies may also file for administrative protection with the State Administration for Industry and Commerce (SAIC) or its local counterparts for trademark infringement matters. However, the SAIC's authority is limited: it can issue an order to halt the infringement, impose fines, conduct raids or seize counterfeit goods, materials or equipment, but it cannot award compensation.

iv Data protection, cybercrime, social media and e-commerce

The laws and regulations relating to cybercrime, e-commerce and other internet-related activities that are applicable to general commercial transactions under PRC law would also apply to franchising activities in China. Though there are no e-commerce provisions specifically applicable to franchising, the increasing regulatory trend to protect personal data is noteworthy. In particular, the PRC Consumer Protection Law, amended in October 2013 and effective from 15 March 2014, newly includes provisions on personal data protection with a specific focus on consumer rights; the State Council and the Ministry of Industry and Information Technology have, one by one, enacted new rules between 2012 and 2013 protecting online personal data or personal data related to other means of telecommunication. The revised PRC Consumer Protection Law came into effect in March 2014, some provisions of which re-emphasise the protection of consumers' personal data, online and offline. The Cybersecurity Law, issued by the Standing Committee of the National People's Congress (SCNPC), came into effect on 1 June 2017, and has had a profound influence on personal data protection. This new Law regulates, for the first time at national level, how information is collected, stored, transmitted, exchanged and processed. 'Operators' will bear additional security protection responsibilities, such as formulating internal security management systems, adopting technological measures to prevent computer viruses, and monitoring and recording the operational status of networks. However, whether these obligations will apply to all enterprises, or only to e-commerce companies, is not clearly stipulated.

v Advertisement Law

The most recent amendment to the Advertising Law, issued by the Standing Committee of the National People's Congress, came into effect on 1 September 2015 and the Interim Measures for the Administration of Internet Advertising issued by the State Administration of Industry and Commerce came into effect on 1 September 2016. Changes introduced by these amendments include: (1) more restrictions on advertising-related matters, with explicit penalties for non-compliance; (2) claims containing superlative words or the advertising of off-limits products or services are generally restricted; (3) the use of 'technical/digital methods' to fabricate or 'improve' the real effect of the product or service in advertisements is punishable as false advertising; (4) further regulation of electronic advertising by defining internet advertising; (5) tighter regulation of endorsements; and (6) changes regarding the advertising of specific products and services. The franchisors, by making advertisements to promote their brands, are subject to the amended advertisement law.

IV FRANCHISE LAW

i Legislation

Under PRC law, there are specific commercial franchising regulations that stipulate among other items, franchise-specific pre-contractual disclosure and franchise requirements. These regulations apply to both foreign-invested and local Chinese franchisors.

Commercial franchising operations are generally defined under PRC law as:

arrangements whereby a franchisor, by contract, authorises a franchisee to use its relevant operational resources, such as its trademark, trade name, logo, patent, proprietary know-how and the franchisee conducts the business in accordance with the franchisor's standardised business model (i.e., uniform visual image, business concept, management model, etc.) and pays fees for participating in the franchise in accordance with the franchise agreement.

However, simply not charging fees does not automatically mean that an entity is not running a franchising operation, as other factors will also be taken into consideration.

The two types of franchising arrangements most commonly seen in the Chinese market are arrangements whereby the franchisor authorises the relevant franchisees to (1) open and operate stores in a specific territory, without any right to grant further sub-franchises; or (2) act as the master franchisor for a specific territory, with the right to grant further sub-franchises to other downstream sub-franchisees as well as directly operate its own franchises as a franchisee. However, the relevant laws and regulations address only the franchising as a direct relationship between two parties and do not distinguish between the different types of franchising arrangements.

An entity must satisfy the following requirements to be eligible to conduct a franchising business in China:

- a* it must be an enterprise;
- b* it must own or have the right to use the relevant operational resources, such as the relevant trademark, trade name, logo or well-established operational model, etc.;
- c* it is capable of providing long-term operational guidance and training support to franchisees;
- d* it (or any of its subsidiaries or its controlling shareholder) must have established at least two directly operated stores and have operated those stores for a period of no less than one year;
- e* it must have established a stable supply system that can ensure sound product quality and render relevant services where the franchising arrangement requires the franchisor to supply the relevant goods; and
- f* it must be of good repute and does not have any record of fraudulent operational activities.

ii Pre-contractual disclosure

A franchisor should positively disclose in writing to the franchisee, at least 30 days before signing the franchising contract, certain information about itself:

- a* basic information on the franchisor and franchise activities (e.g., full name, registered address, registered capital, business scope);
- b* basic information on the business resources of the franchisor (e.g., trademarks, proprietary technologies, business models);

- c* basic information on the franchising expenditures (e.g., franchising fees, deposit, payment, refund);
- d* information on prices and conditions of the products, services and equipment provided to the franchisee;
- e* plans on continued provision of support or training services to the franchisee;
- f* the methods and content of guidance or supervision over the franchise activities of the franchisee;
- g* investment budget for the network of franchises;
- h* information on the franchisees within the territory of China (e.g., number, regional distribution, operational status);
- i* abstracts of the franchisor's financial and accounting reports and audit reports for the past two years audited by accounting firms or auditing firms;
- j* information on major litigation and arbitrations concerning franchises of the franchisor in the past five years, including the cause of action, litigation and arbitration claims, jurisdiction and results;
- k* information on the records of gross violations (i.e., above a certain threshold of fines or amounting to criminal offences) of the franchisor and its legal representative; and
- l* the franchise contract:
 - a sample franchise contract; and
 - a sample of other contracts relating to the franchise if the franchisor requires the franchisee to sign any with the franchisor (or its affiliate).

A franchisor is obligated to provide its franchisees with authentic, accurate and complete information, and keep the franchisees informed of updated information in a timely manner. If a franchisor hides any related information or provides false information to a franchisee, the franchisee will be entitled to terminate the franchise contract and the franchisor may also be ordered to rectify the matter and be punished by a fine of up to 100,000 yuan, with a public announcement if the responsible governmental body (MOFCOM) thinks the franchisor's violation is severe.

Pursuant to the Beijing Appellate Court's Interpretation on Several Issues regarding Adjudication on Franchise Agreement Disputes (effective as of 23 February 2011), the franchise agreement may be invalid when undisclosed false information is material to the operation of the franchise, and the franchisee entered into the franchise agreement on the basis of that information. The courts shall also consider the adverse impact of undisclosed or false information in relation to the performance and purpose of a franchise agreement so as to adjudicate whether the franchise agreement is valid. This interpretation suggests that violation of the disclosure obligation does not necessarily render the contract invalid in every instance.

If any of the information provided constitutes trade secrets, the franchisor may ask the franchisee to enter into a non-disclosure agreement.

iii Registration

Within 15 days of entering into a first franchising contract in China, the franchisor is required to make a filing with the Ministry of Commerce. The franchise contract template, operational manual, business plan for the proposed franchising arrangement and the documents evidencing that it has satisfied the relevant requirements to serve as a franchisor must be submitted as part of the filing.

Regulations are not clear on what constitutes 'a first franchise agreement'. It may be interpreted that the franchisor should only file the franchise agreement concluded with their first franchisee but not every franchise agreement it enters into. According to informal enquiries to the Ministry of Commerce, the franchisor should record as a template the franchise agreement entered into with its first franchisee. After this filing, the franchisor is required to make an online renewal of this filing at the MOFCOM website each year in March to be able to register any new franchisees. This confirms that the franchisor does not need to record every franchise agreement entered into with new franchisees.

iv Mandatory clauses

The franchisor and the franchisee must enter into a written franchise contract; and the main content of the franchise contract shall include the following:

- a* basic information in respect of the franchisor and the franchisee;
- b* content and term of the franchise;
- c* type, amount and payment method for the franchising fees;
- d* specific content and methods for providing business guidance, technical support, business training and other services;
- e* quality requirements and standards for the product or service and methods for assurance thereof;
- f* sales promotion, advertising and publicity in respect of the product or service;
- g* protection of consumers' rights and interests and the assumption of compensation liabilities in the franchise;
- h* alteration, annulment and termination of the franchise contract;
- i* liabilities for breach of the contract; and
- j* methods for dispute resolution.

The franchisor and the franchisee may stipulate in the contract any other matters as they like.

The qualification and validity of a franchise agreement would depend upon the nature of the actual commercial arrangement as set out in the relevant agreement among the parties, even if the agreement itself was not identified as a franchise agreement. This question has been confirmed by the Supreme People's Court recently. The Supreme People's Court also decided on whether a franchise agreement should be invalidated where the franchisor does not comply with the above franchise-related requirements. The question of the non-compliance of the franchisor appears to depend upon whether the non-compliance is remediable; for example, failure on the part of the franchisor to comply with the requirement of directly operating at least two stores will not affect the validity of its agreements with franchisees, whereas franchise agreements entered into by any non-enterprise entity or individual (which by law is not permitted to enter into franchise agreements) will be deemed as invalid.

v Guarantees and protection

The laws and regulations relating to guarantees and protection under PRC law that are applicable to general commercial transactions would also apply to franchising activities in China, but there are no provisions specifically applicable to franchising.

V TAX

i Franchisor tax liabilities

There are no specific tax duties for franchise operations. Any company incorporated in China shall pay corporate income tax on its profits. Unlike most business operators, franchisors as such do not have to file consolidated tax returns covering value added tax (VAT), consumption tax, corporate income tax, etc. However, franchisors must pay taxes on fees received under the franchise agreement, which are generally all subject to business tax (BT). Although in the course of the past 10 years the scope of the application of VAT has been widely expanded to an extensive range of sectors, including most services and sale of goods, franchises in certain sectors (e.g., catering, real estate and construction) are still subject to BT.

ii Franchisee tax liabilities

As business operators, franchisees would have to file consolidated tax returns covering value added tax, consumption tax, corporate income tax, surcharges, etc.

iii Tax-efficient structures

Whether a structure is tax efficient will depend on specific aspects of the franchise.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The duty of good faith is one of the key principles set out in PRC contract law. A party that breaches its duty of good faith may find itself liable for the damages incurred by the other party as a result of the breach.

ii Employment law

The courts are unlikely to treat the franchisees as employees of the franchisor, but the franchisor should provide clear statements with respect to the independent nature of the relationship between the contracting parties stated in the relevant franchise agreements, and make clear that the franchisee is responsible for bearing the responsibility as an employer of the individuals employed in the franchise, and that those individuals are not employees of the franchisor.

iii Consumer protection

In the event of consumer claims in relation to franchise operations, Chinese law gives consumers the choice of claiming against either the franchisee or the franchisor. A franchisor may consider indemnifications by franchisees individually in the franchise agreements. In addition, MOFCOM requires franchisors and franchisees to clarify and disclose to MOFCOM in advance each party's responsibilities for consumers in the franchise agreement.

We are not aware of any specific circumstances under PRC law whereby franchisees would be treated as consumers.

iv Competition law

The laws and regulations relating to competition and antitrust under PRC law that are applicable to general commercial transactions would also apply to franchising activities in

China, although there are no antitrust cases currently involving franchising. It is permissible for a franchisor to exercise control over the franchisee business. Given the increasing enforcement activities by the Chinese competition law authorities, however, it is important to bear in mind that restrictions imposed on the franchisee should not go beyond what is necessary and proportionate to the aims of protecting know-how, brand unity and licensed IP rights. Specific attention has been paid in recent years to fixed-price clauses in retail and distribution agreements; such clauses are prohibited under PRC competition law since it is difficult to justify them in relation to franchise networks.

v Restrictive covenants

There should be no problem with imposing non-compete or other restrictive covenants so long as they do not violate any competition rules or obviously break the principle of fairness. Any non-compete or other restrictive covenants should be set out in the franchise agreement or other agreement to be enforceable. The PRC laws and regulations applicable to general commercial transactions would also apply to franchising activities in China.

vi Termination

PRC laws and regulations that are applicable to general commercial transactions, including termination and transfer of businesses, would also apply to franchising activities in China.

Regarding post-contractual obligations of franchisees, some are stipulated by laws. For instance, a franchisee has contractual and post-contractual obligations to keep the franchisor's trade secrets confidential, whether or not this is agreed by the franchising parties in writing. As to any other post-contractual obligations, franchisors may impose them on franchisees by contractual agreement.

vii Anti-corruption and anti-terrorism regulation

The laws and regulations relating to fraud, anti-corruption and money laundering under PRC law that are applicable to general commercial transactions would also apply to franchising activities in China, but there are no provisions specifically applicable to franchising. Corrupt and fraudulent behaviour in retail operations are generally widespread, however, so franchisors shall implement protective measures against related legal non-compliance and financial risks.

viii Dispute resolution

Contracting parties may elect to settle disputes by arbitration or litigation, and with respect to contracts with a foreign element (i.e., involving one or more foreign parties), arbitration or litigation may take place offshore. At this time, mediation is still not commonly used as a dispute resolution mechanism in China.

Parties that choose to settle disputes by litigation may stipulate that disputes be settled in a Chinese or foreign court with jurisdiction (e.g., located where the contract is signed or performed). However, because it is difficult to enforce a foreign court judgment in China, a foreign party to an agreement should not choose to resolve disputes by means of litigation in a foreign court unless the Chinese party has assets under the jurisdiction of that foreign court. In the absence of these circumstances, it would be prudent to stipulate that disputes be settled by binding arbitration in a neutral location. The arbitration clause must be drafted to expressly provide final and binding arbitration as the sole and exclusive means for resolving any and all disputes arising under or in connection with the agreement, and the arbitration

tribunal designated for this purpose should be named in a clearly identifiable manner. Any ambiguity or other flaws in the arbitration clause may result in invalidation of the clause itself, which would allow a party to refuse to submit to arbitration and leave litigation in a Chinese court as the only viable alternative, or render an award obtained by arbitration under that arbitration clause unenforceable.

The parties may elect to submit their dispute to arbitration before any internationally recognised arbitration commission. As a signatory to the New York Convention, China's courts are obligated to recognise and enforce arbitral awards issued by arbitration tribunals in the country of other signatories to the Convention.

Notwithstanding the above, it may be prudent to carve out an exception so as to give a party the right to seek injunctive relief from any competent court with jurisdiction over the subject matter. This may be useful in cases involving infringement where damage control is necessary, as it is faster to obtain and enforce injunctive relief from a court where the activity at issue takes place. While a case is pending, injunctive relief (preservation of property or evidence and other specific injunctions) may also be sought in urgent circumstances (e.g., instances involving IP infringement), and China's IP laws provide an efficient mechanism for seeking such interim remedies. An applicant that submits an application for injunctive relief must post a bond or provide another form of guarantee. Within 48 hours of an application for injunctive relief, the court must respond with a written decision and must notify the applicant of its decision within five days. Within 15 days of the order for injunctive relief being issued, the applicant must file a complaint with the court, otherwise the injunctive order will be vacated. However, Chinese courts are not bound to follow the agreement of the parties with respect to a party's right to injunctive relief, notwithstanding the fact that it is expressly set out in the agreement. The court is at liberty to review the circumstances to determine whether to order specific performance, or to grant injunctive or equitable relief, and may still require the party seeking relief to prove damages and post a bond or other security. But notwithstanding the above, the provision should not be deleted from the agreement as its inclusion in the agreement may have a persuasive effect on the judge and a deterrent effect on the other party.

There have been various cases involving franchise arrangements in the courts over the years, some of which have been identified by the Supreme People's Court as being noteworthy cases. One of those cases, decided in 2012 by Shandong Province High Court, addressed the issue of an implied obligation on the part of franchisors to avoid competing with their franchisees in the same geographical territory. In that particular case, the franchisor opened a branch company within 200 metres of its franchisee, and both were offering similar real estate agency services. The court held that because of the nature of a franchise arrangement and based on the principle of good faith, a franchisor should reasonably avoid operating in the business territory of its franchisee so as not to threaten or affect the normal operation of the franchisee. The franchisor was ordered to immediately cease the business operations of its branch company.

VII CURRENT DEVELOPMENTS

Since the amended Commercial Franchise Operations Registration Administrative Measures took effect on 1 February 2012, the government has made a significant effort to regulate and monitor franchising activities in China. However, the barriers to market entry in the franchising business have risen with the increasing costs of real estate, equipment, goods and

labour, and made it more challenging to make sustainable profits in these businesses. As an example, to cut down on costs, fast-food outlets have sought to reduce their labour costs by trying to automate many of their work processes and by centralising goods production.

Franchising in China has long focused on many industries relating to retail, food and beverages, and services. The education sector has been booming with high growth rates since around 2005, but reports in late 2013 suggested that certain subsectors in the Chinese education market have become saturated and appear to have slowed down. In particular, the Chinese Private Education Promotion Law, which was passed in 2003 to encourage private funding of non-profit schools, was amended on 7 November 2016 by the SCNPC and became effective as of 1 September 2017. The new law provides that dual-curriculum schools may only be organised as non-profit entities for the nine-year compulsory education phase of the curriculum. Additionally, it reiterates that a core Chinese curriculum should be taught in the compulsory years, which may make it more difficult for dual-curriculum schools to cooperate with overseas schools, by franchising or other means.

One of the fast-growing and promising market areas is currently the baby and mother market. However, the traditional franchising models in this market have suffered largely from e-commerce and parallel import competition, but, on the other hand, the e-commerce model has itself suffered from a crackdown by the customs authorities at the time of writing. Another area showing optimistic signs is the automotive sector, which enjoyed a doubling of sales in 2014 while some other industries were suffering slow or even negative growth.

CZECH REPUBLIC

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I INTRODUCTION

The concept of franchising made its way to the then Czechoslovakia soon after 1989 when the fall of communism brought about the necessary political and economic changes. The opening of the Czech market to both domestic and international businesses led to the establishment of the first franchises, including the fast-food chain McDonald's (1991), the cosmetics shop Yves Rocher (1991) and the DIY retailer OBI (1995).

In 1993 the Czech Franchise Association (CFA), a non-profit professional organisation whose current 60 members include franchisors and various franchising specialists, lawyers and advisers, was established. The CFA is a member of the European Franchise Federation and the World Franchise Council.

Widespread expansion of the franchising model was, however, rather slow during the 1990s because of a variety of factors, including difficulty of access to external funding for small entrepreneurs, an underdeveloped legal system and foreign franchisors or investors' limited knowledge of the Central and Eastern Europe (CEE) markets, as well as Czech small to medium-sized businesses' lack of experience of international trade. This started changing around the time of the Czech Republic's accession to the European Union, in 2004, and after. This political development at the EU level contributed to the creation of a favourable environment for franchising, which has since progressed rapidly. Today, franchising is seen as a common business model with approximately 250 franchises being present on the Czech market. In 2014 there were 5,272 franchisees in the Czech Republic operating 6,432 own branches and 6,364 franchise outlets, which represents almost a doubling of the situation in 2010.² While in the past there was a clear predominance of imported foreign concepts entering the Czech market through franchising, since 2011 franchising concepts originating in the Czech Republic have been in the majority. Among the most successful Czech brands are Husky and Bushman (both outdoor clothes), Benu and Teta (pharmacy and retail) and Fruitissimo and Bageterie Boulevard (both food).

The community of franchising professionals has also been growing. In 2006, the Czech Franchise Institute (which runs the Franchise Club) was established and, three years later, joined the International Franchise Association. The membership currently numbers around 100, making it the largest local franchising body. Other notable developments in the country include the publishing of an annual franchising report, since 2010, and since 2012 a dedicated quarterly magazine, *Vlastní firma FRANCHISING*.

1 Vojtěch Chloupek is a partner at Bird & Bird s.r.o. advokátní kancelář.

2 Franchising Report Czech Republic 2014. PROFIT system. Prague 2014.

II MARKET ENTRY

i Restrictions

In general, there are no restrictions or approvals required in connection with foreign franchisors entering the local market. Obviously, there are some highly regulated sectors, such as defence, telecoms and gambling, but there are no limitations imposed specifically in connection with franchising.

Foreign entities that carry out business activities in the Czech Republic on a regular basis might need to set up a local establishment, whether in the form of a local subsidiary or a branch of the foreign entity, and must comply with the same rules that are applicable to domestic entities, such as acquiring the relevant trade licence and registering in the Commercial Register (although with respect to EU-based entities the latter requirement is disputed among legal commentators). Assessment of this requirement and ensuing obligations should ideally be made on a case-by-case basis and reflect the particular franchising model in question.

There are no general restrictions on a foreign entity granting a master franchise or development rights to a local entity. The terms of the respective agreements must, however, comply with the provisions of competition law.

There are no restrictions on foreign franchisors owning equity in a local business either.

ii Foreign exchange and tax

As far as foreign exchange is concerned, foreign persons (non-residents) can hold bank accounts in any currency and there are no restrictions placed on the import or export of capital. Repatriation payments can be made in any currency.

In general, the Czech tax system has been rather infamous for its complexity and for being rather burdensome for businesses. That said, most aspects of the local tax systems (including mutual assistance and administrative cooperation) stem from EU law. The main taxes include income tax, value added tax, real property tax, road tax (imposed on entities that use vehicles), excise duties and social security. The Czech Republic is party to over 90 double-taxation treaties. As far as withholding tax on royalties paid to non-residents is concerned, the standard rate is 15 per cent but can be 35 per cent if income is paid to a 'tax haven'. These rates can, however, be reduced under either a tax treaty or an exemption granted under the applicable EU legislation. Taxpayers from other EU or EEA countries may file a tax return at year end and deduct expenses related to royalty payments. From 2014, the Czech Republic and the United States cooperate on enforcement of tax duties under the terms of the US Foreign Account Tax Compliance Act.

III INTELLECTUAL PROPERTY

i Brand search

The Czech Industrial Property Office (IPO CZ) keeps a database of trademarks and other intellectual property rights valid on the territory of the Czech Republic, whether national trademarks, European Union trademarks or international registrations. The database is available online (at www.upv.cz) and is a very useful tool for searching protected trademarks, similar brands and other intellectual property rights that may be relevant for franchises. The IPO CZ conducts research as part of its paid services, but it is perhaps more common to use the services of specialised law firms or trademark attorneys. The main reason for this is that

searches should not be limited to the databases maintained by the IPO CZ. For unregistered brands, business names and the like, it is usually necessary to search in the relevant databases of legal entities (especially the Commercial Register), search among registered domain names, or simply carry out research on the internet. For some rights that may also be relevant, such as image rights, no research can be conclusive because copyright is an unregistered right in the Czech Republic. The results of searches should always be discussed with specialists who can carry out a risk assessment and provide advice on the best way forward.

ii Brand protection

Brand protection is typically obtained via registration of the relevant brand as a trademark by the IPO CZ or as a European Union trademark by the European Union Intellectual Property Office. Although Czech law contains tools to achieve protection of non-registered signs, it is always a good idea to rely on registered rights. Trademarks are defined by Section 1 of the Trademark Act No. 441/2003 Coll. (the Trademark Act) as any signs capable of graphic representation, in particular words, colours, drawings, letters, numbers or shape of a product or its packaging, provided that such a sign can distinguish goods and services of one entrepreneur from those of another. Upon receipt of the application, IPO CZ carries out a formal search to ascertain that the application meets all the requirements prescribed by law, as well as a substantive search to find out whether the sign concerned is eligible for registration as a trademark. In the event that the IPO CZ finds no legal obstacles to registration of the trademark, it publishes the application in its regular Bulletin; third parties can oppose the registration within three months of publication. When a trademark is successfully registered, it is protected for 10 years from the priority date, which is usually the date when the application was submitted. This period can be repeatedly extended by an additional 10 years, subject to payment of an administrative fee.

Protection is also granted to designs provided they are new and have an individual character. Applications for registration of Czech national industrial designs must be submitted to the IPO CZ and they are then subject to substantive examination (in contrast to the registration procedure applicable to registered Community Designs, where there is only formal review of the application). When a design is registered, the protection lasts for five years but can be repeatedly renewed up to a total of 25 years.

iii Enforcement

According to the Trademark Act, the owner of a trademark has the exclusive right to use the trademark in connection with goods or services for which the trademark is registered. The term 'use' is defined in a rather broad manner and includes: (1) use of the trademark on the goods or on their packaging; (2) offering goods under the trademark, putting them on the market or storing them for such a purpose or offering or providing services under the trademark; (3) exporting or importing goods under the trademark; and (4) using the trademark in business correspondence and advertising.

According to the Industrial Designs Act (No. 207/2000 Coll.), the registration of an industrial design gives its owner the exclusive right to use the industrial design, to prevent third persons from using it without his or her consent, to grant consent to use the industrial design to third parties or to transfer the right to the industrial design.

Intellectual property rights are typically enforced via courts. The relevant rights and claims that are available in cases of intellectual property rights infringement are (with the exception of copyright, which has a separate regulation) all concentrated in the Act

No. 221/2006 Coll. on Enforcement of Industrial Property Rights (the IP Enforcement Act). The IP Enforcement Act gives the IP owner the right to request that the infringer refrains from the activity that infringes or endangers the rights concerned, and that the consequences of the endangering or infringement be removed, namely by recalling or permanently removing goods and by recalling, permanently removing, or destroying tools or devices determined or used in connection with the activities that infringe or endanger this right. The IP owner can also request information about the origins of the infringing goods and their distribution channels. Regarding monetary claims, the rights holders can claim damages (they can choose whether to claim actual damages and lost profits, if applicable, or the amount calculated as double the standard market licence fee), surrender of unjust enrichment or, in cases of non-monetary harm, reasonable satisfaction, which can take the form of anything from an apology to financial compensation.

Simultaneously with enforcement of intellectual property rights, it is also fairly common in practice to make unfair competition claims. Examples of the activities that are explicitly listed among the types of unfair competition behaviour include misleading advertising, misleading marking of goods and services, and causing risk of confusion and parasitism on reputation, all of which can be especially relevant for franchising. This can be particularly useful for protection against various lookalikes and imitations, where the traditional intellectual property rights may not, for various reasons, provide sufficient protection.

iv Data protection, cybercrime, social media and e-commerce

The Czech Republic has a relatively long tradition of protection of personal data. The first data protection law was adopted in 1992 and the current legislation, Act No. 101/2000 Coll. (the Data Protection Act), is fully harmonised with the EU Data Protection Directive. Among the EU countries, the Czech Republic is sometimes considered to be a country with a strict interpretation of the law regarding personal data protection. However, the Czech Office for Protection of Personal Data (UOOU) does not impose stringent fines or other sanctions on private businesses very often.

Any entity that collects, stores and processes personal data in the Czech Republic must comply with a set of obligations that include the following: data must only be processed with the consent of the data subject, unless a statutory exemption applies; data must only be processed for the stated particular purpose and only for as long as is absolutely necessary; organisational and technical measures must be adopted to ensure the security of the data; the data subject must be provided with all the required information; and the processing of personal data must usually be notified to the UOOU via a simple online form. Any cooperation between a data controller and a data processor must be based on a written data processing agreement, which must have certain contents as stipulated by law. Transfers of personal data outside the EU can occur only with the prior consent of the UOOU, unless made to countries specifically approved by the decision of the European Commission or unless the EU standard contractual clauses are in place. Transfer of personal data to the United States is currently available to the companies registered and compliant with rules of the 'Privacy Shield' agreement, which replaced the previously invalidated 'Safe Harbor' regime. Generally, the UOOU does not handle many applications for consent to cross-border transfers of data because businesses tend to take the other available options. Multinational groups of companies, including franchising structures, can additionally use binding corporate rules, which ease the transfer of personal data within the group but require a considerable amount of consultation with the relevant data protection authorities.

Many medium-sized to large businesses have also started to prepare for the EU-wide General Data Protection Regulation No. 2016/697 (GDPR). The GDPR will come into force in 2018 and will eventually replace national laws, including the Czech Data Protection Act. The GDPR further tightens the rules for processing of personal data, as well as imposing severe sanctions for non-compliance.

Cybercrime is explicitly addressed by the Czech Criminal Code (Act No. 40/2009 Coll.), which provides modern criminal law protection for IT systems and data. The criminal offences include unauthorised access to IT systems and information media (hacking), unauthorised use of data and obtaining technology to violate the secrecy of messages, etc. Furthermore, the Czech Republic was one of the first European countries to take the measure of adopting a Cybersecurity Act (Act No. 181/2014 Coll.). The Cybersecurity Act imposes duties on telecommunication providers or providers of critical infrastructure (e.g., in banking and the defence sector), consequently it is not likely to burden typical franchise businesses. Its purpose is to make the online environment safer. This may serve primarily to benefit digital franchises. The Czech Republic has adopted the EU Directive on Security of Network and Information Systems, known as the NIS Directive, which will slightly extend the number of subjects affected, and will harmonise the rules with the rest of the EU.

Legal regulation of e-commerce is rather complex and spreads across various laws including the Civil Code (No. 89/2012 Coll.), the Electronic Communications Act (No. 127/2005 Coll.), the Consumer Protection Act (No. 634/1992 Coll.), the Data Protection Act, the Criminal Code and the Information Society Services Act (No. 480/2004 Coll.). The latter is especially relevant not only because it contains rules on the liability of internet service providers, but also for its regulation of email marketing (and spam). Similarly, a wide range of rules apply to social media. Franchises must cope with many individual laws governing personal data protection, personality and privacy rights, intellectual property, consumer protection and advertising regulations. Rather than focusing on social media, these laws regulate on a general level.

IV FRANCHISE LAW

i Legislation

In the Czech Republic, there is no legislation dedicated specifically to franchising. However, this absence of franchising legislation is perhaps not unusual, and definitely not a barrier to the development of franchise systems. Franchise arrangements are typically governed by civil law (as far as the actual contract or establishment of the business is concerned) but other areas, including public law (e.g., competition regulation, employment, trade licences and tax), can play an important role. Therefore, it is really a mixture of laws that are relevant in connection with the franchising industry.

A franchise agreement as such would be considered an innominate agreement (meaning a type of contract not specifically provided for in law) pursuant to Section 1746(2) of the Civil Code. The Civil Code is one of the most important pillars of Czech private law. Several years ago, the Civil Code was fully recodified, focusing on, among other things, the extension of contractual flexibility and freedom. Even though the current Civil Code is now in its third year of effect, it will still take time before the courts establish the necessary case law to bridge a few interpretation gaps and provide sufficient guidance to parties affected. A typical

franchise contract would include elements of a sale contract, lease contract, licensing agreement, consignment contract and trade secrets, etc., which are all expressly regulated by the Civil Code. That, in turn, needs to be reflected when drafting a franchising agreement.

The European Code of Ethics for Franchising is not binding legislation in the Czech Republic; however, it seems to have certain persuasive power and tends to be relied on by entities involved in the cross-border franchising business.

ii Pre-contractual disclosure

The Civil Code brought into Czech law the concept of pre-contractual liability (*culpa in contrahendo*), which involves an element of disclosure obligation. Sections 1728 and 1729 of the Civil Code set out the following general rules:

- a* parties are entitled to hold talks freely and they are not liable when the contract is not concluded unless the other party starts or continues negotiations without the intention of concluding the contract;
- b* during the contract negotiations, parties should inform each other about all factual and legal circumstances to allow the other party to determine the possibility of concluding a valid agreement, and be clear about the other party's interest in making the contract;
- c* if during the negotiations the parties reach the point where the conclusion of the agreement appears to be highly likely, the party who, despite the other party's reasonable expectations, terminates the negotiations without justified reason is deemed to have acted unfairly; and
- d* the party that acts unfairly is liable for damages up to the maximum amount corresponding to the loss from non-concluded contracts in similar cases.

Other than this, there are no pre-contractual disclosure obligations specifically relating to franchising under Czech law. Also, the above rules are fairly general, broad and new, hence no proper judicial guidance is available yet. There are no special provisions regarding formal requirements for pre-contractual information concerning franchise agreements.

iii Registration

There are no specific registration requirements for franchises and no franchise register exists in the Czech Republic. Nevertheless, some general registration requirements apply; for example, relating to the setting up of a business in the Czech Republic (e.g., the trade licences register, registration of a legal entity in the Commercial Register and tax-related obligations).

iv Mandatory clauses

There are no mandatory clauses applicable to franchise contracts. In principle, parties can determine the terms and conditions of their contract freely provided that their contract does not infringe good morals (*bonos mores*), public order or protection of personality status or rights.

Despite the fact that the European Code of Ethics for Franchising is not legally binding, members of national associations and federations of the European Franchise Federation (like CFA) undertake to respect the Code's principles and often incorporate these principles into provisions of franchise agreements or attach their national annex to an agreement.

v Guarantees and protection

A franchisor may request guarantees and protection under civil law. According to the Civil Code there are several options for guarantees, such as suretyship, financial guarantees, collateral transfer of rights, liens, bank guarantees, contractual penalties, etc. Guarantees that are in compliance with the law are enforceable.

V TAX

i Franchisor tax liabilities

Regarding Czech tax non-residents, a withholding tax of 15 per cent applies to licence fees paid by Czech tax residents to Czech tax non-residents. Double taxation treaties and EU legislation may reduce the statutory withholding tax rates to 5–10 per cent. Under certain conditions the licence fees paid to related party recipients in the EU, Switzerland, Norway or Iceland are exempt.

Czech tax residents are considered to be entities with their registered office or place of effective management in the Czech Republic. Income from the worldwide operations of Czech tax residents is subject to general corporate income tax. The corporate income tax rate applicable in 2017 is 19 per cent.

The licence fees received from a foreign entity without a permanent establishment in the Czech Republic shall be subject to general corporate income tax and, on the principle described above, can be also subject to taxation in the country of the licence fee payer, depending on the relevant double-taxation treaty and national tax legislation of the payer. The franchisor may avoid double taxation by setting off the tax paid (withheld) in the foreign country against its tax liability in the Czech Republic.

Besides corporate income tax and withholding tax, general value added tax (VAT) rules apply to franchise business. As a member of the EU, the Czech Republic adopted the EU common system of VAT. VAT applies to most goods and services sold for use or consumption in the Czech Republic regardless of their origin (i.e., VAT applies to imports as well as to goods produced or services provided in the Czech Republic). On the other hand, exported goods or services that are consumed outside the Czech Republic are usually not subject to Czech VAT. In 2017, the standard rate was 21 per cent and there are two reduced rates, of 15 and 10 per cent. Reduced rates apply primarily to essential goods and services such as food, medical supplies or goods for persons with disabilities or children. From December 2016, the 15 per cent reduced rate also applies to catering services, potentially including restaurants and fast food services. This benefit was introduced primarily as compensation for the new obligation to maintain electronic records of sales (called EET), which was recently implemented in the Czech Republic.

ii Franchisee tax liabilities

A Czech franchisee that pays a Czech tax resident for the licence fee has no tax liability, except for VAT, if applicable.

As a rule, licence fees paid to Czech tax non-residents are subject to withholding tax of 15 per cent. Double taxation treaties and EU legislation may reduce the statutory withholding tax rates to 5 to 10 per cent and under certain conditions the licence fees paid to related party recipients in the EU, Switzerland, Norway or Iceland are exempt. The tax is withheld by the Czech franchisee when making a payment to the foreign franchisor but

no later than on the day the Czech franchisee must account for this liability. The withheld amount must be transferred to the relevant Czech tax administration office by the end of the month after the month in which the money was withheld.

iii Tax-efficient structures

There is not a generally applicable, one-size-fits-all best practice for tax-efficient franchising in the Czech Republic. It is always a good idea to analyse each particular situation and obtain specific tax advice on any franchising structure before its implementation.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

It is a general principle of civil law that everybody must act fairly in their legal relationships. Nobody should obtain benefit from the performance of an unfair or illegal act, and nobody should obtain benefit by causing or controlling illegal conditions. In civil law disputes, good faith is presumed, whereas a lack of good faith is subject to a burden of proof. Another related principle is that of good morals (*bonos mores*) – a legal act (such as a contract) can be null and void if it is in obvious conflict with good morals.

ii Agency distributor model

Under Czech law, a business agent is an independent entrepreneur who undertakes to work towards long-term goals and carries out activities that aim at the conclusion of contracts of a certain kind. The represented person undertakes to pay a commission (agent's fee). An agency is therefore not a suitable model for franchising. In practice, franchisees typically proceed under their own name and at their own risk, whereas agents act on behalf of a principal and at his or her risk.

iii Employment law

It is highly unlikely, bordering on impossible, that courts would treat franchisees as employees. According to Czech labour law, an employee is a natural person who undertakes to provide dependant work in a basic employment relation. Therefore, relationships between franchisors and franchisees are not treated as employment relations.

iv Consumer protection

Under Czech law, a consumer is defined as any natural person who acts outside the scope of his or her business activities or outside the scope of his or her performance of a profession during the conclusion of an agreement with an entrepreneur (business undertaking). Because franchisees themselves act in their capacity as entrepreneurs or business entities, they cannot be treated as consumers.

v Competition law

In the Czech Republic, competition law is mainly included in (1) the Civil Code, which contains a brief general overview of the topic, rules about unfair competition and non-compete arrangements; and (2) the dedicated Act No. 143/2001 Coll. (the Competition Act). Czech competition law is harmonised with EU law, and the activities and views of the Czech Antitrust Office seem generally to be aligned with those of the European Commission. Obviously, it

is always a good idea to review franchise contracts, especially from the perspective of any potential vertical restraints, which may include any exclusivity arrangements, resale price maintenance, product ties, etc., while checking whether an EU block exemption regulation applies. For more information about competition law aspects of franchising see the dedicated chapter of this *Law Review*, 'The Competition Law of the European Union'.

vi Restrictive covenants

During the term of the agreement, non-compete and other restrictive covenants can be enforced through the courts. In practice, and depending on the circumstances, the most efficient tool can be a request for a preliminary injunction. The court must decide within seven days of receipt of the request for a preliminary injunction, so it can be rather quick. The downside is that the claimant risks being liable for damages to the counterparty in the event that the main action is not successful.

Needless to say, the enforceability of restrictive covenants is subject to their being in line with the aforementioned competition law regulations. The Civil Code now includes a new concept of 'forbidden non-compete clause', according to which non-compete clauses must specify the territory, scope of activity or group of persons to which the restriction applies. A non-compete clause for an indefinite term or for a term longer than five years is forbidden, as is a clause that restricts the other party more than is necessary for adequate protection of the first party. The court may limit such a non-compete clause, revoke it or declare it invalid.

vii Termination

Franchise agreements can be terminated for reasons set out in law or agreed in a contract. Franchise agreements may be typically terminated by mutual consent of the parties or by one of the parties giving notice of termination.

Withdrawal from a contract is possible if it is negotiated by the parties to the contract or on the basis of law. If one party breaches a contract in a substantial manner, the other party can withdraw from the contract without unreasonable delay. Breach of a contractual obligation is substantial if the breaching party knew or should have known that the other party would not have concluded the contract if such a breach had been anticipated.

If a debtor is in default, a creditor can withdraw from a contract on the terms given by the contract or by law. If the default is substantial, one party can withdraw from the contract if it gives withdrawal notice to the other party without unreasonable delay. If the default is not substantial, the party can withdraw from the contract if the other party does not meet its obligation in adequate additional time. The rights to contractual penalties, payment interest, liquidated damages and also all provisions that should remain valid following a withdrawal are not affected by withdrawal from a contract.

The franchisee and franchisor can also terminate a contract if the parties negotiate a cancellation fee. If one party pays the cancellation fee, the agreement is cancelled in the same manner as if the party had withdrawn from the contract.

Revocation of a contract is possible if allowed by law or specifically agreed upon by the parties.

viii Anti-corruption and anti-terrorism regulation

The Criminal Code affects natural persons and their offences, and the Act on Legal Entities' Criminal Liability sets down offences of legal entities, such as corruption, money laundering

or fraud. However, there is not any special regulation applicable to franchise agreements. The Czech Republic is also a member of various anti-terrorism and anti-corruption international treaties and agreements.

ix Dispute resolution

Disputes can be settled in courts or through arbitration. Franchise agreements typically include a dispute resolution clause that points either to a court or to arbitration. In the Czech Republic arbitration is regulated by Act No. 216/1994 Coll. This Act is applicable to all relations, without regard to their character. Disputes before courts are governed by the Civil Procedure Code (No. 99/1963 Coll.). Another supportive procedure was introduced under the Mediation Act (No. 202/2012 Coll.); if it is useful and suitable, the court can order the parties in dispute to attend meetings with a mediator for at least three hours and can interrupt the proceedings (for a maximum of three months). Nevertheless mediation is still not used very often, especially not for commercial disputes.

There is no specific procedure or industry practice for franchising disputes; we are not aware of any of the existing franchising associations in the Czech Republic offering mediation or arbitration services.

Ordinary court proceedings, including first and second instances, may last for several years, depending on the difficulty of the particular case, whereas arbitration proceedings are usually shorter.

Local courts recognise a foreign choice of law. Czech judges are obligated *ex officio* in matters that have international elements to follow conflict of law rules, and cases may use foreign law. Local courts also recognise jurisdiction clauses.

According to the Civil Procedure Code there is an option to obtain a preliminary injunction if it is necessary to arrange rights and obligations between participants to the proceedings. Jurisdiction is the same as in the main action. A security deposit of 50,000 Czech crowns must be paid by the applicant for such a measure to cover any potential damages.

Costs of litigation are allocated according to the principle of success in the dispute and costs are not capped according to law, but court fees are capped and the costs of representation are limited by secondary legislation, so it is usually impossible to obtain meaningful recovery of legal costs.

Enforcement of judgments and awards follows the common rules of enforcement under Czech law. Czech courts readily recognise foreign arbitral awards from other countries that are party to the New York Convention.

VII CURRENT DEVELOPMENTS

In the recent past, we have seen a lot of activity in the area of franchising. The Czech franchise market is approaching maturity. The annual increment of new concepts and outlets is lower than in the market's development phase and customers are more demanding and prefer original concepts. Among the franchises with the highest increase in the number of outlets in 2015 were Exteria (work-safety training services), Orion (household retail chain) and ERA Reality (real estate agency). Besides some well-established food and beverages franchises, the new popular areas seem to be lifestyle, fitness and education (e.g., Naturhouse (diet consultancy centre), UGO (juice bar) and BodyBody (fitness centre)). Franchisees tend to seek lower entry fees and a higher return of investment rather than the costly licences and know-how of the world's most famous franchises. That said, market expansion strategies

remain significant, both inbound and outbound, with foreign brands and franchise systems still eyeing the Czech Republic and considering entry, while some Czech franchisors have been successful in going to other countries (or are at least planning such expansion) – particularly to the bordering countries in the CEE region but also beyond. Local franchisors had a market share of 57 per cent in 2014. Among the most popular foreign franchisors are brands from the United States, and also from Germany or Poland.

From a purely legal perspective, there have been no significant shake-ups attributable to the adoption of the new Civil Code in 2014. While professional practitioners are still eager for judicial interpretation of some parts of this new Code by civil courts, so far the transition has happened smoothly without any substantial increase of risks for franchise businesses.

DENMARK

*Jacob Ørskov Rasmussen*¹

I INTRODUCTION

Most of the franchise systems in Denmark are found in the retail sector, but there are also franchise systems in the restaurant and hotel sector, as well as in the car rental and service sector, and the education sector.

Franchising has experienced a rapid growth in Denmark over the recent decade, which is attributable to both foreign franchise systems establishing in Denmark and Danish companies expanding through the use of franchise systems.

Among the biggest foreign franchise brands in Denmark are McDonald's, Burger King, Domino's Pizza, Subway, 7-Eleven, Avis Rent a Car and Sixt Rent a Car. Some of the latest newcomers are Dunkin' Donuts, Starbucks, Carl's Jr and Pizza Hut.

Several of the domestic franchise brands are small or medium-sized companies that have chosen franchising as a way to expand their business in Denmark. Some of the domestic franchise brands have also expanded their business internationally, such as Bang & Olufsen, Jysk, Vero Moda, Jack & Jones, Bianco and BoConcept.

Dansk Franchise Forening (DFF) is an interest group for Danish companies involved in franchising. It was established in 1984, at a time when franchising was almost unknown in Denmark. DFF has issued a code of ethics, which is based on the European Code of Ethics for Franchising adopted by the European Franchise Federation (EFF). The code of ethics is binding for the members of DFF.

There are no current governmental activities or other official campaigns focusing on franchising as a business model in Denmark.

II MARKET ENTRY

i Restrictions

As a member of the European Union, Denmark is committed to observe the principle of free movement of goods, persons, services and capital, and the general prohibition against discrimination on grounds of nationality. Consequently, there are no market entry restrictions or other approval requirements that apply to foreign franchisors in Denmark. This also applies to foreign franchisors from outside the EU.

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However, persons who are not residents of Denmark and who have not previously been resident in Denmark for a total period of five years may only acquire title to real property in Denmark after having obtained permission from the Ministry of Justice. This also applies to companies that do not have their registered office in Denmark, such as foreign franchisors.

EU or EEA nationals may acquire an all-year dwelling in Denmark without obtaining permission from the Ministry of Justice on certain conditions. The same applies to companies established in accordance with the law of an EU or EEA Member State that have established branches or agencies in Denmark or intend to do so or plan to deliver services in Denmark. It is a requirement that the property will serve as a necessary all-year dwelling for the acquirer or that the acquisition is a precondition for engaging in self-employed activities or providing services.

ii Foreign exchange and tax

Payments to and from Denmark are fully liberalised. This means that there are no restrictions on taking banknotes and coins out of or into Denmark, nor are there restrictions on other external transactions, including loans from and deposits with foreign banks, or portfolio investments and direct investments. However, anyone who enters or leaves the Danish customs area carrying money, etc. exceeding €10,000 in value shall on their own initiative go through a customs check and shall declare all money, etc. to the customs and tax authorities.

There is no tax regulation that relates specifically to franchising in Denmark (see Section V.i).

III INTELLECTUAL PROPERTY

i Brand search

To a large extent the Danish Trademarks Act² has been harmonised with the EU Trademark Directive, but there are still differences. The most notable difference is that a Danish trademark can be acquired through use. Further, the Danish Trademarks Act is to some extent supplemented by the Danish Marketing Practices Act,³ which is a statutory law of unfair competition.

Protected registered trademarks can be searched on <https://euipo.europa.eu/eSearch/#advanced> (EU trademarks) and www.dkpto.dk (Danish trademarks). These websites can also be used for searching EU- and Danish-registered design rights. Unregistered Danish trademarks would have to be found through general knowledge of the market and internet searches.

Copyrighted works, image rights and business processes are not registered, and a search for these would therefore have to be conducted using the internet and through general knowledge of the market.

The process for ascertaining whether there is a conflict follows the normal process of determining whether there is an intellectual property infringement.

2 Consolidated Act No. 223/2017 on Trademarks.

3 Consolidated Act No. 426/2017 on Marketing Practices.

ii Brand protection

There are four ways in which a trademark can be obtained in Denmark:

- a* registration with the Danish Patent and Trademark Office (DKPTO);
- b* use in Denmark;
- c* international World Intellectual Property Organization registration designating Denmark; and
- d* EU trademark registration with the European Union Intellectual Property Office.

The Danish relative and absolute grounds for refusal are similar to those for EU trademarks. The DKPTO will provide a search report of its findings. An application for trademark registration will not be refused based on relative grounds for refusal.

The Danish Trademarks Act contains a rule about ‘trademark theft’. It follows from this provision that registration cannot be obtained for trademarks that are identical or very similar to trademarks that are being used in a foreign country for the same goods or services, if the applicant knew or should have known of this older, foreign mark.

Design rights may also be registered via DKPTO. To be registered a design has to be new and have individual character.

iii Enforcement

A trademark proprietor is entitled to start proceedings based on its trademark rights. A franchisee can be a licensee, and a licensee is also entitled to start proceedings in relation to infringements of the trademark right, unless otherwise agreed upon between the licensee and the trademark proprietor. This will, however, change once the new Trademark Directive comes into force, no later than 2019. The licensee shall duly notify the trademark proprietor of such proceedings.

In general the remedies are the following:

- a* imposition of a court injunction, including a preliminary injunction, on the defendant (i.e., an order to refrain from any – continued – trademark infringement in the future);
- b* the securing of evidence (similar to an *Anton Piller* order);
- c* receiving compensation, in cash or in another form;
- d* imposition of a court order on the defendant (i.e., an order to do something so as to prevent any threatening – continued – trademark infringement);
- e* on conviction, having the defendant publish the judgment in whole or in part;
- f* imposition of a fine on the defendant; and
- g* surrender of the profit enjoyed as a result of the infringement.

The remedies apply regardless of whether the trademark right has been granted by registration or has been obtained by use.

The enforcement of design rights and copyright also follows the enforcement procedures listed in the EU Enforcement Directive.

iv Data protection, cybercrime, social media and e-commerce

The Danish Data Protection Act⁴ applies to the processing of personal data. The purpose of the act is to enable companies, etc. to process personal data within the EU and EEA

⁴ Consolidated Act No. 429/2000 on the Processing of Personal Data.

while ensuring adherence to certain data processing principles and the preservation of the rights of the data subject. It is, *inter alia*, a requirement that personal data, whether related to employees or customers, is protected by special safeguards when said data is transferred outside the EU and EEA, for instance, from a franchisee to the franchisor. The act also requires the responsible entities, 'data controllers', to register and obtain prior approval from the Danish Data Protection Agency when processing certain types of personal data and also for some data transfers outside the EU and EEA. The new EU Data Protection Regulation⁵ will be effective in Denmark as of 25 May 2018. The new regulation will increase existing obligations and constitute new obligations for data controllers, and the requirement for registration and approval from the Danish Data Protection Agency when processing certain types of personal data is likely to cease. However, the new Regulation will not result in any other material changes to the above-mentioned principles and requirements.

So far, special rules regarding cybercrime and notification of government authorities in relation to data breaches have only been adopted for the telecommunications sector.

The Danish E-Commerce Act⁶ contains certain requirements in relation to identification of the trader and a duty to provide information on relevant aspects when purchasing goods or services online, for instance the name of the trader, its physical address and business registration number. In relation to distance sales, a trader must also provide a consumer with a right of cancellation according to the Consumer Contracts Act.⁷

Finally and more generally, a trader, whether a franchisor or a franchisee or other, must comply with the Danish Marketing Practices Act when performing marketing directed towards the Danish market. The Act requires adherence to the principles of good marketing practices, no use of misleading or undue indications or omission of material information if this is designed to significantly distort consumers' or other traders' economic market behaviour. The Act also applies to advertisements on social media such as the internet if directed towards the Danish market. Furthermore, with respect to advertisements on social media such as the internet, a main principle of the Danish E-Commerce Act stipulates that traders within the EU or EEA offering information society services – meaning commercial services delivered online – are subject to domestic control, thus a trader in a country within the EU or EEA has to comply with the requirements regarding digital marketing in said country, even though the marketing is targeted at other countries within the EU or EEA.

IV FRANCHISE LAW

i Legislation

There is no legislation that makes express provisions for franchising in Denmark. This means that every aspect of franchising is regulated by the general rules of law.

The Danish Contracts Act⁸ and general principles of contract law apply to franchise agreements. The overall principle in Danish contract law is the principle of freedom of contract (i.e., the parties are free to decide the contents of their agreement). However, the drafting

5 Regulation 2016/679 of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

6 Consolidated Act No. 227/2002 on Services in the Information Society, etc.

7 Consolidated Act No. 1457/2013 on Certain Consumer Contracts.

8 Consolidated Act No. 193/2016 on Contracts and other Juristic Acts pertaining to Property.

(or carrying out) of a franchise agreement may be regulated by various mandatory rules. In particular, certain statutory rules such as the Danish Competition Act,⁹ the Marketing Practices Act,¹⁰ the Business Lease Act,¹¹ the Product Liability Act¹² and the Interest on Overdue Payments Act¹³ may restrict the parties' room for manoeuvre.

Among the rules to be considered in the Danish Contracts Act when drafting (or carrying out) a franchise agreement, the general clause in Section 36 is of particular relevance. Section 36 stipulates: 'An agreement may be amended or set aside, in whole or in part, if its enforcement would be unreasonable or contrary to principles of fair conduct. The same applies to other legal transactions.'

Danish courts are reluctant to apply Section 36 on commercial agreements, but it may be applied where there is an evident discrepancy between the parties' bargaining positions.

Where the franchise agreement is silent, the parties' relationship may be regulated by general principles applicable to commercial relationships. Such principles may be found in the Danish Sale of Goods Act¹⁴ as well as in the Commission Act¹⁵ and the Commercial Agents Act.¹⁶ However, the principle regarding payment of compensation for goodwill at termination in the Commercial Agents Act will only apply by analogy in very exceptional cases (see also Section VI.ii).

Case law is also a relevant source of law in relation to franchises, especially where an earlier decision has been made in the superior courts. Possible precedents may be found primarily in various law reports. However, not many precedents relating to franchises have been published. This may be because many franchise agreements refer disputes to be settled by arbitration and not by the ordinary courts.

ii Pre-contractual disclosure

There are no specific pre-contractual disclosure requirements in Danish law. Consequently, there are no legal requirements to disclose certain information relating to the franchise prior to entering into the franchise agreement. However, as a general principle, a duty of disclosure arises when reasonable commercial standards of fair dealing require that particular circumstances should be disclosed when entering into an agreement. A misrepresentation prior to entering into a franchise agreement may therefore give rise to an action for breach of the agreement. In a commercial relationship, the parties are also obliged to give information voluntarily if they know or ought to have known that the information is material to the other party.

The basis of liability for contractual damages on account of breach of an agreement is the concept of fault (*culpa*). In addition, liability requires that the non-breaching party has suffered a loss and that there is an adequate causal connection between the breach and the loss. Damages are computed on an expectation basis (i.e., the non-breaching party shall be put in the same position as if the agreement had been performed).

9 Consolidated Act No. 869/2015 on Competition.

10 Consolidated Act No. 426/2017 on Marketing Practices.

11 Consolidated Act No. 1714/2010 on Lease of Business Premises.

12 Consolidated Act No. 261/2007 on Product Liability.

13 Consolidated Act No. 459/2014 on Interest etc. on Overdue Payments.

14 Consolidated Act No. 140/2014 on Sale of Goods.

15 Consolidated Act No. 332/2014 on Commission.

16 Consolidated Act No. 272/1990 on Commercial Agents and Commercial Travellers.

Danish courts are reluctant to award damages for pre-contractual behaviour when no agreement has been entered into. However, the doctrine of *culpa in contrahendo* is recognised as a general principle but only as an exception. As a starting point, pre-contractual liability requires a clear breach of the law in the form of an unfair behaviour or a clear breach of the rules applicable to the contractual process.

Furthermore, the general conditions of liability in terms of loss and adequate causal connection must be fulfilled to impose a pre-contractual liability. Since no agreement has been entered into, damages will be computed based on reliance damages.

iii Registration

There are no registration requirements for franchises in Denmark.

iv Mandatory clauses

There are no mandatory clauses in franchise agreements according to Danish law.

v Guarantees and protection

There is no legislation relating to guarantees made by a franchisee under a franchise agreement, regardless of whether it is provided by a person or a company. A guarantee promise is subject to the rules in the Danish Contracts Act. A guarantee promise is thus binding on the promisor when it has been communicated to the promisee, and it does not require any acceptance from the promisee to be binding. The guarantee commitment as such is subject to the general rule of contractual freedom. Where the guarantee is silent, the reality of the guarantor's obligation must be determined by reference to case law and legal tradition.

Whether the guarantee is enforceable must be evaluated under the general rules on invalid declarations of intent in the Danish Contracts Act. In particular, the general clause in Section 36 may be of relevance (see Section IV.i).

V TAX

i Franchisor tax liabilities

The tax system in general

There is no Danish tax code applicable specifically to franchising structures. Hence, the taxation of a franchise in Denmark depends on whether the franchise is subject to personal or corporation tax.

Furthermore, the Danish tax system distinguishes between tax payers domiciled in Denmark and abroad.

Individuals and companies domiciled outside Denmark can be subject to a limited tax liability to Denmark regarding a number of specified income types.

Foreign persons and companies are, however, obviously often subject to tax liability in another jurisdiction as well. To avoid double taxation for limited liable taxpayers, Denmark has entered into a large number of double-taxation treaties. Further, Denmark has implemented various EU directives seeking to eliminate double taxation.

Corporation tax

A company is domiciled and subject to full tax liability in Denmark if the company is registered with the Danish Business Authority or if the management of the company has its principle place of business in Denmark.

Companies are subject to 22 per cent tax (2017) on income, capital gains, interests, etc.

Companies can deduct from taxable income expenses incurred when obtaining, ensuring or maintaining the taxable income, though with certain limitations. Additionally, companies can obtain a deduction from amortisation of assets. Finally – with some limitations – losses realised on tax relevant assets, such as debt and real estate, are deductible.

For non-domiciled companies withholding taxes on income from Denmark is particularly relevant. Most importantly Danish withholding taxes may apply to royalties, dividends and interests.

Royalties received from a Danish source are subject to limited tax liability. Thus, Denmark will withhold tax on royalty (e.g., from a Danish franchisee to a foreign franchisor). The withholding tax rate on royalties is 22 per cent (2017).

However, for royalties paid to recipients domiciled in a jurisdiction with which Denmark has entered into a double-taxation treaty, the state in which the beneficial owner of the royalty is domiciled has the exclusive right to tax the royalty payment. Additionally, Danish tax on royalties between group-related companies in the EU is normally waived pursuant to the EU Interest and Royalties Directive.

Non-domiciled companies are subject to limited tax liability on dividends at a 22 per cent tax rate (2017). The tax rate for non-domiciled companies was reduced from 27 per cent to 22 per cent on 1 July 2016, but the withholding rate for the Danish dividend-paying company remains at 27 per cent (equivalent to the rate applicable for domiciled companies). Subsequently, the foreign receiving entity can reclaim the excess withholding tax.

Dividends received by non-domiciled companies from Danish subsidiaries are tax exempt if the receiving company would not be taxable pursuant to the EU Parent–Subsidiary Directive or the tax should have been exempt pursuant to a double-taxation treaty.

Similarly, dividends received by non-domiciled companies from related Danish companies are exempt if the recipient is domiciled within the EU or EEA and would be tax exempt pursuant to the EU Parent–Subsidiary Directive or the tax should have been (fully or partially) exempt pursuant to a double-taxation agreement.

If the dividends are not exempt from withholding taxes, but the receiving entity is resident in a state with which Denmark has concluded a double-tax treaty that calls for a lower rate of withholding taxes, tax at the rate of 27 per cent (2017) must generally be withheld, and the receiving entity may subsequently reclaim the excess withholding tax.

Personal tax

An individual is subject to personal tax on employment income. Furthermore, income derived from self-employment is subject to personal tax.

An individual is fully liable to tax in Denmark, if the individual is domiciled in Denmark or has been present in Denmark for a continuous period of at least six months (including short stays abroad in the form of vacations, etc.).

An individual is subject to tax on salary, profits from self-employment, capital gains, interests, dividends, pensions, etc.

For employed individuals the expenses qualifying for a deduction are very limited; hence, for example, certain work-related transport and interest expenses on debt are deductible.

A personal business tax regime is applicable to self-employed individuals to allow for a harmonised taxation of personal businesses and companies. The tax rate applicable to self-employment income under this regime is 22 per cent (2017). Operating costs, such as salary, rent, travel expenses, insurance, training, etc., are deductible from self-employment income (such deductions may also be obtained outside the tax regime for self-employed individuals).

When self-employment income is extracted from the franchise business by the franchisee for personal use it will be subject to ordinary salary tax with a progressive net tax rate of up to 56.4 per cent, including labour market contribution and optional church tax (2017). The tax already paid on the self-employment income will be credited in the personal tax for the individual.

ii Franchisee tax liabilities

See Section V.i.

iii Tax-efficient structures

The structuring of a franchise business in Denmark is generally not driven by tax considerations. Hence, there is no general best practice used specifically for franchises.

Instead the structuring – from a tax point of view – is typically dependent on the specific business drivers for the franchisee, such as the nature of the business, the place of residence, whether the franchise is conducted as an individual concern or partnership or in a corporate form, etc.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Danish contract law recognises the principle of good faith. This means that the parties to an agreement are obliged to care for each other's interests and to give each other information that is necessary to mitigate losses, as well as to avoid acting contrary to previous behaviour and to avoid an abuse of rights.

The principle of good faith has not been expressed in any statutory provision, but its existence is presupposed in some statutes, for example in Section 36 of the Danish Contracts Act (see Section IV.i).

Unfair actions and omissions as well as actions and omissions carried out in bad faith by a contracting party may give rise to an action for breach of the agreement (see Section IV.ii).

ii Agency distributor model

According to Danish law, franchisees are normally treated as independent distributors purchasing and selling goods in their own name and for their own account, and the franchisors are thus acting as suppliers. There are no specific Danish rules on either distribution or franchise agreements.

It is possible to include in the franchise agreement provisions providing for the franchisee to act as a commission agent. It would also be possible to include provisions providing for the franchisee to act as a commercial agent. This would not modify the nature of the franchise agreement as such, but it would constitute an 'agreement within the agreement', which would be governed by the Danish Commission Act or the Commercial Agents Act, as the case may

be. It should be emphasised that the Commercial Agents Act is based on an EU Directive that embodies a number of mandatory provisions serving to safeguard the interests of the agent by ensuring certain minimum rights.

In particular, the provisions in the Commercial Agents Act relating to goodwill at termination and minimum notice of termination may not be deviated from to the detriment of the agent through an agreement stipulating that foreign law shall apply, if the legal relationship would otherwise be governed by the Act. Therefore, if the franchisee acting as an agent has its place of business in Denmark, these provisions will apply regardless of any choice of law clause contained in the franchise agreement (see Section VI.ix).

According to published Danish case law, a distributor is only entitled to compensation at termination under very special circumstances. This could be the case if the distributor or dealer, despite fixing its own resale prices and otherwise being responsible for the commercial risks, has not been duly compensated for its investments, etc. at termination; for example, if the duration of the agreement was very short, and if the distributor or dealer also actively transfers the customer records, etc. to the supplier at termination, provided that the identity of the customers is not generally known. In a case before the Danish Supreme Court on 25 April 2000, a terminated dealer was, under very special circumstances, awarded compensation in the amount of 200,000 Danish kroner. In the ruling the Danish Supreme Court clearly stated that under normal circumstances an independent distributor or dealer will not be entitled to any compensation upon termination of the distributorship or dealership. However, in this specific case the Danish Supreme Court awarded the terminated dealer the compensation mentioned with reference to the fact that the termination of the dealership had taken place with no reasonable explanation and without taking the dealer's interests into consideration (very disloyal behaviour towards the terminated dealer), and with reference to the fact that the terminating supplier in question had taken over the customer base built up by the dealer, thereby preventing the dealer from being duly compensated for its investments in marketing, etc.

iii Employment law

According to Danish law, a franchisee is generally considered as a separate and independent business partner to the franchisor. However, depending on the intensity of the parties' cooperation and provided that the franchisee is a natural person, the franchise relationship may be qualified as a camouflaged employment relationship governed by general principles of employment law, whereby the franchisee is considered similar to an employee, as the weaker party in need of protection. There is also a risk that mandatory rules such as the Danish Salaried Employees Act¹⁷ will apply, as well as statutory tax law relating to employment relationships.

Whether the franchise relationship is to be considered as a camouflaged employment relationship depends on an overall assessment of the circumstances of the case, including the wording of the franchise agreement and the parties' execution thereof. Among the factors to be considered is the extent to which the franchisee may manage its own hours, the extent to which the franchisee is taking on a financial risk by paying for the business premises and any employees, whether the remuneration to the franchisee is determined by the franchisee's performance or the time spent, etc.

17 Consolidated Act No. 1002/2017 on the Legal Relationship between Employers and Salaried Employees.

iv Consumer protection

When entering into a franchise agreement, the franchisee is considered to act in the course of business, and the franchisee will therefore not be treated as a consumer in accordance with any of the Danish laws concerning consumer protection.

However, the parties' position of strength may be of relevance in relation to Section 36 in the Danish Contracts Act (see Section IV.i).

v Competition law

The Danish competition rules, which are found in the Danish Competition Act and executive orders issued on the basis of the Act, are in all relevant aspects identical to the EU competition rules. In particular, the European Commission's Block Exemption Regulation for vertical agreements has been incorporated into Danish law.

This means that issues of exclusivity, pricing, product ties, e-commerce and full-line forcing are treated in the same way under Danish law as under EU competition law.

vi Restrictive covenants

The Danish competition rules are in all relevant aspects identical to the EU competition rules, and non-compete obligations are therefore treated in the same way under Danish law as under EU competition law.

Accordingly, a non-compete obligation relating to the products or services purchased by a franchisee is permitted for the duration of the franchise agreement, provided that the obligation is necessary to maintain the common identity and reputation of the franchised network.

vii Termination

Danish law does not require a minimum period of notice for the parties to terminate a franchise agreement made for an indefinite term and the parties are free to agree the period of notice. If a short period of notice has been agreed, the courts may in rare circumstances establish a reasonable period of notice by applying Section 36 in the Danish Contracts Act (see Section IV.i).

If no period of notice has been agreed, a franchise agreement made for an indefinite term may be terminated with a reasonable period of notice taking all circumstances into consideration, including the duration of the franchise relationship. A period of notice of six months is normally considered reasonable, including in situations in which the parties' relationship has lasted for several years (also, according to case law, if it has lasted over 20 years).

It is the starting point under Danish law that a franchisee is not entitled to compensation for goodwill at termination following an adequate term of notice. However, Danish courts have in some cases allowed a distributor such compensation but only in cases offering very special circumstances (see Section VI.ii).

The Danish competition rules are in all relevant aspects identical to the EU competition rules, and post-term non-compete obligations are therefore treated in the same way under Danish law as under EU competition law. Accordingly, post-contractual non-compete obligations in franchise agreements related to products or services that compete with the products and services covered by the franchise agreement are permissible for a maximum period of one year after termination of the agreement, provided that the non-compete

obligation is indispensable to protect know-how transferred by the franchisor to the franchisee and is limited to the point of sale from which the franchisee has operated during the contract period.

The right for the franchisor to take over the franchisee's business upon termination should be regulated in the franchise agreement. If nothing has been agreed, Danish law predicts that neither party has a right or a duty to take over the other party's rights and obligations under the agreement.

viii Anti-corruption and anti-terrorism regulation

Fraud

The Danish Criminal Code¹⁸ deals with different types of fraudulent behaviour and actions, including embezzlement, deceit, fraud against creditors, breach of fiduciary duties, breach of trust, including providing the authorities with false or misleading information concerning a company's accounts.

There is no strict liability under the Danish Criminal Code. As a general rule, criminal liability requires the intention to commit a criminal fraudulent act for the purpose of gain that causes a corresponding loss to the victim.

Furthermore, negligent and fraudulent accounting under the Danish Bookkeeping Act¹⁹ and the Danish Annual Report Act²⁰ are punishable by a fine with no statutory limit. Wrongful bookkeeping made with fraudulent intent may also be covered by the provisions on fraud in the Danish Criminal Code.

Bribery

The Danish Criminal Code distinguishes between and prohibits public active bribery, public passive bribery and private bribery (both active and passive).

Public active bribery means any person who unduly gives, promises or offers to someone performing a public function or office with a Danish, foreign or international public organisation a gift or another benefit to make the relevant person perform or fail to perform that function or office.

Public passive bribery means any person who unduly receives, demands or agrees to receive a gift or another benefit in the exercise of a Danish, foreign or international public function or office. Facilitation payments are generally considered bribes falling within the scope of public active bribery and public passive bribery.

Private bribery means any person who receives, demands or agrees to receive another benefit for himself, herself or others in a manner contrary to his or her duty of managing the property entrusted to him or her by another person, and any person who grants, promises or offers such a gift or other benefit, including in the form of kickbacks.

Violations of the Danish Criminal Code's provisions on bribery may be sanctioned with criminal fines, imprisonment (only individuals) and forfeiture. Further, violations may be sanctioned with exclusion from public procurement contracts. Directors and employees of a company may under certain circumstances be found personally liable for acts on behalf of a company.

18 Consolidated Act No. 977/2017 on Criminal Law.

19 Consolidated Act No. 648/2006 on Bookkeeping.

20 Consolidated Act No. 1580/2015 on Annual Reports.

Money laundering

The Danish Act on Anti-Money Laundering²¹ is based on the Fourth EU Anti-Money Laundering Directive,²² which was transposed into Danish law on 26 June 2017. The Danish Act on Anti-Money Laundering is to a great extent aligned with the Fourth EU Anti-Money Laundering Directive, although there are a few deviations from the Directive.

Money laundering is defined as any of the following:

- a unlawfully accepting or acquiring for oneself or others a share in economic profits or funds that are obtained by a punishable violation of the law;
- b unlawfully concealing, keeping, transporting, assisting in the disposal of or in a similar manner subsequently serving to ensure profits or funds obtained by a punishable violation of the law; and
- c attempting or participating in such actions.

A franchisor acting and contracting in its own name is responsible for complying with the Act on Anti-Money Laundering (assuming it carries out activities subjecting it to the Act). However, a company may under certain circumstances be found liable for acts committed by a third party, if that third party is in some way connected to or is representing the company. Consequently, although this risk is unlikely to materialise, a franchisor may be found liable for money laundering committed by a franchisee or the employees of the franchisee or for lack of compliance with the Act on Anti-Money Laundering by the franchisee.

For this reason it is recommended that the franchisee agrees to comply with the franchisor's internal guidelines, code of conduct, etc., subject to such adjustments as may be necessary to ensure compliance with the Danish Act on Anti-Money Laundering; such proper adequate procedures can be used as a defence for the franchisor against liability for acts committed by the franchisee or the employees of the franchisee.

ix Dispute resolution

With regard to issues relating to jurisdiction, the 1968 Brussels Convention, the 2007 Lugano Convention and Regulation 1215/2012 apply in Denmark. This means that when entering into an agreement the parties are free to agree on the choice of forum. Many franchise agreements refer disputes to be settled by arbitration and not by the ordinary courts. It is also possible to agree on mediation as a form of dispute resolution. With regard to jurisdiction outside the ambit of these rules, international jurisdiction of Danish courts is based on a number of provisions in the Danish Administration of Justice Act²³ and the starting point is that the defendant must have home court in Denmark.

Regarding choice of law, the 1980 Rome Convention applies in Denmark (not the Rome I Regulation (593/2008) because of Denmark's opt-out from the EU cooperation as regards justice and home affairs). Consequently, the parties are free to agree on the law that shall govern their agreement. To the extent that no valid choice of law has been made by the parties, the starting point is that the agreement shall be governed by the law of the country

21 Consolidated Act No. 651/2017 on Measures to Prevent Money Laundering and Financing of Terrorism.

22 Directive 2015/849/EU of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No. 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC.

23 Consolidated Act No. 1101/2017 on Administration of Justice.

with which it is 'most closely connected'. According to the basic presumption, the closest connection is to be found in the country where the party who is to effect the performance that is 'characteristic of the agreement' has his or her habitual residence or, in the case of a company, its central administration.

It is generally considered in relation to franchise agreements that the franchisor is to effect the performance that is characteristic of the agreement, consisting of the franchise concept, the right to use the franchisor's business names, trademarks and know-how and in some cases also patent rights, which shall be provided to the franchisee against payment of remuneration. Nevertheless, there are many indications that the franchise agreement shall be considered to have its closest connection to the country in which the franchisee is to make use of these rights. There is, however, no relevant Danish case law dealing with these issues.

It is possible to obtain a court injunction, including a preliminary injunction, ordering a former franchisee to refrain from trading in breach of a non-compete provision, or from using the franchisor's trademarks or other intellectual property rights (see also Section III.iii).

As a starting point, damages for breach of contract (and misrepresentation) are calculated on an expectation basis (i.e., the non-breaching party shall be put in the same position as if the agreement had been performed).

The party 'losing' the case will normally be ordered to effect reimbursement to the other party of the costs incurred by the latter in connection with the case (court fees, legal fees, etc.). In principle, the fees of legal professionals are not regulated. However, the High Court has laid down publicly accessible guidance rates for some fees, which are usually followed by the court. The amount to be reimbursed by the losing party according to these guidance rates will normally not cover the actual legal fees for conducting the case.

Foreign judgments against Danish citizens may be enforced in accordance with the rules in the 1968 Brussels Convention and the Lugano Convention, as well as EU Regulation 44/2001. If neither of these rules is applicable, the starting point is that foreign judgments are not recognised and that they cannot be enforced in Denmark. With respect to arbitration awards, Denmark has acceded to the 1958 New York Convention and, according to the Danish Arbitration Act,²⁴ Danish courts recognise foreign arbitral awards, irrespective of the country in which they were made. Recognition and enforcement may, however, be rejected on grounds of public policy, etc.

24 Consolidated Act No. 553/2005 on Arbitration.

FRANCE

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I INTRODUCTION

Franchising is a well-established marketing system in France, and has constantly developed since the 1960s. Today, it is perceived as one of the few sectors creating jobs, despite the ongoing difficult economic conditions. The French press regularly contains recruitment advertisements for new franchisees (in particular through the French Observatoire de la Franchise) and certain trade fairs (such as Franchise Expo Paris) take place at least once a year.

Based on recent statistics from the French Franchising Federation,² franchising accounts for a total turnover in France of €55 billion, covering 71,508 franchised outlets within 1,900 networks and employing directly and indirectly 618,845 people. France is the biggest market for franchising in Europe by the number of networks. International franchisors (for the greatest part of US origin) account for about 10 per cent of the total. Five business sectors represent 60 per cent of the franchising turnover in France: personal and household equipment, food retail, hotels and hairdressing. Most of the networks are mixed, which means they combine the franchisor's own outlets and the franchisees'.

While there are no dedicated government organisations, the French Ministry of the Economy keeps a close eye on the development of distribution networks (including franchising), in particular when it comes to food retail distribution, which is highly concentrated in France.³

Approximately 160 significant franchisors are members of the French Franchising Federation, which represents approximately 45 per cent of the franchisees in France. Its role is to promote and support franchised networks in their development in France and abroad. The services offered to its members include documentation, training, legal assistance, mediation, etc. The French Franchising Federation founded the European Franchise Federation in 1972.

II MARKET ENTRY

i Restrictions

Because of the absence of specific regulations on franchising in France, there are no restrictions on the development of a foreign franchisor's network in the French market, including by way of master franchising, which is often used in practice. Similarly, there is no impediment to

1 Raphaël Mellerio is a partner at Aramis.

2 Source: www.franchise-fff.com/franchise/chiffres-cles/les-chiffres-cles-en-france.html (figures for 2016).

3 Six retailers account for about 85 per cent of the market in France: Carrefour, Auchan, Casino, Leclerc, Intermarché and Système U.

the foreign franchisor taking a stake in the capital of the franchisee and obtaining veto rights in relation to certain decisions affecting the management of the franchised business. If the franchisor intends to develop the franchised network only from its home country, it will make sure not to create a permanent establishment in France (arising from a branch, offices, employees or the appointment of an agent acting on behalf of the franchisor). Franchisees and master franchisees are considered by French courts as the owners of their clientele (at least at local level), which allows them to enter into lease agreements giving them security of tenure.

ii Foreign exchange and tax

Foreign exchange control disappeared a long time ago in France and the French legislation on foreign investments (applicable to certain protected activities such as defence) is of no relevance in the context of franchising. As regards taxation, corporate franchisees located in France are subject to corporate income tax and all other applicable taxes.

III INTELLECTUAL PROPERTY

i Brand search

To be effective against third parties, trademarks need to be registered at the appropriate intellectual property (IP) offices: nationally at the National Institute of Industrial Property in France (INPI), at EC level with the European Union Intellectual Property Office (EUIPO), or worldwide with the World Intellectual Property Organization. Trademark clearance searches can easily be performed using the online trademark databases, updated by the IP offices, to assess the availability of trademarks and prevent infringement of third parties' rights. These databases also allow verification of the status of registration of trademarks, their ownership, the existence of registered licences and sometimes oppositions made by third parties. Company names may also be included in clearance searches thanks to the online commercial registry database. As concerns designs, even though online databases are also available, clearance searches require dedicated tools. Certain forms or fittings may not be protected by registered trademarks or designs, in which case French rules on copyright may apply. As copyrights are not registered in France, searching third parties' rights is far more complicated.

ii Brand protection

Whatever the IP office involved, the registration process follows the same main steps, namely (1) filing and payment of the fee, (2) publication by the relevant IP office of the trademark or design on a special bulletin, (3) examination of the filing request and possible oppositions by third parties and (4) provided the oppositions are rejected by the relevant office and the filing complies with the examination requirements, formal registration of the filed trademark or design. The process takes at least five months at the INPI and 26 weeks at the EUIPO (provided no oppositions are filed).

iii Enforcement

Franchise agreements typically let the franchisor take any action that it deems necessary to protect its distinctive signs, whether through court actions or interim measures. This derives from applicable Association Française de Normalisation (AFNOR) norms in France and

from the European Code of Ethics for Franchising, whereby the franchisor must allow the franchisee to peacefully enjoy the right to use the relevant distinctive signs. If the franchisor does not take appropriate steps to protect this right, despite an official written request from the franchisee, the franchisee may sue third parties on grounds of trademark infringement (and may also request the seizure of counterfeit products). Furthermore, any franchisee is entitled to start legal proceedings on grounds of unfair competition.

iv Data protection, cybercrime, social media and e-commerce

French data protection legislation applies to any 'data controllers'⁴ that are (1) either located in France, (2) or located in a country that is not a Member State of the European Union but use processing means on French territory.

Pursuant to this legislation, franchisors or franchisees have to comply with numerous obligations, such as providing the data subjects (e.g., consumers) with specific information and filing declarations with the French data protection authority, the Commission Nationale de l'Informatique et des Libertés (CNIL). Certain use of personal data may be subject to prior authorisation from the CNIL. This is particularly the case where data is transferred to an entity located outside the European Union. As from May 2018, French legislation will include the EU General Data Protection Regulation.

Failure to comply with this legislation may lead to sanctions by both the CNIL and French criminal courts.

Cybercrime, social media and e-commerce are subject to general laws, such as criminal law, contract law, data protection law, consumer law, etc. Some specific provisions related to e-commerce have been implemented into French law by the EU Directive on electronic commerce dated 8 June 2000.

IV FRANCHISE LAW

i Legislation

Although franchising is a well-established distribution system in France, there is no specific legislation governing franchising. This is strange for a country that is used to producing numerous laws on many different business subjects. As stated by a minister some time ago, this is because legislating on franchising would risk 'weakening its dynamic and evolving features'.⁵

Consequently, franchising is subject to general EU and French laws governing distribution, including competition laws (in particular EC Regulation No. 330/2010 of 20 April 2010 on vertical restraints).

An area in which the French legislator has dealt with franchising is in relation to pre-contractual disclosure, which is described below (known as the Doubin Law of 1989, the provisions of which are set out in Article L330-3 of the French Commercial Code). Franchising is not mentioned as such in the Law (which may apply to other distribution methods as well) but it is at the centre of this Law. More recently, the French parliament adopted the law on growth and business (known as the Macron Law), which contains certain provisions

4 Article 3 of the French Data Protection Law (No. 78-17 of 6 January 1978) defines a data controller as the legal person who decides on the purpose and means of the processing.

5 Ministerial response No. 8419, JO Débats, December 1986, p. 5032.

regarding cross-termination in the context of franchising as well as non-compete clauses. Finally, the 2016 Labour Bill relating to new freedoms and protections for undertakings and employees has introduced some sort of collective representation for franchisees' employees.

ii Pre-contractual disclosure

Article L330-3 of the French Commercial Code requires any party who makes available to another person a trade name, trademark or trade sign in consideration of an exclusivity or quasi-exclusivity commitment by the other party, to provide to that other party at least 20 days before the execution of a contract a document giving accurate information allowing the other party to make an informed commitment. Because a franchisor will in most cases require the franchisee to trade under its distinctive signs on an exclusive basis and sometimes by procuring most of its products or services from the franchisor or parties designated by the franchisor, this provision applies almost systematically to franchising transactions.

The franchisor's pre-contractual information obligation is the subject of extensive case law in France, in circumstances where the franchisee's business is unsuccessful and the franchisee alleges that he or she has been misled by the franchisor on the financial prospects of the franchised business. According to the Doubin Law, the franchisor is required to give a presentation on the state and development perspectives of the relevant market. In cases where the franchisee complains about the lack of forecast figures, French courts tend to adopt the following approach: the law does not require the franchisor to provide a local market survey and a forecast income statement to the franchisee. However, if the franchisor does provide a market survey and forecast figures to the franchisee to allow it to build its business plan, the information must be fair and accurate.

Where a court considers that the lack of (or inaccuracy of) information has deceived the franchisee (which will often be the case where the actual turnover is significantly below the forecast figures, for example by more than 30 per cent), it may hold the franchise agreement as null and void and in some cases find the franchisor liable for damages, if the latter has committed misrepresentation. If the misrepresentation of the franchisor or the error of the franchisee cannot be demonstrated, a judge may nonetheless grant damages to the franchisee for the loss suffered (covering the costs and investments incurred by the franchisee but not the profit he or she was expecting to make on the basis of the figures provided by the franchisor). This will be the case particularly where the franchisee has become bankrupt because of a structurally loss-making business.

iii Registration

No specific registration requirement applies to companies solely on the basis that they are franchisees. However, depending on the business they are involved in, they may be subject to certain regulatory constraints (such as special permits to be obtained in certain professions, e.g., restaurants and travel agencies). It is for the franchisee to apply for such permits, with the assistance of the franchisor if necessary.

iv Mandatory clauses

To constitute a franchise agreement under French law, the agreement needs to provide for three essential obligations on the part of the franchisor, namely (1) the licensing of intellectual property rights to the franchisee, (2) the provision of substantial know-how, and (3) the supply of commercial and technical assistance by the franchisor. The franchisee's

obligations may be more or less detailed (bearing in mind agreements subject to French law are traditionally shorter than English ones) but should include at a minimum the financial conditions, including the entry fee and the franchise royalty payable by the franchisee.

v Guarantees and protection

There are various ways in which a franchisor may secure the payments due by the franchisee. The French Civil Code provides for various kinds of personal guarantees, such as letter of comfort, surety and first demand guarantee. Such guarantees may be issued by the parent company of the franchisee or by a financial institution. From a protection point of view, the franchisor is much better off with a third-party demand guarantee, which can be enforced by the franchisor subject to the conditions set out in the guarantee itself, and the guarantor may not raise objections in relation to the underlying franchising agreement. It is obviously preferable that the guarantor be located in a country where the enforcement of a foreign judgment can realistically be obtained in a timely manner.

V TAX

i Franchisor tax liabilities

If established in France, franchisors will be liable to all taxes applicable to businesses in France (including corporate income tax at a standard rate of 33.33 per cent).⁶ All revenues generated from the licensing of trademarks and know-how and the provision of training services will constitute taxable income. As already mentioned, franchisors wishing to remain outside France must avoid creating a permanent establishment in France.

ii Franchisee tax liabilities

Save in exceptional circumstances (see Section VI.iii), a franchisee is deemed for tax purposes to be an independent party having title to its clientele. Accordingly, it will be subject to applicable taxes in France. All amounts paid to the franchisor (including the entry fee, the franchise royalty and payments for the supply of goods) are normally tax deductible. However, in some circumstances, a master franchisee may have to account for licensed IP rights as an asset and consequently may not be entitled to deduct royalties paid to the franchisor for tax purposes.

iii Tax-efficient structures

To the extent franchisors are generally part of large groups of companies, certain tax-efficient structures generally involve lodging IP rights (trademarks in particular) in countries where tax amortisation of such rights is possible (e.g., in the Netherlands or Switzerland). The know-how, the commercial and technical assistance, and the goods or services that are required for the performance of the franchised business may be made available by other companies of the group. Where the franchisor and the franchisee are located in different countries, close attention must be given to the provisions of the applicable tax treaty between

⁶ The 2017 Finance Bill submitted by the previous government contemplates a gradual reduction of the corporate income tax rate to 28 per cent between 2017 and 2020, and this is not expected to be substantially amended by the current government.

those countries, if any. Generally, franchising agreements include ‘gross-up’ clauses to allow the franchisor to receive the exact net amount, as if no withholding tax in the franchisee’s country applied.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The law of contracts in France (which has been subject to a wide-ranging reform, effective as from 1 October 2016) is based on some general but essential principles, such as the binding force of contracts and the duty of good faith. According to Article 1103 of the French Civil Code, legally formed agreements are as binding as law between the parties. Article 1104 adds that, as a matter of public policy, contracts must be negotiated, formed and performed in good faith. Article 1194 adds that agreements commit the parties not only to what is stated in them, but also to all consequences derived from equity, custom and the law. In most contractual disputes, these texts are often referred to by the parties (among others), and French courts have on the basis of these principles built up a set of rules for the performance of contracts (e.g., the duty of information and the obligation to warn the other party of certain risks). This is why franchising agreements (like other distribution agreements governed by French law) are often shorter than contracts governed by English or US law, as the parties may rely on implied obligations, beyond what is stated precisely in the agreement. With the recent reform of contract law, good faith gives rise to the right of a party to request the revision of an agreement in the event of an unforeseen change of circumstances (Article 1195 of the Civil Code). In such a case, the judge may not only terminate the agreement, but also revise it, which provides for a potentially high level of judicial interference. However, as the new Article 1195 is not a public policy provision, the parties may expressly derogate from it.

Finally, the new Article 1171 of the Civil Code provides that ‘in a preformulated standard agreement, any clause which creates a significant imbalance between the rights and obligations of the parties to an agreement is deemed null and void. The determination of the significant imbalance does not relate to the main object of the agreement or the adequacy of the price to the performance’. As franchise agreements will most probably be viewed as preformulated standard agreements because of the traditionally limited scope of negotiation on the contract terms, it remains to be seen whether judges will use this text to set aside or restrict the application of, for example, exclusion of liability, exclusivity and non-compete clauses.

ii Agency distributor model

Based on EU legislation, a person can be considered as an agent if it is entitled to negotiate and, as the case may be, conclude agreements in the name and on behalf of its principal. Since the agent is not the owner of the clientele, who purchase products or services from the principal, it is entitled to a termination indemnity or compensation upon the expiry or the termination of the agency agreement. If the franchisee (like any other distributor) buys products from the franchisor (or an affiliate of the franchisor) and resells them in its shops or outlets, it may not qualify as an agent. It is therefore rare to see cases where the franchisee has successfully been requalified as an agent, with the consequence that, for the time being, under French law the franchisee is not entitled to any indemnity upon expiry or termination of the agreement (see Section VI.vii).

A closer model to franchising is distribution (including selective distribution) that does not require the licensing of intellectual property rights or the provision of know-how (simply the sale of products and marketing support by the supplier to the distributor). However, the distinction between franchisee and distributor has little impact when it comes to the termination of the agreement and the consequences arising therefrom.

iii Employment law

The application of French employment law to franchisees is another issue highly debated in the courts, with numerous decisions on the subject. There are two ways a franchisee may benefit from protective employment laws in France: one is to demonstrate that despite being called a 'franchisee', he or she is in fact an employee working under the constant authority of the franchisor, who has the power to give orders and instructions, control performance and impose sanctions on the franchisee;⁷ another way, that does not require the demonstration of the existence of the employee's subordination to the employer, is by fulfilling the conditions set out in Article L7321-2 of the French Labour Code, namely (1) the franchisee sells products that are supplied exclusively or quasi-exclusively by the same company, (2) it conducts its activity in premises that are provided or approved by such a company, and (3) at prices and conditions imposed by the same company.

Finally, the franchisor may be held liable to the employees of its franchisees if it behaves as the *de facto* manager of the franchised business, interfering in such a way as to leave no real autonomy to the franchisee.⁸

The application of French labour law to a franchising agreement has serious implications as the franchisor, who in such circumstances will be deemed to be the employer, will be liable to the 'franchisee' for past wages, paid holiday and, in the event of termination, may have to pay indemnities for redundancy and paid holiday, not to mention the repayment of the entry fee and training costs. In addition, all such sums being subject to social security contributions, the franchisor could be requested by social security bodies to pay the related employer's contributions.

iv Consumer protection

To our knowledge, there is no example in French case law of a franchisee being held to be a consumer. This is because the criterion that is widely used by French courts to consider someone as a consumer is that he or she acts for the satisfaction of his or her personal needs (and not those of a business). Consequently franchisees do not benefit from the protective provisions of French consumer law (covering all sorts of issues, such as the extent of the duty of information owed to the consumer, the extent of the statutory warranties in relation to products, the absence of automatic renewal of contracts, etc.).

In the interests of consumer protection, pursuant to Article A441-1 of the French Commercial Code, the franchisee is required to inform consumers that it acts as an independent undertaking. This information must appear on all information documents (including advertising) as well as both inside and outside the franchised outlet.

7 Court of Cassation, Labour Section, 18 January 2012, No. 10-16342.

8 Court of Cassation, Commercial Section, 9 November 1993, No. 91-18351.

v Competition law

One of the laws that has the greatest impact on franchising contracts is certainly competition law. This is because franchising networks (and the inherent vertical restraints, such as exclusivity and non-compete) are sometimes critical in the organisation of the sale of products or services in some sectors of the French economy. In that respect, the French Competition Authority and French courts apply consistently the EU rules derived from EU Regulation No. 330/2010 and its Guidelines. While price-fixing and restrictions on passive sales are *per se* prohibited practices, non-compete clauses are assessed on a case-by-case basis depending on the relevant economic sector and the ability of the franchisee to develop a business independently of the franchisor. Competition law has also led the French Competition Authority⁹ to identify distinctive features for food retail distribution, including for franchised hypermarkets and supermarkets, where some contractual clauses may be forbidden while they are admitted in other sectors.

vi Restrictive covenants

Restrictive covenants applicable throughout the duration of the agreement give rise to little debate before French courts. Decisions are generally in line with the provisions of EU Regulation No. 330/2010, in particular in relation to purchasing exclusivity and non-compete obligations, which are viewed as essential to preserve the identity and reputation of the franchise network. A recent survey indicates that most franchising agreements have a duration of five years (aligned with the duration of the non-compete obligation as provided for in the Block Exemption Regulation), and some go to seven years.¹⁰

vii Termination

Although the termination of franchise agreements is often a hot topic for practitioners and legal commentators, the case law of the French Court of Cassation is at present stable, based on general principles of contract law: while a fixed-term contract may not be terminated prior to its term (unless one of the parties has committed a material breach of its obligations), an indefinite term agreement may be terminated at any time by either party, provided a reasonable notice is granted by the terminating party and that termination is not abusive. Despite numerous arguments raised by franchisees based on their situation of economic dependency in relation to the franchisors upon the expiry of the franchise agreement, the franchisee is not entitled to any compensation or indemnity for loss of business, provided termination is neither abusive nor sudden.

After a lengthy parliamentary debate, the above-mentioned Macron Law of 6 August 2015 has introduced the principle whereby a franchise agreement and its related agreements 'whose common purpose is the operation of one or several retail outlets and include clauses that are likely to limit the freedom of the outlet's operator to carry on its business' must all have the same expiry date. Therefore, if one of the agreements terminates, this shall cause the termination of all other agreements on the same date. The parliamentary debates do not shed much light on what is meant by 'related' or 'ancillary' agreements in this context. The general intention is to avoid franchisees remaining bound by multiple

⁹ Opinion No. 10-A-26 of 7 December 2010 of the French Competition Authority.

¹⁰ Annual Franchise Survey: Summary of Results 2015 (conducted by CSA for Banque Populaire and the French Franchising Federation).

agreements relating to the operation of the sale outlets if their franchise has terminated, for instance under supply agreements for goods or equipment with the franchisor or some of its affiliates.

Except in the specific sector of food retail distribution (see Section VII), French courts will generally enforce these principles, as well as franchisees' post-term obligations, despite the fact that the franchisee may find itself in a difficult economic situation upon leaving the franchise network. This position is derived from the well-established principle whereby the franchisee owns its clientele (at least at local level, because of the investments and risks it has taken) and is therefore to be clearly distinguished from an agent, who has no goodwill.

As far as post-term non-compete clauses are concerned, one generally looks at the criteria for block exemption as set out in Article 5, Paragraph 3 of EU Regulation No. 330/2010 (including the one-year limitation). If these conditions are not fulfilled, a French court will apply the general conditions required for the validity of a non-compete clause under French law, namely it must be limited in time and geographic scope, it must be justified to protect the interests of the franchisor and proportionate to those interests (however, please refer to Section VII in relation to the Macron Law). Despite some franchisees' attempts to include another condition that applies to employment contracts (i.e., the need for the non-compete clause to include financial compensation), French courts have so far resisted making this addition. In practice, this means that non-compete clauses are often enforced in France as long as they meet the above requirements. Moreover, French courts tend to differentiate traditional non-compete clauses (the object of which is to prohibit the conduct of a business similar to that of the franchise network) from non-reaffiliation clauses (which simply restrict the freedom of the franchisee to join a competing franchise network).¹¹ As the latter is less restrictive on the franchisee than a non-compete clause, it is more widely admitted in court, except in sectors where belonging to a network is decisive given the structure of the market (for example, in the food retail or car rental businesses).¹²

Furthermore, under the Macron Law, post-term non-compete clauses in franchising agreements are void unless they meet the four conditions contained in the Block Exemption Regulation (including the one-year limitation). Therefore, the Macron Law may in the future limit the scope of some court decisions, which until now have been keen on accepting longer post-term non-compete clauses in franchise agreements, if they were proportionate to the interests to be protected and deemed necessary for the integrity of the franchisor's network.

Finally, the franchisor is also generally granted a pre-emption right over the shares of the franchisee or its business, subject to paying the price that a third party offers or may offer (on the basis of a willing seller and a willing buyer), and is generally entitled to take over the business and assets of the franchisee (including the lease). Again, subject to changes being seen in the food retail distribution sector (see Section VII), such clauses are perfectly legitimate and it is common for shareholders of the franchisee and the franchisor to enter into a shareholders' agreement setting out certain veto rights for the franchisor. Likewise, if the franchisee is a master franchisee, the takeover by the franchisor of the contracts with the sub-franchisees (in the event of termination of the master franchise agreement) is generally provided for in the sub-franchise agreements and is normally enforceable.

11 Court of Cassation, Commercial Section, 28 September 2010, No. 09-13.888, Bull. Civ. IV, No. 145 – Commercial Section, 31 January 2012, No. 11-11.071.

12 Court of Cassation, Commercial Section, 18 December 2012, No. 11-27.068.

viii Anti-corruption and anti-terrorism regulation

Anti-corruption and anti-terrorism legislation is contained in the French Criminal Code. The anti-corruption provisions, which have recently been strengthened in line with the US Foreign Corrupt Practices Act and the UK Bribery Act,¹³ apply to both the public and the private sector and they do not raise specific issues in relation to franchising.

ix Dispute resolution

Disputes in relation to franchise agreements do not give rise to significant differences from the settlement of disputes in relation to other types of distribution agreements.

However, because the relationships between the parties are generally governed by a set of agreements, including not only the franchise agreement, but also a supply agreement, a services agreement, sometimes a shareholders' agreement, etc., and the fact that these agreements are very much intertwined, it is generally recommended to provide for an amicable mediation or conciliation mechanism to avoid long and often inconclusive litigation. Following the recommendations of various professional organisations, including the International Chamber of Commerce (ICC) and the Paris Chamber of Commerce, there is now in France growing awareness of and interest in alternative dispute resolution (ADR) systems. Where an agreement provides for mediation or conciliation (prior to litigation), French courts now reject any judicial claim if the parties have not previously exhausted the mediation or conciliation process.

Recent statistics indicate that among the ADR systems, mediation is the most common in franchising disputes; various organisations (including the French Franchising Federation and the ICC) offer a forum for mediation that gives rise to a quick outcome (approximately two to three months to reach a positive or negative conclusion), ensures the confidentiality of the discussions and costs little.

Franchisors have an interest in opting for a unified way of dealing with disputes with their franchisees, either through arbitration or via litigation before a designated local court (often those of Paris or the local court of the head office of the franchisor). Apart from the benefit of confidentiality, arbitration will give rise to quicker decisions than in French courts; normal judicial proceedings in front of first instance courts in France tend to last approximately 18 months.

Pending any lawsuit on the merits of a case, it is possible to refer to French courts for interim measures, even if the parties have incorporated an arbitration clause in their agreement. However, as recent decisions indicate, this presupposes that the case has not already been referred to the arbitration tribunal by either party. Interim measures may be granted by the President of the Commercial Court in situations of urgency or to prevent an imminent peril. Interim measures may include an interim payment to the damaged party if the existence of the underlying obligation is not seriously challenged, or even the mandatory performance of the relevant obligation.

Finally, French courts will give effect to a choice of law clause designating a foreign law. This is, however, subject to the application of mandatory provisions of public interest under French law (for instance, where the franchisee is subject to insolvency proceedings).

13 Law No. 2016-1691 of 9 December 2016 relating to transparency, the fight against corruption and economic modernisation, known as the Sapin II Law.

VII CURRENT DEVELOPMENTS

Several decisions rendered by the Court of Cassation and the Paris Court of Appeal in 2012 and 2013 show the importance given to antitrust considerations when deciding on the legality of certain clauses or mechanisms included in franchise agreements: in the food retail sector, courts have ruled out the application of veto rights of a major retailer in the franchisee's decisions, the obligation of the franchisee to source food products (other than private-label products) exclusively from the franchisor (or companies in its group) and a post-term non-compete commitment by the franchisee.¹⁴

Although these decisions are very specific to the organisation of food retail distribution in France, they remind us that any contractual clauses or shareholder mechanisms included in franchise agreements and ancillary agreements are always subject to an analysis of their impact on the affected market of goods and services, and may be set aside if they breach applicable competition laws.

Finally, under the recent labour bill (known as the El Khomri Law), social dialogue committees must be established in franchise networks that have more than 300 employees and whose franchise agreements contain clauses relating to franchise working conditions. The setting up of a committee is the subject of negotiations with trade unions. The committee, which will include both employees' and franchisees' representatives and will be chaired by the franchisor, must be informed of any franchisor decision that will affect the size and structure of the labour force and employee working hours, terms of employment or training conditions. Further, the committee must examine any proposal to improve employee working and training conditions across the whole network, as well as the terms of additional health and welfare insurance. An implementing decree enacted on 6 May 2017 sets out the conditions for the establishment of social dialogue committees, as well as the operating rules that apply in the event that no agreement is reached with the unions.

¹⁴ Court of Cassation, Commercial Section, 30 May 2012, No. 11-18024; Paris Court of Appeal, 3 April 2013, No. 10-24013.

GERMANY

Stefan Münch, Alexander Duisberg, Markus Körner and Michael Gaßner¹

I INTRODUCTION

Germany is a mature franchising market, with a good number of indigenous franchises ranging across more than 42 different sectors, from retail and fast food through hotels, education, car rental and domestic services to energy, health care and telecommunications. The three biggest sectors are services (39 per cent), retail (31 per cent), and hotels and gastronomy (20 per cent).

There are currently more than 950 active franchise systems and 156,662 franchise businesses in Germany, employing more than 686,166 employees, according to the German Franchising Association.² The current annual turnover of the German franchise sector is estimated at about €99.2 billion.

Domestic franchise chains, such as Apollo-Optik, Arko Kaffee und Confiserie and BabyOne sit side by side with the likes of McDonald's, Hertz, Intercontinental Hotels and Mail Boxes Etc.

The German Franchise Association and the German Franchisee Association are both active, and the German Franchise Association is a member of the European Franchise Federation and of the World Franchise Council.

II MARKET ENTRY

i Restrictions

Although the General Trade Act imposes some sector-specific regulations, Germany is a market economy, which typically imposes no restrictions on foreign franchisors as regards the granting of master franchise or development rights.

ii Foreign exchange and tax

There are no foreign exchange controls or restrictions on foreign currency payments applicable to cross-border franchising in Germany. It is prudent to ensure that franchise documentation states the currency in which payments should be made and the rate and time of currency conversion. Likewise, it is preferable to describe ongoing fees as service fees rather than royalties, as these can be more advantageously dealt with tax-wise.

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2 Figures as of 2014 by the German Franchise Association (Deutscher Franchise-Verband e.V.).

Germany has double-taxation treaties in place with most countries and the terms of the relevant treaty should always be taken into account when structuring international payment flows.

III INTELLECTUAL PROPERTY

i Brand protection and search

The key intellectual property rights involved are trademarks, designs, domain names, copyright and database rights (patent rights are usually not relevant). Although copyright is not registrable in Germany, trademarks are, and franchisors can choose whether to register them as domestic German or European Union trademarks (EUTM) or international registrations. The registration fee for an application for a German registration is €300 with a discount of €10 should the registration be made online. A fast-tracked examination is available for an additional fee of €200. If more than three classes of goods and services are requested, a fee of €100 for each additional class will be charged.

Not surprisingly, however, most franchisors opt for EUTM registrations rather than German domestic registrations, although domestic registration is more common if it is a German-language mark used solely for a domestic German business. Franchisors can extend their trademarks to Germany as part of an international registration or subsequent designation, as Germany is a party to the Madrid Protocol.

Germany is a first-to-file jurisdiction, although unregistered marks can be acquired by way of usage if they have acquired a reputation in Germany, and Article 6 of the Paris Protocol also ensures that 'well-known marks' can be protected even if there is no evidence of use in Germany. The German Unfair Competition Act provides supplementary protection to trademarks.

In addition to pure trademark protection, the German Trademark Act also grants special protection for trade designations, which could be business names or titles of works. Their protection does not require a registration, but rather a certain level of usage of the trade designation by the proprietor.

As trade designations are not contained within the trademark register, special search tools are required to identify existing prior third-party rights.

ii Enforcement

Trademark proprietors are entitled to commence enforcement proceedings based upon their trademark rights. It is possible to obtain a preliminary injunction in Germany, even without an oral hearing, within a very short time, but any delay in issuing proceedings can mean that this right may fall away. Both parties must be represented before the court by a lawyer admitted to the German Bar.

German litigation lawyers usually work on an hourly fee arrangement – conditional fees are generally not compliant with German Bar rules. In German litigation, the English rule applies, so attorneys' fees are usually paid by the losing party to the winning party. The amount to be refunded is, however, limited by the Attorney's Remuneration Act and, as a result, the winning party may end up bearing part of its own attorney's fees

iii Data protection, social media and e-commerce

The rules of data protection law play an important role in any dealings with the personal data of end users (and employees); these rules have a significant impact, for example, when

franchisors run loyalty programmes and promotional campaigns. The German Federal Data Protection Act (GDPA), which is based on the EU Data Protection Directive 95/46/EC, will be largely replaced by the General Data Protection Regulation (Regulation (EU) 2016/779 (GDPR) from 25 May 2018 onward. Any processing of personal data by the franchisee (and franchisor) must be based on the consent of the data subject or legal justification under law. Wherever a data controller transfers data outside the EU or EEA, for example, into the United States, measures to ensure an adequate level of data protection compliance must be met. Following the ‘Safe Harbor’ ruling of the European Court of Justice,³ data controllers must now resort to other suitable means for transferring personal data into the United States, such as data subject consent, the EU Model Contract Clauses, Binding Corporate Rules (for transfers within corporate organisations) or the EU–US Privacy Shield Framework (the Privacy Shield). The Privacy Shield replaces the former Safe Harbor Framework, and is intended to ensure greater transparency, accountability, effectiveness and judicial safeguards with regard to European privacy standards when transferring personal data to the United States.⁴ Where a data controller instructs a data processor to process data on its behalf and subject to its instructions within the EU, the parties have to enter into a commissioned data processing agreement. Under the GDPR, the data processor will assume genuine liability towards the data subject and the authorities for complying with data protection law, whereas under the current GDPA only the data controller is responsible towards the data subject and the authorities.

Notably, each regional state in Germany has its own data protection authority, which can take slightly different views on interpreting and enforcing the law. Under the GDPR, the possible scope of interpretation will narrow down given its universal application throughout the EU and EEA; the yet to be established European Data Protection Board will have an important role in giving further guidance; the GDPR also provides for other forms of secondary law that may take consideration of particular industry and sector practices, such as codes of conduct (Articles 40, 41 GDPR) and certifications (Articles 42, 43 GDPR). Further to that, there are also various sector-specific regulations, such as those that apply to providers of telemedia services under the German Telemedia Act, which is relevant for online marketing and user-tracking activities, or to internet service providers. Lack of compliance with data protection laws can lead to serious consequences, including monetary fines and cease-and-desist orders, as well as reputational issues and negative publicity in Germany.

Social media monitoring as well as active marketing through social media raises considerable issues under German privacy rules, which is why use of these channels is typically less developed than in other European jurisdictions. Accordingly, taking proper legal advice on a case-by-case basis is required for activities in this field.

German regulations on e-commerce mainly derive from EU legislation, such as the directives on distance selling⁵ and on consumer rights.⁶ E-commerce providers need to observe a variety of information obligations; failure to comply with these obligations can trigger extended rights of withdrawal for consumers, as well as possible competitor actions.

3 ECJ C-362/14, *Schrems*, 6 October 2015.

4 Certain civil rights organisations have challenged the Privacy Shield; proceedings are pending before the court of first instance, Case T-670/16, *Digital Rights Ireland*.

5 Directive 97/7/EC.

6 Directive 2011/83/EU.

On the basis of unfair competition law, competitors as well as competition associations, qualified consumer protection associations and chambers of industry and commerce, or craft chambers, can launch cease-and-desist actions against market players that do not 'play by the rules' with regard to compliance with requirements on electronic contracting, information obligations, unlawful advertising or even, in certain circumstances, presenting clauses in standard terms of business that are partially or entirely unenforceable. Given the quick reaction times and the speed of courts in granting injunctions (including *ex parte* injunctions), businesses need to pay particular attention to the potential pitfalls in the area of unfair competition law.

IV FRANCHISE LAW

i Legislation

There is no franchise law as such in Germany; provisions concerning franchising can instead be found in the general codes of law such as the Civil and Commercial Codes. These provisions, *inter alia*, impose pre-contractual disclosure obligations and a heavy expectation of good faith on all parties, making claims of profit to potential franchisees particularly risky.

ii Pre-contractual disclosure

Pre-contractual disclosure obligations are imposed on the principle of *culpa in contrahendo*, which is codified in Section 311(2) of the Civil Code. In addition, the law concerning misrepresentation is also relevant.

During the negotiations, both parties – not just the franchisor – must tell the truth, make no false promises and disclose all material facts to each other. This is especially true as regards those facts that will have a material impact on the success of the franchise and that may induce the potential franchisee to become part of the network. Earnings claims are particularly difficult and must be based on reliable and relevant empirical data – estimates must be clearly labelled as such. It is even possible that should the franchisor's directors or agents make dishonest or misleading statements to potential franchisees, they could be held personally liable according to Section 311(3) of the Civil Code.

Franchisors should therefore be very cautious in marketing their franchises in Germany. Any failure to comply with the principle of *culpa in contrahendo* will mean that a contract could be set aside, and any fees paid may have to be repaid in full. There is a statutory period of limitation of three years for such claims, which commences at the end of the year in which the claim arose and the franchisee obtained knowledge of the circumstances giving rise to the claim.

iii Registration

Germany does not require franchises to be registered.

iv Mandatory clauses

The ongoing relationship between franchisor and franchisee is especially affected by agency laws⁷ if the franchisee commits to the ongoing purchase of products and equipment. Antitrust law, based upon Article 101 of the Treaty on the Functioning of the European Union (TFEU), also has an impact on issues such as the grant of exclusivity, tying and price control.

A test of fairness by the rules on unfair contract terms will be imposed on any provision in a standard form agreement that has not been negotiated by the rules on unfair contract terms.⁸ The threshold for qualifying as 'negotiated' is rather high in Germany, so it is very likely that a standard form agreement will fall within the scope of the rules on unfair contract terms. Special justification is generally needed if a provision deviates from the fallback position as set out in the Civil Code to the detriment of the franchisee. Franchisees can be treated as if they were consumers in domestic agreements.

Several statutory provisions will be implicit in the agreement, such as a right of the franchisee to terminate and the franchisor's obligation to provide certain services. There is a great deal of case law on the question of what constitutes sufficient grounds for termination, so franchisors must be cautious when exercising or contesting this right.

v Guarantees and protection

The principle of *contra bonos mores* has a limiting effect on securities, especially if the value of the surety clearly exceeds the debt. In such a case, the suretyship agreement might be declared void or the debtor can demand a partial release of the security.

V TAX

i Franchisor tax liabilities

Franchisors that are tax resident in Germany are liable for corporation tax of 15 per cent plus a solidarity surcharge that is added to the corporate income tax and set at a rate of 5.5 per cent of the corporate income tax rate (equalling an additional 0.825 per cent) and trade tax. Trade tax is a municipal tax. As such, tax rates are individually determined by each municipality (the German average is around 14 per cent). Withholding tax of 25 per cent is payable on dividends.

Royalty fees for the granting of rights under the German Copyright Act (e.g., software licences, although not the licences to use patents or trademarks) bear a reduced VAT rate of 7 per cent, while all other fees paid to the franchisor by the franchisee are subject to VAT at 19 per cent. The initial franchise fee is usually amortised over the duration of the franchise for income tax purposes.

ii Franchisee tax liabilities

In addition to corporation tax and the solidarity surcharge, trade tax is also payable by franchisees.

7 Agency laws, *inter alia*, impose the duty on franchisors to pay compensation to franchisees on termination, the principle of good faith, the rule that unfair contracts are void and the principle that long-term contracts can be terminated for good reason, and cooling-off rights in accordance with European consumer protection law.

8 Section 305 et seq. of the Civil Code.

Tax on personal income falls into bands ranging from 14 to 45 per cent; corporate tax, municipal trade tax and VAT also apply at the rates mentioned in Section V.i.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Franchisors cannot exercise their contractual rights or change their business formats with impunity, as the concepts of good faith and fair dealing are implicit in all agreements. Although both franchisors and franchisees benefit from and carry reciprocal burdens, it is generally franchisors, as the dominant parties, that find they have to defend themselves from allegations of behaving unfairly or in bad faith. This is particularly the case when franchisors seek to issue disciplinary or other actions against their franchisees, so their actions need to be proportionate.

ii Agency distributor model

The courts often apply agency law to franchise agreements by analogy.

iii Employment law

Some employers in low-skill businesses, such as contract cleaning, have been known to use a form of 'false franchising' as a way of reducing their liabilities to their employees. The German courts are very sensitive to this type of abuse and the Federal Labour Court's decision in the *Eismann* case⁹ established that franchisees can be deemed to be 'in fact' employees of a franchisor if the franchisor controls every aspect of an individual franchisee's business.

As of 2015, a uniform nationwide statutory minimum wage of €8.50 was introduced in Germany. This wage is intended to be reviewed by a commission every two years and will increase to €8.84 in 2017.

iv Consumer credit protection

Section 513 of the Civil Code protects new businesses, including some franchisees, in relation to loans, respites or any other forms of financial aid, as well as instalment supply contracts. Specific statutory information requirements apply and such franchisees may be entitled to withdraw from their contracts.

v Competition law

German competition law is based on the corresponding provisions contained in the TFEU. Nevertheless, the German courts can be particularly strict in their approach.

vi Restrictive covenants

Franchisors can prevent their franchisees from competing with them for the duration of their agreements, but prohibiting franchisees from supplying other franchisees within the same franchise systems is regarded as contravening Article 4(b) of the Block Exemption

9 NJW 1997, 2973.

Regulation. Post-termination restrictive covenants must be explicitly provided for in the franchise agreement and limited in time, scope and territory, and are only enforced by the courts in the event that the franchisor has paid the franchisee a consideration for them.

vii Termination

The franchisor cannot terminate a franchise contract for a minor breach. Termination must be proportionate, fair and in good faith.

If the franchisee undertakes to sell its business to the franchisor on termination, this will be enforced by the courts, but is not common practice among franchisors in Germany.

viii Anti-corruption and anti-terrorism regulation

In practice anti-corruption and anti-terrorism compliance considerations do not apply in the context of franchising in Germany.

ix Dispute resolution

Foreign law is generally acceptable in agreements if they have sufficient connection to a foreign country, but not if both parties are located in Germany. Even if foreign law has been agreed, mandatory German and European laws will apply if the franchisee is operating in Germany. Under the Brussels I Regulation, judgments of a court of an EU Member State are enforceable in other Member States without the need for any special procedures, and arbitration awards are fully recognised; mediation is also available.

Injunctions are relatively easy to obtain. Ex-franchisees that continue to use former franchisors' marks are easily stopped by way of interim injunctions. Damages can be awarded but are usually intended to cover actual losses incurred.

VII CURRENT DEVELOPMENTS

The courts continue to wrestle with issues concerning the pre-contractual disclosure, termination, the need to give notice, and cooling-off periods. It is likely that this will remain the situation for the next few years.

GREECE

*Nancy G Gerakini*¹

I INTRODUCTION

The advantages of franchising schemes, such as reasonable initial capital investments, immediate brand awareness and a clear business-management road map, seem to facilitate the endeavours of entrepreneurs in Greece, particularly those who decided to become entrepreneurs because of the crisis and its impact on the labour market, and those who realised the need to change their business focus and enter new market sectors.

Although the situation in the Greek market remains fluid, with businesses starting up and winding down in short time cycles, franchising arrangements may have a role to play in the country's return to growth.

II MARKET ENTRY

i Restrictions

There are no restrictions on foreign franchisors entering the domestic market. The general principles of free movement of goods, persons, services and capital apply in Greece, as a Member State of the European Union.

Foreign franchisors may establish business entities in Greece under the same terms and conditions as Greek natural or legal persons. Moreover, there are no restrictions against a foreign franchisor entering into a franchise agreement without establishing a subsidiary or a branch office. All newly incorporated companies trading in Greece must be registered with the Greek trade registry.

Foreign natural or legal persons must obtain a Greek tax registration number before acquiring real estate property in Greece. Greek law imposes restrictions on the acquisition of real estate property in Greece only on foreign non-EU citizens, and in so far as the real estate property is located in border areas.

At the time of writing, Greece was still under a capital controls regime.

ii Foreign exchange and tax

In general, there are no exchange control restrictions on the payment of royalties to a foreign franchisor. However, because of (currently still applicable) capital controls, transfers of royalties outside Greece require the authorisation of a special committee of the relevant Greek bank.

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Franchise agreements are not regulated in Greece for tax purposes. Bilateral tax treaties for the avoidance of double taxation between the country of the franchisor and Greece usually regulate all issues regarding the payment of royalties, interest, dividends, capital gains, etc.

III INTELLECTUAL PROPERTY

i Brand search

Before applying for trademark registration, one should ensure that it does not conflict with any earlier registered trademark or unregistered rights of third parties.

The relevant search for Greek and international trademarks can be carried out via the TMView database (www.tmview.gr) and searches for European trademarks can be conducted through the European Union Intellectual Property Office database (www.euipo.europa.eu).

ii Brand Protection

Registration and protection of trademark rights is regulated under Law 4072/2012. Unregistered marks are protected under Law 146/1914 on Unfair Competition.

Trademark protection is purely territorial (i.e., a trademark registered in Greece will only be valid within the country). EU trademarks and international trademarks designating Greece or the EU enjoy protection in Greece.

For the registration of a national trademark, an application is filed with the Directorate of Commercial and Industrial Property of the General Secretariat of Commerce (the Greek Trademark Office). E-filing is also available.

After a trademark application is filed, the Trademark Office examiner reviews conformity with the formal requirements set out in Articles 135 and 136 of Law 4072/2012, as well as whether absolute or relevant (earlier rights) grounds of refusal apply. If there are no grounds for refusal, the Trademark Office examiner accepts the application. If grounds for refusal apply, the Trademark Office examiner notifies the applicant, who may: (1) withdraw the application, (2) restrict the scope of protection for the trademark to the extent that it is rendered eligible or (3) submit observations, within one month of the notification. A decision by the Trademark Office examiner rejecting the application can be challenged before the Trademarks Administrative Committee within 60 days.

A trademark application will be refused on relative grounds if it is identical to or confusingly similar to an earlier mark, or if the earlier mark is a famous one and use of the later trademark would take, without due cause, unfair advantage of the distinctive character or the repute of the earlier mark or would damage its distinctive character or reputation, regardless of whether the later trademark is intended to distinguish identical, similar or even different goods or services. The notion of 'earlier mark' is defined in Paragraph 2 of Article 124 of Law 4072/2012.

Other earlier intellectual property (IP) rights, such as copyright, can also be considered as relative grounds for refusal.

The decision accepting or refusing registration of the trademark is posted on the website of the General Secretariat of Commerce.

The Trademark Office examiner's decision accepting the registration of application may be opposed by any third party proving legitimate interest within a three-month period from publication of the decision on the website of the General Secretariat of Commerce.

In accordance with Greek legislation, trademarks can be renewed every 10 years.

iii Enforcement

Provisions on the enforcement of IP rights and anti-counterfeiting measures are set out in various legal instruments, including the following:

- a* Trademarks – Law 4072/2012 (Articles 121 to 183) and amending Law 4155/2013 (Articles 14 to 40) relating to trademarks, trademark prosecution or litigation and anti-counterfeiting protection for all IP rights.
- b* Acts of unfair competition – Law 146/14, as amended.
- c* Copyright – Law 2121/1993 on Copyright, Related Rights and Cultural Issues, as amended.
- d* Patents – Law 1733/1987 on Technology Transfer, Inventions and Technological Innovations, as amended, and Law 3966/2011 (Article 53) on Industrial Property Issues, which transposes, for patents, the EU IP Rights Enforcement Directive (2004/48/EC).
- e* Industrial designs – Law 2417/1996 on the implementation of the Hague Convention for the international registration of industrial designs, Law 259/1997 and Law 3966/2011 on Industrial Property Issues.
- f* Torts and protection of personality – Articles 57–59 and 914 et seq. of the Greek Civil Code.
- g* Border measures – the Greek Customs Code (Law 2960/2001, as amended) and the EU Customs Regulation (608/2013), which is directly applicable.
- h* Infringements that also constitute a criminal offence – the Criminal Code and the Code of Criminal Procedure.

Civil disputes related to infringement of trademarks are heard before the civil courts. Remedies include preliminary and definitive injunctions, seizure of assets, pecuniary or non-pecuniary damages. Trademark owners may also initiate or enjoin criminal proceedings over trademark infringement. Disputes related to the registration or cancellation of trademarks are brought before the Greek Trademark Office and the administrative courts.

iv Data protection, cybercrime, social media and e-commerce

Data protection

Greece transposed the EU Data Protection Directive 95/46/EC via Law 2472/1997 on the Protection of Individuals with regard to the Processing of Personal Data, as amended.

The Hellenic Data Protection Authority (HDPA) is responsible for overseeing the Data Protection Law. The data controller must notify the HDPA in writing about the establishment and operation of a data archive or the commencement of data processing.

Collection and processing of personal data is permitted only when the data subject has given his or her consent. Exceptionally, data may be processed even without this consent, in special circumstances provided by Law 2472/1997. The collection and processing of sensitive data is prohibited. However, exceptionally, the collection and processing of sensitive data, as well as the establishment and operation of the relevant data archive, is permitted by the HDPA, again in special strict circumstances.

The transfer of personal data is permitted for Member States of the European Union and for non-members of the European Union following an authorisation by the HDPA if it deems that the country in question guarantees an adequate level of protection. An authorisation is not required if the European Commission has decided, on the basis of the process of Article 31, Paragraph 2 of Directive 95/46/EC, that the country in question

guarantees an adequate level of protection, in the sense of Article 25 of the aforementioned Directive. The transfer of personal data to a non-Member State of the European Union that does not ensure an adequate level of protection is allowed, following authorisation by HDP, under exceptional conditions, including where the data subject has consented to the transfer and the transfer is necessary to protect the vital interests of the data subject.

The above will apply until 25 May 2018, when the new EU Data Protection Regulation (GDPR) will take effect. The GDPR refers to data controllers and processors within the EU and outside the EU if their processing or monitoring activities refer to EU citizens or data subjects. In certain circumstances, data controllers and processors must designate a data protection officer as part of their accountability obligations to demonstrate compliance.

Data processors must keep a written record of processing activities on behalf of each controller, appoint a representative in certain circumstances and notify the controller if they become aware of a personal data breach.

A data subject's consent must be freely given, informed, unambiguous and as easy to withdraw as it is to give. Data controllers must provide transparent information to data subjects and notify data breaches to the HDP. Moreover, a significant change is the removal of the general requirement to notify the HDP of a controller's data processing activities and seek approval in specific circumstances. As regards international transfer, the GDPR contains essentially the same provisions as were set out in the previous Directive.

E-commerce

E-commerce is regulated under Presidential Decree (PD) 131/2003, as amended, by virtue of which the EU e-commerce Directive 2000/31/EC was transposed in Greece. As this piece of legislation regulates only partially the commercial relationship between the seller or supplier of goods or services and the purchaser or user, all other aspects of this same commercial relationship are regulated by the provisions of the Greek Civil Code, as well as by the legislation for protection of consumers, manufacturer's product liability and unfair competition.

IV FRANCHISE LAW

i Legislation

Franchise agreements are neither regulated in Greece by a specific franchise law nor included among the agreements specifically regulated by the Greek Civil Code. Franchise agreements are considered to be *sui generis* bilateral commercial agreements. This means that parties enjoy wide discretion in structuring their contractual relationships.

In brief and by way of indication, the following legislation applies to franchise agreements:

- a* Commission Regulation (EU) No. 330/2010 of 20 April 2010 on the application of Article 101(3) of the Treaty to categories of vertical agreements and concerted practices;
- b* Greek Law 3959/2011 (the Greek Competition Act);
- c* Law 4072/2012 on Trade Marks;
- d* Law 146/1914 on Unfair Competition;
- e* Law 1733/1987 on Transfer of Technology, Inventions, Technological Innovations and Establishment of an Atomic Energy Committee;
- f* Law 2251/1994 on the Protection of Consumers;
- g* Law 2121/1993 on Intellectual Property;
- h* PD 219/1991 on Commercial Agents; and
- i* general provisions of the Greek Civil Code.

ii Pre-contractual disclosure

Greek Law does not provide for franchise-specific pre-contractual disclosure requirements.

The general provisions of Articles 197 and 198 of the Greek Civil Code, which set out the obligations arising from negotiations, apply. According to these provisions, during the negotiations phase, the parties must follow certain rules of conduct based on good faith and fair commercial practice. On this basis, the franchisor must disclose to the prospective franchisee the necessary information about the system in question before the conclusion of a franchise contract. Failure to reveal this information may be deemed as conduct in bad faith.

The culpable violation of the above-mentioned obligation by the franchisor may result in an obligation to indemnify the prospective franchisee for the damage incurred, even if the franchise contract has not been concluded (responsibility arising from negotiations or *culpa in contrahendo*). This compensation will cover only reliance damages.

On the other hand, the Code of Ethics of the Greek Franchise Association (the Code of Ethics) and the case law of the Greek courts provide for specific pre-contractual obligations for the franchisor. Indicatively, the franchisor must disclose to the prospective franchisee crucial information relating to the franchise system, such as details about the franchisor and its corporate status, a general description of the business and the characteristics of the know-how, an estimation of the investment and expenditure to be carried out by the franchisee, and the essential clauses of the franchise agreement (rights and obligations of the parties, duration or termination of the agreement, etc).

The Code of Ethics is a self-regulatory instrument of the Greek Franchise Association, a private body representing the interests of Greek entities involved in franchising. The provisions of the Code of Ethics are compulsory for the members of the Greek Franchise Association, but they are not legally enforceable.

iii Registration

There are no registration requirements for franchise agreements in Greece.

However, to the extent that a franchise agreement includes licensing or transfer of IP rights, the franchise agreement (or a short form licence agreement) will need to be registered with the competent IP authority (the Greek Trademark Office for trademark licences or the Greek Industrial Property Organisation for designs or patent licensing and transfer of know-how; there is a specific Technology Transfer Register maintained by the Greek Industrial Property Organisation, according to Article 21, Paragraph 1, and Article 22 of Law 1733/1987).

iv Mandatory clauses

There are no mandatory clauses in franchise agreements in Greece.

However, according to the general principles of law and the Code of Ethics, a franchise agreement should include all necessary terms regarding the collaboration between the franchisee and the franchisor, namely the rights and obligations of both parties, the licensing of the franchise 'package' by the franchisor to the franchisee, analysis of the content of the franchise package, the goods or services to be provided to the franchisee, the terms of payment by the franchisee, the duration and renewal of the franchise agreement, etc.

v Guarantees and protection

Greek law includes no specific guarantees for franchisees or franchisors. Guarantees can be provided, on the basis of contractual freedom, in accordance with general Greek contract law.

Guarantees from individuals and companies to the franchisor or franchisee are enforceable according to the general rules of the Greek Civil Code.

V TAX

i Franchisor tax liabilities

The general provisions of Greek tax law apply for both the franchisor and the franchisee, since there is no specific tax framework for franchising in Greece.

If the franchisor has a permanent establishment in Greece, the Greek tax authorities will consider the franchisor as a Greek resident for tax purposes. If the franchisor has no permanent establishment in Greece, the relevant tax treaties for the avoidance of double taxation between Greece and the franchisor's country and specifically the provisions regarding the taxation of royalties will be applicable. In the absence of such a treaty, royalties of intellectual property rights paid to the franchisor will be taxed in Greece with 20 per cent on the gross amount paid by the franchisee to the franchisor. The above-mentioned percentage will be withheld by the franchisee and attributed to the Greek state. This is also a prerequisite for the banks to transfer the royalty payment to the franchisor. After the above-mentioned withholding takes place, the franchisor has no other tax obligation in Greece arising from the franchise agreement.

ii Franchisee tax liabilities

According to Greek tax law, royalties of intellectual property rights paid to the franchisor are deducted from the franchisee's gross income. When royalties are paid to foreign enterprises, they are deducted from the gross income only on the condition that the franchise agreement is in writing and the relevant withholding tax has been attributed to the Greek state.

iii Tax-efficient structures

To determine a tax-efficient structure for a franchise agreement, the parties should carefully review beforehand all the particulars of the franchise relation, the nature of the business, the tax residence of the parties, the type of goods and services to be provided, etc.

During the past few years, efforts have been made to include franchise systems in the framework of projects eligible for funding by EU structural funds.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Article 288 of the Greek Civil Code provides that the contracting parties are required to fulfil their obligations arising from contract, on the basis of the prevalent criteria of 'good faith' and 'fair trade practices'. Good faith is a binding criterion in assessing the conduct of the contracting parties in a franchise agreement.

Moreover, under the Code of Ethics, both the franchisor and the franchisee must act fairly, reasonably and in good faith not only during the term of the franchise agreement but also during the pre-contractual phase (see Section IV.ii) and after the termination of the franchise agreement (see Section VI.vii).

In cases of culpable breach of this good faith, the aggrieved party may be entitled to damages.

ii Agency distributor model

Franchise agreements and agency agreements are conceptually different, as the franchisee acts on its own behalf, bearing the relevant business risk, while the commercial agent negotiates on behalf of the principal or proceeds to transactions on behalf and in the name of the principal.

However, several legal theorists support the analogical application of PD 219/1991 on commercial agents to franchise agreements. According to prevailing opinion, PD 219/1991 applies only where franchisees would be considered as being integrated into the sales organisation of the franchisor. In particular, the following conditions would have to be met for a franchisee to be treated as a commercial agent: (1) the franchisee acts as part of the sales organisation of the franchisor or supplier (being dependent on the franchisor or being integrated into his or her network); (2) the franchisee contributes to the extension of the franchisor's clientele; (3) the franchisee undertakes a non-compete obligation; (4) the franchisee enjoys a specific protected territory; and (5) the franchisor has knowledge of the franchisee's clientele and, after termination of the franchise agreement, the franchisee delivers to the franchisor a list of its clientele.

In such cases (analogous application), relevant provisions of PD 219/1991 regarding goodwill compensation on termination of the agreement, the termination notice term and the post-term obligations would also apply to the franchise agreement.

Over the past few years, Greek courts have addressed the above issue and enriched the relevant case law. The conclusion, therefore, is that the question of whether PD 219/1991 applies to a franchise agreement needs to be answered with a case-by-case analysis of the 'integration' criteria stipulated above.

iii Employment law

Franchisee and franchisor are regarded as separate, independent business partners. In general, the franchisee acts on its own behalf and not as an agent, representative, or employee of the franchisor. If the franchisee is in control of its business, sells the products in its own name and for its own account, and controls its sale prices and working hours, the chances that it may be considered as an employee are limited.

However, under certain circumstances, the franchisee may be deemed to be the franchisor's employee; for example, if the franchisee is financially dependent on the franchisor; or the franchisee takes no business risk and makes no (or limited) investment; the franchisee has no employees and the franchisor is its only customer or supplier; or the degree of supervision of the franchisee and its employees by the franchisor goes beyond what is necessary. In such cases, Greek employment law would apply.

iv Consumer protection

Franchisees are very unlikely to be considered as consumers within the framework of a franchise agreement, taking into consideration that pursuant to Article 1(4)(a) of Law 2251/1994 on

the Protection of Consumers, a consumer is every physical or legal entity or union of entities without a legal personality who constitute the target group for products or services offered in the market and who use products or services and are their end user.

v Competition law

Franchise agreements are subject to competition law and the rules on restrictive agreements.

Competition in the Greek market is primarily protected by Law 3959/2011 on the Protection of Free Competition, which aims at ensuring effective competition.

According to Article 1, Paragraph 1 of Law 3959/2011, all agreements between undertakings, all decisions by associations of undertakings and concerted practices that have as their object or effect the prevention, restriction or distortion of competition in the Greek territory are prohibited and, in particular, those that:

- a* directly or indirectly fix purchase or selling prices or any other trading conditions;
- b* limit or control production, markets, technical development or investment;
- c* share markets or sources of supply;
- d* apply dissimilar conditions to equivalent transactions with other trading parties, thereby impeding competition, in particular by refusing without valid justification, to sell, purchase or conclude any other transaction; or
- e* make the conclusion of contracts subject to acceptance by other parties of additional obligations that, by their nature or according to commercial usage, have no connection with the object of the contracts.

The prohibition captures both horizontal and vertical agreements.

As regards vertical agreements, Commission Regulation (EU) No. 330/2010 (the Block Exemption Regulation) and the related Guidelines, apply in Greece, with exclusivity, resale price maintenance, product ties and restriction of passive sales constituting the main points of concern. As for the vertical restraints on the purchase, sale and resale of goods and services within a franchising arrangement, the Block Exemption Regulation applies up to the 30 per cent market share threshold.

vi Restrictive covenants

An obligation not to compete with the franchisor's business is common in franchise agreements. A non-compete obligation on the goods or services purchased by the franchisee is permitted for the duration of the franchise agreement as long as it is necessary for the protection of know-how and maintenance of the identity and reputation of the franchise network. Generally, such non-compete obligations are compatible with competition law rules for a reasonable period after the termination of the agreement (one year) and as long as the territory that is subject to the post-term non-compete obligation is the same as the territory in which the franchisee operated its business during the term of the agreement.

Resale price restrictions (price-fixing) and restrictions on cross-supply between authorised distributors are prohibited.

vii Termination

The general principles of Greek civil law apply to the termination of franchise agreements.

Termination clauses depend on whether the franchise agreement is entered into for a fixed or an indefinite period. In the first case (fixed term), termination takes place when

the agreed term expires or when there is due cause for early termination. In the latter case (indefinite term), the franchise agreement can be terminated at any time. However, the following should be taken into consideration.

If PD 219/91 is applicable, as mentioned above, according to Article 8, Paragraphs 3 and 4, 'where a contract is concluded for an indefinite period either party may terminate it by notice. The period of notice shall be one month for the first year of the contract, two months for the second year commenced, three months for the third year commenced, four months for the fourth year commenced, five months for the fifth year commenced and six months for the sixth year commenced and subsequent years. The parties may not agree on shorter periods of notice.' Moreover, according to Article 8, Paragraph 5 and 6 of PD 219/91, 'If the parties agree on longer periods than those laid down in Paragraphs 3 and 4 of PD 219/91, the period of notice to be observed by the principal must not be shorter than that to be observed by the commercial agent. Unless otherwise agreed by the parties, the end of the period of notice must coincide with the end of a calendar month.'

If PD 219/91 is not applicable, the time frame for the notice of termination shall be defined on the basis of goodwill, taking also into consideration other criteria such as the duration of the agreement, etc.

Franchise agreements may be immediately terminated, without the application of the above-mentioned periods of notice, if one of the contracting parties fails to comply with all or part of its obligations or in cases of exceptional circumstances.

If PD 219/91 applies, the indemnity clauses mentioned below shall apply in any case (provided that the terms and conditions of the indemnity are met).

According to Article 9 of PD 219/1991, 'the agent, after termination of the agency contract, shall be entitled to an indemnity if and to the extent that he has brought the principal new customers or has significantly increased the volume of business with existing customers and the principal continues to derive substantial benefits from the business with such customers and the payment of this indemnity is equitable having regard to all the circumstances and, in particular, the commission (profits) lost by the distributor on the business transacted with such customers'.

The grant of goodwill indemnity shall not prevent the franchisee from seeking any damages (actual damages or loss of profits, or both of these) arising as a result of the termination of the franchise agreement. Of particular interest is the contractual provision relating to unsold stock and unamortised investment, in the event of termination of a franchise agreement, whereby the franchisor undertakes the obligation to repurchase the products at an agreed price. The above-mentioned obligation derives from the relevant goodwill obligation of the franchisor. If the franchise agreement is terminated for due cause by the franchisor, the latter is not bound by this obligation. The same applies to unamortised investments.

Covenants not to compete are generally enforceable in Greece (see Section VI.vi), the same applies for post-term confidentiality obligations.

Moreover, in the event of breach of the franchise agreement by the franchisee and termination by the franchisor, a 'step-in' right in the franchise agreement (whereby the franchisor may take over the ownership and management of the former franchisee's franchised business) is recognised by Greek law.

viii Anti-corruption and anti-terrorism regulation

There is no specific, franchising-related legislation on prevention of fraud, anti-corruption and money laundering in Greece.

The main regulatory instrument on fraud (and other fraud-related offences) is the Greek Criminal Code (GCC). Article 386 of the GCC defines fraud as any intentional misrepresentation or concealment of facts to convince a third party to dispose of assets resulting in financial loss, for the purposes of the personal gain of the perpetrator. Moreover, Article 237B of the GCC punishes bribery in business or commercial activities. The basic legal provisions against money laundering and terrorist financing were introduced by Law 3691/2008, which is in line with relevant international conventions and other legal instruments in force. Under Greek Criminal Law, legal entities cannot be held criminally liable. On the other hand, there is no general rule concerning the personal liability of managers, officers and directors for offences relating to a business entity's activities. The above-mentioned persons may be criminally liable if their actions fall within the *actus reus* of the relevant criminal provisions. However, for some offences relating to the activities of legal entities, the relevant legal provisions expressly provide for the criminal liability of managers, officers and directors.

ix Dispute resolution

The vast majority of cases in Greece are resolved in court. A smaller fraction of disputes are resolved through arbitration, while the recently introduced method of mediation in commercial disputes is still not common.

The remedies provided by Greek law in the event of violation of the terms of a franchise agreement by either party are:

- a* preliminary and definitive injunctions;
- b* seizure of assets;
- c* disclosure of financial records;
- d* pecuniary or non-pecuniary damages; and
- e* threat of pecuniary penalties in the event of future violation of the court's order.

Criminal action may also be initiated in certain circumstances.

As regards the applicable law, Greek courts recognise the choice of foreign law in a franchise agreement in respect of a franchise business operating in Greece. However, certain Greek law provisions may apply, despite the choice of the foreign law. These provisions relate to the protection of Greek public order, and also to competition law, labour law, tax law, data protection law, etc.

Greek Law provides for two different categories of rules, to apply to domestic and international arbitration respectively.

International commercial arbitration proceedings are governed by Law 2735/1999 on International Commercial Arbitration, which incorporates the UNCITRAL Model Law in the Greek legal system. Articles 867 to 903 of the Greek Civil Procedure Code regulate domestic arbitration. The Greek legal framework is supplemented by numerous international conventions, such as the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (the New York Convention).

In general, parties are free to decide on the procedural rules of the arbitration subject to mandatory rules of the law. An arbitral award is not subject to appeal.

A foreign arbitral award is recognised automatically in Greece, provided that the recognition requirements set out in Article IV, Paragraph 1 of the New York Convention are met and none of the grounds for refusal referred to in Article V of the Convention exists. Awards in domestic arbitration are recognised and enforced in the same way as the decisions of the national courts.

Mediation is not common in Greece. Law 3898/2010, transposing Directive (EC) 2008/52, governs, among other things, confidentiality issues, enforcement of mediation procedures and the professional certification process for mediators.

The board of directors of the Greek Franchise Association encourages the use of a simplified mediation procedure for dispute settlement, which is different from the procedure provided in Law 3898/2010. The mediator is appointed from a list of mediators accredited by the Greek Franchise Association.

VII CURRENT DEVELOPMENTS

Two key characteristics of franchise relationships, namely the ‘transfer’ of brand recognition and business operation methods, seem to fit well with the current situation in the Greek economy.

According to statistics, despite the fact that many small businesses ceased operations as a result of the recession, many others started up on the basis of franchise agreements. Moreover, the pool of entrepreneurs appears to have increased in numbers as a result of unemployment.

Part of this entrepreneurial body seems to be interested in reaping the benefits of franchise deals, which potentially reduce costs associated with creating brand awareness, and with know-how, particularly, during the crucial, initial phase of operations.

HONG KONG

*Michelle Chan*¹

I INTRODUCTION

The Hong Kong Special Administrative Region (Hong Kong) is an important centre for international finance and trade, and is perennially ranked as one of the freest economies in the world. With its high standard of living, cosmopolitan population and low barrier of entry for businesses, the city has also become internationally famous as a shopping destination and food centre. Many international brands have an established presence in the city, and those without a presence see Hong Kong as an important link to the ever-growing mainland Chinese market.

Hong Kong does not have any laws or regulations specific to franchising. Local and foreign companies alike are free to establish and operate franchises as they see fit, subject to general consumer protection legislation.

The Hong Kong General Chamber of Commerce has established the Hong Kong Franchise Association (HKFA) committee to monitor and promote the development of franchising in the territory. Membership of the HKFA and adherence to its guidelines are on a voluntary basis.

II MARKET ENTRY

i Restrictions

There are no franchise-specific restrictions on foreign franchisors who wish to enter the Hong Kong market. Foreign entities are free to grant their local partners master franchise or development rights. Foreign entities are also free to own real property or equity in a local business.

ii Foreign exchange and tax

The Hong Kong dollar is the currency of Hong Kong. The Hong Kong dollar is pegged to the US dollar at around HK\$7.8 to US\$1. The Hong Kong dollar is fully convertible into other currencies around the world. There are no capital restrictions on capital flows into and out of Hong Kong, neither are there foreign exchange restrictions in Hong Kong.

Hong Kong has a straightforward tax regime. Companies simply need to pay profits tax on income sourced in Hong Kong. There is no tax on dividends, capital gains, goods and services. However, 'withholding tax' is levied on income (royalty payment) derived from the use of intellectual property rights in Hong Kong. The current effective rate is at 4.95 per cent.

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III INTELLECTUAL PROPERTY

i Brand search

The Hong Kong government's Intellectual Property Department (IPD) maintains an online central database of trademarks, patents and registered designs.² Anyone can access the database for free via the internet and search for intellectual property currently registered with the IPD. Alternatively, the IPD provides a service where they can perform the search for a small fee.

ii Brand protection

Trademarks are protected first by registering with the IPD. Registration requires the completion of an application form that can be downloaded from the IPD website.³ The application must then be submitted to the IPD in person or by post, together with the application fee (HK\$2,000 for one class as of November 2016). The IPD will then review the application to ensure that all the required information has been provided.

A search will then be conducted to ensure there are no conflicts. If conflicts are cleared, the IPD will publish a public notice that the application has been filed. There is a three-month period from the date of publication of the notice during which an objection to the application can be filed. If there have not been any objections, the IPD will issue a certificate of registration at the end of the period. The official date of registration of the trademark will be the filing date of the application.

iii Enforcement

Enforcement of intellectual property rights is performed through the Hong Kong Courts. The process of filing a claim against a trademark infringer follows the same process as that of a normal civil claim (see Section VI). Failure to comply with a court order will be considered contempt of court, punishable by a fine or imprisonment.

More importantly, in Hong Kong, enforcement of provisions under the Copyright Ordinance, the Trade Description Ordinance and the Trademark Ordinance that give rise to a criminal offence are undertaken by the Customs and Excise Department, which has been given broad powers, including seizing and removing articles that may be infringing copies of a copyright work and entering and searching premises to carry out its duties, upon obtaining of a warrant from a magistrate.

iv Data protection, cybercrime, social media and e-commerce

Hong Kong does not have any specific legislation regulating 'social media' or 'e-commerce'. Activities will be regulated under general law.

In relation to personal data and data protection, the primary legislation is the Personal Data (Privacy) Ordinance (PDPO).⁴ The PDPO governs the use of personal data, which is defined as any data that relates to a living individual from which it is practicable for the identity of the individual to be ascertained. Collection of personal data is only allowed if the individual is first informed of the purpose for which the data is to be used; and the classes of persons to whom the data may be transferred. Personal data may not be used for a new purpose without the prescribed consent of the individual.

2 www.ipsearch.ipd.gov.hk/index.html.

3 www.ipd.gov.hk/eng/applicants/trademarks.htm.

4 Chapter 486 of the Laws of Hong Kong.

Any collection and use of personal data for direct marketing purposes requires the express consent of the individuals concerned.

Franchises must ensure that all personal data that has been collected are accurate and are protected against unauthorised or accidental access, processing, erasure, loss or use. Franchises must also ensure that the personal data collected are accessible to the individual they relate to upon the individual's request for access or correction.

Personal data collected may not be retained for longer than is necessary for the fulfilment of the purpose for which they were obtained.

On cybercrime, the Telecommunications Ordinance⁵ expressly provides for a number of criminal offences relating to unauthorised access of data contained on a computer.⁶

IV FRANCHISE LAW

i Legislation

There is no specific franchise legislation enacted in Hong Kong. However, there are a number of consumer protection laws that would be relevant to a franchise and basic common law principles would also apply:

- a* the Consumer Goods Safety Ordinance⁷ requires manufacturers, importers and suppliers to ensure that consumer goods meet the general safety requirement;
- b* the Control of Exemption Clauses Ordinance⁸ prevents the supplier of goods or services from the exclusion or restriction of particular liabilities in its contractual terms;
- c* the Sales of Goods Ordinance⁹ provides that goods for sale must be of merchantable quality, fit for purpose as described on the package or by the seller, and must correspond with any samples on display;
- d* the Supply of Services (Implied Terms) Ordinance¹⁰ sets out the implied terms applicable to all service contracts, for example reasonable care and skill, performance within a reasonable time and that a reasonable charge should be paid;
- e* the Trade Descriptions Ordinance¹¹ prohibits false trade descriptions in respect of goods and services made in consumer transactions; and
- f* the Unconscionable Contracts Ordinance¹² empowers the court to give relief to consumers in respect of contracts relating to the sale of goods or supply of services found to be unconscionable.

Statutory and common law in relation to intellectual property will also be relevant with regard to activities relating to franchises.

5 Chapter 106 of the Laws of Hong Kong.

6 For example, Section 27A, *ibid.*

7 Chapter 456 of the Laws of Hong Kong.

8 Chapter 71 of the Laws of Hong Kong.

9 Chapter 26 of the Laws of Hong Kong.

10 Chapter 457 of the Laws of Hong Kong.

11 Chapter 362 of the Laws of Hong Kong.

12 Chapter 458 of the Laws of Hong Kong.

ii Pre-contractual disclosure

There are no specific pre-contractual disclosure requirements. The HKFA has published a Code of Ethics,¹³ which states that a franchisor should provide to the prospective franchisee full and accurate written disclosure of all information material to the franchise relationship within a reasonable time prior to execution of the agreement. A franchisee should provide full and frank disclosure of all information material to facilitate the franchisor's selection of a franchisee.

Under Hong Kong law, however, a misrepresentation is a ground for rescission of a contract or the award of damages. This is where one party – the representor – makes a false representation to another – the representee – to induce the representee to enter into a contract. Under Hong Kong common law, if the representation was made fraudulently or negligently, the representee may also claim for damages suffered as a result of entering into the contract. Under the Misrepresentation Ordinance,¹⁴ the representee may also claim for damages despite the absence of fraud.

In a franchise context, the key elements required for a franchisor or a franchisee to bring such a claim against the other party are: (1) the misrepresentation was an untrue statement of fact or law; (2) the statement induced it to enter the contract; and (3) it has suffered a loss as a result of the entering into of the contract.

iii Registration

There are no franchise registration requirements.

iv Mandatory clauses

There are no mandatory clauses specific to franchise agreements.

v Guarantees and protection

There is no legislation or mandatory legal requirement under Hong Kong law relating to guarantees and protection. It is for the parties to agree whether guarantees from the principle owner or parent company are required.

V TAX

i Franchisor tax liabilities

Hong Kong operates a territorial system of taxation. All profits derived from Hong Kong are subject to profits tax while any foreign-sourced income is non-taxable. The current tax rate applicable to corporations is 16.5 per cent.¹⁵

ii Franchisee tax liabilities

All profits derived from Hong Kong are subject to profits tax while any profit derived overseas is non-taxable. The current tax rate applicable to corporations is 16.5 per cent.¹⁶

13 www.franchise.org.hk/codeofethics.asp.

14 Chapter 284 of the Laws of Hong Kong.

15 www.gov.hk/en/residents/taxes/taxfiling/taxrates/profitsrates.htm.

16 Ibid.

Owners of property are charged property tax, which is computed at the standard rate on the net assessable value of the property. The current standard rate is 15 per cent.¹⁷ Depending on the terms of the retail property's lease, a franchisee may be required to pay to the owner all or a portion of the property tax.

iii Tax-efficient structures

Hong Kong has a relatively simple system of taxation. The guiding principle is that all profits derived from Hong Kong will be subject to profits tax.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Recent decisions of the English courts on good faith relating to good faith cooperation and implied terms of good faith when making a genuine decision and relating to honesty¹⁸ are likely to be applied and followed by Hong Kong courts. Although court decisions of England and Wales no longer form part of the law of Hong Kong, the case of *Yam Seng Pte Ltd v. International Trade Corp Ltd*¹⁹ has already been applied by Hong Kong courts in a recent decision (albeit the case has been cited with regard to an issue unrelated to good faith).²⁰ It is therefore important to consider the implications of these cases in assessing the obligations of the franchisor and the franchisee under Hong Kong law.

In addition, the HKFA has published a Code of Ethics (the Code) that generally states the parties should act in good faith.²¹ The Code is a guideline for HKFA members to follow and is not binding. The Code specifically points out that disputes should be resolved with good faith and goodwill. To the extent reasonably possible and with good faith, the franchisor shall give notice to the franchisee of any contractual breach and grant reasonable time to remedy the default.

ii Agency distributor model

Franchisors and franchisees may contractually agree to an agency or distributor business model. In an agency model, the franchisee will sell the franchisor's products on behalf of the franchisor as agent to customers. Legally, the products are never owned by the franchisee. In a distributor model, the franchisee will purchase the franchisor's products in its own right and will then sell the products to customers.

iii Employment law

It is unlikely that a franchisee would be considered an employee of a franchisor. To be considered an employee, one must enter into a contract of employment whereby one person agrees to employ another and that other agrees to serve his employer as an employee. If a franchisee is considered an employee of the franchisor, the franchisee would be entitled

17 www.gov.hk/en/residents/taxes/taxfiling/taxrates/propertyrates.htm.

18 See corresponding United Kingdom chapter, Section VI.i.

19 *Yam Seng Pte Ltd v. International Trade Corp Ltd* [2013] EWHC 111.

20 *Ng Chi Kwan, Danny Summer (alias 夏韶聲) & Anor v. Yeung Yiu Kwan & Anor* [2014] 5 HKLRD 744.

21 www.franchise.org.hk/codeofethics.asp.

to the minimum statutory protection and benefits conferred under the Employment Ordinance²² (e.g., statutory rest days, mandatory provident fund payments and employees' compensation insurance).

iv Consumer protection

It is unlikely that franchisees would be considered 'consumers' or 'dealing as a consumer' under Hong Kong law. They would therefore be considered 'businesses' and would be required to comply with the consumer protection legislation discussed in Section VI.i, in their dealings with consumers.

In Hong Kong, there is no comprehensive or overarching consumer legislation. Statutory protection is offered under a number of ordinances in Hong Kong.²³

v Competition law

In June of 2012, Hong Kong enacted its first legislation governing cross-sector competition, the Competition Ordinance.²⁴ The Competition Ordinance seeks to: (1) prohibit agreements and cooperation arrangements from restricting competition (price fixing, limiting supply to drive up prices, dividing segments of the market between competitors, etc.); and (2) prohibit the abuse of substantial market power to restrict competition. The Competition Ordinance came into full effect on 14 December 2015. The law will be enforced by the Competition Commission.²⁵

In July 2015, the Competition Commission and Communications Authority jointly issued six guidelines on how the Competition Ordinance will be interpreted and enforced by the authorities, namely:

- a* the Guideline on the First Conduct Rule;
- b* the Guideline on the Second Conduct Rule;
- c* the Guideline on the Merger Rule;
- d* the Guideline on Complaints;
- e* the Guideline on Investigations; and
- f* the Guideline on Applications for a Decision under Sections 9 and 24 (Exclusions and Exemptions) and Section 15 Block Exemption Orders.

The Guideline on the First Conduct Rule, for example, provides that retail price maintenance (i.e., where a franchisor establishes a fixed or minimum resale price for the franchisee to follow) might be considered, by its nature, to be anticompetitive. Nevertheless, the guidelines further provide that retail price maintenance might be exempted if the arrangement can be proved to entail pro-competitive benefits. For example, retail price maintenance may assist a franchise arrangement to organise a coordinated price campaign of limited duration.

22 Chapter 57 of the Laws of Hong Kong.

23 See Section IV.i.

24 Chapter 619 of the Laws of Hong Kong.

25 Where a matter concerns the telecommunications and the broadcasting sectors, the Competition Commission will have concurrent jurisdiction with the Communications Authority. See Section 159 of the Competition Ordinance and the Memorandum of Understanding between the Competition Commission and the Communications Authority entered into pursuant to Section 161 of the Competition Ordinance.

In addition to the six guidelines mentioned above, the Competition Commission also issued in November 2015 two policies specifically on enforcement entitled 'Enforcement Policy' and 'Leniency Policy for Undertakings Engaged in Cartel Conduct' in anticipation of the coming into force of the Competition Ordinance.

vi Restrictive covenants

Generally restrictive covenants are unenforceable in Hong Kong on public policy ground. The courts may find exception to the rule provided the franchisor can demonstrate that it has a legitimate interest to protect (e.g., system of the business, confidential information vital to the business) and that the scope of the restriction is no more than is reasonably necessary for the protection of that interest.²⁶ To ensure the enforceability of restrictive covenants, the restriction should be limited in scope, time period and geographical area.

A breach of a restrictive covenant contained in the franchise agreement may be enforced by applying to the court for an interim injunction. To obtain an interim injunction, the franchisor will need to satisfy the court that there is a serious issue to be examined and that if the franchisee's activities are not immediately stopped, the damage to the franchisor's business could be so great that there could be no adequate financial compensation. In urgent cases, the franchisor may make the application to court without notice to the franchisee.

vii Termination

Termination of a franchise agreement is a contractual matter and should follow the termination clause of the agreement. As a matter of common law, the parties have a right to terminate the agreement in the event of a repudiatory breach and where it is clear that the party in breach does not intend to honour the agreement.

Depending on the contractual terms, a franchisor may take over the franchisee's business. There are no restrictions on foreign ownership of local business or leasing property.

viii Anti-corruption and anti-terrorism regulation

A franchisor or franchisee's liability for fraud will mainly be in the context of fraudulent misrepresentation, as discussed in Section II.iv.

There are a number of relevant laws that set out a range of offences relating to bribery, money laundering and terrorism that may apply to the franchise relationship. These are:

- a* the Prevention of Bribery Ordinance,²⁷ which provides that any person who, acting as an agent (this includes an employee), solicits or accepts any advantage (e.g., money, loans, commission, contracts, services and favours) as an inducement or reward to do any act in relation to its principal's affairs, commits an offence;
- b* the Drug Trafficking (Recovery of Proceeds) Ordinance²⁸ and the Organised and Serious Crimes Ordinance,²⁹ which states it is a criminal offence to deal with any

26 See, for example, *Lush Ltd & Anor v. Red Channel International Ltd & Ors* [2015] HKCU 1349, in which Lush alleged that Red Channel has been in breach of a non-compete provision.

27 Chapter 201 of the Laws of Hong Kong.

28 Chapter 405 of the Laws of Hong Kong.

29 Chapter 455 of the Laws of Hong Kong.

property knowing or having reasonable grounds to believe that the property, in whole or in part, directly or indirectly, represents proceeds of drug trafficking or an indictable offence; and

- c the United Nations (Anti-Terrorism Measures) Ordinance,³⁰ which provides that it is a criminal offence to provide or collect property, by any means, directly or indirectly, with the intention that the property will be used, or knowing that the property will be used, in whole or in part, for the purposes of terrorism.

ix Dispute resolution

As a dispute resolution forum, arbitration and litigation are equally valid; this will depend on the circumstances of each case. For court proceedings, the parties must file a mediation certificate with the court signifying that they have at least considered mediation soon after the close of pleadings (i.e., filing of the statement of claim and defence). The Hong Kong courts will generally uphold a foreign choice-of-law clause. As a matter of best practice, Paragraph 9 of the HKFA's Code of Ethics states that the parties should resolve disputes through arbitration.³¹

There are no litigation procedures specific to resolving franchising disputes. A franchise dispute will follow the standard court procedure for contractual disputes:

- a to commence a court action, a writ of summons and statement of claim must be filed with the court and served on the defendant. The statement of claim must state the nature of the claim, the facts relied upon and the remedy claimed;
- b the defendant must file an acknowledgment of service within 14 days of service of the writ to indicate if it wishes to defend the action; any defence must be filed with the court and served on the plaintiff within 28 days of the time limit for acknowledgment of service or after the statement of claim is served on him, whichever is later;
- c the parties then enter the discovery phase and must disclose all documents related to the case and allow the other party to inspect the actual documents;
- d each party must file and serve a timetabling questionnaire within 28 days of pleadings as provided in paragraph (b) being closed (the questionnaire assists the parties and the court in managing the case);
- e within 14 days of receiving the timetabling questionnaire from all defendants, the plaintiff is to issue a case management summons for the court to give directions on the management of the case;
- f after the court has given directions that the case may be set down for trial, the plaintiff should make an application to the court to do so and pay the prescribed fee;
- g at the trial, the court will hear the submissions of the parties and any witness evidence. The court may adjourn the case if further information or evidence is required;

30 Chapter 575 of the Laws of Hong Kong.

31 www.franchise.org.hk/codeofethics.asp. The court would also stay proceedings for petition for a winding up order against a joint venture company set up for operating a franchise pending the decision of the related arbitration proceeding if the relevant franchise agreement has provided for disputes to be resolved through arbitration, and this includes if the shareholders have grounds to petition for the winding up of the joint venture company. See *Quiksilver Greater China Ltd v. Quiksilver Glorious Sun JV Ltd & Anor; sub nom Re Quiksilver Glorious Sun JV Ltd* (HKLRD) [2014] 4 HKLRD 759.

- b* the court may give its judgment on the date of the trial or at a later date; and
- i* a party can notify the court and other party of its intention to appeal the decision within the time limit.

It is possible to obtain an interim or permanent injunction to prevent the continued breach of a non-compete provision or unauthorised use of trademark (see the discussion on restrictive covenants above). The court will seek to place the plaintiff into the position that it would have been in had the contract been fully performed. Damages for breach of contract are calculated based on actual loss arising from the breach. The court will generally order the unsuccessful litigant to pay all or part of the legal costs of the successful party (in addition to paying its own costs).

Hong Kong is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitration Awards, and will enforce foreign arbitral awards. In addition, arbitral awards made in Hong Kong are enforceable in mainland China under the Arrangement Concerning Mutual Enforcement of Arbitral Awards between mainland China and Hong Kong.³²

In the case of *TGI Friday's Inc v. Perfect Wave Ltd*,³³ the franchise agreement was terminated by the franchisor for poor performance. The franchisee continued to operate the restaurant under the franchisor's brand name. The franchisor sought an interim injunction to stop the operation of the restaurant under the brand name. The court found that the agreement had been validly terminated and granted the injunction on the basis that the franchisor would have suffered irreparable damage if the franchisee had been allowed to continue.

VII CURRENT DEVELOPMENTS

Although there are already a substantial number of foreign brands with an established presence in Hong Kong, other brands are seeking to enter into the market. This is due to Hong Kong's reputation as a regional centre for shopping and food, and the rapid growth of mainland Chinese tourists visiting the territory. To illustrate, the period between 2012 and 2014 saw the opening of various fashion retailers, such as Abercrombie & Fitch, Forever 21, Topshop, Victoria's Secret, J Crew and Urban Outfitters. Hong Kong has also seen franchises closing down in 2016. In terms of the legal landscape, it will be interesting to see how the Competition Ordinance affects the franchise market, when it comes into force, in the medium term.

In terms of case law in relation to contractual law development, the Supreme Court recently held in *Cavendish Square Holding BV v. Talal El Makdessi and ParkingEye Limited v. Beavis*³⁴ that it is no longer necessary to show a genuine pre-estimate of loss in enforcing a liquidated damages clause. Instead, the Supreme Court found that penalty clauses should be determined based on whether the innocent party's legitimate interest in enforcing the counterparty's contractual obligations were 'out of all proportion'. This is relevant in the franchising context as a liquidated damages clause is common in franchising agreements. Where franchisees and franchisors have equal or similar bargaining power in negotiating

32 www.doj.gov.hk/eng/mainland/pdf/mainlandmutual2e.pdf.

33 [2013] HKEC 488.

34 *Cavendish Square Holding BV v. Talal El Makdessi and ParkingEye Limited v. Beavis* [2015] UKSC 67.

franchising arrangements, the court will be more reluctant to interfere with a contractual liquidated damages clause. *Cavendish Square Holding BV v. Talal El Makdessi* and *ParkingEye Limited v. Beavis* were cited in various cases in the Hong Kong Court of First Instance³⁵ and the Lands Tribunal.³⁶ However, the Hong Kong Court of Appeal has not expressed its view on *Cavendish Square Holding BV v. Talal El Makdessi* and *ParkingEye Limited v. Beavis* in the recent case of *Brio Electronic Commerce Limited v. Tradelink Electronic Commerce Limited*³⁷ in relation to liquidated damages and penalty clauses. Whether this new test will be adopted by the Hong Kong higher courts remains to be seen. Nevertheless, the Court of Appeal rejected the rigid test in *Murray v. Leisureplay Plc*,³⁸ which examines the discrepancy between the liquidated damages and the losses that would have been suffered in every case. In its approach to find the liquidated damages clause enforceable in *Brio Electronic Commerce Limited v. Tradelink Electronic Commerce Limited*, the Court of Appeal has shown its willingness to respect parties' contractual intention.

35 *Leung Wan Kee Shipyard Ltd v. Dragon Pearl Night Club Restaurant Ltd* (No 2) [2016] 1 HKLRD 657.

36 饒旋鋒 對 黃麗惠 LDPE 642/2015, 龍珠島別墅F1至F7座業主立案法團 對 何正行 LDBM 155/2014.

37 *Brio Electronic Commerce Limited v. Tradelink Electronic Commerce Limited* CACV 271/2013.

38 *Murray v. Leisureplay Plc* [2005] EWCA Civ 963.

HUNGARY

Péter Rippel-Szabó and Bettina Kövecses¹

I INTRODUCTION

Franchising in Hungary is a common business model and enjoys continuously growing popularity. In aggregate, around 300–350 franchise networks operate in Hungary, the number of franchisees is approximately 20,000, and around 100,000 employees (including suppliers) work in the franchise sector. The vast majority of franchise networks are active in the retail, services and hospitality industries.²

Hungary's membership status in the EU since 2004 has contributed to the growth of the number of foreign franchisors. According to publicly available data³ there are currently approximately 76 foreign franchise networks with more than 1,000 units in Hungary. Most of them are from the United States (20) and Germany (14). Some well-known franchisors are present in the country (e.g., McDonald's, Nordsee, Dallmayr, BioTechUSA, Kodak and Hertz). Famous Hungarian franchises include Fornetti (food), Diego (decor), Duna House (real estate) and Coop (retail).

The Hungarian Franchise Association (HFA) was established in 1991 and currently has approximately 60 members. The HFA, working to the European Code of Ethics for Franchising and its own Code of Ethics,⁴ supervises the operation of franchise networks and represents and promotes the Hungarian franchise sector and its own members. The HFA has acceded to the European Franchise Federation and the World Franchise Council.

To date, no government report has been prepared on franchising in the Hungarian market, but a brief overview of the local franchise market in English is accessible on the HFA's official website⁵ and the HFA, from time to time, issues short summaries on the status of its members and franchising in general.

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2 Source: Hungarian Franchise Association, 'Franchising in Hungary', accessible at www.franchise.hu/English/Franchising+in+Hungary (last accessed 12 November 2016).

3 Source: official website of the Hungarian Franchise Association, accessible at www.franchise.hu (last accessed 12 November 2016).

4 The Code of Ethics is accessible at www.franchise.hu/Etikai+k%C3%B3dex.

5 See footnote 2.

II MARKET ENTRY

i Restrictions

As a general rule, no restrictions apply and no approval is required by foreign franchisors to enter the Hungarian market. However, if a foreign franchisor pursues economic activity in Hungary, it might be required to set up a local company (see Section V.i); setting up such a company follows the general rules of company formation (see Section IV.iii).

There is no general restriction on a foreign entity granting a master franchise or development rights to a local entity, although the parties to franchise agreements must comply with the provisions of competition law (see Section VI.v) and some specific sectoral rules may also affect the establishment of a master franchise relationship.

There is no general restriction on foreign franchisors owning equity in a local business. EU- and EEA-based individuals and entities, and entities that enjoy the same treatment on the basis of an international treaty, can acquire title of ownership to Hungarian non-agricultural real estate under the same conditions as Hungarian nationals. Other foreign individuals or entities may acquire Hungarian non-agricultural real estate if they obtain a permit granted by the county or metropolitan government office; however, no foreign party, whether a private individual or company, may acquire title or any other right to Hungarian agricultural land or protected natural areas. The same restriction applies to acquisitions by Hungarian subsidiaries owned by foreign investors.

ii Foreign exchange and tax

No withholding tax is levied in Hungary on dividends. However, cross-border franchising can face value added tax (VAT) issues (e.g., when offsetting marketing and other services fees against franchising fees in the form of a discount).

III INTELLECTUAL PROPERTY

i Brand search

The Hungarian Intellectual Property Office (HIPO) maintains an online database of all Hungarian and Community-registered intellectual property (IP) rights, such as trademarks, patents and design rights. Before considering the use of a sign or device as a brand identifier conducting a search in the HIPO database is recommended. To avoid the risk of future opposition or cancellation of a trademark the search should cover not only the identical, but also the possible similar versions of the proposed sign to avoid any conflict with earlier registered rights. When considering the scope of the search, special attention must be paid to the goods and services for which the sign or design is to be used. Although the existence of a company name does not hinder the registration of a similar or identical sign as a trademark, a preliminary assessment should include a search of the company register for any commercial and company names that have been in the market for a long time and may cause problems in the future. The principal data on Hungarian companies, including company names, is freely accessible through the online company registry. An online presence may be identified by searching in the official .hu (dot hu) domain registry operated by the Council of Hungarian Internet Providers. As the Hungarian language uses accented letterforms (á, é, í, ó, ö, ő, ú, ü, ű) and such use is also allowed in domain names, a search for variations is strongly recommended to avoid cybersquatting.

ii Brand protection

A Hungarian trademark is obtained through registration with the HIPO. A sign can be registered as a Hungarian trademark, a European Union trademark (EUTM) or as an international trademark designating Hungary under the Madrid Agreement of 1891 Concerning the International Registration of Marks and the Madrid Protocol of 1989. The use of a sign does not create trademark protection in Hungary; a trademark must be registered. Trademark protection may generally be granted for any sign that can be represented graphically and is capable of distinguishing goods or services from those of other undertakings (origin-indicating function). A sign is excluded from trademark protection if it is devoid of any distinctive character. The procedure for registration of a trademark begins with the filing of a trademark application with the HIPO or the European Union Intellectual Property Office (EUIPO); registration is granted for 10 years and may be renewed without limitation.

Design protection grants legal protection for the appearance of a product. Design protection is granted for any design that is new on a worldwide level and has individual character, and for which there are no grounds for refusal that exclude it from protection. Design protection can be obtained by filing a design application with the HIPO, with the EUIPO or by filing an international application under the Hague Agreement Concerning the International Deposit of Industrial Designs.

Under the Hungarian .hu top-level domain, domain names may be registered according to the Domain Registration Rules and Procedures of the Council of Hungarian Internet Providers.

A licence for the use of a trademark or design must be given in writing, and to gain effect against third parties, it must be registered with the relevant registry (i.e., the HIPO or the EUIPO).

iii Enforcement

The trademark owner (or licensee) can prevent any third party from using a sign without the proprietor's consent in the course of trade. The Trademark Act⁶ contains examples of use that can be objected to: (1) using the trademark on the goods or on packaging thereof, (2) putting on the market or offering for sale the goods under the trademark or stocking them for such purposes, (3) offering or supplying services under the trademark, (4) importing or exporting the goods under the trademark, and (5) using the trademark in business correspondence and in advertising.

Under the Design Act,⁷ design protection confers on its holder the exclusive right to exploit the design. The holder of the design protection is entitled to prevent any person not having the holder's consent from exploiting the design. Exploitation covers in particular the making, using, putting on the market, offering for sale, importation and exportation of the product embodying the design, as well as the stocking thereof for such purposes.

The trademark proprietor or the holder of a design right is entitled to start proceedings to stop infringement of such a right. A licensee recorded in the Trademark or Design Register may also commence infringement proceedings in his or her own name if he or she provided the right holder with an opportunity to take appropriate actions against infringement, but the right holder has failed to take actions. The civil law sanctions are (1) establishment of

6 Act XI of 1997 on the protection of trademarks and geographical indications.

7 Act XLVIII of 2001 on the legal protection of designs.

infringement by the court; (2) permanent injunction to cease infringing activity or any activities directly threatening to infringe as well as desist from doing so in the future; (3) providing information about the persons who participated in the production and distribution of the goods concerned by the infringement, and about the business relations created for the dissemination of such goods; (4) public apology; (5) recovery of unjust enrichment; and (6) seizure, transfer, recall and definite removal from the channels of commerce; destruction of the infringing products and the packaging thereof, as well as the means and materials exclusively or principally used for infringement. These sanctions can be claimed regardless of whether the infringer acted in good or bad faith. The trademark or design owner (or licensee) can also claim compensation for damage (in the amount exceeding the unjust enrichment), but for such a claim the general provisions of the Civil Code⁸ would apply, requiring the culpability of the infringer to be proven as well.

General civil law applies in relation to questions that are not regulated by the Trademark or Design Acts. Under the Civil Code individual rights enjoy protection. Individual rights include (1) the right to bear a name, (2) protection of goodwill, (3) business secrets and (4) know-how. Under the Civil Code a remedy – an award (lump sum) – for the infringement of individual rights can also apply. For the application of this remedy, it is not necessary to prove the amount of damage or the culpability of the infringer, only the fact of the infringement.

iv Data protection, cybercrime, social media and e-commerce

The Data Protection Act⁹ does not set out specific restrictions on the transfer of personal data within the European Economic Area (EEA) and to Switzerland. Outside the EEA and Switzerland personal data can only be transferred to data controllers or technical data processors pursuing data processing or technical data processing activities if (1) the data subject has given explicit consent; or (2) the legal basis of data processing specified in the Data Protection Act is satisfied and an adequate level of protection of the personal data in the third country is ensured during the processing or technical processing of the transferred data.

The E-Commerce Act,¹⁰ in full harmonisation with the related EU laws, regulates (1) the service provider's obligations on the provision of data, (2) the service provider's liability, (3) the conclusion of contracts via electronic means, (4) notice and takedown proceedings and (5) the rules concerning electronic advertisements. Crimes in relation to cybercrimes and franchising under the Criminal Code¹¹ may include the circumvention of protective technologies or technologies protecting information systems, as well as violation of information systems or data.

There is no specific law on social media. This area is primarily regulated by the general provisions of civil law as well as the Data Protection and E-Commerce Acts.

8 Act V of 2013 on the Civil Code.

9 Act CXII of 2011 on informational self-determination and freedom of information.

10 Act CVIII of 2001 on certain issues of electronic commerce services and information society services.

11 Act C of 2012 on the Criminal Code.

IV FRANCHISE LAW

i Legislation

In the absence of a dedicated franchise act, franchises are subject to the same laws – primarily the Civil Code¹² – that govern other businesses. The general rules of civil and contractual law as well as the Civil Code's specific chapter on franchise agreements (in the wording of the Civil Code, 'agreements on the lease of rights') apply to franchises in Hungary. According to the definition of the Civil Code, the lessor (i.e., the franchisor), in exchange for remuneration, licenses its copyright, IP rights and know-how to the lessee (i.e., the franchisee), whereas the franchisee manufactures and sells products or provides and sells services through the use of the franchisor's rights. This definition does not include any reference to the licensing of trademarks and focuses on service and distribution franchises instead of the most common commercial franchises. The Civil Code also includes provisions on (1) the licensing of copyright, IP rights and protected know-how, (2) the franchisor's supply obligation, (3) the protection of the good reputation of the franchise network, (4) the franchisor's instruction and supervisory rights, and (5) rules on the termination of contracts concluded for an indefinite period. Because of the Civil Code's dispositive nature the parties may deviate from these provisions in their agreements. Since the focus of the franchise agreement in the Civil Code is rather one-sided and the provisions are not comprehensive, the parties, using the freedom-of-contract principle, usually exclude the application of the provisions of the Civil Code on franchise agreements.¹³

The Civil Code entered into force as of 15 March 2014 and replaced the previous Civil Code.¹⁴ The rules of the previous Civil Code apply to agreements that were in place on 15 March 2014 and statements and declarations made concerning such agreements. Nonetheless, the parties may agree to apply the provisions of the current Civil Code to their contract even if the contract was entered into before 15 March 2014.

Franchise agreements must be in compliance with the Competition Act.¹⁵ In the absence of a special block exemption regulation on franchises, the Block Exemption Regulation¹⁶ sets out the criteria as to how franchise agreements may be exempted from the prohibitions relating to the restriction of competition.

In relation to IP rights, the provisions of the Trademark Act, Copyright Act¹⁷ and Patent Act¹⁸ may apply to franchise agreements.

Although they are not binding legislation, the Code of Ethics and the HFA guidelines¹⁹ have been considered by courts in civil proceedings on an increasing number of occasions.

12 Act V of 2013 on the Civil Code.

13 In the summer of 2016, a draft amendment of the new Civil Code was accepted by the parliament. The original conception of this draft amendment intended to take out all franchise rules from the Civil Code on the basis that the rules of the Civil Code cannot contribute to the growing importance of franchise agreements in relation to small and medium-sized companies, and in relation to the Hungarian national economy. Ultimately, the accepted version of the amendment did not modify the current provisions on franchise agreements.

14 Act IV of 1959 on the Civil Code.

15 Act LVII of 1996 on the prohibition of unfair and restrictive market practices.

16 Government Decree No. 205/2011 (X.7) on the exemption for certain groups of vertical agreements from the prohibition of restriction of competition.

17 Act LXXVI of 1999 on copyright.

18 Act XXXIII of 1995 on the protection of inventions by patents.

19 The guidelines are accessible at www.franchise.hu/Ir%C3%A1nyelvek (last accessed 12 November 2016).

Additionally, these regulations may also serve as a basis for assessing whether the parties to a franchise agreement acted in good faith and according to the applicable standard of conduct in a particular situation.

ii Pre-contractual disclosure

Under the rules of Hungarian civil law, contracts must be concluded on the basis of mutual agreement by the parties. The parties must agree on all material details. There is no need to agree on details that are regulated by law. However, the Civil Code does not define the term 'material details'. According to the standard practice and the HFA's Code of Ethics, in the case of franchise agreements material details include: the licensing of know-how, commercial appearance, trademarks, the franchisee fee and royalties to be paid, and duration and termination of contract (see Section IV.iv).

The Civil Code recognises the doctrine of *culpa in contrahendo*. Under this principle the parties are obliged to (1) cooperate during the conclusion of the franchise agreement, (2) respect each other's rightful interests and (3) before the conclusion of the franchise agreement inform each other regarding all essential circumstances in relation to the proposed contract. There is no explicit statutory provision on the formal requirements of the pre-contractual information duty concerning franchise agreements.

Under Hungarian law, a franchisor may be exposed to a damages claim in tort over pre-contractual statements if the franchisee is able to prove that (1) the franchisor unlawfully concealed or misrepresented essential circumstances prior to entering into the franchise agreement (breach of duty); (2) the franchisee incurred damage (damage); (3) the damage was incurred by the franchisee because of the concealment or misrepresentation of essential circumstances (causal link); and (4) the franchisor is not able to excuse itself by proving that it proceeded as generally expected under the given circumstances (i.e., acted according to the applicable standard of conduct in the particular situation). However, neither party may be held liable for not entering into the agreement.

It is generally accepted practice that, to protect their business interest and trade secrets, franchisors require franchisees to sign a non-disclosure agreement before the franchisor delivers the draft of the franchise agreement.

iii Registration

There are no specific registration requirements for franchises. However, there are registration requirements that may have an impact on franchising:

- a* for the purpose of pursuing economic activities in Hungary, everyone can freely establish a company. Companies are registered by registry courts;
- b* before a newly established company can be registered by the competent registry court and its tax number issued, a preliminary tax registration procedure is completed by the tax authority;
- c* after their registration by the registry court, companies are obliged to apply for registration at the competent chamber of commerce and industry within five days; and
- d* if the franchisor or the franchisee pursues a specific activity, additional registration (e.g., at chambers or authorities) may be required.

iv Mandatory clauses

Under Hungarian law, there are no specific mandatory statutory clauses to be included in franchise agreements. According to the general contractual rules, the parties must agree on

all material details of the contract, otherwise it may be invalid or unenforceable. The Civil Code regulates some of the basic content of franchise agreements (see Section IV.i). However, parties may deviate from or even exclude these statutory provisions and agree on additional contractual provisions.

The HFA's Code of Ethics, which does not constitute a mandatory legislative act, is often considered by courts as a guideline for assessing the fulfilment of the duty of good faith. It sets out minimum requirements to be included in franchise agreements. These are (1) the franchisor's and the franchisee's rights and obligations; (2) the description of goods and services to be provided to the franchisee; (3) the term of the agreement, which must be sufficiently long to enable the franchisee to achieve a return on its initial investments; (4) provisions on renewal of the agreement; (5) conditions under which the franchisee may sell or assign the business being subject to the franchise agreement and the franchisor's related rights; (6) the advantages on the franchisee's side resulting from the use of the business name, trademarks, signs, images and other marks of the franchisors; (7) the franchisor's rights to adapt new or changed methods with regard to the franchise system; (8) termination of the agreement; and (9) conditions for post-contractual mechanisms concerning goods, real estate etc. that belong to the franchisor or third parties.

v Guarantees and protection

The franchisor may request guarantees or other types of securities from the franchisee. Those securities are regulated in the Civil Code. The parties to the franchising agreements usually rely on suretyship, security deposit, liens, bank guarantee, contractual penalty or purchase options. Under the Civil Code, in line with the protection of the good reputation of products and services subject to franchise agreements, each party is obliged to protect the good reputation of the franchise network.

Guarantees provided to the franchisor by the franchisee are enforceable. To ensure proper enforcement, the guarantee should be properly drafted. It is also recommended that the scope of the franchisee's collateral commitments cover the franchisee's breach of its contractual obligations towards suppliers.

V TAX

i Franchisor tax liabilities

Generally, the position of a foreign franchisor will most likely not constitute a permanent establishment in Hungary. Thus, there will be no tax liabilities for the franchisor in Hungary. However, if there is a permanent establishment or a branch office or a commercial representative office established by the franchisor, general tax liability will arise as described below.

Foreign entrepreneurs may conduct their business in Hungary by opening a branch office in the country. Such a branch office is a separate organisational unit of the foreign business association without legal personality registered by the Hungarian court of registration. Through their branch offices, foreign businesses are entitled to carry out permanent business activities in Hungary and are represented towards the authorities and third parties by their branch offices.

A commercial representative office is a unit of a foreign company without a legal personality, which can operate from the time it is registered in the company register. The

scope of activities of commercial representative offices is limited to mediating and preparing contracts and carrying out information, advertising and propaganda activities on behalf of the foreign company.

If the franchisor is a Hungarian entity, there are advantageous tax allowances in connection with the franchising fee if it qualifies as a royalty. Provided that certain conditions are fulfilled, 50 per cent of the revenues accounted as royalties may reduce the tax base.

ii Franchisee tax liabilities

Taxpayers with Hungarian residence have tax-paying obligations for their income originating both from Hungary and abroad. Non-resident businesses are only taxable on activities conducted in Hungary.

Corporate tax is 10 per cent of the positive tax base up to 500 million forints, and 19 per cent of the remaining portion of the tax base.

Companies are required to file a corporate tax return every year (for each business year). Generally, the financial year is identical to the calendar year, but companies may use a different financial year and, in relation to this, a tax year different from the calendar year.

Business associations are required to file their corporate tax returns and pay corporate tax by 31 May following the tax year. If the taxpayer opts for a different tax year, the filing and payment deadline is the last day of the fifth month after the last day of the financial year.

Besides corporate income tax, general VAT rules apply to the franchise business as well. Currently, with some exceptions, the VAT rate is 27 per cent.

iii Tax-efficient structures

Numerous structuring solutions are favoured. Because of the deduction from the corporate income tax base of 50 per cent of received royalties, a franchisor set-up in Hungary is definitely an option to be considered.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

According to the general principles of civil law, in the course of exercising civil rights and fulfilling such obligations, the parties must act in good faith and cooperate with each other. Unless stricter requirements are prescribed by law, the parties must act according to the generally applicable standard of conduct in the particular situation (i.e., during the conclusion, fulfilment and termination of franchise agreements). Compliance with the standards of good faith and cooperation is especially required in the case of long-term relationships (such as franchise agreements) and during the fulfilment of requirements concerning the provision of information. The duty of good faith is further specified in some provisions of the Civil Code (e.g., in relation to breach of contract). Upon the incurrance of any damage, the person incurring the damage may claim damages, if all relevant prerequisites are met (see Section IV.ii). Courts and arbitration tribunals rarely decide on a case expressly and exclusively on the basis of a violation of the duty of good faith under the Civil Code.

ii Agency distributor model

Under Hungarian law franchisors or franchisees are not treated as agents or distributors.

Under the provisions of the Civil Code on agency agreements agents intermediate in sale, purchase or other agreements in exchange for a fee. Under the main rule, agents may not enter into agreements on behalf of the principal. In the case of long-term agency arrangements, however, agents are entitled to conclude agreements on behalf of their principal. In any scenario, agents are only entitled to the agency fee; the economic results of the agreements concluded by the agents exclusively benefit the principal. The Civil Code expressly sets out that franchisees proceed under their own name and at their own risk.

The Civil Code also contains specific regulations on distribution agreements; such agreements, however, solely relate to the purchase and selling of goods. The supplier is only entitled to instruct the distributor on the appropriate distribution of the goods. So, although retail franchises usually have some common features with distribution agreements, distribution and franchise agreements have some significantly different features in practice. In comparison with distribution agreements, franchise agreements constitute a closer cooperation of the parties. In the case of distribution agreements, the manufacturer does not instruct and closely monitor the distributors and does not provide extensive support to the distributors.

iii Employment law

Courts do not treat franchisees as employees and to date there is no case law from the Hungarian Supreme Court dealing with this issue. Considering the basic features of the employment relationship under the Labour Code²⁰ (e.g., employees can only be individuals, not undertakings or private entrepreneurs; work must be performed in accordance with the employer's instructions; employees must arrive at work on time, in a condition fit for work, perform work during working hours and cooperate with fellow workers) and the standard practices of franchise agreements, it is very unlikely that franchisees will be considered employees by Hungarian courts.

iv Consumer protection

Under the Civil Code and the Consumer Protection Act²¹ the term 'consumer' means a private individual (i.e., a natural person) who is a party to a contract concluded for reasons other than the person's economic or professional activity. As franchise agreements necessarily relate to the franchisee's economic and professional activity, franchisees cannot be treated as consumers.

v Competition law

The Competition Act, in full harmonisation with Article 101 of the TFEU and further related EU regulations, sets out that (1) agreements; (2) concerted practices between undertakings; and (3) decisions by social organisations of undertakings, public corporations, associations or other similar organisations that have as their object or potential or actual effect the prevention, restriction or distortion of competition are prohibited. Under this prohibition, franchise agreements, in the vast majority of cases, constitute vertical restrictions of competition as they are concluded between undertakings from different levels of the value chain. However, franchise agreements may fall within the scope of statutory exemptions:

20 Act I of 2012 on the Labour Code.

21 Act CLV of 1997 on consumer protection.

- a* agreements concluded by undertakings that are not independent of each other do not qualify as agreements restricting competition. However, as the independence of the franchisee is an essential feature of franchising, this exemption cannot be applied to franchise agreements;
- b* franchise agreements of minor importance are not prohibited, unless the agreements relate to price-fixing or market sharing. A franchise agreement is of minor importance if the joint market share of the participating undertakings and undertakings that are not independent from them does not exceed 10 per cent of the relevant market;
- c* if franchise agreements are in compliance with the provisions of the Block Exemption Regulation, they are automatically exempted from the prohibitions on the restriction of competition. The block exemption does not apply to agreements in which, by the cumulative effect of those agreements and similar other agreements on the relevant market, the requirements of general exemptions are not satisfied; and
- d* the prohibition of restriction of competition may also be inapplicable if the franchise agreement fulfils the criteria for general exemption under the Competition Act.

The Block Exemption Regulation applies to vertical agreements entered into between an association of undertakings and its members, or between such an association and its suppliers, if all its members are retailers of goods and if no individual member of the association, together with its connected undertakings, has a total annual turnover exceeding the sum of Hungarian forints equalling €50 million. The exemption also applies to the licensing of IP rights provided that these provisions (1) do not constitute the primary object of the franchise agreement; (2) are directly related to the use, sale or resale of goods or services by the franchisee or its customers; and (3) do not contain restrictions of competition having the same object as vertical restraints that are not exempted under the Block Exemption Regulation. The exemption, however, applies only if the franchise agreement does not contain mutual vertical restrictions and the franchisor is not a competitor to the franchisee concerning the production of goods or the provision of services. Finally, to be exempted, the market share of both the franchisor and the franchisee may not exceed 30 per cent on the relevant market.

Franchise agreements may not be granted exemption from the prohibition if the objective is the limitation or restriction of (1) the franchisee's ability to determine its sale price; (2) the territory or clientele in or to which the product or service can be sold; (3) the active or passive sale at the retail level of a selective distribution system; (4) the cross-supply among distributors of a selective distribution system; or (5) the sale of components as spare parts, if the agreement was concluded between the supplier and the person who incorporates the spare parts (specific exemptions may apply in some cases).

No exemption may be granted for (1) any direct or indirect non-compete obligation, the duration of which is indefinite or exceeds five years; (2) any direct or indirect obligation causing the franchisee, after termination of the agreement, not to manufacture, purchase, sell or resell goods or services (specific exemptions may apply); (3) any direct or indirect obligation causing the franchisee as a member of a selective distribution system not to sell the brands of particular competing suppliers.

Reasonable and necessary contractual clauses on exclusivity and full line forcing, which are essential features of most franchise agreements, may usually be exempted from the prohibition of the restriction of competition, if the parties comply with the statutory provisions and the case law of the Hungarian Competition Authority (see Section VI.vi). Any agreement or practice to fix prices is, in the vast majority of the cases, prohibited and

cannot be exempted. It is important to note that compliance with competition law must be assessed by the parties themselves. Improper formulation of franchise agreements may entail significant legal risks, therefore it is strongly recommended that franchisors and franchisees seek proper legal advice and prepare an economic analysis on a case-by-case basis.

vi Restrictive covenants

Generally, all non-compete and other restrictive covenants that fall within the scope of hardcore or excluded restrictions, or do not fulfil the requirements under the Block Exemption Regulation, may not be enforced. In addition, all clauses that unnecessarily and unreasonably narrow the scope of the franchisees' freedom to set (reselling) prices and make decisions as to where to purchase the goods subject to the franchise agreement restrict the competition.²² Thus, franchise agreements may be exempted under the Block Exemption Regulation, or the general exemption, if they contain only restrictive provisions that are in compliance with the principles of franchising and necessary for the protection and operation of the licensed know-how.

Therefore, the parties are advised to (1) continuously supervise the compliance of the franchise agreement with the provisions of competition law; and (2) avoid any clauses that unnecessarily and unreasonably restrict or have an objective to restrict the competition. Non-compete and other restrictive covenants may be enforced by incorporating appropriate clauses into the franchise agreements.

vii Termination

Under the Civil Code, the parties may freely determine the rules regarding the termination of contracts entered into for both a definite and an indefinite period. Franchise agreements may be terminated by the mutual consent of the parties or by one of the parties giving notice of termination. If the contract is terminated with immediate effect, it ceases to exist upon the time of delivering of the notice. Otherwise the agreement terminates at the end of the notice period.

The Civil Code sets forth specific rules with regard to the termination of franchise agreements concluded for an indefinite period, from which the parties may deviate by mutual consent. Franchise agreements concluded for an indefinite period may be terminated any time, effective as of the last the day of the calendar month concerned. The termination period is one month in the first year of the agreement, two months in the second year, three months in the third and following years. Upon the termination of the franchise agreement, all rights of the franchisee relating to copyright, IP rights or protected know-how cease to exist. The Civil Code contains no provisions on the termination of franchise agreements concluded for a definite period; nonetheless, the parties, under the principle of freedom of contract, will be entitled to enter into a franchisee agreement for a definite period and regulate the termination of such a contract.

If agreed by the parties, the franchisor may take over the franchisee's business after the termination of the franchising agreement.

22 Position statements 2006 of the Competition Council of the Hungarian Competition Authority; Section 11.26 (Vj-171/2002). Pursuant to the Competition Council, the safeguarding of competition within a given brand where only a handful of competitors are present is especially important. The position statements reflect the Competition Council's law interpretation with regard to the Competition Act.

viii Anti-corruption and anti-terrorism regulation

If the services set forth in the franchise agreement fall within the scope of the Anti-Money Laundering and Anti-Terrorism Act,²³ the service provider must comply with the general provisions on customer due diligence measures, reporting obligations and preparation and application of internal regulations. The Anti-Money Laundering and Anti-Terrorism Act does not provide for any specific franchise-related regulations.

ix Dispute resolution

In practice, parties to franchise agreements tend to opt for litigation via local courts and arbitration tribunals. While mediation is a recognised form of alternative dispute resolution, it is not mandatory under Hungarian law and parties are usually reluctant to choose this way of solving their disputes. There is no specific procedure or industry practice for franchising disputes; neither does the HFA offer mediation or arbitration rules or services. However, the HFA, upon request by HFA members, may play a conciliatory role in disputes arising between members.²⁴

Under the Code of Civil Proceedings²⁵ business entities (i.e., franchisors and franchisees), before filing a claim with ordinary courts, are obliged to try to resolve the dispute out of court.

A request for a preliminary injunction (PI) may not be submitted before the claims on the merits of the case are filed with the court – except for matters concerning IP rights. It must be proved that the PI is necessary (1) to prevent the occurrence of imminent damage; (2) to preserve the situation that is the subject of the proceeding (*status quo*); or (3) for special legal protection of the applicant. Regardless of which of these grounds is referred to, there is an additional general precondition to be fulfilled: the disadvantages caused by the PI should not exceed the advantages achieved thereby. So, it is possible to obtain a PI to prevent a former franchisee from continuing to trade in breach of a non-compete provision or from using the franchisor's trademarks or other IP rights. The court decides on the PI 'without delay'; the law does not set out a mandatory deadline. Issuance of a PI usually takes three to six weeks.

Local courts recognise and uphold foreign choice of law or jurisdiction clauses, if the clauses are in compliance with relevant Hungarian laws. Ordinary court proceedings, including first and second instances, may last for several years, arbitration proceedings are usually shorter.

Under Hungarian contractual law, the party breaching the contract may be held liable for damages. The franchisor or the franchisee is not liable for the damage caused, if it is able to prove that (1) the circumstances causing the damage were out of its control, (2) the circumstances were not foreseeable by it at the date of the conclusion of the agreement, and (3) it was not obliged to prevent such circumstances or damage. The consequential damage and lost profit must only be reimbursed if the injured party is able to prove that the potential damage could be foreseen at the time of entering into the franchise contract. If the damage was caused wilfully, the full amount of damages must be reimbursed. The person incurring

23 Act CXXXVI of 2007 on the prevention of money laundering and terrorism.

24 Article 4.6 of the statutes of the HFA. The HFA statutes are accessible only in Hungarian at www.franchise.hu/Alapszab%C3%A1ly (last accessed 12 November 2016).

25 Act III of 1952 on the Code of Civil Proceedings.

the damage has the obligation to mitigate damages and the party causing the damage would not be held liable for that portion of damages that could have been avoided by the person incurring the damage.

Litigation costs are allocated proportionally between the parties depending on the outcome of the litigation. These costs are not statutorily capped; however, excessive attorney fees and court costs may be reduced by the court. Enforcement of judgments and awards follows the common rules of enforcement under Hungarian law. Hungarian courts readily recognise foreign arbitral awards from other member countries of the New York Convention,²⁶ though violation of Hungarian public order may serve as grounds for refusal.

VII CURRENT DEVELOPMENTS

Because of its strategic geographical location, its EU membership status, its relatively cheap and skilled workforce, and low investment requirements, Hungary is likely to remain a target country for foreign franchisors and there are no current developments that would deter foreign franchisors from entering the Hungarian market. The Civil Code entered into force on 15 March 2014 and it contains specific provisions on franchise agreements. These provisions may serve as guidance for franchisors when entering into contracts with franchisees. The parties, however, usually exclude the application of the provisions of the Civil Code on franchise agreements for practical reasons. The Civil Code replaced not only the previous Civil Code, but also the previous Companies Act, and modified several laws. As a result, local franchisors and franchisees, if they have not yet done so under the transition period provided by the new law, may need to adapt their current business model to comply with the new legislation.

²⁶ United Nations Convention on the Recognition and Enforcement of Foreign Arbitration Awards, implemented into Hungarian law by Law Decree No. 25 of 1962.

INDIA

*Nipun Gupta and Divya Sharma*¹

I INTRODUCTION

India is an attractive destination for a franchising entrepreneur. The continued growth of the economy and the central government's continuous efforts to liberalise the foreign investment policy and improve the ease of doing business has led to foreign investors considering India as an attractive investment destination. The Indian franchising market has been projected to quadruple between 2012 and 2017 and its estimated worth is expected to reach approximately US\$50.4 billion by 2017.²

Today India is home to over 3,700 international brands that have entered the market using the franchising model.³ Many of these are food and beverage (F&B) and luxury brands. Prominent examples include Burger King, Pizza Express, Dunkin' Donuts, Hard Rock Cafe, Hermès, Fendi, Burberry, Bottega Veneta, Paul Smith, Jimmy Choo and Roberto Cavalli.⁴ In 2015, Jamie Oliver launched two restaurants in India, both being set up in partnership with Dolomite Restaurants Pvt Ltd; in addition H&M, part of the largest retailer in the world, and GAP entered the market.

Looking ahead, F&B, education, fashion, hospitality and tourism will continue to emerge as high-potential service sectors for franchising.⁵

II MARKET ENTRY

Various market entry options are available to foreign brands. The available options include operating the Indian business through an Indian subsidiary wholly owned by the foreign brand; entering into a joint venture, franchise arrangement or licensing arrangement with an Indian partner; or a combination of these structures.

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2 'Collaborating for Growth, Report on Franchising Industry in India 2013' by KPMG and the Franchising Association of India, available at www.kpmg.com/IN/en/IssuesAndInsights/ArticlesPublications/Documents/Collaborating_for_Growth.pdf (last visited on 4 November 2015).

3 www.franchiseindia.com/articles/research/latest-trends/Franchise-trends-that-entrepreneurs-can-t-miss-in-2015-724/#sthash.FjvF7ivC.dpuf (last visited on 4 November 2015).

4 'Luxury Brands Gaining Ground in India', available at www.businessinsider.in/LuxuryBrands-Gaining-Ground-In-India/articleshow/33494855.cms (last visited on 4 November 2015).

5 See footnote 2, p. 6.

i Restrictions

Foreign investment is permitted in India in most sectors of the economy, except for sectors such as atomic energy, lottery, gambling, etc. where foreign direct investment (FDI) is not permitted. The few limitations that may affect a prospective franchise arrangement are as follows.

FDI policy

India's FDI policy is relevant for foreign brands looking to own an equity interest in Indian businesses. The policy prescribes the requirements for foreign investment, including the extent to which foreign investment is permitted and if the investment needs any government approval. India's current policy makes the following provision.⁶

Single brand

Foreign companies can own up to 100 per cent equity interest in an Indian company offering single-brand retail services. For this purpose single-brand retail refers to retail trading of products that are sold under a 'single brand' – that being the brand name under which the products are sold internationally. Products should be branded as such during manufacturing. International brands such as Zara, IKEA, Mothercare, Clarks and Marks & Spencer have entered India using this route.

Although 100 per cent FDI is permitted in single-brand retail, prior approval of the Foreign Investment Promotion Board (FIPB) is required for foreign investment in excess of 49 per cent. If foreign investment in the Indian company exceeds 51 per cent, then 30 per cent of the value of goods purchased by the Indian company must be sourced from India, preferably from micro, small or medium-sized enterprises, village and cottage industries, artisans and craftspeople. These sourcing norms do not apply up to three years from the opening of the first store by single-brand retail entities having state-of-the-art and cutting-edge technology, and where local sourcing is not possible.

An application seeking permission to invest more than 49 per cent in a single-brand retail company must specifically indicate the product or product categories to be sold under the single brand and any change in product or product categories to be sold requires prior approval of the government. In cases of foreign investment up to 49 per cent in a single-brand company, the list of product or product categories to be sold, except food products, must be provided to the Reserve Bank of India.

Entities permitted to undertake single-brand retail trading are also permitted to undertake e-commerce activities.

Multi-brand

Foreign companies can own up to 51 per cent equity interest in an Indian company offering multi-brand retail services, with prior FIPB approval. An Indian company operating multi-brand stores, and that has foreign investment, can set up stores in states that have permitted multi-brand retailers to operate. In the permitted states, stores may be set up in

⁶ For details refer to the FDI Circular published by the Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce and Industry, Government of India on a biannual basis. The circular as at 7 June 2016 is available at http://dipp.nic.in/English/Policies/FDI_Circular_2016.pdf (last visited on 19 December 2016).

cities above a specified population. Additionally, sourcing conditions similar to those set out above for single-brand retail apply to multi-brand retail: multi-brand retailers are required to invest a minimum amount of US\$100 million and certain requirements for investment in back-end infrastructure must be satisfied. The UK-based Tesco Plc was the first to apply and obtain DIPP approval to carry out the business of multi-brand retail trading in India. The Modi government has not changed the FDI policy in this respect, but equally this sector has not seen any foreign investment since the Modi government took office.

Setting up master franchise agreements in India

An international franchisor that does not wish to own an equity interest in the Indian business may, subject to Indian law, grant franchise rights to a local franchisee to establish and operate the brand in India through a contractual mechanism. There are no restrictions on a foreign entity granting master franchise or development rights to a local entity and, given the geographical size of India, it is not uncommon for international franchisors to appoint several master franchisees responsible for specific parts of India. Currently foreign investment rules do not permit foreign companies to invest in or establish companies in India that are engaged in an inventory-based model of e-commerce,⁷ although relaxations have been made for single-brand retail companies to engage in e-commerce, and FDI up to 100 per cent has been permitted in marketplace-based models of e-commerce, subject to certain conditions.⁸

Owning real estate

Indian exchange control regulations impose restrictions on non-Indian nationals and companies acquiring real estate in India. However, franchisors who have established a branch office or other place of business in India, or companies incorporated in India that are owned by international franchisors, can acquire immovable property, including through a lease as necessary for or incidental to carrying on their activity.⁹

Foreign exchange

Indian exchange control laws¹⁰ are relevant to several aspects of franchise arrangements, particularly with regard to payments between Indian franchisees and international franchisors. Indian franchisees can make royalty payments and remit fees for technical services to international franchisors without any limit and without approval of the Reserve Bank of India (RBI). Certain other trade payments may also be made without approvals. If the payment sought to be made to an international franchisor does not fall within the permissible categories, the Indian franchisee will require specific approval from the RBI to make the payment. The approval process can be time-consuming and it is uncertain whether the RBI would grant approval. Therefore, it is advisable to seek legal advice on the type of

7 An inventory-based model of e-commerce is defined as a model in which inventory of goods and services is owned by the e-commerce entity and sold to consumers directly.

8 A marketplace model of e-commerce is defined as the provision of an information technology platform by an e-commerce entity on digital and electronic networks to act as a facilitator between buyer and seller.

9 Under the provisions of the FEMA.

10 Indian exchange control laws are comprised of the FEMA and rules, regulations and notifications made under it from time to time. The FEMA is administered by the RBI, India's central bank.

payments proposed to be made under the franchise arrangement so as to ensure that the payments are correctly structured in such a manner that they are freely permissible under the Foreign Exchange Management Act 1999 (FEMA).

III INTELLECTUAL PROPERTY

Following India becoming a signatory to the WTO TRIPS Agreement,¹¹ Indian intellectual property (IP) laws were amended to make them more consistent with globally accepted IP norms and practices. These amendments coupled with better enforcement of the law have significantly improved the IP protection regime.

To protect their trademarks and brands, franchisors will normally also register their trademarks in India. They enter into contractual arrangements with the franchisee, such as through trademark licence agreements or by including detailed provisions in the franchise agreement.

i Brand search

The process of searching for protected trademarks and other IP relevant to franchises (such as image rights) is quite simple. This can be done using the public search engine for trademarks on the Ministry of Commerce and Industry website.¹² For a franchisor considering India as a franchising destination, this search engine can be helpful as it can enable a potential franchisor to identify commonly known marks and prohibited marks, while also showing the business images that are currently trademarked in India.

ii Brand protection

To register a trademark, the proprietor of the mark must make an application in the prescribed form.¹³ Applications for registration of trademarks are examined by the Registrar of Trade Marks. If the Registrar decides to accept the application, the application is published in the official gazette, the Trade Marks Journal. Following publication in the gazette, any person can, within a specified period, file an opposition. Where oppositions are filed they must be dealt with according to the procedure prescribed and the decisions of the Registrar may be appealed before the Intellectual Property Appellate Board. If no opposition is filed within three months, the trademark proceeds to registration. Registered trademarks are protected in perpetuity subject to renewal of the registration after every 10 years.

iii Enforcement

If a trademark is infringed, civil remedies can be pursued under the laws of passing off or under the Trade Marks Act 1999 (the Trademarks Act) depending on whether the trademark in question is registered, pending registration or unregistered. Further, in respect of registered trademarks, criminal remedies set out by the Trademarks Act may also be available. Typically,

11 The Agreement on Trade-Related Aspects of Intellectual Property Rights is Annex 1C of the Marrakesh Agreement Establishing the World Trade Organization, signed in Marrakesh, Morocco on 15 April 1994.

12 <https://ipindiaonline.gov.in/tmrpublicsearch/frmmain.aspx> (last visited on 19 November 2015).

13 <https://ipindiaonline.gov.in/trademarkefiling/user/firmlogin.aspx>.

in cases of trademark infringement, provided the court is satisfied, interim injunctions may be obtained to stop the infringing conduct until the infringement suit is decided. Such injunctions are normally granted at an early stage of the trial.

Indian courts have generally been good at recognising the international reputation of trademarks even if the trademark is not registered in India. There have been numerous examples where courts have stepped in to protect unregistered trademark holders, for example, in the *Calvin Klein* case.¹⁴ More recently, courts have also restrained online retailers from using branded names, such as L'Oréal, to sell cosmetics.¹⁵

In addition to the Trademarks Act, customs laws prohibit import of infringing goods into India. Holders of registered trademarks may notify Indian customs authorities of goods infringing their IP rights. The customs authorities are empowered to suspend clearance of infringing goods and take certain other actions as are specified in the relevant rules.¹⁶

Know-how belonging to a franchisor may also be protected under the Indian Copyright Act 1957 or the Patents Act 1970 if it is capable of protection under those laws. If statutory protection is not available to know-how, contractual remedies will still be available to the franchisor and it is usual to see detailed provisions in the franchise agreement dealing with protection of know-how.

iv Data protection and e-commerce

Customer data is important for companies looking to market or cross-sell their products. India's data protection provisions are not located in one cohesive piece of legislation. This can therefore be an area that needs careful consideration by lawyers reviewing the types of personal data that may be collected by the franchisee or the franchisor and the impact that legislation such as the Information Technology Act 2000 (the IT Act) and the Information Technology (Reasonable security practices and procedures and sensitive personal data or information) Rules 2011 (the DP Rules) may have on the manner in which personal data may be collected, handled, stored and processed.

On a strict reading of the DP Rules, difficulties can arise in determining whether the DP Rules apply to personal data that is not sensitive personal data and to companies that are not based in India. The pragmatic view is that consent should be obtained to collect, process, store, handle and export personal data. In addition to the DP Rules, Indian law generally recognises the right to privacy of an individual and a person who discloses personal data in violation of their contractual obligations commits an offence under the IT Act.

So far as sensitive personal data is concerned (which includes bank and credit card information), the DP Rules would generally apply. Under the DP Rules, sensitive personal data must not be exported to a country that does not afford the same level of data protection

14 *Calvin Klein Inc. v. International Apparel Syndicate* 1996 PTC 293 (Cal).

15 Delhi High Court restrains online retailer from using L'oreal [sic] trademark' (21 October 2014), at http://articles.economictimes.indiatimes.com/2014-10-21/news/55279633_1_l-oreal-online-retailer-trademark (last visited on 19 November 2015).

16 Intellectual Property Rights (Imported Goods) Enforcement Rules 2007, available at www.wipo.int/wipolex/en/text.jsp?file_id=201652 (last visited on 19 November 2015).

as that offered by the DP Rules, although export is permitted if the transfer is necessary for performance of a contract or if consent for the transfer has been obtained from the data controller or the data subject.

The IT Act also deals with cybercrime such as hacking, identity theft, tampering with computer records, and prescribes penalties and offences in respect of those matters.

IV FRANCHISE LAW

i Legislation

Unlike many jurisdictions, India does not have a specific statute dealing with franchise matters. The closest point for interpretation can be seen in India's Finance Act, which had defined 'franchise', in the context of service tax, to mean an agreement by which the franchisee is granted representational right to sell or manufacture goods or to provide service or undertake any process identified with a franchisor, with respect to any trademark, service mark, trade name, logo, etc. A 'franchisor' is defined as any person who enters into a franchise with a franchisee and the term 'franchisee' is construed accordingly.¹⁷

However, the Indian Contract Act 1872 (the Contract Act), the Sale of Goods Act 1930 and the Specific Relief Act 1873, which apply to all commercial arrangements, are relevant to franchise agreements (these are discussed in detail below).

In contrast to the requirements in the United States, there are no laws requiring a franchisor to provide a lengthy franchise disclosure document to potential franchisees within a stipulated period prior to signing the franchise agreement. Aspects of potential litigation, bankruptcy, initial fee, estimated initial investment, etc. are expected to be captured by a party's own due diligence and commercial understanding. Franchise agreements are not required to be registered in India.

Indian law does not regulate termination of franchise agreements. Parties are therefore free to incorporate provisions in the franchise agreement dealing with termination. Franchise agreements will usually permit termination for breach of contract and insolvency, and stipulate the consequences of termination.

If the franchise agreement is terminated, an international franchisor's ability to take over the franchisee's business is predicated on the applicable foreign investment guidelines. If the Indian company operating the business is a joint venture between the international franchisor and the Indian franchisee, in the single-brand retail sector, the franchisor could acquire the franchisee's interest in the joint venture such that the Indian company becomes a wholly owned subsidiary of the international franchisor. However, if the Indian company operates in the multi-brand retail sector, and assuming the current foreign investment guidelines continue to apply, the international franchisor could not acquire all the franchisee's interest in the joint venture and would have to find a local Indian partner to own 49 per cent interest in the Indian company. Alternatively, if the international franchisor wishes to exit the joint venture, it could sell its stake in the joint venture, to the franchisee.

The FEMA provides that transfer of shares in an Indian company by a foreign party to an Indian party must not take place at a price more than the fair value calculated using any internationally accepted pricing methodology for valuation of shares on an arm's-length basis.

17 Finance Act 1994 (as amended), Chapter V, definitions 47 and 48, available at www.servicetax.gov.in/resources//htdocs-servicetax/st-act-ason24oct2013.pdf.

The foreign party must not be assured an exit price at the time of making its investment and the price must be certified by a chartered accountant or a merchant banker registered with the Securities and Exchange Board of India.¹⁸

In a purely contractual relationship where the franchisor does not own an equity interest in the franchisee or the Indian company operating the business, the franchise agreement should specify the consequences of termination, including any step-in rights for the franchisor. Step-in rights must be drafted keeping the FEMA in mind. For example, under the FEMA, foreign companies cannot directly enter into a lease for property in India, except in limited circumstances (as discussed in Section II.iv). Therefore, an international franchisor desirous of stepping into the franchisee's position will need to establish an entity in India to whom the lease may be assigned.

Contract Act

The Contract Act deals with various matters, including formation, performance and breach of contracts. Contracts are voidable at the instance of an innocent party in certain circumstances, including if consent to the contract was granted by the innocent party because of misrepresentation. Alternatively, the innocent party may insist on performance of the contract consented to as a result of misrepresentation, and be put in a position such that the misrepresentation was not made.¹⁹ Misrepresentation is defined in the Contract Act as:

- a* a positive assertion of untrue matters (although the person making the assertion believes it to be true);
- b* a breach of duty that gains advantage to the person committing the breach by misleading the other person to their prejudice; and
- c* causing (even innocently) a party to a contract to make a mistake as to the subject of the contract.²⁰

Importantly, a contract that is formed as a result of consent being given on account of a misrepresentation is not voidable if the innocent party had means of discovering the truth by due diligence.²¹

Sale of Goods Act

Inter alia, the Sale of Goods Act 1930 stipulates conditions that are implied into contracts for sale of goods (some of which can be contractually waived), rules relating to passing of title and risk in the goods, and the remedies for breach of such contracts.

Specific Relief Act

The Specific Relief Act 1963 set outs the remedies available for enforcement of contracts. Specific performance of a contract is a discretionary remedy that may be awarded if the court is satisfied that damages would not be adequate for breach of a contract.

18 RBI circular, https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9903 (last visited on 18 November 2015).

19 Section 19 of the Contract Act.

20 Section 18 of the Contract Act.

21 See the exception to Section 19 of the Contract Act.

ii Guarantees and protection

Franchise agreements may require a franchisee to deliver a parent company guarantee or a bank guarantee, guaranteeing performance of the franchisee's contractual or payment obligations under the franchise agreement. Guarantees are contractual in nature and are regulated by the Contract Act.

Under the FEMA, an Indian company or individual cannot issue a guarantee in favour of a company or individual resident outside India, except in limited circumstances, without prior permission of the RBI and there is no certainty as to whether the permission would be granted by the RBI.

V TAX

Normally payments under franchise agreements attract direct and indirect taxes in India. Income tax will be payable by a franchisee on the income earned from franchise operations. If the franchisee is providing a service to consumers (for example, a restaurant), service tax will be payable by the entity providing the services. Value added tax would also be payable on sale of goods by the franchisee. As value added tax is levied by each state in India, the rate of tax payable may differ from state to state.

The government proposes to introduce a goods and services tax (GST). The Constitution of India has been amended to pave the way for GST's introduction, but work is under way with respect to ancillary legislation and administrative machinery required for its implementation. The government hopes to implement GST between 1 April 2017 and 16 September 2017. Once implemented, GST would replace indirect taxes on goods and services such as central taxes (e.g., central excise duty, additional excise duty, service tax, additional custom duty and special additional duty) and state level taxes (e.g., VAT or sales tax, central sales tax, entertainment tax, entry tax, purchase tax, luxury tax and Octroi). Therefore, GST is likely to be a game changer and would have a cascading effect on the economy once implemented.²²

i Franchisor tax liabilities

A franchisor may be liable to pay income tax in India if it is resident in India for tax purposes. If the franchisor is based outside India, the franchise agreement should be structured carefully because if the franchisor is considered to have a permanent establishment in India, there may be tax consequences.

ii Franchisee tax liabilities

Subject to the FEMA provisions, a franchisee can make royalty payments to an international franchisor from India.²³ However, the franchisee will be obliged to withhold tax on payments towards royalties and technical services made to the franchisor under the franchise agreement. The rate of withholding tax is 25 per cent (plus any additional cess or surcharge).

22 For more information on GST see www.cbec.gov.in/htdocs-cbec/gst (last visited on 19 December 2016).

23 Press Note No. 8 (2009 series), <http://pib.nic.in/newsite/erelease.aspx?relid=56146>.

This is subject to double-taxation avoidance agreements (DTAA), or treaties, and for treaty countries the effective withholding tax liability may be reduced. India has in force DTAAAs with approximately 120 countries.²⁴

India recognises franchising as a taxable service. This covers agreements, including those that are incidental to a franchise arrangement (for example, licensed production agreements). Any agreement by which the franchisor grants representational rights to a franchisee (to sell, manufacture goods or provide services identified with the franchisor) will be liable to pay service tax of up to 14 per cent (plus any additional cess or surcharge).²⁵ If the franchisor is based outside India, the franchisee will be legally obliged to pay service tax to the Indian tax authorities. Furthermore, depending on the terms of the franchise agreement, additional taxes such as customs duty may be levied on goods imported by the franchisee from the franchisor.

iii Tax-efficient structures

International franchisors often route their investment or contractual arrangements in India through entities based in tax-efficient jurisdictions.

VI IMPACT OF GENERAL LAW

i Good faith

Except in the context of fiduciary relationships, Indian law does not imply an overarching duty of good faith into contractual arrangements. Parties may, however, contractually agree a duty to act in good faith. Having said that, in the event of a dispute, even in the absence of any contractual understanding regarding good faith, courts will consider conduct of the parties in granting relief and the equitable principle that a party cannot take advantage of its wrongdoing may be considered by the court in granting relief.

ii Agency

The Contract Act deals with contracts of agency. An agency arises if a person is employed to undertake acts for another person or to represent that person. Franchise agreements will normally be drafted to clarify that the parties do not intend to create a principal-agent relationship. If an agency relationship is taken to exist, the provisions of the Contract Act that deal with such relationships would apply, including the principal being liable for acts of the agent in certain circumstances, such as tortious acts. There could also be tax consequences for the franchisor if the agent is considered to constitute a permanent establishment of the franchisor in India.

In instances of sub-franchising, the sharing of liability between parties would be governed by the contractual agreements between them.

iii Employment law

It is unlikely that the franchisee would be treated as an employee of the franchisor under Indian employment laws, as often the franchisee would be a corporate entity rather than an

24 DTAAAs, www.incometaxindia.gov.in/Pages/international-taxation/dtaa.aspx.

25 Section 65 (105) (zze) of the Finance Act, 1994 (as amended), available at www.cbec.gov.in/resources//htdocs-servicetax/st-act-ason24oct2013.pdf;jsessionid=8F8F39FCC88A9540B9FCC13A022F4B92 (last visited on 18 November 2015).

individual. It would be advisable to incorporate clear drafting in the franchising agreement demarcating responsibilities with respect to franchisee employees, and their salary and benefits. There are a plethora of employment laws in India, which cover aspects such as wages, payment of benefits, gratuity and leave. Companies formed in India are bound by these laws, and additional regulations depending on individual states may also apply.

iv Consumer protection

The Consumer Protection Act 1986 deals with the rights of consumers. While consumers can seek relief under this legislation for deficiency in goods or services supplied to them, by definition an entity that purchases goods, hires or avails of services for resale or commercial purposes is excluded from the definition of a consumer. Accordingly, a franchisee may not be able to pursue actions against a franchisor under this legislation, unless a more expansive view of the definition of 'consumer' is adopted by the courts.

v Competition Act and restrictive covenants

The Competition Act 2002 deals with anticompetitive agreements and arrangements that constitute an abuse of a dominant position. Broadly speaking, anticompetitive agreements, such as exclusive distribution agreements are void if they cause or are likely to cause an appreciable adverse effect on competition within India, although there are exceptions that entitle a person to restrain infringement of or impose reasonable conditions to protect rights conferred on it under the Trademarks Act and other specified statutes protecting IP. If the Competition Commission determines that a party is abusing its dominant position, based on the criteria specified in the Competition Act 2002, civil penalties may be levied.

Non-compete covenants that apply during the term of a contract would normally be enforced. Clauses in franchise agreements restraining a franchisee from carrying out competing business may be treated as reasonable by the Indian courts and historically have been held enforceable.²⁶

The Contract Act generally provides that except in limited circumstances contracts in restraint of trade that operate after termination of the contract are void. Having said that, it is not unusual for franchise agreements to contain post-termination non-compete arrangements, while recognising that there may be limits on their enforceability. Non-solicitation obligations restricting a party from poaching employees of another party that apply during or after the term of a contract are generally enforceable.

vi Anti-corruption

Several statutes in India deal with fraud, anti-corruption and money laundering matters. In general, the Prevention of Corruption Act 1988 penalises corruption by public officials and both the public official as well as the giver of a bribe are potential offenders. It is important to note that there are no exceptions for speed money or facilitation payments under the Prevention of Corruption Act 1988. The Prevention of Money Laundering Act 2002 seeks to prevent money laundering, including laundering of property derived from corruption.

In addition to Indian laws, the US Foreign Corrupt Practices Act 1977 and the UK Bribery Act 2010 may also be relevant to the Indian operations, given their wide scope of operation. Recently, anti-corruption allegations seem to have been more robustly investigated

²⁶ *Gujarat Bottling Company Limited v. Coca-Cola Company*, AIR (1995) Supreme Court 237.

and some convictions of high-profile people have occurred. A more transparent environment and rigorous enforcement of corporate governance and anti-corruption legislation is a positive development.

vii Dispute resolution

Since litigants face backlogs and delays in the Indian court system, it is usual for commercial contracts to provide for disputes to be settled by arbitration in India or outside India; for example, through the London Court of International Arbitration or the Singapore Court of International Arbitration.

The Arbitration and Conciliation Act 1996 (the Arbitration Act) is the Indian legislation relating to arbitration. The Arbitration Act is divided into several parts. Part I of the Arbitration Act deals with various stages of arbitration proceedings such as initiation and conduct of arbitration and enforcement, and challenge of arbitral awards. Part II of the Arbitration Act deals with enforcement of foreign arbitral awards (being awards delivered in foreign-seated arbitration proceedings) pursuant to either the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards 1958 (the New York Convention) or the Geneva Convention on the Execution of Foreign Arbitral Awards 1927 (the Geneva Convention).

In relation to arbitration to which Part I of the Arbitration Act applies, Indian courts can grant interim measures, such as injunctions, before, during or after the making of an arbitral award but prior to enforcement of the arbitral award. An equivalent provision is missing from Part II of the Arbitration Act.

In a significant judgment²⁷ handed down by the Supreme Court of India (India's highest appellate court) in September 2012 (the *Balco* decision), the Court ruled that:

- a Part I of the Arbitration Act does not apply to arbitration proceedings seated outside India;
- b the Arbitration Act does not confer jurisdiction on Indian courts to annul foreign arbitral awards. This approach according to the Supreme Court is consistent with the New York Convention;
- c if the seat of arbitration is outside India, Indian courts are not empowered to grant interim relief. The court specifically observed that parties that choose to have the seat of their arbitration outside India are 'impliedly understood to have chosen the necessary incidents and consequences of such choice'; and
- d if the seat of arbitration is outside India, pending conclusion of the arbitration proceeding, parties cannot file a suit in India for interim relief, even if the suit is limited to restraining a party from disposing of assets in India.

This judgment overrules a previous judgment of the Supreme Court in the case of *Bhatia International v. Bulk Trading*, wherein it was held that Part I of the Arbitration Act applied to all arbitration, whether seated in or outside India, unless the parties expressly or impliedly agreed to exclude application of Part I of the Arbitration Act. The intention was to enable parties to seek interim relief from Indian courts in foreign-seated arbitration, which would not otherwise be available under the Arbitration Act. However, this resulted in parties approaching Indian courts to apply other provisions of Part I of the Arbitration Act to arbitration seated outside India, so that Indian courts were entertaining proceedings relating

27 *Bharat Aluminium Co v. Kaiser Aluminium Technical Services Inc*, Civil Appeal No. 7019 of 2005.

to the appointment of arbitrators and the setting aside of arbitral awards. This overarching application of Part I of the Arbitration Act not only resulted in increased judicial intervention in arbitral proceedings as a result of an expansive interpretation adopted by Indian courts as to the grounds on which arbitral awards may be challenged on public policy grounds, but also delayed the progress of the arbitration proceedings, resulting in widespread criticism of the Indian approach.

Through the *Balco* case and another recent decision,²⁸ the Supreme Court sought to establish a pro-arbitration trend as it sought to narrow the ability of Indian courts to interfere in foreign-seated arbitration and the public policy grounds on which foreign arbitral awards may be refused enforcement.²⁹

The Arbitration Act has been amended by the Arbitration and Conciliation (Amendment) Act, 2015 (the Amendment Act).³⁰ Some of the key amendments are outlined below:

- a Indian courts can grant interim relief and assist in collection of evidence in relation to commercial arbitrations seated outside India where at least one of the parties is not resident in, incorporated in or centrally managed and controlled in India. The *Balco* decision had created a position where Indian courts could not grant interim relief in support of foreign-seated arbitrations. This position has now been reversed by the Amendment Act.
- b The Amendment Act seeks to further define the 'public policy' ground for setting aside an arbitral award, a term that has previously been interpreted expansively by Indian courts. The Amendment Act states that this ground will only be applicable where (1) an award has been obtained by fraud or corruption; (2) an award contravenes the fundamental policy of Indian law; or (3) an award is in conflict with the most basic notions of morality or justice. Further 'patent illegality' has been recognised as a ground for setting aside arbitral awards only in domestic arbitrations and it has been clarified that an award should not be set aside merely on the ground of an erroneous application of the law or by re-appreciation of evidence.
- c Given that arbitration in India was fraught with delays, the Amendment Act imposes a 12-month time limit for arbitration awards to be handed down. This time frame can be extended by six months with the consent of the parties. If the award is not made within this period, the mandate of the arbitrators automatically terminates and any extension can only be granted by courts upon sufficient cause being shown and subject to terms imposed by the court. There are also financial incentives in terms of arbitrator fees for awards being handed down within six months and penalties for delays in handing down awards.
- d Parties can also choose a fast-track procedure for completing arbitration within six months using a sole arbitrator.

28 *Shri Lal Mahal Ltd v. Progetto Grano Spa* (2014) 2 SCC 433.

29 The decision in *Bhatia International* was followed by courts in India on numerous occasions and also led to parties agreeing to exclude application of Part I of the Act in foreign-seated arbitrations by contract. In the Supreme Court's view in the *Balco* case, to complete justice, the law declared by the *Balco* decision applies only to arbitration agreements executed after 6 September 2012 (the date of the *Balco* decision).

30 See <http://taxguru.in/wp-content/uploads/2016/01/Arbitration.pdf> (last visited on 6 January 2016).

Pursuant to the Commercial Courts, Commercial Division and Commercial Appellate Division of High Courts Act, 2015,³¹ separate commercial courts at the district level and a commercial division of High Courts at the appellate level are being established to decide on commercial disputes of a specified value (currently 10 million rupees), including applications or appeals arising out of domestic or international commercial arbitrations. Importantly, the definition of commercial disputes includes disputes arising out of franchising agreements, distribution and licensing agreements.

While the enactment of these laws is promising, their actual impact on the dispute resolution process, including timelines for resolving disputes, in India remains to be seen. Until further clarity is available, it is recommended that franchisors choose to settle disputes by arbitration outside India over submission to jurisdiction of Indian courts.

VII CURRENT DEVELOPMENTS

Since taking office in May 2014, the government, led by Prime Minister Narendra Modi, has been key to boosting investment into India by providing responsive fiscal policies, improving the ease of doing business, rationalising the FDI policy and enhancing the economic and political climate. These reforms are visibly producing positive results: during the period January 2016 to September 2016, FDI inflow saw a growth of 28 per cent compared with the same period in 2015, and India has improved its ranking in the World Bank's ease-of-doing-business rankings from 134th in 2015 to 130th in 2016.³²

On 11 November 2016, the government demonetised high-value currency notes with a view to tackling issues of black money in the cash economy. Recent data suggest that the demonetisation decision has resulted in a fall in consumer demand following cash availability constraints. Opinion is divided on the impact this move may have on the economy, although there is an expectation that economic demand will slow down for a few months until the situation normalises.

Notwithstanding the limitations surrounding FDI in multi-brand retail and the demonetisation move, we believe that there are significant opportunities for international companies looking to establish a presence in India through the franchising model.

31 For text of the Act see <http://egazette.nic.in/WriteReadData/2016/167379.pdf> (last visited on 6 January 2016).

32 See http://dipp.nic.in/English/Publications/FDI_Statistics/2016/FDI_FactSheet_April_Sep_2016.pdf (last visited on 19 December 2016), and www.doingbusiness.org/data/exploreconomies/india/ (last visited on 19 December 2016).

INDONESIA

Risti Wulansari¹

I INTRODUCTION

The franchising structure was first seen in Indonesia in the late 1970s with the entry into the market of fast-food restaurant chains. Many local businesses have adopted this practice by bringing in a name or brand that is famous or well-known within a certain business line. Franchising thus also seems to be an option for many foreign principals seeking to expand their business into the Indonesian market. Until the late 1990s, the franchising concept in Indonesia was dominated by foreign franchises (mainly fast-food chain retailers), although two local fast-food chains have survived in competition with these foreign franchises.²

The rapid growth of the franchising concept led the Indonesian government to enact legislation to regulate franchising for the first time in 1997. Prior to 1997, franchising schemes were treated as general agreements, falling within the scope of the provisions of Indonesian civil law. It was only after the issuance of this legislation in 1997 (comprising a government regulation and a ministerial decree) that franchising began to be recognised and registration became obligatory. Since 1997, more than 200 franchisees of foreign franchisors have registered at the Ministry of Trade and Industry.³

The rising value of the US dollar in the 1990s and then the 1997 Asian financial crisis badly affected local franchisees, leaving them unable to meet their obligations to pay royalties and franchise fees (as these are normally paid in foreign currency). Consequently, from 1998 to 2000, the growth rate of foreign franchises in Indonesia fell significantly (by as much as 86 per cent).⁴ It took until 2007 for the number of local franchises to surpass 13,000 outlets⁵ and to outnumber foreign franchises,⁶ but the development of local franchises remains rapid today.

The first association for franchise business holders, the Indonesian Franchise Association (AFI), was established in 1991. Before the AFI was established, coordination was achieved through the Ministry of Trade and Industry, the International Labour Organization and the Management Education and Development Institution.⁷ Following the establishment of the

1 Risti Wulansari is a partner at K&K Advocates.

2 Lukman Hakim, *Info Lengkap Waralaba [Detailed Information on Franchising]*, MedPress, Yogyakarta, 2008, p. 41.

3 Indonesian Franchise Association, *SWA Magazine Edition*, No. 09/XXVIII/26 April–9 May 2007.

4 Lukman Hakim, *op. cit.*, p. 42. Whereas local franchises grew by 40.2 per cent in the same period (see Lukman Hakim, *loc. cit.*)

5 Indonesian Franchise Association, *op. cit.*

6 Indonesian Franchise Association, *SWA Magazine Edition*, 26 July 2009, Jakarta, p. 29.

7 <http://panduanfranchise.wordpress.com/2012/10/19/peran-asosiasi-franchise-indonesia-afi/>.

AFI, the Association of Indonesian Business Actors for Franchising (APWINDO), and the Indonesian Franchising and Licensing Society (WALI) were also established. At present, the AFI remains Indonesia's largest franchising association.

II MARKET ENTRY

i Restrictions

There are currently no restrictions on foreign franchises granting franchising rights to local companies in Indonesia. With regard to the franchising schemes themselves, there are some restrictions on carrying out business under a franchising scheme in accordance with the current Ministry of Trade regulations for franchising.⁸ The idea of having restrictive policies derives from the main objective of protecting local, traditional and small and medium-sized enterprises and businesses, and these restrictions apply to both franchisor and franchisee.

The main effect of these restrictions is the '80 per cent obligation' – a requirement to use local products or services as raw materials – and this may be considered a market barrier to foreign investors if their franchise activities cannot comply with this obligation. An exemption is possible under the regulations, but this requires a separate application, which is subject to further examination by an independent team appointed by the Minister of Trade.

There is also a requirement for the franchisor to appoint a franchisee over whom it has direct or indirect control. Given this, it is not possible for a franchisor to own equity in its franchise activities in Indonesia. In addition, Indonesian land regulation also prohibits a foreign entity or person from owning land (i.e., rights of ownership or freehold). The only land title that can be used by a foreign entity or person is the right of use.

Interestingly, the other main barrier to entering the local market results from trademark protection in Indonesia. In many cases, the principals (foreign franchisors) have been unable to enter the Indonesian market because they had not secured protection of their trademark and, surprisingly, another party (usually a local party) already held the registration. In practice, in many cases, the franchisor may have to choose either to undergo an exhausting litigation process in court or to 'buy' the trademark from the local party.

ii Foreign exchange and rates

The Indonesian Currency Law (issued by the Ministry of Finance) requires the use of rupiahs for transactions conducted in Indonesia, subject to certain exemptions. The obligation to use the rupiah aims to uphold Indonesia's sovereignty, as well as to support macroeconomic stability. However, as the policy initiator, Bank Indonesia provides space to request an exemption for those business actors who object to using the rupiah. The use of foreign currency is still possible for certain activities in strategic infrastructure projects, such as system adjustment, bookkeeping, business strategy, evaluation of business processes and corporate finance.

Furthermore, agreements made before 1 July 2015 may still fulfil the obligation to use a foreign currency denomination up to the termination of the agreement, as long as there are no changes relating to the parties in the agreement, the price of goods or services, or the object of the agreement, or a combination of these.

8 Note that the name for the Ministry of Trade and Industry has now changed to the Ministry of Trade.

III INTELLECTUAL PROPERTY

i Brand search

Under the laws of Indonesia, protection of intellectual property (IP) rights, except for copyright, is obtained by way of registration (under the first-to-file principle). In a franchising structure, trademark, patent and copyright (and know-how) serve as the key elements of IP that require serious attention by the franchisor as regards protection and maintenance.

Of rights in a franchise concept that can be registered, trademarking is the first priority, primarily because the brand helps customers to first identify the relevant franchise business. Taking this into consideration, clearance trademark searches are essential for the franchisor (especially for foreign companies) prior to entering into a franchising agreement with a local party in Indonesia. This ensures that no party has filed for the same trademark. Also, because of the requirements of the franchising legal regime, the franchisor must hold the necessary trademark registrations (or at least have submitted an application to register a trademark) to carry out franchising activities and to obtain further registration with the Ministry of Trade.

A clearance trademark search can be carried out both formally or informally with the Directorate of Trademark and Geographical Indications, at the Directorate General of Intellectual Property at the Ministry of Law and Human Rights (the Indonesian Trademark Office).

Formal searches can be carried out by addressing a formal letter to the Indonesian Trademark Office enquiring whether a specific trademark has been registered at that office. The drawback to carrying out a formal search is the uncertainty as to when the Indonesian Trademark Office will carry out or complete the search. In some cases, the interested party has to follow up its enquiry letter. In such cases, an informal search is a preferable option.

Informal searches can be done by checking the online database of the Indonesian Directorate General of Intellectual Property (DGIPR). The online database provided by the DGIPR now covers information on pending applications, published trademarks, registered trademarks and pending renewals. However, the downside of the current database is, at times, inaccurate data input by DGIPR officials, which usually results in the provision of inadequate information. With this in mind, further informal searches by IP firms can be carried out at the Indonesian Trademark Office through the official non-computerised databases (i.e., manual searches). Searches should also be carried out for both identical and similar trademarks and particularly for details of goods or services that constitute the franchisor's main business interest or are used in the franchise's activities.

Note that if a franchisor has not yet registered its trademarks and the searches reveal an existing identical or similar trademark, use of the trademark by the franchisor will potentially be an infringement. The available courses of action in this situation would be to file an opposition, cancellation or deletion claim against the pre-existing registration. The two latter actions should be filed with the Indonesian Commercial Court.

ii Brand protection

As described above, the basis of trademark protection in Indonesia is a first-to-file system. An application for trademark registration is filed by completing certain forms and documentation required by the Indonesian Trademark Office, or by online application through the electronic filing system (e-filing). Upon submission of an application form, the Indonesian Trademark Office will conduct an examination to check that the supporting documents and the

administrative requirements of the relevant application are complete. Theoretically, under Indonesian Trademark Law, the administrative examination must be completed within two months of the filing date of the application.

If the supporting documents are deemed complete, the Indonesian Trademark Office will publish the trademark application in the Official Trademark Gazette for a two-month period. If no opposition is filed by a third party within 30 days of the date of the expiry of the publication period, the trademark examiners will proceed to conduct a substantive examination of the application for a period of five months. If the examiners are of the view that the application is acceptable for registration, the Indonesian Trademark Office should issue a certificate of trademark registration within 30 days of the said publication.

Despite the timeline provided by the Indonesian Trademark Law, it is common for the process of trademark registration to prove lengthier as the number of trademark applications received by the Indonesian Trademark Office is higher than that for other IP registrations. This can cause trademark applications to take longer than expected.

It is important for the franchisor to ensure that all the descriptions of goods and services registered (or to be registered) under the franchisor's trademarks in Indonesia have sufficiently covered the line of services or products in which the franchise concept is being used. Specific advice is required from a qualified IP consultant to ascertain adequate information on this particular issue.

iii Licence recordation

Under Indonesian law, a franchise scheme qualifies as an IP licensing scheme, which allows the franchisee to legally exploit the other party's IP. The licensing covers most IP areas, from trademarks to patents, with any of these being available for licensing.

The licensing provisions vary among the IP regulations, with each of these having its own requirements, as well as provisions regarding the terms of engagement between licensor and licensee. However, licence agreements must be recorded at the DGIP to have legal effect in relation to third parties, as stipulated under the Minister of Law and Human Rights Regulation No. 8 of 2016 concerning the Procedure and Requirements of Intellectual Property Licensing Agreements.

iv Enforcement

Enforcement actions in franchising matters follow the same process as actions taken by third parties against independent rights holders. The most important point is to expressly determine in the franchise agreement which party holds the rights to carry out enforcement actions, including the relevant procedures, in the event of infringement.

Enforcement actions of IP rights in the franchise business may only be exercised if the relevant IP rights have been registered. As to copyright, while registration is not compulsory, the presence of a copyright registration serves as *prima facie* evidence for the court.

Enforcement of IP rights can be carried out through both civil and criminal routes. For enforcement against criminal infringement, the owner of the IP rights should file a criminal complaint with the Indonesian police, giving notice of the alleged infringement of trademark or IP rights. The Indonesian Trademark Regulations provide that a trademark infringer can be sentenced to imprisonment or fine.

A civil action (specifically for trademark cases) can be initiated by filing a civil claim with the Indonesian Commercial Court. The purpose of filing a civil claim under the Indonesian Trademark Law is to get the counterparty to pay damages to the owner of the registered trademark.

v Data protection, cybercrime and social media

While there is no official separation under the Indonesian legal framework, data protection is divided into two classifications, namely general data protection and personal data protection. Despite both having same purpose, general data protection applies to data on a bigger scale, such as corporate documents and general electronic information. On the other hand, the focus of personal data protection is mainly on data owned by the individual. As both types of data are deemed relevant and important for the franchisor and franchisee, an explanation of the laws affecting each type is provided below.

General data protection

Given the broad range of data falling within the scope of protection, in theory, general data protection is regulated by the following laws:

- a* Law No. 8 of 1997 on Company Documents (Law 8/1997);
- b* Law No. 11 of 2008 on Electronic Information and Transactions as amended by Law No. 19 of 2016 on Amendment to Law No. 11 of 2008 on Electronic Information and Transactions (Law 11/2008);
- c* Government Regulation No. 82 of 2012 on the Operation of Electronic Systems and Transactions (GR 82/2012); and
- d* Law No. 28 of 2014 on Copyright.

Protection granted under Law 8/1997

A franchisee falls under the classification of a company pursuant to Law 8/1997.⁹ Consequently, the franchisee's data may be classified as corporate documents¹⁰ and therefore subject to the provisions of Law 8/1997. This classification requires the franchisee as document owner to comply with retention requirements; for financial documents this is at least 10 years, while the retention period for valuable company documents other than financial documents¹¹ is dependent upon the value of the document for the company.

Law 8/1997 further stipulates that any transfer, assignment and obliteration of documents shall be at the discretion of the head of the company.

9 Article 1 Paragraph 1 of Law 8/1997 defines a 'company' as any form of business that undertakes activities permanently and continuously with a view to making profits, and that is operated by an individual, or a business company in the form of a statutory body or otherwise, established and domiciled in the territory of the Republic of Indonesia.

10 Article 1 Paragraph 2 of Law 8/1997 defines a 'corporate document' as any data, note or information made or received by a company in the framework of implementing its activities, either written on paper or on other materials or recorded in whatever form can be seen, read or heard.

11 Article 7 Paragraph 1 defines 'financial data' as administrative data related to finance and used as supporting material for the arrangement and drawing up of financial documents.

Protection granted under Law 11/2008 and GR 82/2012

Given the possibility of data being electronic information,¹² data owned or collected by a franchisee may be subject to data protection requirements under Law 11/2008 and GR 82/2012.

Protection granted under Law 28/2014

Under Article 40 Paragraph 1(p) data is protected as a form of copyrighted creation. Data may obtain protection through being declared a creation of the data owner. Where data is protected under the copyright regime, the data owner is entitled to protecting its data by filing a criminal report of copyright infringement, as stipulated under Article 113 of Law 28/2014. The data owner seeking material compensation is also further entitled to file a copyright lawsuit against the infringer.

Personal data protection

In general, the matter of personal data protection is regulated by Law 11/2008, GR 82/2012 and MCI¹³ Regulation No. 20 of 2016 concerning Personal Data Protection in Electronic Systems (MCI 20/2016) (collectively the Data Protection Regulations).

While there is no specific provision regulating data protection, the Data Protection Regulations may treat the franchisee as an electronic system of organisation (ESO). The franchisee is granted recognition as an ESO because of the possibility of it carrying out personal data processing¹⁴ activities. Consequently, franchisees are subject to the Data Protection Regulations.

Obligations for ESOs

Under MCI 20/2016, any franchisee regarded as an ESO is required to comply with the following obligations.

Personal data obligations

Article 28 of MCI 20/2016 stipulates that ESOs shall ensure the validity, legality, confidentiality, integrity, relevancy and appropriateness of the data for the purpose of the data collection, processing, analysis, storage, publication, announcement, transfer, distribution and obliteration. The ESO should also ensure the security and protection of personal data by enacting internal policies in accordance with the law.

Obligations for data owner

Article 28 of MCI 20/2016 requires ESOs to provide data owners with the following:

- a* audit track record of any electronic systems operated by the ESO;
- b* access or opportunity to update or amend the personal data owned by the data owner;

12 Article 1 Paragraph 1 of Law 11/2008 defines 'electronic information' as one piece or a compilation of electronic data, including but not limited to writings, voices, drawings, maps, plans, photographs and electronic data interchange documents.

13 Ministry of Communications and Informatics.

14 There is no specific provision defining 'processing'. However, Article 3 of MCI 20/2016 stipulates that personal data should be protected during the processes of (1) collection or obtaining; (2) analysis or processing; (3) storage; (4) display, announcement, transfer, distribution or disclosure; and (5) obliteration.

- c the option to allow or to forbid the personal data of the data owner to be published, distributed, disclosed or utilised, or a combination of these, by a third party; and
- d the right to have the personal data obliterated upon request by the data owner.

Consent obtaining requirement

Pursuant to Article 15 of GR 82/2012 in conjunction with Article 6 of MCI 20/2016, the consent of the data owner is required for any collection of personal data. Upon obtaining the consent of the data owner, the ESO is also required to inform the data owner of the purpose of the data collection. The purpose of the data collection serves as the limitation of the ESO in processing the personal data. When obtaining consent, the ESO may only obtain the consent of the personal data owner by means of an Indonesian-language consent form.

Data breach notification

Article 28 Paragraph (c) of MCI 20/2016 specifically requires the ESO to provide written or electronic notification to personal data owners in the event of a breach of personal data. This notification shall relate the cause of the breach and be provided to the data owner within 14 days of the discovery of the breach at the latest.

Contact person obligation

Article 28 Paragraph (d) of MCI 20/2016 stipulates that the ESO is required to provide a contact person who is accessible to data owners. The contact person shall be made accessible to data owners to facilitate the management of individuals' personal data.

Data localisation

Indonesian legislation prohibits the storage of personal data outside Indonesia and specifically requires data centres to be located in Indonesia, especially in the case of public service electronic system providers. This requirement particularly applies to personal data pertaining to Indonesian nationals and data on transactions conducted within the Indonesian jurisdiction or relating to Indonesian nationals.

Transfer of personal data

Article 22 of MCI 20/2016 requires that the transfer of personal data must be coordinated with the MCI. In practice, this 'coordination' is carried out by submitting a personal data transfer implementation plan (the Transfer Plan) and report (the Transfer Report) to the MCI, as well as requesting advocacy from the MCI where necessary. The Transfer Plan must contain at least the following information: the country of the data recipient, the full name of the data recipient, the date of the transfer implementation and the background to or purpose of the transfer. Upon completion of the transfer, the ESO is required to provide a Transfer Report to the MCI, containing the result of the Transfer Plan implementation. Given that an unauthorised transfer of personal data may constitute unauthorised distribution or disclosure of personal data, which is subject to criminal punishment as stipulated under Law 11/2008, the ESO must ensure that it has obtained the consent of the data owners prior to transferring personal data.

Penalties for non-compliance

In Indonesia, the penalties for non-compliance with the law are found in the Data Protection Regulations. These take the form of administrative sanctions, fines and imprisonment. Imprisonment may be imposed for severe breaches and intentional infringement.

The applicable sanctions are as follows:

- a* Under Article 48 in conjunction with Article 32 Paragraph 2 of Law 11/2008, a maximum of nine years' imprisonment or a maximum fine of 3 billion rupiahs, or both, may be imposed on any person who knowingly and without authority, or unlawfully, accesses computers or electronic systems in any manner whatsoever with the intent to obtain electronic information or electronic records.
- b* Failure of an ESO to comply with GR 82/2012 and MCI 20/2016 would be subject to administrative sanctions (which do not eliminate any civil and criminal liability as provided under Article 84 Paragraph 6 of GR 82/2012). The relevant administrative sanctions are in the forms of:
 - a written or verbal warning;
 - administrative fines;
 - temporary suspension of current activities;
 - public online announcement; and
 - expulsion from the list of registrations (as required under the GR 82/2012). This sanction relates to the obligation to obtain an electronic certificate, a certificate of reliability and a licence for the information system by registering the electronic systems operator or electronic agent operator with the MCI.

Cybercrime

As to cybercrime and social media, the Indonesian government has not yet passed any specific regulations, and general provisions under existing regulations apply to the extent possible and on a case-by-case basis. Although there is no specific provision regarding standard-setting or requirements for the protection of electronic information, Law 11/2008 is the most relevant of the existing regulations pertaining to cybersecurity, and it determines the following actions to be violations that may constitute cybercrime. Law 11/2008 prohibits any unauthorised action of adding, decreasing, transmitting, damaging, eliminating, obliterating, removing, transferring or hiding of electronic information or documents. Violations of these prohibitions may be subject to penalties of up to nine years' imprisonment or a fine of up to 3 billion rupiahs, or a combination of these.

Franchisors and franchisees should therefore consider having the proper terms of use, licence agreements and manuals or guidelines in place to ensure compliance with the prevailing legislation with respect to the use of data.

IV FRANCHISE LAW

i Legislation

The Indonesian regulatory framework on franchising comprises the following regulations:

- a* Government Regulation No. 42 of 2007 concerning Franchising;
- b* Minister of Trade Regulation No. 53/M-DAG/PER/8/2012 on the Implementation of Franchises as amended by Minister of Trade Regulation No. 57/M-DAG/PER/9/2014 concerning Amendment to Minister of Trade Regulation No. 53/M-DAG/PER/8/2012 on the Implementation of Franchises;

- c* Minister of Trade Regulation No. 68/M-DAG/PER/10/2012 concerning Franchising for Modern Store;
- d* Minister of Trade Regulation No. 60/M-DAG/PER/9/2013 concerning Obligations on the Use of a Franchise Logo;
- e* Minister of Trade Regulation No. 58/M-DAG/PER/9/2014 concerning Partnership Development in Franchising for Food and Beverage Services; and
- f* Decision of the Director General of Domestic Trade No. 16/PDN/KEP/3/2014 concerning Technical Guidelines for Franchise Implementation and Monitoring.

In addition to these regulations, there are also regulations concerning applicable registration procedures for franchise businesses under Ministry of Trade Regulation No. 85 of 2016 concerning Integrated Trade Services (MoT 85/2016) and Ministry of Trade Regulation No. 86 of 2016 concerning Online Licensing Services Provisions and Digital Signature (MoT 86/2016).

The Indonesian franchising regulations set out the main criteria for a business concept to be considered a franchise arrangement. Those criteria are as follows:

- a* The franchise has certain business characteristics that could differentiate it from other similar businesses.
- b* The franchise has been proven to be profitable.
- c* The franchisor has a written standard operating procedure relating to the goods or services involved in the franchise business.
- d* The method for carrying on the business is easy to teach and apply.
- e* The franchisor is in a position to provide continuous assistance to the franchisee.
- f* The business involves certain IP rights that have been registered or filed for registration in Indonesia.

The following requirements are also specifically provided under the current Indonesian franchise regulations:

- a* The franchise arrangement must take the form of a written agreement between the franchisor and the franchisee.
- b* The franchise agreement is governed by the laws of Indonesia.
- c* The franchise agreement must be in or translated into the Indonesian language by a sworn translator for registration purposes with the Ministry of Trade.
- d* A franchisor cannot appoint a franchisee that has a control relationship with the franchisor, either directly or indirectly.
- e* The franchisor is obliged to provide development assistance to the franchisee in the form of training and assistance in management, marketing and research and development.
- f* Prior to signing the franchise agreement, a franchisor must provide a contractual disclosure document called a 'franchise offering prospectus' to the proposed franchisee at least two weeks before the signing of the agreement.
- g* Once executed, the franchise agreement must be registered by the franchisee with the Ministry of Trade.
- h* Both franchisor and franchisee are obliged to use raw materials, industrial or business equipment and to sell traded goods of which at least 80 per cent must be local products or services. An exemption may be granted by the Minister of Trade in relation to the 80 per cent requirement upon a separate written formal application and by virtue of a recommendation rendered by an assessment team established by the Minister of Trade.

- i* Both franchisor and franchisee may only carry out franchise activities as covered under their business permits or licences. They may sell supporting goods related to their main business, but this is limited to a maximum of 10 per cent of the total amount of all goods sold.

The franchisor is also obliged by law to provide development assistance to the franchisee in the form of training and assistance in management, marketing, research and development.

Further, the Indonesian franchising regulations provide that the parties should prioritise the use of domestic goods or services to the extent that such goods or services meet the quality standards stipulated in writing by the franchisor. Cooperation with local small or medium-sized businesses or local distributors, provided that the latter satisfy the franchisor's requirements, should also be prioritised.

ii Recent changes

In 2016, The Ministry of Trade (MoT) introduced a new online system for franchise registration. The system was launched by virtue of the Ministry of Trade Regulation No. 85 of 2016 concerning Integrated Trade Services (MoT 85/2016) and Ministry of Trade Regulation No. 86 of 2016 concerning Online Licensing Services Provisions and Digital Signature (MoT 86/2016). This new system supersedes all manual submissions for franchise registration certificates (STPW), including new applications, amendments and extensions.

Unlike the previous scheme, where a franchise offering prospectus had to be registered prior to obtaining an STPW, the current regulations allow foreign franchisors to apply for prospectus registration and an STPW simultaneously. This system is also provided for franchisees obtaining an STPW following the execution of a franchise agreement.

Through this new system, called the integrated licensing information system (SIPT), franchisors or franchisees must submit all their STPW-related applications online and are no longer required to submit the original documents to the MoT. However, in certain cases where the online system is not working, the application can still be submitted manually.

iii Pre-contractual disclosure

The Indonesian franchising regulations stipulate that the franchisor has an obligation to prepare and convey to the appointed franchisee the franchise offering prospectus, which will subsequently have to be registered with the MoT.

Since the implementation of the SIPT, the following requirements or stages must be completed before entering a franchise agreement:

- a* The franchisor must register the franchise offering prospectus with the MoT and obtain an STPW.
- b* Once the franchisor has obtained the STPW, it will be required to provide the franchise offering prospectus to the proposed franchisee at least two weeks before signing the franchise agreement.
- c* A draft franchise agreement containing the standard clauses as provided under the Indonesian franchise regulations must be prepared.

iv Registration

As stated above, the franchisor is required to prepare and convey to the franchisee the franchise offering prospectus, which will subsequently have to be registered with the MoT. However, there is a change of procedure for franchise registration under the new online system, the

SIPT. Now the franchisor or franchisee must first sign up with the SIPT to obtain a username and a password. After obtaining these, the applicant should be able to log in to the system and start filling out the online registration form and uploading all the required documents.

The required documents are set out in the online system after the applicant logs in, and include, among others:

- a* the franchise offering prospectus, containing at least the information on the identity of the franchisor, the franchisor's business licence as registered in the franchisor's country of origin, a brief history of the franchisor's business (outlining information on the establishment of the business, the business activities and business development), the franchisor's organisational structure, the franchisor's financial reports for the past two years audited by a public accountant, information concerning the number of outlets owned by the franchisor, a list of the franchisor's appointed franchisees (names and addresses), and the rights and obligations of the franchisor and the franchisee;
- b* the master franchise agreement, owned by franchisor and containing the mandatory agreement clauses as stipulated by law (see Section IV.v, below);
- c* business registration;
- d* IP registration;
- e* ID card of the owner or the responsible person in the company;
- f* employment composition; and
- g* material composition of franchise goods.

Once all requirements have been met, the MoT will issue either an STPW, for a correct and complete submission, or a rejection containing information on the aspects of the submission that require correction. The STPW is automatically generated on the system website, where the digital signature of the authorised representative is shown.

As previously mentioned, under the Indonesian franchising regulations, the obligation to register to obtain an STPW rests on both the franchisor and the franchisee. The STPW will be valid for five years and is renewable upon written application.

Both parties should also submit an annual report to the Ministry of Trade to report on, *inter alia*, the development of the franchise business.

v Mandatory clauses

The Indonesian franchising regulations provide that a franchise agreement must contain at least the following clauses:

- a* the name and address of each party;
- b* the type of IP involved in the franchise;
- c* the type of the franchise business (e.g., restaurant, services, clothing and accessories);
- d* the parties' rights and obligations;
- e* assistance, facilities, operational guidance, training and marketing that will be provided by the franchisor to the franchisee;
- f* the area of business;
- g* the period of agreement;
- h* the method of compensation (to the franchisor);
- i* the ownership, change of ownership and the rights of any successor or heir;
- j* dispute resolution method;
- k* procedures relating to expiry, extension and termination of the agreement; and

- l* warranties from the franchisor that it will perform its obligations in accordance with the agreement until it expires.

The franchise agreement may also contain a clause stipulating the granting of rights for the franchisee to appoint a sub-franchisee in Indonesia, in which case, the main franchisee must own and operate at least one franchise branch.

Foreign franchisors should bear in mind that it is compulsory to use Indonesian law as the governing law of the franchise agreement and it is important to adhere to the legal formalities in respect of the agreement.

vi Guarantees and protection

As to these particular elements, the Indonesian franchise regulations do not yet deal specifically with guarantees and protection. Note should be taken that the general principle of agreement under the Indonesian Civil Code provides a freedom to contract in construing or entering into an agreement. Under this principle, as long as the requirements of a valid contract are satisfied, the parties are free to determine the terms of their contract, including any additional clauses on guarantees and protection as agreed by the parties. This freedom is limited by statute, good morals and customs.

V TAX

i Franchisor tax liabilities

Tax liabilities arise in relation to any income derived within the country. For a franchisor, this would include income arising from royalties, dividends or profits.

Apart from income taxes, franchisors may also be subject to other general tax liabilities, such as stamp duties arising from the execution of the franchise agreement and applicable sales and VAT, and including tax requirements that apply differently to foreign (or foreign-owned) franchisors and domestic franchisor companies.

ii Franchisee tax liabilities

Like franchisors, franchisees are required to pay tax on taxable income. Apart from income tax, the franchisee may also be subject to other general tax liabilities such as those arising from applicable sales and VAT.

iii Tax-efficient structures

Indonesia does not currently have a tax-efficient structure solely for or particularly suited to franchisors or franchisees. It does, however, have more than 60 tax treaties in place, under which the rate of withholding tax on royalties is lower than that stipulated under domestic law.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

As a general principle in Indonesian civil law, any agreement made between parties should be executed in good faith. If a party fails to exercise an agreement in good faith, the counterparty may opt to file a civil claim in the Indonesian civil court. The grounds for filing a civil claim may be breach of contract or tort, and the plaintiff may request completion of the agreement

and settlement of a claim for damages. Note should be taken that in filing a civil claim in the Indonesian courts, the plaintiff must be able to prove that the defendant is in fact acting in bad faith in exercising the agreement.

ii Agency distributor model

In Indonesia, a franchise arrangement is not treated as a principal and agent or distributor relationship – a different set of regulations apply under the agency or distributorship-specific regulations. Once all the above-mentioned criteria of a franchising structure have been met, the provisions of the Indonesian franchise regulations will apply, regardless of the title of the agreement.

iii Employment law

In a franchisor–franchisee relationship under a valid franchise arrangement, the franchisee would not be regarded as an employee of the franchisor. Additionally, the franchise relationship itself does not fall under the Indonesian manpower regulation. Compliance of the franchisee with the current employment law regime would, of course, prevent any further complication in dealings between the franchisor and franchisee.

iv Consumer protection

Franchisees may not be treated as consumers under Indonesian consumer protection law, which defines consumers narrowly as end users.

v Competition law

Under the Anti-Monopolistic Practices and Unfair Business Competition Law, a specific exemption applies to agreements relating to franchises and intellectual property. However, the Business Competition Supervisory Commission has issued a further decree that, to a certain extent, is contrary to the exemption clause under the Anti-Monopolistic Practices and Unfair Business Competition Law. This decree provides that a franchise agreement that prohibits a franchisee from being engaged in a business activity similar to that of the franchise, for a period after the termination of the agreement, is not necessarily exempted from the Law but the agreement may stipulate such a period provided that the intention of the prohibition is to protect the franchisor's IP or its identity and reputation. The implementation of this decree is not yet clear and, in practice, businesses would usually adopt the exemption provided under the Law.

Furthermore, practice has developed such that non-compete provisions are included as an integral part of franchise agreements to specifically prohibit the franchisee from entering the same line of business using the same type of business model within a certain period upon the expiry or early termination of the franchise agreement. It has become common for such provisions to be included and agreed upon at the outset of the engagement process to ensure the proper interests and goodwill of the franchisor are being appropriately protected.

vi Restrictive covenants

Non-compete and other restrictive covenants may be subject to the Anti-Monopolistic Practices and Unfair Business Competition Law, as explained above.

vii Termination

Although the general principle of freedom of contract applies when entering into an agreement, the Indonesian franchising regulations provide that early termination of a franchise agreement does not become effective automatically. The regulations stipulate that following early termination of the agreement, the franchisor may not appoint a new franchisee for the same business unless the parties have reached a mutual settlement (called a 'clean break') or upon issuance of a final and binding court decision. Therefore, to avoid the necessity of court proceedings should an amicable solution with the franchisee not be reached, the franchisor should consider having a standard-format clean-break agreement or acknowledgement – to be signed by the franchisee – to supplement the franchise agreement so that the agreement may be terminated prior to expiry.

As explained above, it is not possible for the franchisor to take over the franchisee's business since there is a restriction on the franchisor having a direct relationship with its franchisee under Indonesian franchising law.

viii Language provision

Although it may seem a minor issue, the governing language of the franchise agreement is important. Given the requirement for Indonesian law to be the governing law in a franchise agreement, any provision stipulated under the agreement must be in compliance with Indonesian laws, including those relating to language. Following the enactment of the Law on Flag, Language, State Symbol and National Anthem, any documents being executed and performed in Indonesia, under Indonesian law, must be written in the Indonesian language. As vague as the provision may seem, it has, in fact, resulted in the cancellation of an agreement by verdict of an Indonesian district court.

This condition could, of course, endanger a franchise agreement executed by both franchisor and franchisee. From a practical point of view, therefore, for the purposes of clarity and compliance, it would be beneficial if an Indonesian-translation version of the franchise agreement were made available, thus preventing the possibility of the franchise agreement being deemed null and void by virtue of this point of law and providing security for the parties to the franchise agreement.

ix Anti-corruption and anti-terrorism regulation

In Indonesia, fraud, anti-corruption or money laundering regulations are not generally relevant to franchising arrangements. They would only be relevant if, in registering or obtaining certain licences from the Indonesian government (i.e., the Ministry of Trade), the franchisor or franchisee were to bribe officials at certain government agencies, which is clearly prohibited by anti-corruption law.

x Dispute resolution

There is no formal and dedicated procedure with regard to franchise dispute resolution in Indonesia under the current Indonesian franchising regulations, so the routes followed would be the same as those applicable for dispute resolution in relation to general contracts.

For foreign franchisors, only foreign arbitral awards are recognised and enforceable in Indonesia, and their enforcement is not automatic. Foreign arbitral awards can be enforced in Indonesia only after securing an execution order from the Head of the District Court of Central Jakarta. Note that foreign court judgments are not enforceable unless they are being

used as a evidence in a civil lawsuit instituted in an Indonesian domestic court. However, Indonesian law allows recognition and enforcement of foreign arbitral awards and Indonesian courts will accept and enforce foreign arbitral awards subject to certain qualifications. The District Court of Central Jakarta will decide whether the foreign arbitral award should be recognised and enforceable in Indonesia. If the Court recognises the award as enforceable, it will be final and binding. If the Court decides otherwise, the relevant party may appeal to the Supreme Court.

If the franchise agreement adopts the arbitration rules set by the Indonesian National Board of Arbitration (BANI) and chooses Indonesia as the arbitration venue, the enforcement and execution of an arbitral award may, as a result, be less complicated in the event of dispute. If the assets of the counterparty are situated in Indonesia, the choice of BANI rules and an Indonesian arbitration venue will certainly be preferable.

VII CURRENT DEVELOPMENTS

Franchising in Indonesia (for both foreign and domestic parties) is predicted to continue expanding. Franchising business schemes have become one of the win–win structures preferred by franchisors (with the objective of penetrating the huge Indonesian market) and by franchisees (with the objective of being able to implement a business venture without having to start the business process from scratch).

The Indonesian government has grown aware of the importance of safeguarding this particular business structure to ensure the flow of foreign investment into Indonesia. This can be seen from the government's active involvement in supervising the growth of domestic franchising, and in the efforts to enforce appropriately the provisions of the current franchising regulations. The government is also becoming more focused on implementing relevant policies, including those relating to domestic franchises, which have recently seen unexpectedly significant growth. The provisions concerning the obligation for foreign franchises to use local products or locally sourced products are also being actively promoted.

IRAN

*Shelley Nadler and Farid Kani*¹

I INTRODUCTION

Iran is the second-largest economy in the Middle East and North Africa region after Saudi Arabia, with gross domestic product (GDP) in 2016 of US\$431 billion.² It also has the second-largest population of the region after Egypt, with 78.8 million people in 2015.³ Official statistics indicate that over 47 per cent of the Iranian population is aged between 15 and 35.⁴

The retail market, though remaining underdeveloped, has recently been growing extensively. As a result of the transition from street shopping to modern shopping malls, the country is estimated to have around 16 million square metres of commercial property nationwide (mainly shopping malls).⁵ It is estimated that with an average income of US\$17,000 per head, Iranian consumers exercise more purchasing power than consumers in comparable developing countries such as India, Brazil, Egypt and China.⁶ It is generally acknowledged that there is high demand in the Iranian market for the presence of western brands and that Iranian consumers, particularly the growing young population, want more choice in areas such as fashion, retail and food and beverage concepts.

The retail market in Iran is also expanding through the emergence of e-commerce companies. Digikala, an online e-commerce platform, has become the biggest in the Middle East, with around 750,000 unique visitors per day and estimated to be worth US\$150 million as of May 2015.⁷

There is also potential for service industries in Iran, including a great deal of interest in children's development and well-being, for all ages, from toddlers to university students.

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- 1 Shelley Nadler is a legal director at Bird & Bird LLP and Farid Kani is a senior associate at Atieh Associates Law Firm.
 - 2 Iran overview, The World Bank (2016), available at www.worldbank.org/en/country/iran/overview; Iran GDP Forecast 2016–2020, Trading Economics (2016), available at www.tradingeconomics.com/iran/gdp/forecast.
 - 3 Ibid.
 - 4 Iran National Data Centre, Report of Year 1390 (2011), available at [http://iran.unfpa.org/Documents/Census2011/census-90-results\(3\).pdf](http://iran.unfpa.org/Documents/Census2011/census-90-results(3).pdf).
 - 5 'Tehran Teeming With Shopping Malls', *Financial Tribune* (2015), available at <https://financialtribune.com/articles/economy-business-and-markets/23543/tehran-teeming-with-shopping-malls>.
 - 6 'Luxury tempted Iran is a dream market for retail', *exportiamo.ir* (2016), available at www.exportiamo.it/aree-tematiche/12836/luxury-tempted-iran-is-a-dream-market-for-retail/.
 - 7 'From Digikala to Hamijoo: the Iranian startup revolution, phase two', *The Guardian* (2015), available at www.theguardian.com/technology/2015/may/31/amazon-iranian-style-digikala-other-startups-apat-hamijoo-takhfifan.

With an ageing population and poor local provision, there would also be demand for domiciliary care franchises that would train staff to provide care at a higher standard. Fitness and weight management is another area with potential in Iran, particularly for full-service gyms segregated at different times for men and women.

The lifting on 16 January 2016 of the economic and financial nuclear sanctions through the Joint Comprehensive Plan of Action allowed Iran to trade more freely globally, and this is highly expected to boost the consumer and retail market and provide essential opportunities for international franchisors to benefit from one of the largest emerging markets in the region.

It should be noted that US sanctions are still in place, as are some EU sanctions relating to a small number of Iranian banks and some individuals and organisations. It is recommended that due diligence is carried out for parties either directly or indirectly involved in a transaction before entering into any legally binding arrangement.

II MARKET ENTRY

i Restrictions

There are in principle no restrictions *per se* imposed on local or foreign franchisors wishing to operate a franchise business in the Iranian market. No prior approval by regulatory bodies is required before entering into a franchise agreement. Indeed, Iranian law adopts a fairly flexible approach towards franchise agreements. This authorises the parties to regulate their business freely in all sorts of franchise schemes, including setting up area development agreements or master franchise agreements, to the extent that mandatory provisions of the Iranian law are complied with. These mandatory provisions are generally enforced in the form of a requirement to obtain specific licences for a certain activity or in the form of payment of statutory taxes and duties.

Franchisors have the option to set up a business directly or enter into an arrangement with a local franchisee. In principle, there exists no legal restriction on shareholdings by foreign persons in companies established in Iran, and foreign persons may hold up to 100 per cent of the shares in an Iranian company without the need for Iranian participation, sponsorship, or any special formalities or licences such as are required in other jurisdictions.

Further, to the extent that the area of activity triggers a requirement for a special licence, including by way of example a licence from the Ministry of Health (MOH) in the case of import and sale of health-related products, or a licence from the Ministry of Industry Mine and Trade (MIMT) in the case of the sale of clothing, the licences, in the vast majority of cases, are required regardless of whether the franchisee's shareholders are of Iranian or foreign nationality. These licences must be obtained by any company trading in the specific sector whether they are franchising or not.

There are a number of corporate vehicles available to foreign entities and individuals investing or doing business in Iran. From a legal point of view, the foreign investor is free to choose from any type of entity permitted under the Iranian Commercial Code, or it may register a branch or representative office.

In practice, the most common vehicle used by foreign investors in Iran is the private joint stock company, followed by the limited liability company. These two types of entity have proven themselves to be the most suitable for the purposes of modern business. Once established, the company will be deemed of Iranian nationality irrespective of the percentage of the foreign shareholding.

There exists an additional restriction with respect to direct ownership of real property by foreign persons (i.e., individuals and legal entities). Such ownership is conditioned on the specific permission of the Iranian Council of Ministers and this is rarely granted. The restriction does not apply to registered Iranian entities (as described above) irrespective of the percentage of the foreign shareholding.

No restrictions on the rent of real property exist, whether in relation to a foreign company or a local entity owned fully or partly by a local company.

ii Tax and Foreign exchange

The Iranian Direct Taxation Code applies tax liability to foreign persons (individuals and entities) deriving Iran sourced income from payments of royalties by Iranian entities. Therefore, to the extent that foreign investors enter into a franchise agreement with a local entity (even those fully owned by the foreign company) and royalties are charged, the liability for payment of royalty tax is triggered. Depending on the category of royalties (i.e., type of contract), from 20 to 40 per cent of the received royalties are deemed profit, which is taxed at a rate of 25 per cent.

There are no restrictions on local currency transactions save for those caught by anti-money laundering regulations. There are similarly no restrictions in place on private individuals in relation to foreign exchange transactions performed on an *ad hoc* basis.

III INTELLECTUAL PROPERTY

i Brand search

Searches for trademarks, patents and industrial designs, as well as searches for trade names and information on corporate entities, can be made in the database of the Official Gazette available at www.rrk.ir. The State Organization for Registration of Deeds and Properties Intellectual Property Center (the Registry) also provides for a database search of all intellectual properties available at <http://iripo.ssaa.ir>.

ii Brand protection

Trademark registration is not compulsory for franchisors under Iranian law; this is only a legal requirement for advertising purposes. Registration of a trademark will, however, provide the trademark owner with maximum protection available under Iranian law. Such protection is highly recommended, given the various common infringements found in the market. Protection is granted under the umbrella of the Law on the Registration of Patents, Industrial Designs and Trademarks 2009. Iran is also a member of the following international agreements, and therefore offers the protections and mechanism provided by these treaties:

- a* Madrid Agreement Concerning the International Registration of Marks of 1891 together with its Protocol (1989); and
- b* the Paris Convention for the Protection of Industrial Property 1883.

To register a trademark an application must be submitted with information on the applicant as well as details and descriptions of the trademark itself.

Upon receipt of the application, the Registry reviews the application within 30 days to ensure compliance with the relevant laws and regulations. It also cross-checks and confirms that the trademark classes applied for are in conformity with the international trademark

classes. If the application is rejected because of any faults or discrepancies, the Registry will require the modification of the application within 30 days. If the application is approved, the trademark will be published in the Official Gazette.

Third parties will have the right to object to the application within 30 days of it being published. Otherwise, the registration will be finalised. The validity of the registration will be for a period of 10 years, with the possibility of renewal for an unlimited number of times.

iii Enforcement

Violations of trademark rights are handled by a specialised court sitting in the capital (i.e., Tehran), which processes all lawsuits related to trademark and trade name disputes in all civil and criminal claims. There is also a special prosecution office vested to hear criminal complaints made for breach of trademark and trade name rights. In dealing with breach of trademark rights (including, for example, the sale of counterfeit products) a number of remedies are available. These are, *inter alia*, imposing pecuniary penalties, requesting compensation, ordering product recalls and issuing necessary injunctions or preventive measures.

iv Data protection, cybercrime, social media and e-commerce

Data protection is a relatively new area of law under the Iranian legal regime and is not particularly well regulated. There is no specific law on private data, but this is an area dealt with in a number of laws and regulations including, *inter alia*, the Law on Electronic Commerce 2003 (EC), the Publication and Free Access to Information Law 2009, the Law on Cyber Crimes 2009 (LCC), and the newly amended Penal Code 2014.

Private data are protected from disclosure and all state, public or private organisations and entities dealing with such data and information must comply with the pertinent regulations.

Private data are defined as 'data belonging to a real person' including the name, surname, residential and work address, family situation, personal habits, physical disorders, bank account number and passwords of the relevant person. Data are defined as 'any representation of facts, information and concepts which is produced, sent, received, stored or processed by electronic, optical or other new technological means'.

As noted above, regulations exist in areas of e-commerce, namely the EC, the LCC in relation to cybercrime, and various by-laws issued by the Ministry of Culture regulating the activities of social media, in particular, the Implementing By-laws on Regularising and Development of Digital Media 2010.

IV FRANCHISE LAW

i Legislation

The concept of a franchise is not explicitly provided for by Iranian law, including the Iranian Civil and Commercial Codes. Therefore, there are no specific commercial agency or franchise laws in Iran granting special rights to franchisees and agents. In addition, franchise and agency relationships are not regulated under Iranian legislation.

This distinguishes Iran from most other Middle Eastern countries, where there are regulations in place protecting local franchisees, distributors and agents and, in particular, commercial agency laws that provide the local party with enhanced rights on the termination of the relationship.

Given the lack of specific legislation addressing this matter in Iran, franchise agreements will be governed and regulated by ordinary contract principles. As such, the parties to a franchise agreement have the freedom to determine the different aspects of their relations such as the terms of the contract, notices, early termination, payment of damages, etc.

ii Pre-contractual disclosure

In general, no particular duty of good faith or recognition of the doctrine of *culpa in contrahendo* can be identified in Iranian contract law provisions. There is a school of thought that believes that a fraudulent disclosure of facts in a pre-contractual disclosure can result in liability based on the general civil liability provisions of Iranian law. However, this approach is not widely accepted in Iranian jurisprudence.

iii Registration

A factor that is quite distinct from the general freedom of parties to enter into a franchise agreement is that mandatory registrations must be made with certain authorities, namely the MIMT and the MOH for import and distribution of foreign products. These registrations are the responsibility of the franchisee and not the franchisor.

In particular, in line with the provisions of the Consumer Protection Law 2009 (CPL) all providers of capital and durable goods must register themselves with the MIMT, as without this registration the import of products into Iran is not possible. To implement the CPL requirements, the MIMT has issued instructions relating to the registration of distributors and agents, namely the 2016 Instructions, which are currently in force.

From a legal perspective, registration with MIMT is not for the purpose of granting or triggering commercial agency protection of registered franchisees in Iran, as there are no such legal provisions under Iranian law. Rather, the registration is intended to ensure continuity of supply, aftersales and similar requirements.

The same applies to the import and distribution of health-related products, where approval must be obtained from the MOH pursuant to Article 16 of the Law on Foodstuffs, Beverages, Cosmetics and Hygiene 1967. Numerous implementing regulations have been issued to implement the above in all different sorts of areas including pharmaceutical drugs, medical devices, foodstuffs, beverages, cosmetics, etc. by the Iranian Food and Drug Administration.

iv Mandatory clauses

There are no mandatory clauses required in franchise agreements under Iranian law.

v Guarantees and protection

No particular legislation addresses this matter. To the extent that a franchise agreement contains provisions relating to a personal guarantee and guarantees from entities to the franchisor, those guarantees are in principle valid and enforceable (subject to compliance with general mandatory provisions).

V TAX

i Franchisor tax liabilities

As noted above, foreign persons receiving an income from Iranian persons (individuals or entities) for any grant of royalty, technical assistance, transfer of technology, rights to use property and any grant of rights, privileges or licences to Iranian persons, will be subject to withholding tax payments. Taxation is calculated on a deemed profit basis. Depending on the category of royalties (i.e., type of contract) between 10 to 40 per cent of the received royalties are deemed profit and are taxed at a rate of 25 per cent. Given the scarcity of foreign entities in Iran, it is the responsibility of the Iranian party making the payment to withhold and deduct the tax and pay it to the Tax Office on behalf of the foreign party. Previously, the provision of services was also subject to withholding service tax. However, pursuant to a recent amendment of the Tax Law approved in early 2016, the only withholding tax applicable to foreign entities is in relation to royalties. Therefore, in cases where a foreign franchisor provides support in the form of training of personnel, or if it charges the franchisee service fees for services provided under the franchise agreement, these will be free of withholding tax.

ii Franchisee tax liabilities

All corporate entities in Iran irrespective of their shareholding or nature of business (including representative offices and branches of foreign companies) must pay tax on their taxable income at a rate of 25 per cent. Taxable income is income less allowable expenditures and exemptions. All companies (as well as certain individuals) are required to maintain statutory records of accounts (comprising a journal and a general ledger) that must be sealed by the Tax Office prior to the commencement of each fiscal year.

There is additionally a value added tax at the rate of 9 per cent applicable on the purchase or supply of goods and services. In addition, withholding tax on salary and rent also applies.

iii Tax-efficient structures

Incentives exist for setting up entities in free trade zones or special economic zones. Most of which, however, apply to the income generated from those specific areas, so this would probably not be that helpful for a franchise business. Iran has also concluded a number of tax treaties with various countries, including Croatia, France, Germany, Norway, Russia and Turkey to avoid double tax payments on, *inter alia*, income, capital and transport, which can be used in adopting an efficient tax structure.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Iranian law and Iranian jurisprudence take a fairly formalistic approach towards contract interpretation and performance of contracts. Therefore, there are no statutory provisions under Iranian contract law pertaining to the principle of good faith in performing contractual obligations.⁸ Good faith can nevertheless be voluntarily incorporated as a contractual clause if the parties agree to this and, if it is incorporated, this obligation must be complied with.

⁸ Except for limited areas, including insurance laws.

There exist other contractual principles, including, by way of example, the *La Zarar* principle, which is quite similar to the doctrine of abuse of right under the UNIDROIT principle of International Commercial Contracts.

ii Agency distributor model

The concept of ‘franchise’ under Iranian law, despite being known in many forms (e.g., agency, representation), is best described as having the form of a distributor agreement in which products are involved. In fact, in a franchise agreement involving products, the supplier (franchisor) sells products directly to the distributor (franchisee), who then sells the products on to its customers, adding a margin to compensate its costs and provide profits. The distributor cannot in principle create any legal relationship between the supplier and the customer.

Iranian law offers great flexibility in its contract law, as there are no mandatory contractual requirements for franchise agreements, and because of the fact that no specific commercial agency or franchise law exists in Iran. Therefore, parties to a franchise agreement are free to agree to extend, limit or materially alter the nature of their rights and obligations to one another insofar as mandatory provisions of the general law are complied with and the terms are agreed between the parties.

iii Employment law

Iranian law does not regard the parties to a franchise agreement as entering into an employer–employee relationship and therefore franchise agreements are excluded from employment law provisions.

iv Consumer protection

Under Iranian law, in particular, Article 4 of the CPL, importers and distributors of goods and services such as franchisees are defined as suppliers and therefore cannot benefit from the statutory protections provided under the CPL relating to consumer protection.

v Competition law

Iran adopted its competition law in 2008, which is otherwise known as the Law Amending Certain Provisions of the Fourth Development Plan Act and Principle 44 of the Constitution 2008. The 2008 law addresses various issues including, *inter alia*, pricing, tying agreements and territorial restrictions. In principle, and as in many other jurisdictions, Iranian competition law addresses the following two main issues, and which are prohibited:

- a* discriminatory behaviour and agreements, concerted or solo practices that restrict or impede free trade and competition between businesses, or those aiming to distort the market; and
- b* abusive behaviour by a company by dominating a market, or practices that tend to lead to a dominant position, as well as supervising mergers and acquisitions of large corporations resulting in distortion of the market or creation of a dominant position in the market.

A number of prohibited anticompetitive behaviours that are potentially relevant to a franchise agreement are discussed below:

- a* Discriminatory pricing, which is defined as the provision of goods and services of a similar nature or condition at different prices to different parties or in different geographical areas.
- b* Concerted practices or agreements between parties with the aim of fixing prices, limiting or controlling the supply or sale or forcing discriminatory conditions on supply, sale or purchase of goods or services and dividing or limiting access to the market.
- c* Tie-in agreements by way of forcing the purchase of intended goods and services by the other party to be dependent on obtaining extra services or goods.
- d* Obligatory sale, whereby the sale of a product or service becomes subject to obligatory sale in a way that another party is barred from transacting with a competitor.
- e* Territorial restriction.
- f* Pricing restrictions, whereby it would be unlawful to make the sale of a product or service subject to a limitation or restriction on the resale price.

Implementation of the Competition Law is mainly carried out by the Competition Council, which also supervises the proper enforcement of the Competition Law's provisions.

vi Restrictive covenants

There are no statutory provisions of Iranian law preventing parties to agree on non-compete terms or restrictive covenants. Such agreements are binding and enforceable to the extent that they are not contrary to the mandatory provisions of Iranian law. In particular, the laws and regulations relating to Competition Law. Notable examples of such provisions are territorial restrictions, restrictions on resale price and restrictions on entering into business arrangements with certain third parties.

vii Termination

In general, Iranian law takes a strict view on termination of an agreement. For the most part, termination is not automatically allowed and a party must either apply to a court to obtain a judgment of termination or the agreement must specifically empower a party with the right to terminate under certain circumstances including for cause or convenience. Given the above, even in cases of a breach, the non-breaching party may not exercise the right of termination and the right does not exist automatically. Rather, the non-breaching party must apply to a court to compel performance and, if this is not possible, to request a court order for a third party to perform and, if not successful as a last resort to request termination of the contract through a court order. Conversely, to the extent that parties to an agreement provide provisions for termination of their agreement and the agreement is subject to a foreign law where a contractual right to terminate under the agreement is permitted, Iranian law would generally recognise the rights of termination according to the terms of the agreement.

The termination of the franchise agreement will not have any effect on those terms and conditions of the contract that have been explicitly or implicitly (by custom) agreed to survive upon termination.

One issue that must be addressed is the deregistration of the registered franchisee with the pertinent authorities, including the MIMT and the MOH. The practice of these authorities is that in cases of termination of the franchise agreement, so long as the marketing authorisation licence issued by these authorities remains valid, they will be likely to require the consent of the franchisee before they effect the termination and deregister the registration. In particular, if the licence is still valid upon termination of the franchise agreement, the

franchisee will still be authorised to continue trading the products or services under the franchise in view of the Iranian authorities. The franchisor must ensure that the franchise agreement is drafted in a way that the franchisor secures, to the extent possible, means to prevent the franchisee from continuing such trading and requires the franchisee to promptly apply for the deregistration.

viii Anti-corruption and anti-terrorism regulation

Numerous regulations exist under Iranian law that deal with fraud, anti-corruption and money laundering. Notable examples are the newly amended Penal Code 2014, Anti-Money Laundering Law 2008, the Law Intensifying the Penalties of the Perpetrators of Embezzlement, Fraud and Bribery 1985, and the Law on Anti-Corruption 2011. Iran is additionally a member of the United Nations Convention against Corruption 2004.

In accordance with the legislation mentioned above, fraud, corruption (including bribery) and money laundering are criminal offences and punishable by penalties including, for example, pecuniary penalties and imprisonment.

ix Dispute resolution

In general, there are no legal prohibitions in choosing a law other than the law of Iran to govern an agreement. There are procedural issues to be complied with for such a choice to be deemed valid under Iranian law. If these conditions are met, foreign governing law clauses will be recognised and enforced in Iran. However, Iranian law provides for the rejection of foreign laws if they are found to be against public order.

While Iranian law has restrictions on choice of forum in court, with regard to the dispute settlement mechanism, Iranian law provides for absolute freedom for parties to select domestic or international arbitration as a dispute resolution mechanism. Commercial arbitration is recognised under the Iranian Civil Procedure Act and the Law on International Commercial Arbitration. Iran is also a member of the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards 1958 (the New York Convention). Therefore, to the extent that a foreign arbitration award has been obtained in a Member State of the New York Convention, such an award is in principle enforceable in Iran.

In the absence of parties' choice of forum for disputes in the agreement, disputes are settled by referring the matter to an Iranian court of law. Iranian courts are divided into civil and criminal courts governed by the Code of Civil Procedure 2000, the Law on Formation of Public and Revolutionary Courts 1994 as amended, the Law on Dispute Settlement Councils 2015 and the Code of Criminal Procedure 2015.

Commercial disputes (including any dispute over matters related to a franchise agreement) are treated the same as any other civil dispute, as there are no separate procedural regulations related to such cases. Courts can, at the request of the claimant, grant injunctions and provisional orders, and preventive orders if the claimant's action is successful.

With regard to damages resulting from a breach of contractual obligations, two elements must exist in respect of a claim for damages: first, the loss must in fact have been suffered (or the suffering of it is a certainty) – therefore by implication it must be a monetary loss; second, the loss was a direct result of (1) the failure of the other party to perform or (2) a delay in performance by the other party. Claims for loss of profit or consequential loss are not recoverable. In our opinion, these losses should be recoverable if contractually expressly agreed to by the parties.

No other official dispute settlement mechanism exists under Iranian law.

VII CURRENT DEVELOPMENTS

We do not expect any major changes in the laws and regulations relating to franchising or franchise agreements in the near future.

ITALY

*Claudia Ricciardi*¹

I INTRODUCTION

The good news from the 2012 study by Assofranchising is that, notwithstanding the current difficult economic situation, franchising is developing in Italy.² The reason for this is seen as being the strength of brands, which are likely to be viewed by consumers as a guarantee, especially during periods of recession, of the quality claimed for purchased services or products, in addition to offering reduced prices. Compared with stand-alone strategies, on one hand franchising networks facilitate the diffusion of the brand while maintaining a uniform standard of quality and, on the other, they may benefit from a reduction of fixed costs, resulting in reduced prices for the end customer. This is why every day more entrepreneurs in Italy decide to invest money in franchising networks.

Concrete figures for franchising in 2012 include an increase in turnover of 4.4 per cent and the number of active networks has grown from 878 in 2011 to 938 in 2012. Of the new franchising networks that opened in Italy in 2012 in the field of food and beverages, most are dedicated to the sale of ice cream. The presence of foreign franchising is also significant. In Italy in 2012 foreign master franchisors numbered 66, with 34 foreign networks operating in the country with registered offices in other countries.

II MARKET ENTRY

i Restrictions

Our analysis of the Italian legislation on franchise contracts is conducted from the standpoint adopted by the legislature in relation to the entry of foreign franchisors to the domestic market.

Notably, the sole reference to international franchising made by the legislator within the Franchise Act is regarding the disclosure to be made by foreign franchisors intending to set up

1 Claudia Ricciardi is an associate at Studio Legale Bird & Bird.

2 From a study by the Italian Association of Franchising (Assofranchising Italia). See www.assofranchising.it. The Italian franchising sector is represented by two national associations: Assofranchising Italia and Federazione Italiana del Franchising. Both associations have adopted ethical codes on the basis of the experience accrued in other European countries.

a franchise network in Italy;³ in particular, in Section 4.2 of the Franchise Act, the legislature required the government to issue a specific regulation detailing the quantity and quality of the information to be provided by foreign franchisors to Italian potential franchisees.⁴

The main issue with this regulation, issued by the Ministry of Manufacturing Activities⁵ as Decree No. 204/2005, is that it is applicable solely to those franchising agreements regulated by Italian laws by operation of international law; indeed there is still a gap in the law as no specific rule is provided with reference to pre-contractual agreements between foreign franchisors and local potential franchisees (the weak party of the agreement, in the view of the law) wherein the parties may have covenanted to have the contract regulated by a foreign law.

That said, from a practical standpoint, in addition to the information that the franchisor is required to provide to the franchisee under Decree No. 204/2005,⁶ upon request the latter may be given any information concerning the contract and the relevant annexes in Italian.

ii Foreign exchange and tax

See Section V.

III INTELLECTUAL PROPERTY

i Brand search

Brand searches are carried out among Italian and Community applications and registrations, and international registrations with effect in Italy to verify that there is no identical or similar trademark nor reference to identical or similar products or services that could prevent the use of the protected trademark relevant to the franchise nor be a valid basis for starting a nullity action against the trademark.

Internet searches are also carried out to verify the validity of previously traced trademarks, if any, and also any prior use of identical or similar trademarks or identical or similar products or services that could present a challenge to the validity of the protected trademark relevant to the franchise.

It is also possible to carry out similar searches regarding designs rights for Italian and Community designs.

ii Brand protection

If searches do not identify any obstacles, an Italian trademark application can be filed in respect of the goods or services that are the subject of the franchise. The application will be examined and then published by the Italian Patent and Trademark Office. If no objections are raised by third parties within three months of the date of publication, the relevant registration will be issued.

3 The Italian Franchise Act, enacted in 2004, is mainly aimed at regulating the pre-contractual stage, by setting the legislature's requirements regarding the disclosure obligations of the parties to the agreement (see Section IV.ii).

4 The Italian Franchise Act does not allow the franchisor and franchisee to belong to the same corporate group, requiring that the parties to the agreement are independent, from an economic and a juridical standpoint.

5 Ministero delle Attività Produttive.

6 See www.assofranchising.it/testi/Decreto_204_2005.pdf.

In Italy rights run from the filing date of the application. Moreover, within six months of the filing date, it is possible to extend the protection in other countries, claiming priority under the Paris Convention (Article 4).

Italian and Community design applications can be also filed and the registration process is straightforward as no examinations are carried out by the relevant offices.

iii Enforcement

Franchise-related intellectual property rights can be enforced on an administrative and a judicial level.

It is possible to file oppositions against subsequent identical or similar trademarks referring to identical or similar products before both the Italian and the Community trademark authorities. Moreover, cancellation actions can also be started before the Office for Harmonization in the Internal Market, which administers the Community Trade Mark.

At the judicial level, trademark owners are entitled to start the following types of actions:

- a infringement and non-infringement actions (including possible counterclaims for revocation or invalidation of the trademark at issue);
- b action for revocation or invalidity; and
- c all other actions regarding trademarks (i.e., licence disputes).

Infringement and non-infringement actions

The owner of a registered trademark is entitled to start proceedings based on its trademark rights. The owner of a non-registered trademark and the owner of an application for registration of a trademark have the same right.

In cases of infringement, the following remedies may be requested of the competent court:

- a prohibition of the manufacturing, commercialisation and use of the infringing goods;
- b seizure of the infringing goods;
- c withdrawal of the infringing goods from the market;
- d a penalty to be paid for every violation or non-fulfilment of the decision or for every day of delay in the execution of what was provided by the decision;
- e destruction of the infringing goods;
- f assignation of the infringing goods to the trademark owner;
- g compensation of the damage suffered by the trademark owner;
- b surrender of the profit enjoyed as a result of the infringement;
- i publication of the decision at the defendant's expense; and
- j administrative fines.

Moreover, as long as the two requirements of the *fumus boni iuris* (i.e., likelihood of the validity of the enforced trademark and of the infringement) and of the *periculum in mora* (i.e., urgency of the requested measures) are deemed to subsist, Italian legislation provides for the possibility for the trademark owner to ask for different preliminary measures.

In cases of trademark infringement, the two most important measures are seizure – which may apply to allegedly infringing goods as well as goods with which the infringement is carried out – and the preliminary injunction. In granting the said injunction, the court may also provide for a penalty due for every violation or day of delay in complying with the court's order.

Another very typical measure of the Italian system is the ‘description’, which is aimed at gathering evidence of the claimed infringement when it is not otherwise available (e.g., when the purchase of goods is not feasible or not sufficient to provide evidence of the infringement).

In those cases in which the summoning of the counterparty is likely either to compromise the effectiveness of the granted precautionary measures or to irreparably damage the interests of the applicant, the above-mentioned precautionary measures can be granted *ex parte* and the court should set the hearing for the appearance of the parties no later than 15 days from the issuing of the order.

Along with the order granting the precautionary measures, the judge is required to provide a term for the parties to start the relevant proceeding on the merits. In the absence of the provision of this term, the proceeding may be started no later than 20 working days (or 31 calendar days, whichever term is the longer) from the communication of the order. If the parties fail to proceed within this term, the granted precautionary measures lose any effectiveness, with the exception of those measures that anticipate the effects of the decision in the action on the merits (injunction orders are deemed to be included in such measures).

Action for revocation or invalidity

Any interested party can seek the invalidity of a trademark, for non-use or lack of distinctiveness, within a judicial proceeding aimed at obtaining the invalidation of a trademark.

In addition, the owner of an earlier trademark may claim before the relevant court the revocation of a trademark (1) for lack of novelty because of the existence of prior trademarks; (2) because the contested trademark infringes a third party’s copyright, intellectual property or other exclusive right; (3) because the contested trademark infringes a third party’s right on his or her name or portrait; (4) because the contested trademark has been registered by a non-entitled subject. Such actions can be started by the prior right owner or by the relevant assignee only.

iv E-commerce

Building an online franchise network sets a number of issues not only on the structural or organisational side, but also from a juridical standpoint.

In this last respect, the most likely issues to be explored by literature and case law would relate to:

- a* the way in which the know-how would be transferred during the contract and how the franchisor could be protected upon termination of the agreement in that regard;
- b* the protection of the trademarks upon termination of the contract; and
- c* the scope of the possible exclusivity right upon the franchisee, since no specific reference could be made to territory.

IV FRANCHISE LAW

i Legislation

The Italian Franchise Act is over 10 years old, having been approved by Parliament on 6 May 2004⁷ after a gestation of more than seven years (the first bill having been proposed in 1997).

Italian law recognises a number of types of contract (which find their specific definition and regulation within the Civil Code or within *ad hoc* acts), though it also allows for parties regulating their respective relationships outside those recognised contracts (e.g., a trademark or patent licence is not a recognised contract in our jurisdiction; nevertheless such contracts are fully effective and enforceable on condition that they include those basic elements required under general Italian contractual law).

With the entry into force of the Franchise Act, the franchising contract has finally been recognised by Italian law,⁸ being defined (under Article 1) as:

the contract that, irrespective of the relevant naming, is executed between two juridical parties, legally and economically independent, with which a party grants to the other party, against a consideration, the right to dispose of a number of industrial and intellectual property rights related to trademarks, trade names, signs, utility models, design, copyright, know-how, patents, technical and commercial assistance and advice, including the franchisee in a system constituted by a plurality of franchisees distributed on the territory, to commercialise certain goods and services.

From a very first reading it can therefore be inferred that the franchising contract is distinguished by the following two main elements:

- a the franchisor grants to the franchisee the right to use certain intellectual property (IP) rights and undertakes to provide to the latter certain services for the exploitation of the activity; and
- b the franchisee pays a consideration in relation to the grant of IP rights and for the provision of the services mentioned.

From a subjective standpoint the legislature, on the one hand, has expressly not excluded that an individual may be a party to a franchising agreement; however, the mention of the commercial purpose of the activity would lead to the assertion that the parties must in any case be entrepreneurs; and, on the other hand, has required that franchisor and franchisee are ‘juridically and economically independent’, thus entailing that the parties to the contract should not belong to the same corporate group or be parties to a joint venture in which control is reserved for the franchisor.

Finally, a number of debates have arisen over the provision according to which the franchisee should be included ‘in a system constituted by a plurality of franchisees distributed on the territory’, and also in relation to the rule set out under Article 3, Paragraph 1, which states that ‘for the purposes of the establishment of a franchising network, the franchisor shall have tested its commercial formula on the market’. While these questions certainly

7 The Franchise Act was published in the Official Gazette on 24 May 2004 and entered into force on 25 May 2004.

8 Previously, since its adoption by the European Court of Justice on 28 January 1986, the decision within the high-profile *Pronuptia* case constituted the main reference for both literature and case law.

deserve a much deeper analysis, it is anticipated that the main issue will continue to be the applicability of the Franchise Act to the 'pilot contracts', through which the franchisee starts experiencing its commercial formula.

ii Pre-contractual disclosure

The legislature's requirements in the Franchise Act (which consists of nine articles) focus, in substantial part, on pre-contractual obligations.

In particular, Section 6 of the Franchise Act sets out generic information obligations upon the franchisor, stating that the latter should be timely in providing any data and information that it believes necessary or useful for the franchisee for the execution of the contract (to the extent that the data and information are not confidential or the relevant disclosure would not entail the violation of third parties' rights).

Section 4 provides a list of specific information to be provided to the franchisee at least 30 days before the date of the execution of the franchising agreement. Namely, as well as the full copy of the agreement to be executed, enclosures providing the following information are to be delivered to the franchisee:

- a* main data relating to the franchisor (including the corporate name, corporate capital and – if the franchisee so requires – a copy of the balance sheet for the past three years);
- b* an indication of the trademarks used within the franchising system (mentioning the data relating to the filing or registration of the licence granted to the franchisor by a third party or the documents attesting to the use of the trademark);
- c* a short description of the elements that feature the activity constituting the subject matter of the franchising;
- d* a list of the franchisees belonging to the network and of the direct points of sale of the franchisor;
- e* an indication of the variation, year by year, of the number of franchisees (including the relevant locations in the past three years or, if the shorter period, from the starting of the activity); and
- f* a short description of the possible judicial or arbitration cases started against the franchisor and concluded within the past three years in relation to the franchising system.

Although providing a detailed disclosure obligation for the franchisor, the legislature has omitted to state the sanction to be applied in the event that the franchisor fails to disclose any of the mandatory information. Indeed, Section 8 of the Franchise Act allows a party to claim the annulment of the contract only in cases of 'false information' having been disclosed, thus limiting the range of situations in which this sanction may be applied.

We consider, therefore, the general principles that apply in matters of pre-contractual liability; in brief, these entail that:

- a* the franchisor may be required to compensate the possible damage suffered by the potential franchisee through withdrawal from the negotiations as a result of conduct by the former contrary to the *bona fide* principle; and
- b* should the contract be executed despite conduct by the franchisor contrary to the *bona fide* principle, the possibility should be explored that the franchisee's will to execute the agreement may be affected by that conduct, allowing the possibility of claiming the annulment of the contract and compensation for the damage suffered (or even solely this latter, should the franchisee decide to maintain the contract in place).

Notwithstanding that the franchisee is plainly seen as the weak party of the agreement, the legislature actually intended there to be two-way disclosure obligations, stating that the franchisee (in addition to a general *bona fide* obligation) should in its turn, in a timely manner, provide the franchisor with exact and complete information and data that may be necessary or opportune to the franchisor in view of the execution of the contract (though not specifically required by the franchisor).

The wording used by the legislature in relation to the franchisee's obligations does not exactly mirror that used with reference to the franchisor, and is actually more favourable to the latter. This slip can be explained by recalling that the franchise contract is characterised by the *intuitus personae* and, thus, certain information (which could hardly be known or obtained by the franchisor otherwise) should be spontaneously disclosed by the franchisee.⁹

iii Registration

Franchisees should observe all corporate and administrative regulation regarding registration (e.g., registration with the Chamber of Commerce) and collection of the required licences, and which may depend on the subject matter of the franchise.

iv Mandatory clauses

Under Section 3 of the Italian Franchise Act the legislature sought to provide a sort of checklist of the elements that must and may be included within the agreement.

The following are mandatory elements of the agreement, the lack of which entails that the whole contract is null and void:

- a an indication of the investment required by the franchisee prior to the start of the activity;
- b the modalities of calculating and paying royalties; in this respect according to a view in Italian legal literature, royalties may be omitted in a franchise contract under certain circumstances in specific cases;
- c the specification of the know-how to be provided;
- d the features of the services to be provided by the franchisor (i.e., technical and commercial assistance, dressing and design of the point of sale); and
- e the terms and conditions for the renewal and termination of the agreement.

As mentioned, Section 3 also indicates those elements (i.e., possible entry fees, possible minimum takings, possible exclusivity related to a certain territory, possible provisions on the assignment of the contract and possible modalities for recognising the know-how provided by the franchisor) that, while not mandatory, may be included in the agreement. The inclusion of such a list has been questioned, given that the failure to include any of these elements within the agreement entails no specific consequence in terms of the nullity of the agreement.

By the same rule (implicitly), the term of the contract may be either open-ended or provide a specific duration. In the latter case, the term of the agreement should allow the franchisee to amortise the investment and, in any case, should be no less than three years. In accordance with the aforementioned principle, legal literature unanimously asserts that

⁹ The failure of the franchisee to comply with these obligations will entail the same consequences as those outlined regarding the possible failure of the franchisor to comply with obligations set out under Section 4 or Section 6 of the Franchise Act.

in the case of open-ended contracts no withdrawal should be allowed before the expiration of a three-year term from the date on which the contract has become effective, and that no right of withdrawal should be admitted in a contract of a specific term before the expiration of the three-year term.

v Guarantees and protection

Although the Italian Franchise Act requires that the parties to a franchise agreement are autonomous and independent of one another, facts show how franchising networks produce close integration between franchisor and franchisees due, *inter alia*, to the use of the same trademarks and of the same layout of the points of sale, such that third parties (including, but not limited to, consumers) may consider franchisees' outlets as mere branches of the same company.

Case law has been required following such an event to evaluate whether a third party – having contracted with a franchisee while believing they had contracted merely with a branch of the franchisor – could start an action against the franchisor and, if so, whether the franchisor could require indemnification from the franchisee.

According to the 'appearance principle', the guiltless trust of the third party who, on the basis of the seeming facts, believed they had contracted with a branch of the franchisor's business should be protected.

However, these appearances may be determined by the conduct of either the franchisor or the franchisee. Thus, the jurisprudence – moving from one orientation to another – has tried to fix the main principles according to which the franchisor might be directly liable towards the third party for the conduct of the franchisee; briefly (as the matter warrants much deeper examination), the Court of Appeal of Naples, on 3 March 2005 stated that the franchisor has an obligation to control the conduct of the franchisee and the way in which the franchise activity is performed. Lack of such control would thus entail an extra-contractual liability of the franchisor towards the third party in respect of the conduct of the franchisee.¹⁰

V TAX

i Franchisor tax liabilities

Pursuant to Articles 85 and 109 of the Italian Tax Code (ITC) royalties arising from a franchising agreement are relevant for corporate income tax purposes (IRES). They qualify as revenues and are added to the taxable base of the franchisor on an accrual basis.

If the franchising agreement provides for an entry fee, this latter is subject to the aforesaid tax provisions, and as a consequence is relevant for IRES purposes and added to the taxable base of the franchisor on an accrual basis.

Pursuant to Article 5 of the Italian Regional Production Tax (IRAP) Law both royalties and entry fees are subject to this regional income tax and are included as taxable income.

Pursuant to Article 3 of the VAT Law both royalties and entry fees qualify as services and consequently value added tax (VAT) is applicable.

In cases of cross-border franchising, according to domestic law, royalties due to a non-resident franchisor are relevant for tax purposes in Italy and a withholding tax of

¹⁰ Relevant decisions have been issued by the Court of Milan on 21 July 1992; by the Court of Crema on 23 November 1994 and by the Court of Fermo on 3 November 2001.

30 per cent is applied on the amount of royalties paid by the franchisee (or on 75 per cent of the amount of royalties paid, if certain requirements are met); however, a double-taxation treaty between Italy and a third country (i.e., the country of the franchisor) may entitle the franchisor to a lower withholding tax.

Clause-by-clause analysis of the particular franchising agreement is needed to determine whether, and to what extent, the entry fee constitutes remuneration for services or IP rights. Generally speaking if the entry fee qualifies as a consideration for the licence or right to use IP (e.g., trademarks, patents and know-how), the domestic and international tax treatment is that described above. If the entry fee qualifies as a consideration for services rendered by the franchisor (advisory services, technical assistance, etc.), upon certain conditions, the income deriving from such activity should be taxable only by the country in which the franchisor is resident.

ii Franchisee tax liabilities

Pursuant to Article 109 of the ITC, royalties arising from a franchising agreement are relevant for IRES purposes. They qualify as costs and are deductible from the taxable base of the franchisee on an accrual basis.

If the franchising agreement provides for an entry fee, according to Italian generally accepted accounting principles (GAAP),¹¹ this amount has to be capitalised as an intangible asset and subject to amortisation for a period equal to the life of the franchising agreement. Pursuant to Article 103, paragraph 2 of the ITC, the amortisation charge recorded in the profit and loss is deductible for IRES purposes.

Pursuant to Article 5 of the IRAP Law both royalties and entry fee are relevant for IRAP and are deductible from the taxable base.

VAT charged on royalties and entry fees can be deducted by the franchisee.¹²

Registration tax is applicable under the following conditions:

- a* if all the provisions included in the franchising agreement are relevant for VAT purposes and it is concluded as private deed, the agreement is subject to registration tax (€200) only in cases of use;¹³ and
- b* if the franchising agreement is concluded as a public deed or with authenticated signing, registration tax is due (€200) within 20 days of the signing.

In cases of cross-border franchising, the reverse-charge mechanism for VAT should be applied by the franchisee both for entry fees and royalties.

iii Tax-efficient structures

The franchising agreement may provide that the franchisor allows the franchisee to use an immoveable property in which to carry out its business and the compensation for this use is included in the royalties amount. In such an event, the tax authorities¹⁴ have stated that

11 See Italian Accounting Standard OIC No. 24 – Intangible Assets.

12 The VAT Law provides some limitations on VAT deductibility connected to some activities. It is possible, therefore, that the franchisee may not be able to deduct the VAT, partially or entirely, depending on the activity carried out.

13 A case of use, or *caso d'uso*, is when the agreement has to be used during a judgment in front of a court.

14 Ministerial Resolution No. 49/E, 13 March 2007.

the use of an immoveable property qualifies as a lease and therefore it has to be treated for registration tax purposes as a separate agreement. As a consequence, the compensation for the lease is subject to registration tax (1 per cent).

As regards cross-border franchising, if the master franchisee and the franchisor are respectively resident and non-resident in Italy for tax purposes, and they qualify as ‘related parties’, pursuant to Article 110, paragraph 7, the transactions between the two entities must take place at fair market value. Therefore it is important to support the master franchising agreement with a transfer pricing study.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

See Section IV.ii.

ii Agency distributor model

Under Italian law franchise agreements and agency agreements appear alike in many respects.

First, both the franchise and the agency distributor model are characterised by the stability of the contractual relationship between the parties involved. The relevant contracts, in fact, do not aim at regulating one or more affairs concluded by the franchisee or the agent individually considered, but rather they regulate the entirety of the affairs concluded by the franchisee or the agent while carrying out their activity.

Furthermore, the contracts at issue are also characterised by the fact that the franchisee as well as the agent autonomously undertake the business risk and bear the costs necessary to perform their activities.

However, notwithstanding the aforementioned resemblances, the franchise agreement and the agency agreement also show several structural differences that distinguish the two types of contracts from one another and make any overlap, even partial, impossible.

In fact, according to the Italian Franchise Act, the franchisee, unlike the agent, pursues his or her activity in the name and on behalf of him or herself, albeit through the franchisor’s brand and trademarks. The franchisee then remunerates the franchisor – in fees and royalties – because the latter makes it possible for the franchisee to start up his or her business, whereas the agent is remunerated by the principal in light of the business volume generated by the agent’s activity.

iii Employment law

The subjection of the franchisee to strict control by the franchisor regarding the organisation of the business may take franchising agreements close to employment contracts.

The Italian courts, however, have denied the existence of such a subordinate, job-like relationship between the franchisor and the franchisee on the grounds that both parties are necessarily autonomous entrepreneurs and that the franchisee does not lose such status as a result of the contractual bonds to which the affiliate company is subject.

Moreover, one of the main features of an employment contract is the absence of work-related risk for the employee, who carries out the activity under the direction of the employer, who undertakes the business risks.

On the contrary, the franchisee retains a certain degree of organisational autonomy (i.e., in involving other people as well as in managing or financing the activity), and the controlling powers of the franchisor are largely related to the franchise agreement only.

iv Consumer protection

As stated previously, the franchise agreement is a contract between entrepreneurs. However, in a large number of cases the franchisee actually acquires this status on joining the franchise network.

In the past, this has given rise to the question of whether the protection provided by Legislative Decree No. 206/2005 to consumers, because of their weaker contractual position with respect to entrepreneurs, was applicable to franchisees as well.

The answer to this question can only be negative because, as previously explained, the franchisee carries out an entrepreneurial activity and, therefore, does not meet the criteria required by law to qualify as a consumer.

Nonetheless, since, as stated previously, pursuant to the Italian Franchise Act the franchisor must provide the franchisee with the general terms and conditions of the contract the parties are going to enter into, Articles 1341 and 1342 of the Italian Civil Code apply, requiring the specific written approval of certain onerous clauses (also at a business-to-business level) unless the clauses have been specifically negotiated. Thus the franchisee, while not considered a consumer, is still granted a particular level of protection in light of the assumption by the Italian legislator of the weaker contractual position of the franchisee with respect to the franchisor (again, solely in the event that general terms and conditions have not been specifically negotiated with reference to those categories of clauses listed under Article 1341 of the Italian Civil Code).¹⁵

v Competition law

The domestic antitrust law, Act 287/1990 (the Antitrust Act),¹⁶ applies to the sole extent that the concerned vertical agreements, abuse of dominant position or concentrations do not fall within the scope of the EU rules (this principle being explicitly provided under Section 1 of Act 287/1990). In other words, domestic antitrust law applies solely to those franchise agreements that do not jeopardise intra-EC commerce. Pursuant to a consolidated EU case law, even agreements affecting the whole of a national territory are seen as affecting trade among Member States.

However, not only is the domestic regulation substantially the same as the EU regulation, Article 2 on anticompetitive agreements is also very similar in its wording to Article 101 of the TFEU and must be interpreted consistently with EU competition case law. The same articles of the Antitrust Act should indeed be interpreted in accordance with the principles of the EC in matters of competition.

Act 57/2001 sought to recognise that the abuse of economic dependence might produce anticompetitive effects, and thus provided the Italian Antitrust Authority with the power to intervene in such cases.

Furthermore, the prohibition of the abuse of the economic dependence¹⁷ of a third party, as set out under Article 9 of Act 192/1998, which is specifically aimed at regulating the sub-supply, is now considered a general principle of our jurisdiction.

15 Failure to obtain in writing the specific approval of these clauses renders them null and void, and consequently unenforceable.

16 The present paragraph is limited to the domestic provisions relevant in antitrust issues and does not deal with the provisions set out under EC regulations.

17 According to the stated provision, economic dependence is the 'situation in which a company is able to determine, in the relationship with a third party, an excessive imbalance of rights and obligations' (such

From an antitrust standpoint, such an abuse has been defined by one author as a situation of relative dominant position.¹⁸ Nonetheless, from a practical point of view, the abuse of economic dependence has a very restricted application: should this correspond to an abuse of a dominant position, Section 3 of Act 287/1990 would apply, while the weaker party would preferably claim before the ordinary judicial authority the abuse of the right and the protection of the weaker party.

vi Restrictive covenants

As far as the non-compete obligation is concerned, the consensus in the legal literature is that it does not represent a 'natural element' of the franchise agreement. The enforcement of the non-compete obligation therefore requires that the contract include a specific provision in that respect.

As admitted by Commission Regulation (EU) No. 330/2010 (under the conditions provided therein) and explained under the Commission Guidelines of May 2010, such an obligation *ratione temporis* may concern either the period in which the contract is in full force and effect between the parties or may represent a post-contractual obligation upon the franchisee.

On the enforceability of such a clause, the Court of Pesaro, in the decision issued on 3 April 2008 in the context of a preliminary injunction proceeding, recalling the principles and conditions stated under Regulation (EC) No. 2790/1999 on vertical restraints, confirmed the validity of a post-contractual non-compete clause (the violation of which was the subject of the plaintiff's complaint), and finally prohibited the franchisee from marketing, either directly or indirectly through third parties, products competing with those of the franchisor, throughout the whole period set forth in the non-compete clause.¹⁹

vii Termination

In practice, termination of the franchise contract presents a number of issues in terms of management of the conflicting interests of the parties.

In the silence of the Franchise Act the main orientation excludes that, should the contract omit any reference to goodwill compensation, the franchisee could be assimilated to an agent, thus not being entitled to claim the compensation that Article 1751 of the Italian Civil Code guarantees to the latter.

Another contentious issue related to the termination of a franchise contract is the management of leftover stock. Particularly, writers from both sides of the debate have questioned whether, in the absence of any contractual provision in that respect, the franchisor should be considered to be obliged to repurchase leftover stock according to the general principle of *bona fide* (according to which each party would have an obligation to safeguard the other party's interest to the extent that this does not entail a substantial sacrifice).

a situation is to be evaluated taking into consideration the possibility of the third party finding possible satisfactory alternatives on the market).

18 A Frignani, 'Abuso di posizione dominante', in *Diritto Antitrust Italiano*.

19 Accordingly, see also the decisions of the Court of Torino issued on 29 November 2007 and on 23 April 2008.

viii Dispute resolution

Pursuant to Section 7 of the Italian Franchise Act, the parties may agree to try to amicably resolve the disputes arising from the franchise agreement before resorting to the courts or to arbitration. The parties, in fact, are free to opt for such a dispute resolution procedure, which, under Italian law, is not mandatory in the context of franchise claims.

The same principle has recently been confirmed by Law No. 69/2010 (concerning mediation aimed at settling disputes in civil and commercial matters), which does not include franchises among the areas in which mediation is mandatory.

The mediation procedure can be carried out before public or private entities; to this end, the chambers of commerce have created specific bodies to promote and facilitate mediation for the resolution of disputes arising from franchise agreements.

Furthermore, to foster fair contractual practices, the national franchise associations Assofranchising and Federfranchising have been set up; these associations are responsible, *inter alia*, for promoting awareness of the franchise system, of setting contractual and behavioural standards between industry operators, and thereby helping to prevent issues arising in relation to franchise agreements.

While offering enormous advantages in terms of cost and time saving, mediation has not had much success in Italy so far. Parties have been more inclined to resort either to the courts or to arbitration, consequently suffering the slowness of Italian proceedings, which usually last an average of between two and five years.

An exception is represented by preliminary injunction proceedings, as provided for by Articles 669 et seq. of the Italian Civil Procedure Code, which usually last a few months (one to six months, save for the necessity of particular technical assessments). Said provisions apply also with regard to enforcing clauses included in franchise agreements, if the legal requirements (such as the likelihood of the right at issue and the urgency requirement) are met. Preliminary injunction proceedings, because of their brevity, are particularly suitable for settling disputes regarding the breach of non-compete clauses by the franchisee (see Section VI.vi).

Another particularly relevant issue to be considered is that of damage compensation and fees and costs allocation between the parties. Under Italian law, damages are awarded and calculated on the basis of whether they arise from contractual liability (pursuant to Article 1218 et seq. of the Italian Civil Code) or tort liability (pursuant to Article 2043 et seq. of the Italian Civil Code); however, Italian courts usually do not award very high amounts for damage compensation.

Ultimately, the allocation of fees and costs of the proceedings will be provided by the judge according to liabilities ascribable to the parties as ascertained during the proceedings, as well as to the specific circumstances of the case at issue.

JAPAN

Yoshihiko Fuchibe and Kentaro Tanaka¹

I INTRODUCTION

The franchising market in Japan has recorded a steady and continuous growth since 2010. The Japan Franchise Association reported that, in 2016, the number of franchise systems had increased by 0.5 per cent to over 1,335 systems, and the number of establishments had increased by 0.8 per cent to over 263,109 franchise establishments. Franchise establishments generated over ¥26 trillion in sales in 2016.²

The franchise scheme is often seen in the industries of convenience stores, bakeries and pastries, fast food restaurants, Japanese pubs, dry cleaners and private preparatory schools.

Convenience store franchise systems such as 7-Eleven, FamilyMart and Lawson are uniquely dominant in the Japanese franchising market. Sales from convenience store franchise systems account for approximately 43 per cent (over ¥10 trillion) of all sales generated from franchise establishments in 2016.³

In addition to the universally known American franchise systems such as McDonald's, Subway, Burger King and KFC, Japanese franchise systems also have significant presence in the franchising market in Japan. Examples of franchise systems originating in Japan are: Sukiya, Yoshinoya and Matsuya (beef bowl restaurants); MOS Burger (hamburger restaurant); and Doutor Coffee, Café de Crié and UCC Ueshima Coffee Co (coffee shops).

In recent years, responding to the growing popularity of Japanese cuisine, Japanese franchise systems have ventured overseas. These franchise systems have proactively expanded their businesses in Asian countries, including China, Taiwan and other ASEAN countries.

The Japanese laws relevant to the franchise business include the Small and Medium-Sized Retail Business Promotion Act, the Anti-Monopoly Act, the Civil Code and the Consumer Contract Act. In addition, franchise businesses may be subject to the ethic general plan, guidelines and independent standards of the Japan Franchise Association.

There are many franchisees that have left their jobs as corporate employees to start their own business. These franchisees tend to lack sufficient knowledge to conduct franchise businesses, and a number of problems have emerged as a result. These problems often involve franchisors' obligation under franchise agreements to provide sufficient explanations to franchisees, franchisees' obligation to report and franchisees' anti-competition obligation, as well as franchisors' abuse of dominant position. There are many cases where these problems have developed into disputes and litigation.

1 Yoshihiko Fuchibe is a partner and Kentaro Tanaka is an associate at TMI Associates.

2 Website of the Japan Franchise Association.

3 Ibid.

II MARKET ENTRY

i Restrictions

In Japan, there are no restrictions on foreign investment specific to franchises. In addition, there are fundamentally no restrictions on foreign companies granting master franchise rights and similar rights to Japanese corporations.⁴

On the other hand, under the Foreign Exchange and Foreign Trade Act, if a foreign company (1) acquires the shares or equity of a company other than a listed company, etc.⁵ (including when acquiring new shares as a result of formation), or (2) will be acquiring 10 per cent or more of the shares of a listed company, etc.,⁶ a prior notice or a subsequent notice will be required depending on the business type of the investing company.

Moreover, under the Foreign Exchange and Foreign Trade Act, since prior notice is required for instances of investments in restricted business types, such as those that have affect Japan's national security (aeroplanes, satellites, etc.), those concerning public order (telecommunications businesses, broadcasting businesses, passenger transportation businesses, etc.), those regarding public safety (security services, etc.), and investments from countries considered to require examination with regard to the principle of reciprocity, a franchise business is not likely to require a prior notice.

Furthermore, no special regulations have been prescribed with respect to foreign companies acquiring real property in Japan.

ii Foreign exchange and tax

There is no obligation to seek approval nor a reporting obligation imposed on local franchisees regarding the payment to foreign franchisors as long as the amount of the payment is not more than ¥30 million. Tax issues are discussed in Section V.

III INTELLECTUAL PROPERTY

i Overview

In franchising, a well-known brand is the most valuable asset of the business. It is, therefore, essential to protect and reinforce brand trademarks when expanding the franchise business.

If a franchisor fails to apply for and register its trademarks, and if a third party who conducts a similar business using commercial indications that are similar to the franchisor's trademarks emerges, the franchisor will need to claim its rights under the Unfair Competition Prevention Act (UCPA). Under the UCPA, a plaintiff must prove that an indication is well

4 Further, strictly speaking, under the Foreign Exchange and Foreign Trade Act, there is a restriction that a prior or subsequent notice must be made if a technology introduction contract relating to aeroplanes, weapons, explosives, nuclear energy or space development will be made with technology that is likely to impair Japan's national security, disturb the maintenance of public order or hinder the protection of public safety; however, we believe this will not become an issue since, fundamentally, one cannot consider engaging in those types of business through franchises.

5 'Listed company, etc.' means a company that issues shares listed on a stock exchange and shares that have been registered or designated as those for which the selling prices are announced for over-the-counter sale.

6 This includes instances where 10 per cent or more will be acquired when shares acquired are combined with those that the acquirer already owns, and by combining the shares owned by a person in a special relationship with such an acquirer (for example, a corporation that owns 50 per cent or more of the voting rights through such an acquirer and the like).

known or famous among consumers, and proving such a fact could be time-consuming. Furthermore, if the third party has already registered a trademark similar to the franchise system brand or trademarks, and has already been using the trademark in products or services similar to those of the franchisor, there is a possibility that the third party may seek an injunction preventing the franchisor from using the franchisor's own brand and trademarks.

In fact, in the decision rendered on 10 September 2012 (see the website of the courts in Japan for the *INAIL case*), the Tokyo District Court granted an injunction suspending use of signage and other materials and ordered the destruction of the signage and other materials, among other orders, based on the third party's infringement of the registered trademark of the plaintiff, against the defendant who operated a franchising business using a similar mark.

Based on the foregoing, a franchisor should apply for and register its brand or trademarks after deliberating whether it is possible to register the brand or trademarks. Most franchisors follow these practices.

ii Brand search

A 'trademark right' means an exclusive right to use a trademark, registration of which has been accepted by the Japan Patent Office following an examination by the Japan Patent Office (registered trademark), for certain products or services (designated products or designated services) (Articles 25 and 37(i) of the Trademark Act) that arises as a result of registration of establishment of such a right (Article 18 of the Trademark Act). A trademark holder has the exclusive right to use the registered trademark for the designated products or the designated services without any interference by others (exclusive right to use), and, in cases where others use the registered trademark or a similar trademark for identical or similar designated products or designated services, a trademark holder also has the right to suspend such acts and claim damages (prohibition right) (Article 37(i) of the Trademark Act).

The common method of determining whether a trademark has been registered is to use a database such as that available from the Japan Platform for Patent Information (formerly the Industrial Property Digital Library). However, because there is a time lag between actual registration and the updating of the database, a prospective applicant often obtains a copy of the trademark registry for important trademarks. A copy of the trademark registry may be applied for and obtained at the Japan Patent Office by submitting an issuance request in a designated form and paying a fee of ¥800 per case in ordinary cases. If, in relation to the trademark that a franchisor uses in its franchise business, the franchisor desires to register a new trademark or considers the registered scope to be insufficient, the franchisor should investigate whether there are any trademarks of other companies that have already been registered, and consult with experts (such as patent attorneys and attorneys) about the possibility of infringement based on the result of the investigation.

Franchisors often use domain names when carrying out a franchise business. Japan Registry Services manages the database of Japanese domain names comprehensively, and multiple registrars accept applications for the registration of individual domain names.

iii Brand protection

A person who desires to register any trademark must submit to the Commissioner of the Japan Patent Office an application for registration that provides the applicant's address, name (or name of its representative if the applicant is an entity), date of submission,

designated products or designated services and categories of the designated products or designated services, together with documents indicating the trademark and necessary written explanations thereof.

In Japan, if there has been any application for registration of a trademark that is identical or similar to another trademark, the person who first applied for registration is entitled to the trademark, not a person who has simply started using the trademark first. For details of the procedures for registering trademarks, please refer to the website of the Japan Patent Office (www.jpo.go.jp/tetuzuki_e/t_gaiyo_e/tr_right.htm).

iv Enforcement

Infringement of a trademark refers to an incident where a person without authorisation (1) uses (2) a trademark identical or similar to any registered trademark (3) for designated products or designated services (the designated products or services). The infringement of a trademark may be organised as follows:

Designated products or services			
Trademark	Identical	Similar	Dissimilar
Identical	Infringement	Infringement	–
Similar	Infringement	Infringement	–
Dissimilar	–	–	–

In the *Kozo Sushi* case (Judgment of the Supreme Court, 11 March 1997, Minshu Vol. 51, No. 3, Page 1055), in which a third party filed an action against a franchisor, the Court rendered a decision on standards to determine similarity between trademarks, which relate to factor (2) above. With respect to similarity between the Plaintiff's 'Kozo' (in Japanese) trademark and the Defendant's 'Kozo Sushi' (in Japanese) and 'KOZO SUSHI' trademarks, the Supreme Court opined that similarity between trademarks must be observed comprehensively in consideration of impression, recollection and association that business partners and consumers may have with respect to a trademark based on its appearance, concept and designation and that actual circumstances of transactions of such products must be investigated and similarity between trademarks must be determined based on specific transactions. The Court further opined that similarity in appearance, concept or designation of trademarks may provide certain standards to determine whether products using such a trademark cause misunderstanding or confusion as to the origin of the products; however, trademarks may be said to be dissimilar if, despite similarity in their appearance, concept or designation, there are other aspects of the trademarks that are significantly different or there is no misunderstanding or confusion as to the origin of the products based on the specific circumstances of the transactions. In actual practice, when finding similarity of combined trademarks, as in the *Kozo Sushi* case, examination of similarity with other trademarks by extracting part of the combined trademarks may often become an issue (*Tsutsumino Ohinakkoya* case, Judgment of the Supreme Court, 8 September 2008). According to the precedents, when examining 'specific circumstances of the transactions', the Court tends to take into account not only the manner of the handling of products and other general aspects of the business environment, but also the degree of fame of trademarks, existence of other trademarks, use and manner of use of trademarks, and other unique circumstances of trademarks.

v Data protection, cybercrime, social media and e-commerce

In recent years, while social networking sites have become increasingly popular, there have been many cases where the brand reputation of restaurants and other franchise systems were damaged because of information posted by employees and customers with malicious intent.

Because under the law the personal, economic and social reputation of an entity is protected just like honour of any individual (Judgment of the Supreme Court, 28 January 1964, *Minshu* Vol. 18, No. 1, Page 136), an entity may file an action for defamation. However, it is extremely difficult to restore a brand reputation once it has been damaged. Therefore, it is important to prevent such an incident by providing seminars for employees of franchisors and franchisees, as well as establishing internal rules and guidelines.

IV FRANCHISE LAW

i Legislation

There are no separate laws that relate specifically and solely to franchising in Japan. The general laws of Japan apply equally to franchise-related issues. Among relevant general laws, the Small and Medium-Sized Retail Business Promotion Act (SRPA) and the Anti-Monopoly Act (competition law) particularly affect the franchisor–franchisee relationship, while the Japanese Civil Code governs basic contractual relationships. With regard to the Anti-Monopoly Act, the Japanese Fair Trade Commission (JFTC), which is a government department that enforces the Anti-Monopoly Act, has issued a guideline from an anti-monopoly perspective for franchise businesses (the Franchise Guideline). The Franchise Guideline provides the JFTC’s attitudes to franchising. Although it is not mandatory, many franchisors follow the Franchise Guideline.

ii Pre-contractual disclosure

There are no general requirements for pre-contractual disclosure imposed on franchisors in general. However, for franchisors running retail or restaurant-related franchise businesses, there is a mandatory pre-contractual disclosure obligation set forth in the SRPA. This disclosure should be in writing. Although franchisors operating services outwith the retail or restaurant sectors are not required to provide pre-contractual disclosure, in practice many franchisors voluntarily perform this pre-contractual disclosure to avoid misunderstandings with franchisees.

The items required to be disclosed are as follows:

- a* the name, address, number of employees, and titles and names of directors of the franchisor;
- b* the capital amount, the names of major shareholders of the franchisor, and the contents of other operating business, if any;
- c* the names of subsidiaries and the contents of their business;
- d* balance sheet and profit and loss of the past three years;
- e* when the franchisor began its franchise business;
- f* the changes in the number of franchisees’ stores in the past three years;
- g* the amount of litigation relating to franchising in the past five years;
- h* store hours, business days and holidays;
- i* whether the franchisor may operate its store or permit others to open a store around the franchisee’s store;

- j* details of any non-competition clause that applies after the termination of the franchise agreement;
- k* details of any non-disclosure clause that applies during and after the term of the franchise agreement;
- l* details of fees regularly charged on franchisees;
- m* if the franchisor requires franchisees to regularly transfer sale proceeds, the timing and measure;
- n* if the franchisor provides loans to franchisees, the interest rate and other conditions;
- o* if the franchisor takes interest from the offsetting amount that arises from the transaction between franchisor and franchisees, the interest rate and other conditions;
- p* if the franchisor imposes special duties regarding the structure or decorating of a store on franchisees, the contents thereof;
- q* penalties for the violation of the franchise agreement;
- r* details of the initial fees;
- s* sales conditions for franchisees;
- t* details of the franchisor's management and training of franchisees;
- u* trademarks; and
- v* the term, renewal and termination of the franchise agreement.

In addition, the Franchise Guideline recommends that franchisors (not limited to retail or restaurant franchisors) disclose some items.

There is no general requirement for the disclosure of sales forecasts. However, once a franchisor discloses sales forecasts to a candidate franchisee, a court may review the accuracy of the disclosure. Then, if the forecast is based on inaccurate information or the analysis process is unreasonable, a franchisor may be responsible for damage suffered by the franchisee, on the basis of the 'fair and equitable principle' set forth in the Japanese Civil Code.

iii Registration

There is no registration requirement for a franchisor or franchisee in Japan.

iv Mandatory clauses

There is no mandatory clause requirement to be included in a franchise agreement. Parties are free to negotiate the terms of the deal.

Having said that, as discussed further below, some clauses imposed on franchisees, such as non-competition clauses or pre-fixed penalty clauses, may be rendered void by a court on the basis of the general 'public policy principle' set forth in the Japanese Civil Code, or the Anti-Monopoly Act, even if the franchisee agreed to the clauses.

A non-competition clause, especially one that imposes a non-competition obligation after the termination of a franchise agreement, may be rendered void by a court. A typical situation is that a franchisor seeks injunctive relief or damage compensation against a breaching franchisee and the franchisee raises a counter-argument that the clause is void, arguing that the restriction is too excessive. A court determines whether the restriction is excessive or not, considering the scope of the business, place and term of the non-competition clause. In terms of the scope of the business, in a franchise agreement, franchisors typically prohibit franchisees from operating 'same or similar' businesses. In general, such a restriction is not likely to be considered excessive. In terms of the place of non-competition, the absence of

any limitation on the scope of the place would have a high risk of being deemed an excessive restriction. The term of a non-competition clause is normally set forth as two years, which is not likely to be considered excessive.

Many franchisors provide a pre-fixed penalty clause in their franchise agreement. Under such a clause, in the event that a franchisee violates each term and condition of the agreement, a franchisee must pay the fixed amount as damages to the franchisor. Franchisors prefer such a clause since it may be difficult to prove the amount of their damages, especially damages resulting from the violation of a non-competition or non-disclosure obligation. An excessive fixed-penalty amount may be voided by a court. In general, as long as the amount is not more than the equivalent of 30 months' royalty fees, the risk of such a pre-fixed penalty being deemed void would be low.

v Guarantees and protection

Guarantees from individuals and companies to the franchisor are generally enforceable. It is relatively common practice for local franchisors to require a director of a franchisee's business to guarantee the franchisee's obligation under the franchise agreement.

V TAX

i Franchisor tax liabilities

A franchisor may choose its business structure when operating in Japan, such as establishing a corporation (subsidiary) or a branch in Japan. Income of corporations established in Japan is subject to corporate income tax, regardless of where the income is sourced, whether in Japan or foreign countries, but where the income includes profits earned in foreign countries that are taxed in the source countries of that income, foreign taxation deductions are applied. On the other hand, for branches of foreign corporations, only income earned in Japan (domestic-sourced income) is taxable.

Japanese corporate income taxes consist of:

- a* corporate tax (national tax);
- b* local corporate tax (national tax);
- c* corporate inhabitant tax (local tax);
- d* enterprise tax (local tax); and
- e* special local corporate tax (national tax).

Transactions that include the transfer or lease of assets, or the provision of services as a business in Japan by an enterprise for consideration, are subject to consumption tax, which works like VAT. The rate of consumption tax is currently 8 per cent and is scheduled to be raised to 10 per cent in October 2019. Since the royalty fees paid by franchisees are deemed taxable for consumption tax, a franchisor must collect from franchisees and pay the consumption tax to the tax office.

ii Franchisee tax liabilities

Local franchisees are also subject to corporate income taxation.

Withholding income tax is assessed against payments of certain taxable income made in Japan. Whether certain payment is subject to withholding income tax is determined in accordance with the type of income and the classification of the recipient of that payment. As

long as the recipient is a domestic corporation, payments of only interest and dividends are subject to withholding tax at source. On the other hand, if the payment is made to foreign corporations, tax should be withheld.

iii Tax-efficient structures

There is no single, optimal structure from a tax perspective. There are merits and demerits in choosing business structure options. For example, if establishing a corporation, the transfer of profits to the foreign parent company is subject to withholding tax, while withholding tax is not applicable to the transfer of profits by a Japanese branch to the main company.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Where equitable principles or public policy under the Civil Code are violated, the exercise of rights will be restricted, or there is a possibility that a part of a contract will be determined as invalid. The question of whether there is a violation of equitable principles or public policy in a franchise agreement may, therefore, be at issue. Since there is no explicit standard as to what constitutes a violation of equitable principles or public policy, determinations must be made while referring to the accumulation of past court precedents.

For example, with respect to penalties determined on the basis of a franchise agreement, if the penalty amount is too high, special attention is required as there may be a risk of a violation of public policy and of the agreement being deemed invalid.

While there have been court precedents recognising penalties of 60 months' worth of royalties⁷ and precedents recognising a penalty of three times the admission fee,⁸ in general, most examples are of penalties being limited to approximately 30 months' worth of royalties.⁹

Furthermore, in many instances where a penalty is deemed invalid, only a part of the penalty will become invalid, rather than all of it; and even from the perspective of the Anti-Monopoly Act, there are issues that make it appropriate to limit penalties to approximately 30 months' worth of royalties.

ii Agency distributor model

While in practice it may seem unlikely that a franchisee would be deemed to be an agent or distributor, since the theoretical possibility cannot be eliminated it should be set forth in the franchise agreement that the franchisee will not correspond to an agent or distributor.

iii Possibility that the franchisor will bear responsibility for the franchisee

In addition, as long as the franchisor and franchisee are individual entities, the principle is that the franchisor will not be liable to third parties for the acts of the franchisee. However, under the franchise system, the renown and reputation of the franchisor become important

7 Tokyo District Court, 12 January 1994, Hanrei Times No. 860, p. 198.

8 Tokyo District Court, 27 January 2009, unpublished.

9 Tokyo District Court, 12 January 1994, Hanrei Times No. 860, p. 198; Tokyo High Court, 28 March 1996, Hanrei Jihou No. 1573, p. 29, etc. Further, if the penalties for some franchisees, when compared with those imposed on other franchisees, are found to be set at relatively high amounts, the possibility of these being deemed as violating public policy and becoming invalid increases relatively.

determinants for customers when choosing to purchase products. Therefore, if a third party that transacts with the franchisee incurs damage because of the acts of the franchisee, from the perspective of the third party, not only the franchisee, but also the franchisor should be thought to bear certain liability.

In particular, in many instances, franchisees are individuals or companies lacking financial resources and third parties incurring damage may take into consideration the recoverability of damages and think to pursue liability against the franchisor that does have financial resources. In this context, issues resulting from the acts of franchisees come to be disputed between franchisors and third parties, and while the numbers are low, court precedents have affirmed the basis of liability of lending trade name, joint tort or *respondet superior*. Therefore, it would be prudent to determine from precedents, etc. any potential areas of difficulty and take corresponding preventative measures, such as substantiating the provisions of manuals, etc., for the franchisor to avoid being sued for defective guidance to franchisees.

iv Employment law

Nature of 'workers' under the Labour Standards Act

Under the Labour Standards Act, a 'worker' is defined as 'one who is employed at an enterprise or office and receives wages therefrom, without regard to the kind of occupation'.¹⁰ Notwithstanding the form of the agreement, if a person corresponds substantially to a worker, that person will receive protection under the Labour Standards Act; the following factors have been raised as a standard by which to determine this nature of workers.¹¹

Core standard of determination	Factors for determining whether it is labour under direction and supervision	Whether there is freedom to accept or refuse requests to work, instructions for work to be engaged in, etc.
		Whether there is direction and supervision in the execution of services
		Whether there are restrictions of workplace and work times
		Whether it is permitted to let another person perform the services on behalf of the person
	Nature of consideration for remuneration of labour	Whether the method of calculation of remuneration has a nature of being consideration for labour provided (for example, hourly pay basis, payment of overtime pay would be in the direction of recognising the nature of workers)
Factors reinforcing the determination of the nature of workers	Whether there is the nature of enterprises	Whether the worker him or herself is bearing the expenses, such as for the equipment and facilities
	Whether there is exclusivity	Whether it is permitted to engage in other work at the same time
	Awareness of the user side	Whether withholding is made at the source as earned income or labour insurance is enrolled in

In a franchise agreement, a franchisee is an independent enterprise and it should be deemed that there is (1) freedom to accept or refuse requests to work, instruction for work to be engaged in, etc. In addition, it is reasonable to consider that there is no (2) direction and supervision in the execution of services. Although there is guidance, training and provision

¹⁰ Article 9 of the Labour Standards Act.

¹¹ Labour Standards Act Study Group Report, 'Standard of Determination of the "Worker" of the Labour Standards Act' (1985).

of know-how by the franchisor, these are the performance of obligations by the franchisor in conducting a joint business and mutually raising profits, and they can be thought to be fundamentally different in nature from directing and supervising in an employment relationship. With respect to (3) restrictions on workplace and work times, there may be times when workplaces will actually be restricted, for shops, etc., and these are obviously necessary for executing business and are different in nature from restrictions on the workplace in employment relationships. Even though there are cases where working time is actually restricted (for example, in the form of shop business hours), the working time of individual workers is not being restricted. All these factors, including those that reinforce a determination of the nature of workers, tend towards denying that a franchisee in a franchisee agreement has the nature of a worker. Accordingly, a franchisee in a franchisee agreement is considered not to correspond to the definition of a worker under the Labour Standards Act.

‘Workers’ under the Labour Union Act

Under the Labour Union Act, ‘workers’ means ‘those persons who live on their wages, salaries, or other equivalent income, regardless of the kind of occupation’.¹²

Since the purpose of the Labour Union Act is to promote and protect the composition of labour unions that have been guaranteed the right to collective bargaining, the determination of the nature of ‘workers’ under the Labour Union Act is different from that under the Labour Standards Act; and this nature is decided from the perspective of whether or not workers are subject to be granted protection by collective bargaining. Determinations are made by comprehensively taking into consideration the standard as follows:¹³

Fundamental standard of determination	Incorporation into business organisations
	Unilateral and regular decisions on contract contents
	Nature of consideration for remuneration of labour
Factors reinforcing the determination of the nature of workers	Relations requiring compliance with requests for service
	Provision of labour under direction and supervision in a broad sense, with certain temporal restriction on location
	Conspicuous nature of businesses

In a case concerning this point, the Okayama Labour Committee issued an order on 13 March 2014, to Seven-Eleven Japan, which was going to develop a convenience store, to comply with collective bargaining with the labour union. Since this order was the first order of the Labour Committee to recognise franchisees in franchise agreements as having the nature of workers under the Labour Union Act, it has attracted considerable attention (at the time of writing, this matter is being deliberated in the higher Central Labour Committee).

This order raised the aforementioned six factors as determining the nature of workers under the Labour Union Act, and each is being applied in the direction of recognising the nature of workers on the franchisee side. Thereafter, on 16 April 2015, in a similar type of case in which FamilyMart was a party, the Tokyo Labour Committee found against FamilyMart in respect of unfair labour acts, with a framework similar to that in the aforementioned order of the Okayama Labour Committee, and issued an order to comply with collective bargaining.

¹² Article 4 of the Labour Union Act.

¹³ See the Employer and Employee Relations Study Group Report, ‘Standard of Determination of the Nature of Workers under the Labour Union Act’.

In these determinations, it seems that the fact of franchisees being independent enterprises was not given so much weight and, following strong criticism from franchisors, the results of the decisions of the Central Labour Committee are awaited with interest.

When executing agreements, therefore, it will be important to construct and operate transactional relationships, paying sufficient attention to the nature of workers.

v Consumer protection

The Consumer Contract Act will be applied to contracts other than labour agreements and with consumers other than business operators. Since a franchisee is an individual business operator and does not correspond to a consumer, the Consumer Contract Act is not likely to be applicable.

vi Competition law

The franchisor–franchisee relationship is one of the major targets of the Anti-Monopoly Act. The Franchise Guideline issued by the JFTC identifies actions by franchisors against franchisees that raise issues from an anti-monopoly perspective.

According to the Franchise Guideline, practices that may be considered anticompetitive include:

- a* enticing a candidate franchisee into the franchise business by creating a false impression that the franchise business is more advantageous than it really is, by failure to disclose important facts, or by false or exaggerated explanation;
- b* demanding franchisees trade only with the designated supplier, and prohibiting franchisees from trading with other suppliers who can provide better conditions than the designated supplier without good cause;
- c* requiring franchisees to purchase a certain volume of goods and rejecting the return of excess goods;
- d* where royalties are calculated based on the gross profit on sales including the cost of loss, prohibiting franchisees from discounting prices to avoid disposal without good cause; and
- e* where the suggestion of the retail price is lawful, imposing restrictions on the retail price of goods.

vii Legal principle of continuous contracts

With respect to continuous contracts such as franchise agreements, from the perspective that the expectation of the party (mainly the franchisee in franchise agreements) to continue the contract should be protected, the cancellation of the agreement is generally restricted.

On the other hand, by focusing on the principle of the freedom of contract, opinions recognising the freedom to cancel continuing contracts have been asserted. For example, in a case regarding the exercise of a right to terminate an agreement in a special store agreement for cosmetics, the Tokyo High Court held that an ‘unavoidable reason’ was not required in exercising the right to terminate an agreement.¹⁴ In addition, regarding rejections of renewal of franchise agreements, there have been cases in which it was held that the franchise agreement would end with the expiration of the term of the agreement unless there were

¹⁴ Tokyo High Court, 31 July 1997, Hanrei Jihou No. 1624, p. 55 [Kao Cosmetics Distribution Case]. Further, in this case, the Supreme Court did not indicate an express determination in this regard.

special circumstances such as the rejection of renewal violating public policy or the principle of good faith.¹⁵ Moreover, with respect to franchise agreements in particular, there are many court precedents that restrict the cancellation of contracts.

viii Applicable anti-corruption laws and regulations

First, bribing public servants in Japan conflicts with the Penal Code, and imprisonment of three years or less or a fine of ¥2.5 million will be imposed.¹⁶ In addition, bribing foreign public officials conflicts with the Unfair Competition Prevention Act, and imprisonment of five years or less or a fine of ¥5 million will be imposed, and it should be noted that if the company fails to give necessary warnings, a fine of ¥300 million or less will be imposed thereon.¹⁷

VII CURRENT DEVELOPMENTS

The House of Representatives passed an amendment to the Civil Code on 4 April 2017 and the House of Councillors subsequently passed it on 26 May 2017; it was then promulgated on 2 June 2017. Moreover, the Act on the Arrangement of Relevant Acts Incidental to Enforcement of a Part of the Civil Code, in which the law concerning the obligations changed to a large extent, was also promulgated on the same day. The new Civil Code will become basically effective from 1 April 2020.

In light of the introduction of the Civil Code amendment on franchising, franchisors will have to consider modifying their franchise contracts and related documentation.

An employee of convenience-store giant FamilyMart died during work and the bereaved family sought damages from the franchisee and franchisor on the basis of tort and joint tort, because the employee died as a result of an accident that occurred during overtime work. On 22 December 2016, the Osaka District Court reached a settlement requiring the franchisor, along with the franchisee, to pay ¥43 million.¹⁸

It is extremely unusual for a franchisor to be found liable for a settlement payout in relation to matters concerning a franchisee's employees who do not have a direct employment relationship with the franchisor. The Court opinion was not made publicly available because the case was settled privately, but this seems to be the first case in which the issue of joint employment liability has arisen in Japan.

15 Nagoya District Court, 31 October 1989, Hanrei Jihou No. 1377, p. 90.

16 Article 198 of the Penal Code.

17 Articles 18(1), 22(2)(vii) and 22(1) of the Unfair Competition Prevention Act.

18 Asahi-shinbun Digital news (www.asahi.com/articles/ASJDZ6VN2JDZUBQU003.html).

KAZAKHSTAN

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I INTRODUCTION

Franchising has been used as a route to the Kazakhstan market by overseas businesses since the 1990s when brands such as Coca-Cola, Adidas and InterContinental appeared on the market.² Over the past few years the country's strong economic growth, rising household incomes and the government's ambitious diversification plan³ have prompted other foreign franchisors to turn their sights to the country, which is quickly becoming a leading market in Central Asia. International brands such as Zara, Pizza Hut, Debenhams, Mothercare, Mango, Regus, Gap, Next, Burberry, Cinnabon and KFC are currently represented in the market, and major player Alhokair Fashion Retail recently increased its investment in Kazakhstan with the opening of two new New Look stores and further Accessorize, F&F and Blanco outlets. It is estimated that the number of foreign brands franchising in Kazakhstan will reach 550 by 2022.⁴

Franchising is used as a business system by foreign and domestic brands in nearly every industry that contains small and medium-sized businesses, but as in other Central Asia markets it is most common in the fast-food and casual dining, retail and leisure, and services sectors. Many foreign franchisors prefer to work on the basis of sub-franchising agreements with master franchisees in other countries rather than contracting directly with Kazakhstani partners, although the number of direct franchises is growing.

There is a range of agencies and associations with an interest in promoting franchising and foreign business in Kazakhstan. The Kazakhstan Franchise Association was created with the support of the US Agency for International Development as a non-governmental industry group to promote franchising by offering a variety of services, including consultation, information, matchmaking programmes and other educational events,⁵ although associations such as the Eurasian Franchise Association and Central Asian Franchising and Licensing

1 Nick Green is an associate at Bird & Bird LLP and Saule Akhmetova is a partner at GRATA Law Firm LLP.
2 Beknur Kisikov, 'In 2014 one expects demand on Restaurant franchise', MinTax (1 January 2014). Accessible at: <http://mintax.kz/eng/files/v-2014-godu-budet-spros-na-restorannye-franshizy.html>.
3 Central Intelligence Agency, 'The World Factbook: Kazakhstan'. Accessible at: <https://www.cia.gov/library/publications/the-world-factbook/geos/kz.html>.
4 Raissa Kaziyeva, 'Franchise Expectations: Case of Kazakhstan', CBU, International Conference Proceedings 2014: Innovation, Technology Transfer and Education (3–5 February 2015).
5 Andrei Chursov, 'New Legislation Improves Franchising Opportunities in Kazakhstan' Business Information Service for the Newly Independent States. Accessible at: www.ad-mkt-review.com/public_html/govdocs/bis/wmfs/wmfs02111.html.

Agency have also previously taken on similar roles. The Franchise Union of Kazakhstan also provides education and referral services and general advice on franchise arrangements and practices.

The Entrepreneurship Development Fund JSC (EDF) was established by the Kazakhstan government in 2001 with the objective of supporting and promoting small businesses in Kazakhstan, providing financial and non-financial support to small to medium-sized enterprises. The EDF also works alongside the state to improve financial resource management and the allocation of funding to small businesses.⁶

II MARKET ENTRY

Franchising in Kazakhstan is regulated by specific franchise legislation and general commercial law that varies between sectors and according to the structure of the commercial relationship.

One of the most important steps for franchisors contemplating entering the Kazakhstan market to take is protecting their intellectual property – in particular any trademarks or know-how that will be licensed to and used by a local franchisee. Kazakhstan's intellectual regime is relatively sophisticated, recognising that exclusivity arises in relation to a variety of types of intellectual property. Kazakhstan is a member of many of the major international organisations – including the Singapore Treaty of the Law of Trademarks, the Trademark Law Treaty, the Berne Convention and the Madrid Agreement Concerning the International Registration of Marks⁷ – and trademarks, service marks, utility models and other industrial designs are generally capable of being registered.

In most areas of business, Kazakhstan law does not require any approvals and does not contain any restrictions on franchisors entering the local market. In fact, the law provides for the support and promotion of franchising in the country. Kazakhstani legislation is not burdened with details and nuanced obligations, nor does it provide detailed restrictions governing the relationship between the parties to a franchise agreement. In this regard, there are no specific restrictions or limitations on a foreign entity granting a master franchise or development rights to a local entity.

In most cases, the law does not impose restrictions on foreign franchisors owning equity in a local business or owning real property. Certain restrictions, however, can be specified in respect of owning equity, where the business is associated with areas of strategic importance for the state, such as telecommunications, and other issues relating to national security and public safety. In addition, there are some restrictions on ownership of real estate in Kazakhstan by foreign nationals and entities.

Franchisors should also keep in mind the geographical issues involved in entering the Kazakhstan market. Kazakhstan is a large country but has a very low population density with less than six people per square kilometre.⁸ Almaty and the capital, Astana, are the largest

6 DAMU Entrepreneurship Development Fund JSC, 'Development Strategy for 2014–2023' (2014). Accessible at: www.fund-damu.kz/content/files/FundDamuStrategy2014_2023EngFinal.pdf.

7 IP-Coster, 'Intellectual property protection system in Kazakhstan' (April, 2015). Accessible at: <https://www.ip-coster.com/IPGuides/c/intellectual-property-kazakhstan>.

8 The World Bank Group, Data: Population density. Accessible at: <http://data.worldbank.org/indicator/EN.POP.DNST>.

cities by population but account for a very small fraction of the country's total population. Franchisors should therefore undertake careful due diligence on the geographic reach of any potential local partner, and consider how best to treat any potential exclusive arrangement.

Payments made between Kazakhstan residents (whether entities or individuals) must be made in the local currency, Kazakhstani tenge. Under the Law on Currency Regulation and Control No. 57-III dated 13 June 2005, payments made between residents and non-residents may generally be in any currency, although certain transactions must be notified to or registered with the National Bank of the Republic of Kazakhstan (the Bank). A franchise agreement falls under currency regulation as an import (or export) of goods (or works or services) operation. Depending on the terms and payment obligations of the parties under a franchising agreement (e.g., an obligation on a resident to pay more than US\$500,000, or on a non-resident to pay more than US\$100,000), the agreement may need to be registered with or notified to the Bank, in accordance with the relevant regime.

III INTELLECTUAL PROPERTY

Recently Kazakhstan has been taking significant steps to attract foreign investment into the country, including through changes to its intellectual property-specific legislation. For example, in April 2015 the law was amended to reduce the amount of time it takes to register a trademark, and to simplify the procedure for transferring trademark rights (among other measures). To date, the government has developed a draft law to introduce amendments to some legislative acts on intellectual property (the Draft Law). The principal agency involved in regulating intellectual property matters is the Department for Intellectual Property Rights (DIPR) of the Ministry of Justice of the Republic of Kazakhstan. Under the Draft Law, the principal agency in the area of intellectual property rights will be the expert panel, the functions of which are currently performed by the Republican State Enterprise 'National Institute of Intellectual Property', which reports to the DIPR.

i Intellectual property searches

Preliminary searches should be made to establish whether there are any similar or identical marks already on the register. Kazakhstan is a 'first to file' and not a 'first to use' jurisdiction, so it is important to register intellectual property rights as soon as possible, to protect them.

ii Intellectual property protection

Patents must be registered with the DIPR to be protected. Patent protection is given to an invention if it is new, involves an inventive step and is industrially applicable. Patent protection can be granted for inventions, utility models, industrial designs and selection achievements. The duration of protection varies for each protected item.

As of 1 January 2015, a party can choose to apply for a national patent or a Eurasian Patent – a unitary patent that, if registered in one of the eight contracting states (Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Turkmenistan), is valid upon grant in each of those jurisdictions (provided that corresponding annual fees are paid for the selected countries after the issuance of the patent).

Trademarks should also be registered with the DIPR although they may also be protected without national registration under international treaties to which Kazakhstan is a party. Trademark and service mark registration is granted for 10 years, renewable every 10 years.

Applications for registration of patents or trademarks should be filed with the National Institute of Intellectual Property of the DIPR, which will prepare an expert opinion. The DIPR will then decide, on the basis of the expert opinion, whether the intellectual property application meets the relevant criteria. Assignments and licences for patents and trademarks must be registered with the DIPR to be valid.

Copyright items are protected by virtue of their creation without registration or other formalities (although it is advisable to register them with the DIPR where possible). The DIPR will not examine the materials or verify the information in a copyright application. Copyright applies during an author's lifetime plus 70 years. An author is free to assign his or her copyrighted work.

Confidential know-how and trade secrets are protected provided that the information: (1) has an actual or potential commercial value by virtue of its being unknown to third parties; and (2) cannot be freely accessed on a legal basis. It is also necessary for the holder of such information to take measures to protect its confidentiality.

iii Enforcement

While Kazakhstan is a signatory to most major international agreements and conventions on intellectual property, enforcement of the law is not always strong. A number of state authorities protect and enforce intellectual property rights, including customs. Owners of certain intellectual property rights (e.g., trademarks) can ask the customs authorities to add their trademark to the customs register of intellectual property rights. Following such a registration, the customs authorities can suspend the import of any objects bearing that trademark for 10 business days. They will also alert the rights holder of the importation so that the rights holder may challenge the import or request interim relief.

The legislation of Kazakhstan provides for civil, administrative and criminal forms of protection of intellectual property rights.

Civil protection

Civil remedies – including damages and injunctive relief – can be claimed through court proceedings for infringement of intellectual property rights. The damages calculation process is subject to the usual civil remedies limitations. Both direct losses and loss of profits can be claimed, although the process of proving loss of profits in court is fairly complicated. Pursuant to the Draft Law, instead of damage recovery a right holder may make a claim for the infringer to pay compensation of a sum ranging from 500 to 10,000 monthly calculation indexes as ruled by the court, depending on the nature of the infringement, or up to twice the value of the goods unlawfully bearing the trademark.

Administrative protection

Alternatively, infringement can constitute an administrative offence. Such offences can be pursued via an application from the rights holder to the relevant authority. The primary administrative sanction is a fine calculated in accordance with the size of the infringing entity.

From 1 January 2015, administrative proceedings may also be initiated by the state revenue authorities for infringement of intellectual property rights.⁹ Previously, only the judiciary and financial police authorities had the right to initiate administrative cases.

9 Resolution of the Government of the Republic of Kazakhstan, dated 14 August 2014, No. 933.

Criminal protection

Infringement of intellectual property rights can constitute a criminal offence in some circumstances, the consequences of which can be severe. For example, criminal liability for illegal use of a trademark can result in either a fine or correctional labour, or a sentence of community service, or arrest.

The elements that need to be established to constitute an administrative or criminal offence are similar. Whether a particular act will qualify as a crime is dependent on the scale of the damage and whether an administrative sanction was imposed in the previous year.

IV FRANCHISE LAW

i Legislation

There are two key areas of legislation that franchisors need to be aware of when entering the Kazakhstan market. The Law of the Republic of Kazakhstan No. 330-II on Complex Entrepreneurial Licence (Franchise) (the Franchise Law) was passed in 2002, and is a law specifically regulating franchises in Kazakhstan. The legislation defines a franchise (a 'complex entrepreneurial licence') as 'entrepreneurial activity, in which a holder of the complex of exclusive rights provides it into use on a paying basis to another individual or entity'. The legislation also sets out the general rights and obligations of a franchisor and franchisee, in particular in relation to the requirement for the franchisor to provide to the franchisee a set of exclusive rights (such as know-how, trademarks, service marks, etc.) for the franchisee to utilise in its entrepreneurial endeavours.

The Civil Code of the Republic of Kazakhstan also sets out general principles of contract law that apply to every commercial agreement, and the Civil Code (Special Part) No. 409-I dated 1 July 1999 requires certain businesses to obtain a business licence before commencing operations.

ii Disclosure

There is a pre-contractual disclosure requirement under the Franchise Law, which is specific and unusual. Under the Franchise Law, a franchisor must provide the franchisee with details of the bundle of exclusive rights being granted to the franchisee, and must inform the potential franchisee of the confidential nature of this information. This provision of the Law, however, can be interpreted by courts both as a franchisor's right and as a franchisor's obligation, as the case may be. The Franchise Law does not prescribe how much information has to be provided, however, nor how much detail has to be given or what format the information is to be provided in. Best practice, therefore, is to provide as much information as the franchisor considers sufficient to allow the prospective franchisee to make an informed decision on the viability of the franchised business. Franchisors contemplating master franchise arrangements should also be aware that master franchisees will need to provide similar information to their sub-franchisees.

The absence of a comprehensive pre-contractual disclosure requirement does not give franchisors a 'free pass' with regards to pre-contractual sales and recruitment activity, however. Franchisors may be held liable for losses suffered by a franchisee as a result of fraud or wilful misrepresentation by the franchisor. The franchise agreement may also be held invalid if the franchisee can demonstrate it entered into the arrangement either based on an error material to the transaction, or as a result of fraud. A consequence of invalidity of the agreement may, at

the court's discretion, be that the parties are obliged to return to the other all benefits received during the relationship, or financially compensate the other party where such a return is not possible. Damages may also be awarded in addition.

iii Registration

The Franchise Law detailed above requires any franchise agreement that contains a trademark licence (for trademarks having a Kazakhstani registration certificate) to be registered with the DIPR. The Draft Law also provides for obligatory registration of franchise agreements relating to trademarks having international registration. To register the agreement, the relevant marks themselves must first be registered with the DIPR. The franchise agreement should be submitted for registration no later than six months after it is signed by both parties. Failure to register the agreement may result in it being deemed unenforceable and, in addition, a franchisee might be restricted from making royalty payments to an overseas franchisor as the agreement may need to be provided to the bank as evidence for the transfer of funds. The parties may also be prevented from claiming tax relief under applicable double-tax treaties for similar reasons.

Until recently, the registration process required that the full franchise agreement had to be submitted to the DIPR. On 20 April 2015 new legislation came into effect¹⁰ that made a number of important amendments to the IP regulatory regime in Kazakhstan. One of the most significant amendments is the harmonisation of the country's IP legislation with the provisions of the Singapore Treaty on the Law of Trademarks 2006 (the Treaty), meaning that if one of the parties to the franchise agreement is based in a contracting member country of the Treaty, only a summary of the main terms of the agreement need be registered rather than the full agreement. As the law has only recently been passed, the said procedure is not yet widely used by the DIPR. The Draft Law does, however, now describe in detail the requirements of the simplified registration procedure for franchise and licence agreements, having removed the requirement to provide the full text of an agreement and reduced the list of documents filed for registration. This modernisation will simplify the process for all foreign and local franchisors and reduce the amount of commercially sensitive information required to be provided for the register.

Franchisors should note that the Law of the Republic of Kazakhstan dated 11 July 1997, No. 151-I on Languages in Kazakhstan requires that all agreements are written in the Kazakh language and a language acceptable to the parties (usually English). For the purposes of registration, the agreement, or a notarised translation, must be provided in Kazakh. The Draft Law will allow registration documents to be submitted with a Russian or an English translation.

iv Mandatory clauses

Franchisors and franchisees are generally free to determine the terms of the agreement between them in accordance with the principle of freedom to contract. This includes the ability for the parties to elect that the agreement is governed by a foreign law and subject to a foreign jurisdiction.

¹⁰ The Law on Amendment to Some Legislative Acts of the Republic of Kazakhstan on the Issues of Legal Regulation in the Area of Intellectual Property.

There are some restrictions, however, on this general freedom. One key area often found to be of concern to foreign franchisors is the limitation on the scope of the franchisee's indemnity to the franchisor for liability to third parties. This is a common clause in many international franchise agreements, but under Kazakhstani law non-contractual liability to third parties falls on the person responsible for the action causing the third party's loss, which may be the franchisor or franchisee.

Another key area is in relation to provisions in the agreement dealing with intellectual property. As mentioned above, a franchisor may only license a trademark to a franchisee if the trademark itself is registered in Kazakhstan and the period of protection for such a trademark will determine the term of the agreement. The franchise agreement should also clearly define what intellectual property rights are being transferred or licensed, the scope of any exclusive territory, the specific purposes for which the rights may be used and when the grant of the rights will expire. The franchisor should also be sure to include audit and inspection rights in respect of goods and services provided by the franchisee and any premises from which the franchisee operates to ensure they are adequate and comply with brand standards.

V TAX

Kazakhstan's tax regime is set out in the Code No. 99-IV of the Republic of Kazakhstan on Taxes and Other Obligatory Payments to the State Budget dated 10 December 2008 (the Tax Code), which was rewritten in 2009. It provides for a relatively simple framework based on self-assessment with inspections and audits. Franchisors should note, however, that the penalties for non-compliance (such as improper declaration or non-payment) are high – even if unintentional – and that keeping proper documentation to evidence proper reporting and payment is critical. A difficulty both residents and non-residents often encounter is the lack of coherence between the Tax Code and widely accepted international taxation principles (on which many of the double-taxation treaties Kazakhstan is party to are based). This ambiguity can lead to an inconsistent approach both by parties to an agreement and by the relevant tax authorities across the country, causing uncertainty.

Often of most importance to foreign franchisors is the application of withholding tax to payments made by a resident to a non-resident legal entity. In Kazakhstan the withholding tax rate depends on the type of payment in question, although the rules on what rate applies to the different type of source income paid to non-residents are complex and at times inconsistent. Non-residents' business income is generally subject to a 20 per cent withholding tax. This includes (among other things) income from the sale of goods or services or generally for the performance of work in Kazakhstan, income from management, consultancy, legal and audit services performed outside Kazakhstan, and capital gains from a sale of shares or interest in a Kazakhstan registered entity. Royalties¹¹ (traditionally the main fee type to be earned by a franchisor), however, are subject to a 15 per cent withholding tax, as are dividends, capital gains and interest. If a franchisor is to provide a level of management or consultancy, or supply goods or services, the franchise agreement should be clear on the anticipated rates applicable to the different fees due, or – for tax efficiency and administrative ease – separate the arrangement into individual agreements.

11 Defined by the Tax Code as a payment for the use of trademarks, patents, copyright, software, designs, models, know-how and other similar rights.

Franchisors should also be aware that different rules apply to non-residents depending on where the non-resident is tax registered. Any payments being made to a resident of a recognised tax-haven jurisdiction are subject to a 20 per cent withholding tax rate. The List of Tax Haven Jurisdictions approved by Decree of the Government of the Republic of Kazakhstan No. 1318 dated 31 December 2008 sets out those jurisdictions that are considered to be tax havens, and the list is updated annually by the central tax authorities. As of 1 January 2015, Kazakhstan had concluded and ratified 46 double-taxation treaties (DTTs) – with another five currently pending – which typically reduce the applicable withholding tax rate on dividends, interest and royalties. Most royalty rates are reduced to 10 per cent to 15 per cent, provided the conditions in the relevant treaty are met. These conditions are largely administrative requirements set out in the Tax Code, and include ensuring the franchisee has been provided with a tax resident certificate confirming that the franchisor is a tax resident in a DTT country before the end of the year in which the relevant income was paid. The tax certificate must include the franchisor's full and accurate name and address, state the period in which the franchisor was a tax resident, be signed by an authorised employee of the franchisor and the signature and company seal must be notarised and apostilled. The practice shows that the most tax-efficient franchising structure is one implemented through countries that have effective double-tax treaties with Kazakhstan, such as the Netherlands, Luxembourg and the UAE. Such a structure will allow reduced withholding tax rates to be paid on royalty payments.

In addition, franchisors working in the education sector should note that royalty payments made by a resident franchisee that is recognised as an autonomous educational organisation are exempt from withholding tax in Kazakhstan. An 'autonomous educational organisation' means a non-commercial organisation established by the decision of the Parliament of Kazakhstan and engaged in educational, healthcare or scientific activity.

Royalty payments for the use or right to use trademarks, patents, know-how, technologies or other similar types of right are also subject to the reverse-charge value added tax (VAT) at a rate of 12 per cent. Under the Kazakhstani tax law, services are subject to VAT if they are deemed to be supplied in the territory of Kazakhstan under the 'place-of-supply' rules and if such services are supplied by a taxpayer registered as a VAT payer. Under the place-of-supply rules, services on transfer of right to use trademarks, patents, know-how, technologies or other similar types of right are deemed to be rendered at a location of the acquirer's business (i.e., the Kazakhstani franchisee) and, consequently, constitute a VAT-able operation in Kazakhstan. As a result, the Kazakhstani franchisee will be required to self-assess and pay VAT in Kazakhstan at a rate of 12 per cent on the amount of royalties payable to the non-resident franchisor under the franchise agreement. Subject to certain conditions, the amount of the reverse-charge VAT can be offset.

The franchisee is the party responsible for retaining and paying withholding tax (acting as a 'tax agent' for the franchisor), and must pay in accordance with the strict time frames established under the Tax Code. The franchisee must also be provided with confirmation from the franchisor of its tax residency status.

VI IMPACT OF GENERAL LAW

i General

The Civil Code contains a general requirement for citizens and entities to abide by the moral principles of Kazakhstan society and act in good faith, reasonably and fairly when exercising

their rights. These requirements cannot be contracted out of or excluded in an agreement, even if subject to a governing law that is not Kazakhstani law. There is no objective test for these terms, however, so in each case their meaning will depend on the circumstances and the interpretation of the courts.

ii Agency distributor model

Provided the franchise agreement is clearly and expressly stated to be a franchise agreement, and is carried out by the parties as a franchise arrangement, then it should not risk being interpreted as a commercial agency agreement. In practice, franchisors – particularly those supplying goods – should be careful when imposing minimum purchase requirements on franchisees and should ensure that franchisees act at all times on their own behalf and at their own financial risk.

iii Employment

Kazakhstani employment law is prescriptive and enforces a Labour Code, which sets out certain minimum requirements that an employment contract must contain. It is rare for a franchisee to be classified as an employee, so in most instances this will not be an issue, but franchisors should take care to structure the documentation so that the relationship of the parties is not in any doubt.

iv Consumer protection

Franchisees do not fall under the definition of ‘consumers’ under Kazakhstani consumer law as they purchase goods and services for the purposes of business rather than for their own personal needs. Accordingly, consumer legislation does not apply to franchise arrangements. For additional protection franchisors may consider only entering into franchise agreements with franchisees that are legal entities (rather than individuals) to confirm that it is a business-to-business relationship. However, bear in mind that a consumer has the right to proper quality of goods and services, including when buying them from a franchisee. Furthermore, the Civil Code provides for a subsidiary liability of the franchisor for consumer claims against a franchisee in respect of the quality of goods and services provided.

v Competition law

Kazakhstan’s competition law is primarily set out in the Entrepreneurial Code of the Republic of Kazakhstan dated 29 October 2015, No. 375-V (the Entrepreneurial Code). The Entrepreneurial Code expressly prohibits anticompetitive practices, abuses of dominance and monopolistic activity. The Entrepreneurial Code does, however, generally permit vertical agreements – including franchise agreements – and the Civil Code provides certain restrictive conditions that may be included in a franchise agreement even though they are considered in other circumstances to be anticompetitive. This includes the ability for the parties to agree that the franchisee has the exclusive rights to the franchised business in a particular territory to the exclusion of both third parties and the franchisor, and in-term and post-term non-compete restrictions on the franchisee. Resale price maintenance is prohibited in all agreements, however, as are exclusivity arrangements that seek to carve up a market based on specific categories or types of customer.

vi Termination

The respective termination rights of the parties will generally be determined by the governing law to the agreement. If the agreement is subject to Kazakhstani law then the Civil Code provides restrictions and conditions for termination rights. If the agreement is for a fixed term, then it may only be terminated by mutual consent, where one party is in material breach or in circumstances clearly detailed within the agreement. In many franchise agreements, therefore, the parties include a schedule detailing ‘termination events’ or grounds upon which one or both parties may end the arrangement. Franchisors should note, however, that in most cases one month’s notice is required to terminate an agreement. The Civil Code also states that if the agreement is for an indefinite term then both parties may terminate with six months’ notice (or such other longer period as may be stated in the agreement).

vii Anti-corruption

Kazakhstan has a broad range of legislation designed to combat corruption including, among others, the Law on Fighting Corruption (1998), the Law on Preventing Legalisation (Laundering) of Illegal Proceeds and Financing of Terrorism (2009) and the Law on Law Enforcement Bodies (2011). The Law on Fighting Corruption sets out the fundamental principles of the anti-corruption regime, defining what ‘corruption’ is, what constitutes a corruption offence and the liability for committing such offences. A new Criminal Code also came into effect on 1 January 2015, which introduces additional sanctions for corruption-related crimes, such as loss of rank and a lifetime ban on holding public office. The government has also implemented programmes, such as its 2015–2025 strategy, to help foster an anti-corruption culture.

At an international level, in 2008 Kazakhstan ratified the UN Convention against Corruption and the UN Convention against Transnational Organized Crime and all its protocols. The ratification of these significant anti-corruption conventions serves to effectively prevent corruption and ensure alignment between national legislation and international principles.

Additionally, Kazakhstan entities, specifically their joint venture partners, suppliers, agents and service providers, are required to comply with the provisions of the US Foreign Corrupt Practices Act (1977) and the UK Bribery Act (2010). Under this legislation, future partners or contractors of US and UK companies must have anti-corruption compliance policies in place. These policies will be thoroughly examined before any contract is concluded. Complex due diligence is undertaken by the US and UK companies to ensure they do not assist in any corruption, and such an examination is a key aspect of this process. Therefore, both of these foreign laws contribute to efforts to reduce the prevalence of corruption in Kazakhstan.

viii Dispute resolution

Kazakhstan legislation does not require a particular dispute resolution forum to be used, so the parties may agree on the resolution method that will apply to disputes arising in relation to the franchise agreement.

Arbitration, mediation and other forms of alternative dispute resolution (ADR) are used in Kazakhstan to varying effect. Arbitration is the most commonly used ADR method, whether through the Kazakhstani International Arbitrage (KIA) or other arbitral regimes. The KIA may be selected as a dispute forum if at least one party is a non-resident of the Republic of Kazakhstan and the parties have agreed in the franchise agreement – by way

of an arbitration clause – that the KIA will have jurisdiction.¹² Mediation is available in Kazakhstan, and is offered as a resolution forum by the KIA, although it is not currently as popular as arbitration or litigation.

Kazakhstan is a signatory to a number of international treaties providing for or relating to the enforcement of foreign court judgments and arbitral awards, including:

- a* the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958;
- b* the European Convention on International Commercial Arbitration (Geneva, 1961);
- c* the Agreement on the Procedure for Settling Disputes Relating to Economic Activities (Kiev, 1992); and
- d* the Convention on Legal Assistance and Legal Relations in Civil, Family and Criminal Matters (Chisinau, 2002).

A foreign judgment may be filed for enforcement within three years of the date the decision became effective, and will only be enforced by a local court if provided for by Kazakhstani law (very limited grounds are detailed in the Civil Procedure Code, mostly relating to family and marital law) or an international treaty.

The Civil Procedure Code provides that a party in receipt of an arbitral award may apply to a Kazakhstani court for its enforcement if the other party does not perform its obligations voluntarily. The court will review the application within 15 days of receipt and provide notice to the parties of the time and date of the review for the parties' attendance (although attendance is not required). The court may issue an enforcement order that may be used by the claiming party as the basis for initiating enforcement proceedings. The Civil Procedure Code and the Kazakhstan arbitration legislation set out the circumstances in which a court may refuse to enforce an arbitral award, which reproduce the grounds for refusal detailed in the New York Convention.

VII CURRENT DEVELOPMENTS

Although franchising in Kazakhstan is still relatively new compared with other jurisdictions, its popularity as a route to market for foreign brands continues to grow. The number of foreign brands currently franchising in Kazakhstan is close to 500, estimated to equate to over 3,000 franchising outlets generating an annual turnover of US\$1.2 billion. Those 500 are expected to rise to 550 by 2022.

The rapidly developing infrastructure of retail outlets – in particular new shopping malls and hypermarkets – is one key element of this growth, as it opens up opportunities for franchisors to target more easily large groups of consumers in one space, particularly those with mid-market and premium brands that require quality retail space. Several new hypermarkets have opened in Almaty and Astana over the past few years and this scale of development looks likely to be repeated in other major cities, with 550,000 additional square metres of retail space anticipated by 2017. Recent challenges for Kazakhstan include the significant currency depreciation in August 2016 triggered by China's economic slowdown, which resulted in higher inflation and living costs and a decrease in consumer confidence.

12 KIA Rules of Arbitration, Section 1, Article 1. Accessible at: www.arbitrage.kz/145.

With increased government support for business development and an improving regulatory environment, including stronger intellectual property protection, Kazakhstan looks set to remain an attractive prospect to foreign and domestic franchisors.

KOREA

Kenneth T Kim, Jason Sangoh Jeon and Jin Woo Hwang¹

I INTRODUCTION

The franchising business in Korea has experienced continued growth in the past few years. According to statistics from the Korea Fair Trade Commission (KFTC), there were 2,405 franchisors and 2,947 brands in 2011. Since then, the market has been on the rise and as of 2016 it boasted 4,268 franchisors and 5,273 brands.² In 2014, franchisors recorded total sales revenue of 50.9 trillion South Korean won³ and franchisees recorded total sales revenue of 42.9 trillion South Korean won.⁴ In sum, the franchise business accounted for 6.3 per cent of the nominal GDP of Korea in 2014.

The franchise business sector in Korea can be broadly categorised into food service business, service business and wholesale–retail business. As of 2016, in terms of the number of franchisors, the franchise market in Korea is composed of franchisors involved in the food service business (75.4 per cent), service business (18 per cent) and wholesale–retail business (6.6 per cent), and, therefore, the food service business share is high.⁵

Based on the data from 2014, 6.8 per cent of franchisors have entered foreign markets, such as China, the Philippines and Singapore, with the Chinese market being the primary target.⁶ Overseas expansion by Korean franchisors is anticipated to continue into the future.

In 1998, franchisors founded the Korea Franchise Association (KFA) to promote the advancement of franchise businesses in Korea. The KFA performs diverse tasks, such as hosting exhibitions to advance the Korean franchise industry, presenting awards to outstanding companies and franchisees that have contributed to the advancement of the franchise industry, and offering educational programmes to train a professional franchise workforce.

II MARKET ENTRY

i Restrictions

There is no specific regulation of franchising in respect of the entry of foreign franchisors into the Korean market. Foreign entities also face no limitations on granting master franchises or development rights to local entities.

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2 See statistics by the KFTC (Korean only, at <http://franchise.ftc.go.kr/main/subIndex/22.do>).

3 See Ministry of Trade, Industry and Energy (MOTIE) press release dated 15 January 2016.

4 See Statistics Korea, 'Results of Service Industry Surveys in 2014'.

5 See statistics by the KFTC (Korean only, at <http://franchise.ftc.go.kr/main/subIndex/22.do>).

6 See MOTIE press release at footnote 3.

Under the Foreign Investment Promotion Act (FIPA), if a foreign investor acquires shares in a Korean company, an *ex ante* or *ex post* report may be required, depending on the method of the relevant stock acquisition. With respect to a foreigner's acquisition of real property, the Foreigner's Land Acquisition Act, the FIPA and the Foreign Exchange Transactions Act (FETA) apply. However, unless the relevant real property requires a government permit, a foreigner may, in principle, acquire real property based on simple reporting pursuant to certain procedures.

ii Foreign exchange and tax

The framework law applied to foreign exchange issues is the FETA. There is no regulation specific only to franchise businesses with respect to foreign exchange, and there is no tax regulation specific to franchising; these issues will be discussed further in Section V.

III INTELLECTUAL PROPERTY

i Brand search

In Korea, the Fair Transactions in Franchise Business Act (the Franchise Business Act) regulates franchising in Korea, while the government authority in charge of enforcing the relevant statute is the KFTC. The KFTC has launched a separate website that allows the public to access information related to the trademark and business mark of each franchisor and the status of the franchise business of the relevant franchisor.⁷

Moreover, through the website operated by the Korean Intellectual Property Office (KIPO), the public can access information on the specific details of a trademark, such as its shape, to verify the trademark owner of the relevant business mark within Korea.⁸

ii Brand protection

To obtain stable trademark protection in Korea, a franchisor has to register its trademarks with the trademark register. Since Korea is a first-to-file jurisdiction, when two or more applications for trademark registration compete for the same or similar trademarks, the first applicant is granted the registration.

A registered trademark can be protected under the Trademark Act. Furthermore, any widely known, yet unregistered, trademark and sign can be protected under the Unfair Competition Prevention and Trade Secret Protection Act.

iii Enforcement

Once a trademark is registered, its owner may seek an injunction against a person who infringes or is likely to infringe the owner's rights, requesting the prohibition or prevention of infringement. When seeking an injunction, the trademark owner can request the destruction of the infringing goods, the removal of facilities provided for infringement, or

7 See KFTC franchise business search website (Korean only, at <http://franchise.ftc.go.kr/user/extra/main/62/firMst/list/jsp/LayOutPage.do>).

8 See KIPO trademark search service website (www.kipris.or.kr/khome/main.jsp).

other necessary measures.⁹ Moreover, a trademark owner may make a claim for damages arising from an infringement against a person who has wilfully or negligently infringed on its trademark rights.¹⁰

iv Data protection, cybercrime, social media and e-commerce

With respect to data protection, since the Personal Information Protection Act (PIPA) is enforced in Korea, a franchisor or franchisee has to comply with the PIPA in respect of the handling and protection of personal information in the course of operating a franchise business.

The PIPA imposes the following obligations with respect to the handling and protection of personal information: (1) collection of personal information¹¹ must be limited to the minimum extent necessary to achieve the purpose thereof; (2) the consent of the information subject is necessary for collection, use and third-party provision of the personal information; (3) any use and provision beyond the purpose for which the personal information was obtained is restricted; (4) a personal information manager¹² has to take technical, administrative and physical measures necessary for the safe management of personal information; (5) upon request by, the personal information manager has to inform the information subject of the source of personal information and the purpose of handling that information when the personal information manager handles personal information about the information subject collected from a person other than the information subject; (6) the personal information manager is required to destroy any personal information in its custody without delay when the information becomes unnecessary. Any non-compliance with the foregoing obligations may be subject to criminal liability.

The recent increase in the use of social networking sites and social media has resulted in diverse issues, such as defamation of franchisors or brands by malicious posts, causing difficulties for franchisors. With respect to malicious defamation, legal responses, including criminal complaints, may be necessary on a case-by-case basis.

With respect to electronic commerce (e-commerce), the Korean government has enacted the Act on Consumer Protection in Electronic Commerce, Etc. This act provides diverse provisions to protect e-commerce consumers by prohibiting e-commerce entrepreneurs from making false or exaggerated claims, from inducing or trading with consumers by using deceptive means, or from interrupting the withdrawal of subscriptions or termination of contracts.

9 See Article 107 of the Trademark Act.

10 See Article 109 of the Trademark Act.

11 The term 'personal information' refers to information that pertains to an individual, including the full name, resident registration number, images, etc. by which the individual in question can be identified (including information that cannot be used alone to identify the individual in question but that can, when combined simply with other information, identify the individual) (Article 2(i) of the PIPA).

12 The term 'personal information manager' refers to a public institution, corporate body, organisation or individual, etc. who manages personal information directly or via another person to administer personal information files as part of his or her duties (Article 2(v) of the PIPA).

IV FRANCHISE LAW

i Legislation

In Korea, the Franchise Business Act and its Enforcement Decree regulate matters related to franchise businesses in general.

The Franchise Business Act is composed of six broad Chapters. Chapter I explains the purpose of the Franchise Business Act and provides the definitions of various terms used in the Act. Chapter II presents the fundamental principles of franchise business transactions, while Chapter III prescribes the provisions regarding the registration and provision of information disclosure statement, the franchise fee and franchise agreement and provisions concerning prohibited unfair trade practices. Chapter IV stipulates dispute resolution methods for franchise business transactions and Chapter V includes the provisions regarding the case handling procedure of the KFTC, the enforcement agency for the Franchise Business Act. Finally, Chapter VI prescribes the penalties for violations of the Franchise Business Act.

While Korea's Monopoly Regulation and Fair Trade Act (MRFTA) (the statute that governs fair trade and antitrust issues) applies to all business transactions, the Franchise Business Act only applies to franchise business transactions. Hence, for matters regarding franchise business transactions, where the Franchise Business Act applies, some of the regulations of the MRFTA do not apply (Article 38 of the Franchise Business Act). Moreover, since franchise business transactions can also be viewed as commercial transactions, the Korean Commercial Code may also be applicable.

ii Pre-contractual disclosure

According to Article 6-2(1) of the Franchise Business Act, a franchisor is required to register an information disclosure statement¹³ with the KFTC. A registered information disclosure statement subsequently has to be provided to a prospective licensee.¹⁴ When providing a registered information disclosure, a franchisor has to attach the documents stating the trade names, locations and telephone numbers of the 10 franchisees closest to the future store of a prospective franchisee (documents on the status of neighbouring franchisees). Unless 14 days have elapsed since the provision of a registered information disclosure statement and the documents on the status of neighbouring franchisees, the relevant franchisor cannot execute a franchise agreement with a prospective franchisee.¹⁵

Moreover, when providing information to prospective franchisees or franchisees, franchisors are prohibited from engaging in the following acts: (1) providing information different from the facts, or exaggerated information, and (2) providing information by

13 The term 'information disclosure statement' refers to a document that includes the general status of a franchisor; the current status of the franchise business of a franchisor; franchisee charges; conditions of and limitations on business activities; detailed procedures for the commencement of the franchise business and the duration required for the commencement of business; explanation on the management role of a franchisor; support, education and training in relation to business activities; and the relevant facts governing violations of the MRFTA or the Act on the Regulation of Terms and Conditions (Article 2(x) of the Franchise Business Act) by a franchisor or its executive.

14 To partially change the contents of a registered information disclosure statement, the relevant franchisor has to register with or (for minor changes) report to the KFTC, depending on the importance of the matters changed.

15 See Article 7 of the Franchise Business Act; a violation may be sanctioned by imprisonment of up to two years and criminal fine of up to 50 million South Korean won.

suppressing or reducing facts that have a material impact on the execution or maintenance of a contract. Additionally, franchisors are obligated to provide information about the past profits or the expected future profits to the prospective franchisees and franchisees in writing.¹⁶ If a franchisor provides false, exaggerated or deceptive information to its prospective franchisees or franchisees in violation of the above, it may be subject to corrective measures or surcharges by the KFTC. In addition, the relevant franchisor could also bear damages liability or criminal liability.

iii Registration

Other than the registration of the information disclosure statement discussed in Section IV.ii, no separate specific registration process is required for a franchisor or for a franchisee.

iv Mandatory clauses

According to Article 11(2) of the Franchise Business Act, a franchise agreement must cover each of the following matters:

- a* grant of licence for business marks;
- b* terms and conditions of the business activities of the franchisee;
- c* education, training and business guidance for the franchisee;
- d* payment of franchise and other fees;
- e* demarcation of business territory;
- f* term of the agreement;
- g* transfer of business;
- h* grounds for termination of the agreement;
- i* the fact that a franchise deposit shall be deposited in the depository for two months from the date on which the prospective franchisee or franchisee executes a franchise agreement;
- j* if the perspective franchisee has consulted an attorney or a franchise trader with regard to the information disclosure statement, the fact that it has done so; and
- k* other matters specified by Presidential Decree concerning the rights and obligations of parties to a franchise business.¹⁷

v Guarantees and protection

Typically, guarantees from individuals and companies to the franchisor are enforceable. It is generally a common practice for local franchisors to require a franchisee to guarantee the franchisee's obligations under the franchise agreement.

¹⁶ See Article 9 of the Franchise Business Act.

¹⁷ Article 12 of the Enforcement Decree of the Franchise Business Act mentions the following as the 'matters prescribed by Presidential Decree': (1) conditions regarding the return of funds, such as franchisee fees; (2) installation of equipment and fixtures, etc. for the business of a franchisee and the maintenance and repair thereof, and the bearing of these expenses; (3) measures to be taken according to the expiration and termination of a franchise agreement; (4) just cause by which a franchisor may refuse to renew a franchise agreement; (5) franchisor trade secrets; (6) compensation for loss because of violation of a franchise agreement; (7) procedures for the resolution of disputes between franchisors and franchisees; (8) in the event of transfer by a franchisor of a franchise to another franchisee, the franchise agreement with the former franchisee; and (9) measures to be taken at the expiration of the term of validity of a franchisor's intellectual property rights.

V TAX

i Franchisor tax liabilities

As mentioned above, with respect to tax issues, the Korean Tax Code applies, with no specially applied regulation for franchises. The primary taxes relevant to business entrepreneurs in Korea are corporate tax, value added tax, individual income tax, customs duties and inhabitant tax levied on corporate tax, income tax and other taxes.

If a franchisor is a corporation, a Korean company has the duty to pay corporate tax on all income generated in and outside Korea, while a foreign company has a duty to pay this tax only on domestic-sourced income. Company income in each fiscal year is charged with a 'corporate tax on income from each fiscal year', and if the company transfers land and buildings, housing and adjacent land located in a specific area, or non-business-purpose land, it is subject to a 'corporate tax on income from transfer of land and other real properties'. If a domestic company is dissolved, 'corporate tax on income from liquidation' is levied; however, a foreign company is not subject to the duty to pay tax on income from liquidation.

ii Franchisee tax liabilities

If a franchisee is a corporation, the same tax rule applies as in Section V.i. However, if a franchisee is a natural person, the main tax issue would be the income tax levied on the business income in lieu of corporate tax. While a resident bears the duty to pay income tax on all income generated in and outside Korea, a non-resident, conversely, only has the obligation to pay income tax on domestic-sourced income. However, if a non-resident becomes a resident, such as through the method of dwelling in Korea for at least one year, income tax is imposed only on the domestic-sourced income generated up to the day before the non-resident's transition to resident and any income, both foreign or domestic, generated from the date of residency will be subject to income tax.

iii Tax-efficient structures

While there are both advantages and disadvantages depending on the business entity and the business structure, no single, optimal tax-efficient structure exists specially for franchise businesses.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

In Chapter (II), as a fundamental principle of the franchise business transaction, the Franchise Business Act requires the parties engaged in the franchise business to carry out each of their duties in good faith.¹⁸ By specifying this fundamental principle, the Franchise Business Act prescribes the obligations of the franchisors (Article 5) and those of the franchisees (Article 6). However, the Franchise Business Act does not separately prescribe sanctions for violations of the above fundamental principle and the obligations of the franchisors and of the franchisees. Therefore, these provisions can be viewed to have significance as best-practice standards rather than as mandatory rules. However, under the Franchise Business Act, any breach of

18 See Article 4 of the Franchise Business Act.

these obligations may be regulated under other provisions within the Franchise Business Act. Hence, it is worth noting that any breach of the above obligations may trigger civil or criminal liabilities.

ii Agency distributor model

In principle, a franchisee governed by the Franchise Business Act and an agency distributor are distinguished pursuant to the actual details of the business, regardless of the term used. However, since in many respects a franchisee and an agency distributor engage in similar transactions, distinguishing between the two business models is not easy. This is because an agency distributor, like a franchisee, also pays contract fees or deposits, and purchases various types of products or goods to resell them to end customers.

The actual standard for distinguishing a franchisee governed by the Franchises Business Act from an agency distributor is the 'payment of compensation for use of business marks and assistance or training for business activities'. In other words, if compensation for use of business marks and assistance or training for business activities is paid separately, the business operator should be viewed, reasonably, as a franchisee. Conversely, if such compensation is not paid, but rather only deposits are paid to engage in business, the business operator should be termed, reasonably, an agency distributor. Although the Franchise Business Act is not applicable to dealings with an agency distributor, the MRFTA remains applicable.

iii Employment law

The term 'worker' refers to a person, regardless of the occupational type, who offers labour to a business or workplace for the purpose of earning wages.¹⁹ The Supreme Court determines whether a person falls within the definition of a worker under the Labour Standards Act based on whether the person has actually provided labour to an employer under a subordinate relationship at a business or workplace for the purpose of earning wages.

Since a franchisee independently engages in a business upon its own initiative and bears the risks itself, and because the franchisee obtains a separate business licence for tax return purposes under the actual business practice, a franchisee is not viewed as a worker. Rather, a franchisee is generally treated as a separate, independent entrepreneur.

iv Consumer protection

According to the Framework Act on Consumers, the term 'consumers' refers to those who use goods or services provided by entrepreneurs for their daily consumption or for their production activities as designated by Presidential Decree.²⁰ With respect to the scope of those who use goods or services for production activities, the Presidential Decree stipulates the following: (1) an end consumer of the goods or services provided (provided that those who use the furnished goods, etc. as raw materials, capital goods or other equivalents for production activities are excluded), and (2) a person who uses furnished goods, etc. for agricultural activities (including in the livestock industry) and fishery activities (excluding those engaged in deep-sea fishing).²¹

19 See Article 2(1)(i) of the Labour Standards Act.

20 See Article 2(i) of the Framework Act on Consumers.

21 See Article 2 of the Enforcement Decree of the Framework Act on Consumers.

Since franchisees are not end consumers of the goods furnished by the franchisor, but rather persons that use the furnished goods, etc. as raw materials, capital goods or other equivalents, they are difficult to treat as consumers.

v Competition law

The Franchise Business Act prohibits a franchisor from engaging in, or causing any other business entity to engage in, acts that are likely to impede fair franchise business transactions and enumerates the following five types of prohibited acts:²²

- a* suspending or refusing the supply of goods or services or business assistance to a franchisee or placing significant limitations thereon;
- b* imposing unreasonable restraints or limitations on the prices of goods or services that a franchisee handles, its transacting counterparty, transacting territory or the business activities of a franchisee;
- c* imposing unreasonable disadvantages on a franchisee by abusing a franchisor's superior trading position;
- d* imposing on a franchisee unreasonable obligations to pay damages, such as imposition of penalties that are excessive in relation to the object and content of the contract, the size of the potential damages, the existence and extent of the faults between the parties and the normal trade practice in that type of business; and
- e* any act that does not fall under (a) through (d) above that is likely to interfere with fair franchise business transactions, such as the franchisor unreasonably inducing the franchisees of a competing franchisor to conduct transactions with it instead.

Moreover, the Franchise Business Act prohibits the franchisor from providing false or exaggerated information to franchisees, unreasonably pressuring franchisees to improve store environments, unreasonably restricting business hours and unreasonably infringing on the franchisees' sales territory.²³

Further, any area where the Franchise Business Act is inapplicable may be governed by the MRFTA, which governs fair trade and antitrust issues.

vi Restrictive covenants

A franchisor is permitted to include a provision in the franchise agreement that prohibits its franchisee from engaging in a business that competes with the franchise business during the term of the franchise agreement under the franchisee's own name or the name of a third party without the consent of the franchisor. For reference, the standard form franchise agreement distributed by the KFTC via its website also includes such a non-compete clause. In the event of a franchisee's breach of the non-compete clause, a franchisor can seek an injunction against the breaching franchisee requesting the suspension of business, and further the franchisor can claim any damages arising from the breach.

There is no clear consensus on whether a non-compete duty can be held to be binding even after the expiration of the franchise agreement. However, when the KFTC previously investigated whether a franchise agreement used by chicken and pizza franchisors violated the Act on the Regulation of Terms and Conditions, it held that a non-compete clause has

22 See Article 12(1) of the Franchise Business Act.

23 See Articles 9, 12-2, 12-3 and 12-4 of the Franchise Business Act.

to be reviewed by comparing and balancing the franchisor's interests in protecting its trade secrets against the franchisee's freedom of occupation choice. Based on this premise, the KFTC decided that, since chicken and pizza franchises can be opened without particularly special know-how from the franchisors, chicken and pizza franchisors cannot be found to have significant interests in protecting their trade secrets, if any. Accordingly, the KFTC ordered the non-compete clause in the franchise agreement to be removed or substituted with a clause that specifically protects trade secrets.²⁴ In light of the foregoing standard presented by the KFTC, if special know-how is transferred in a franchise business, which substantiates the need to protect trade secrets of the franchisor, a short-term non-compete obligation may be extended beyond the expiration of the contract term.

In connection with the confidential clauses in franchise agreements, a franchisor can include a clause that prohibits a franchisee from disclosing to a third party a franchisor's trade secrets acquired in the process of executing the franchise agreement and of operating a franchise business. If a franchisee breaches the clause, a franchisor can apply for an injunction against the breaching franchisee barring the infringement of trade secrets, and can claim compensation for damage that the franchisor incurred because of the infringement.

vii Termination

Where a franchisee requests to renew the franchise agreement during the period from 180 days to 90 days prior to the expiration of the franchise agreement, a franchisor cannot reject the request without justifiable reasons. A franchisee's right to request the renewal of the agreement may be exercised only when the total term of the franchise agreement, including the initial term, does not exceed 10 years.²⁵

Furthermore, apart from the exceptional grounds for immediate termination²⁶ prescribed by the Franchise Business Act, if a franchisor seeks to terminate the franchise agreement, it must clearly state the fact of the franchisee's breach during the grace period of not less than two months, and give a written notice at least twice indicating its intent to terminate the agreement unless the breach is corrected during the grace period. If this procedure is not complied with, the termination of the franchise agreement is not effective.²⁷

After the expiration of the franchise agreement, the shares, assets or business of franchisees can be acquired by the franchisor pursuant to the agreement between the parties; the Franchise Business Act does not provide specific regulation of such transfers.

viii Anti-corruption and anti-terrorism regulation

With respect to anti-corruption and anti-terrorism regulations, there is no regulation specifically applicable to franchising. Generally, the relevant laws that govern the bribery of domestic government officials include (1) the Korean Criminal Code, (2) the Act Concerning Aggravated Punishment of Specific Crimes, and (3) the Act on the Prohibition of Improper Solicitation and Provision or Receipt of Money and Valuables. In connection with the issue of bribery of foreign public officials, based on the OECD Convention, Korea enacted the Act on Prevention of Bribery to Foreign Public Officials in International Business Transactions.

24 See KFTC, Press Release Dated 15 September 2009.

25 See Article 13 of the Franchise Business Act.

26 See proviso of Article 14 of the Franchise Business Act and Article 15 of the Enforcement Decree of the Franchise Business Act.

27 See Article 14 of the Franchise Business Act.

ix Dispute resolution

In principle, a franchise agreement can designate a foreign court as the applicable jurisdictional court. However, an exclusive jurisdiction agreement, excluding the jurisdiction of the Korean court and recognising only the jurisdiction of a foreign court, is valid if the relevant case does not come under the exclusive jurisdiction of the Korean court and the jurisdiction of the designated foreign court can be established in addition to the existence of a reasonable connection between the relevant case and the designated foreign court. Furthermore, the exclusive jurisdiction agreement should not constitute a legal act that is significantly unreasonable and unfair to the extent that it is adverse to public order and good morals.²⁸ Moreover, any agreement that sets a foreign law as the governing law is valid, unless there is a justifiable basis for the claim that the agreement causes a significantly unreasonable or unfair consequence.²⁹

Most franchise disputes are addressed or resolved before the courts, or through mediation or arbitration, like most other commercial disputes in Korea. However, Korea has also established the Franchise Business Dispute Mediation Council under the Korea Fair Trade Mediation Agency as an agency in charge of mediating disputes related to franchise businesses. Both parties to a dispute can apply for mediation in cases involving franchise business disputes. Also, the KFTC can request mediation in cases that the KFTC is handling or investigating.

As discussed earlier, if a franchisee breaches the non-compete clause during the term of the franchise agreement or if a former franchisee uses the franchisor's trademarks even after the expiration of the franchise agreement or breaches the confidentiality clauses in connection with the franchisor's trade secrets, the franchisor can file a motion for injunctive relief against the infringements and claim compensation for any damage suffered. In Korea, property damages arising from tortious acts are calculated based on proprietary disadvantages suffered because of the harmful act (i.e., the discrepancy between the financial condition in the absence of the tortious act and the financial condition after the tortious act).

With respect to recognition and enforcement of foreign arbitral awards, Korea recognises or enforces any domestic arbitral award made in Korea pursuant to the Arbitration Act. Any foreign arbitral award made in jurisdictions other than Korea is recognised and enforced pursuant to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention).³⁰

VII CURRENT DEVELOPMENTS

An amendment to the Franchise Business Act in 2017 introduced the system of punitive damages (treble damages).

In principle, if a franchisor harms a franchisee by violating the Franchise Business Act, the franchisor is liable to the franchisee for damages. However, if the franchisor were to successfully prove that it lacked intent or negligence, the liability would not be established. Nonetheless, (1) provision of false and exaggerated information, and (2) unreasonable refusal to deal (i.e., unreasonable refusal to renew the underlying franchise agreement, or termination of the agreement, etc.) by the franchisor are deemed to show significant malevolent intent

28 See Supreme Court, Decision No. 96Da20093 rendered on 9 September 1997.

29 See Supreme Court, Decision No. 2010Da28185 rendered on 27 May 2010.

30 See Articles 38 and 39 of the Arbitration Act.

and to cause harm through loss of considerable sums in investment and the potential exit of the franchisee from the market. In the light of this deemed malicious intent and its effects, the punitive damages system was introduced to sanction such behaviour by imposing on the franchisor liability for damages of up to treble the amount of the costs incurred as a result of the damage suffered by the franchisee.³¹

31 See Article 37-2 of the Franchise Business Act.

MALAYSIA

Lee Lin Li and Chong Kah Yee¹

I INTRODUCTION

The Malaysian government has been an active proponent of franchising as a business model. In 2016, the franchising market in Malaysia contributed 26.6 billion ringgit to the Malaysian gross domestic product (GDP) compared to 26.8 billion ringgit in 2015² and it is expected that the franchise industry will contribute between 25 and 26 billion ringgit to GDP in 2017.³ Driven by the strong commitment of entrepreneurs and the efforts in promoting homegrown brands to the international arena, Malaysia is on track to achieve its aim to become a regional franchise hub in South East Asia in the next five years, and it is anticipated that this will be realised by 2020.⁴

The Ministry of Domestic Trade, Consumerism and Cooperatives (MDTCC) has been charged with monitoring the continued growth of the franchising sector in Malaysia. These efforts have culminated in the enactment of the Franchise Act 1998 (amended in 2012) (the Act) and the establishment of the Franchise Registry.

Foreign franchisors, particularly those with unique franchise models and concepts, are actively encouraged to enter into the Malaysian market. Between January 2000 and July 2017, the number of registered franchise businesses from various sectors in Malaysia has increased to 931, up from 830 last year, and of which 574 are local brands.⁵ This represents an increase of approximately 12.2 per cent of registered franchise businesses in Malaysia.

The Malaysian government, in recognition of the revenue streams that franchising models offer, has actively promoted the growth of domestic franchises. This support has been in the form of state grants, soft loans and business education programmes organised by the MDTCC and Perbadanan Nasional Berhad (PNS). PNS falls within the joint purview of the Ministry of Finance and the MDTCC. PNS is charged with spearheading the growth of the local franchise industry and assisting its expansion abroad, allocating and managing grants and offering business support in the form of franchise consultation and other advisory services. These efforts have led to significant growth in the number of local franchisors in the past decade.

1 Lee Lin Li is a partner and Chong Kah Yee is an associate at Tay & Partners.

2 See <http://www.thesundaily.my/news/2017/11/21/rm266b-gdp-local-franchise-industry>.

3 See <https://themalaysianreserve.com/2017/04/03/malaysia-on-track-to-become-regional-franchise-hub-by-2020/>.

4 Ibid. at 3.

5 See <http://www.kpdnkk.gov.my/kpdnkk/wp-content/uploads/2017/09/STATISTIK-UTAMA-KPDNKK-JULAI-2017.pdf>.

Since the introduction of the Franchise Development Assistance Fund (DBPF) in 2005, which was intended to assist companies in developing their brands or franchise businesses, 85 local franchise companies have received 5.65 million ringgit in funds from the programme.⁶ To date, the number of Malaysian franchise brands that have expanded worldwide has increased to 65 brands in 66 countries, with a total of 4,271 outlets.⁷

The Malaysian Franchise Association (MFA) was formed in 1994. It has a wide membership base that includes representatives from the franchising industry, service providers such as accountants, franchise consultants and bankers, and government bodies. All members are required to abide by the MFA's Code of Ethics of a Professional Conduct of Franchise Practitioners.⁸ The MFA maintains professional and ethical standards by enforcing this code of practice among its members.

The MFA serves as a resource centre for franchisors and franchisees, the media and the public. It also acts as a networking and discussion forum between the private sector, franchise industry and government agencies.

II MARKET ENTRY

i Restrictions

Prior to the introduction of the Act, parties were free to negotiate their own terms and were governed by contract and common law. This allowed for a higher degree of flexibility. The franchising industry is now regulated by the Act, which places greater restrictions on foreign franchisors and introduces criminal liability for certain acts.

Section 54 of the Act requires that all foreign franchisors intending to set up franchises or enter into franchise agreements with any Malaysian citizen obtain prior approval from the Franchise Registry. Applications for registration are required to be supported by documents that include:⁹

- a* a sample franchise agreement;
- b* a certified true copy of the applicant's certificate of incorporation;
- c* document evidencing changes in shareholding of the company, if applicable;
- d* details of the franchise concept, including the uniqueness of the brand's franchise system and franchise experience;
- e* official declaration from the Insolvency Department that the board of directors are free from bankruptcy;
- f* a certified true copy of the registration certificate of the franchise's trademarks issued by the intellectual property office of the brand's country of origin and the Intellectual Property Corporation of Malaysia (MyIPO) (or proof of an application for such a registration);
- g* the company's brochure or profile;
- h* pictures of a prototype outlet; and
- i* a certified true copy of the latest three years' audited accounts that have been notarised by a notary public.

6 Ibid. at 2.

7 Ibid. at 2.

8 See <http://www.mfa.org.my/newmfa/background/>.

9 See <https://myfex.kpdnkk.gov.my/>.

Decisions are communicated by the Franchise Registrar in writing and the approval remain in place until the Registrar issues an order suspending, terminating, prohibiting or refusing the sale and registration of the franchise as permitted under the Act or where an applicant or franchisor seeks a cancellation of the approval.

Apart from Section 54 of the Act, there are no restrictions placed on foreign franchisors with regard to granting a master franchise or development rights to a local franchisee. The appointed master franchisee or a franchisee of the foreign franchisor is required to register its franchise with the Franchise Registry before making an offer to sell the franchise to any person or commencing the franchise business, respectively.¹⁰

Foreign franchisors are permitted to acquire equity in local businesses and real property subject to certain conditions.

Franchises with foreign equity must be incorporated locally, either as a subsidiary, a representative or branch office to carry on business in Malaysia.

All distributive trades, which includes retailers, wholesalers, franchise practitioners and direct-selling businesses, are required to obtain approval from the MDTCC before they are able to operate in Malaysia and are required to comply with the MDTCC's Guidelines on Foreign Participation in the Distributive Trade Services (the MDTCC Guidelines).¹¹

These Guidelines are extensive and cover the following:

- a* acquisitions, mergers or takeovers by foreign participation;
- b* the opening, relocation, expansion of branches or outlets or chain stores;
- c* buying over or taking over of outlets of other operators; and
- d* real property transactions relating to distributive trade activities (prior to obtaining other necessary approvals or licences from local authorities and other government agencies).

In addition, all distributive trades with foreign equity are required to:

- a* appoint a *bumiputra* director or directors (*bumiputra* is a local term that refers to the indigenous peoples of Malaysia encompassing ethnic Malaysia and other minority indigenous ethnic groups);
- b* hire personnel at all levels, including management, to reflect the racial composition of the Malaysian population;
- c* formulate clear policies and plans to assist *bumiputra* participation in the distributive trade sector;
- d* utilise local airports and ports in the export and import of goods;
- e* utilise local companies for legal and other professional services;
- f* submit annual financial reports to the MDTCC;
- g* comply with all local authority by-laws and regulations; and
- h* ensure that persons with disabilities make up at least 1 per cent of their total hypermarket workforce (in relation to franchises operating in the hypermarket sector).

10 A master franchisee is required to obtain approval under Section 6 of the Franchise Act 1998, whereas a franchisee of a foreign franchisor is required to obtain approval under Section 6A of the Franchise Act 1998.

11 Guidelines on Foreign Participation in the Distributive Trade Services Malaysia, by the MDTCC; see http://www.kpdnkk.gov.my/kpdnkk/wp-content/uploads/2017/04/WRT_Guideline.pdf.

The MDTCC Guidelines also impose specific conditions on franchises operating in certain industry sectors. These include:

- a* for businesses operating in the hypermarket sector, a minimum capital requirement of 50 million ringgit and a requirement for a minimum 30 per cent of equity to be held by *bumiputras*;
- b* in the department store sector, a minimum capital requirement of 20 million ringgit;
- c* for superstores operating as self-service distribution stores retailing mainly consumer goods that comprise of a mix of food and non-food products, a minimum capital requirement of 25 million ringgit; and
- d* for specialty stores serving an exclusive brand name, product or line of goods, a minimum capital requirement of 1 million ringgit.

Generally, in an effort to promote local participation, government agencies are actively tasked with encouraging the formation of joint ventures between Malaysians and foreign investors instead of allowing wholly foreign-owned corporations to operate independently.

Pursuant to the National Land Code, a foreigner is required to obtain prior approval from the relevant state authority for transactions regarding real property. Any property transactions without this formal approval are rendered void.¹² In addition to the requirements of the National Land Code, there are further restrictions in place and these are, broadly, as follows:¹³

- a* foreigners are generally prohibited from purchasing properties valued at below 1 million ringgit; and
- b* where the property is valued at or above 1 million ringgit, there are generally no restrictions, but where a property is valued at over 20 million ringgit and the purchase results in the dilution in the ownership of property held by *bumiputra* interest or government agency, prior approval will be required from the Economic Planning Unit.

ii Foreign exchange and tax

Foreign exchange

Foreign exchange issues are governed by the Foreign Exchange Administrative Rules issued by the Central Bank of Malaysia (BNM) and the Financial Services Act 2013 (FSA).¹⁴

Residents¹⁵ and non-residents¹⁶ are defined within Section 213 of the FSA. The Malaysian market is generally accessible by foreign investors. Payment for investments can be made in a foreign currency or in Malaysian ringgit. Non-residents are free to remit

12 Sections 433A, 433B and 433C of the National Land Code 1965.

13 Guidelines on the Acquisition of Properties (2014), by the Malaysian Economic Planning Unit; see <http://epu.gov.my/en/en/sites/default/files/GP%2520EPUJPM%2520-%2520English%25202014.pdf>.

14 BNM press release: 'Financial Services Act 2013 and Islamic Financial Services Act 2013 Come into Force'. See http://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=607&lang=en; in this press release, the BNM confirmed that all prevailing foreign exchange rules in operation prior to the Financial Services Act 2013 would remain in force.

15 Section 213 of the Financial Services Act 2013. Residents include Malaysian citizens, foreign citizens who have been accorded permanent residence status and who reside in Malaysia and companies incorporated in Malaysia.

16 Section 213 of the Financial Services Act 2013. Non-residents include foreign citizens, foreign embassies or high commissions, supranational Malaysian citizens who have acquired permanent residence status abroad and who reside abroad and foreign corporate entities.

divestment proceeds, profits, dividends or any income arising from investments in Malaysia abroad. Any repatriation of funds must, however, be made in foreign currency. Non-residents are also free to:

- a* open ringgit or foreign currency accounts in Malaysia;
- b* obtain credit facilities in Malaysia in ringgit or foreign currency;
- c* obtain loans of any amount from Malaysian residents to finance the purchase of immoveable properties in Malaysia; and
- d* enter into foreign exchange contracts on a spot or forward basis with onshore licensed banks to hedge investments in Malaysia.¹⁷

Non-resident travellers may:

- a* bring in or take with them, Malaysian currency up to the value of US\$10,000; and
- b* bring in any amount of foreign currency, including traveller's cheques.¹⁸

Tax

The imposition of tax is governed by the Income Tax Act 1976. Non-resident companies are subject to withholding tax on royalty payments derived from within Malaysia. This imposes a legal obligation on the party or franchisee making the payment to a non-resident to withhold tax at source and remit it to the Inland Revenue Board of Malaysia within a specified period (usually within a month of the date of the payment or royalties).¹⁹

III INTELLECTUAL PROPERTY

i Brand search

Registration of intellectual property rights (IPRs) such as, trademarks, patents, industrial designs and geographical indications is administered by MyIPO. Prior to filing an application to register marks, it is prudent for franchisors seeking to enter into the Malaysian market to undertake trademark searches against the databases maintained by MyIPO to ascertain whether there are any conflicts, potential or otherwise. Similar searches may be conducted with regard to other IPRs, such as industrial designs and patents.

Following the launch of an online search portal by MyIPO in 2010, all trademark searches are now conducted online.²⁰ However, as the online search portal is limited in its field of searches, the search results may not be comprehensive. It is, therefore, advisable to conduct searches using the online facilities provided at the Registry of Trade Marks. Such searches will be subject to official fees but will provide more comprehensive search results.

MyIPO also maintains databases for granted patents and registered industrial designs, which are open to public search and inspection and which may similarly be searched using

17 Foreign Exchange Administration Rules, by the BNM; see http://www.bnm.gov.my/microsite/fxadmin/new_fea_rules/FEA_rules_Part_2_Non-residents.pdf.

18 Ibid.

19 Section 109(1) of the Income Tax Act 1967 and the Income Tax (Deduction for Expenditure on Franchise Fee) Rules 2012.

20 See https://iponline.myipo.gov.my/ipo/main/search_tm.cfm?CFID=fe97bd8c-9b6e-4001-80da-442a70cbf73e&CFTOKEN=0.

the MyIPO online search portal.²¹ As with trademarks, however, it is advisable to conduct searches at the Registry of Patents and the Industrial Designs Registration Office to obtain more comprehensive search results.

Franchisors should also perform further searches against the database for registered companies and businesses maintained by the Companies Commission of Malaysia (CCM).²² The CCM is charged with approving applications for, and maintaining the registration of, companies and businesses in Malaysia. As the CCM does not, as a matter of practice, conduct any cross-reference searches with MyIPO, a registered trademark may well be registered by a third party as a company name. In such an instance, and in the absence of any direct settlement with the company or business concerned, the only recourse available to a trademark owner is to commence court proceedings for the alteration of the registered company or business name.

ii Brand protection

Section 24 of the Act requires a franchisor to register any trademarks relevant to his or her franchise prior to applying for registration with the Franchise Registry. Trademark applications take time to mature to registration. Hence, it is important to file the applications for registration of the marks early, before the franchise commences operation and, wherever possible, as soon as practicable after the franchisor has made a decision to expand its franchise in Malaysia. The Franchise Registry usually accepts proof of filing for registration in place of a certificate of registration of the marks.

The trademark filing process involves two main stages. After the trademark application is filed, it will be examined for compliance with formalities and substantive requirements. If the requirements were met, the Registrar would issue a request for publication of the application, which essentially means that the application is accepted for registration, subject to third-party oppositions. The application would then be published in the Government Gazette for opposition purposes by third parties. If there are no oppositions, the certificate of registration will be issued. The entire process takes between nine and twelve months from the filing date to registration. If the requirements were not met, the Registrar would issue an office action containing the objection to the application. The applicant would be required to submit a response to the objection by filing written submissions and evidence of use. Thereafter, if the application is accepted, a request for advertisement is issued. If the application were not accepted, the applicant would be given an opportunity to submit oral arguments at an *ex parte* hearing. If the applicant is successful at the *ex parte* hearing, a request for advertisement would be issued and the steps indicated above are followed until the certificate of registration is issued. If the applicant is unsuccessful at the *ex parte* hearing, the application will be refused registration. An applicant may appeal to the High Court against a decision by the Registrar refusing an application and, thereafter, there is a final recourse by way of an appeal to the Court of Appeal.

The initial period of registration is 10 years from the date of application, which is deemed to be the date of registration.²³ The trademark may be renewed every 10 years before the expiry date. If it is not renewed before the expiry date, late renewal may be filed within

21 See <http://onlineip.myipo.gov.my/index.cfm?CFID=fe97bd8c-9b6e-4001-80da-442a70cbf73e&CFTOKEN=0>.

22 See https://www.ssm.com.my/en/ssm2/reg_search.

23 Section 32(1) of the Trade Marks Act 1976.

one month of the expiry date. If late renewal is not filed, an application to restore and renew the registration may be filed within one year of the expiry date. Failure to do either of these will result in the registration being removed from the Register.

A registered trademark is also vulnerable to cancellation on the grounds that: (1) the trademark was registered without an intention in good faith to use the trademark in relation to the goods or services and, in fact, there has been no use in good faith of the trademark up to one month prior to the date of the application seeking the cancellation of the registration; or (2) there has been no continuous use of the trademark, in good faith, for a period of three years up to one month prior to the date of the application seeking the cancellation of the registration.²⁴

iii Enforcement

The main IPRs applicable to a franchise are trademarks, confidential information or trade secrets, know-how and copyright. In certain businesses, other IPRs such as industrial designs and patents may also be applicable.

A registered proprietor has recourse under the relevant legislation or common law to seek relief for the infringement of any of its IPRs. Infringement actions in respect of trademarks, copyright, industrial designs and patents are generally initiated in the High Court. Other rights such as breach of confidentiality or trade secrets or passing off may also be initiated in the Sessions Court (a subordinate court) if the claim for damages does not exceed 1 million ringgit.²⁵ Both the High Court and the Sessions Court have jurisdiction to grant interim or permanent injunctive and specific reliefs.²⁶ The reliefs ordinarily sought in civil actions for infringement are permanent injunctive orders prohibiting further infringing acts, orders for the delivery of the infringing articles, damages or an account of profits and legal costs.

Where a trademark is infringed, a registered proprietor or an exclusive licensee of the trademark may commence a civil action pursuant to the Trade Marks Act 1976 (TMA),²⁷ and where the mark has been used in Malaysia such that there is goodwill and reputation associated with it, there is additional recourse under common law for passing off. The standard reliefs are usually available in such actions.

A registered proprietor may also have recourse to administrative relief, in the form of border protection measures to prevent the importation of counterfeit goods under the TMA, and criminal remedies pursuant to the Trade Descriptions Act 2011²⁸ whereby the Enforcement Division of the MDTCC may be moved to initiate a raid, seize infringing or counterfeit goods and prosecute the persons responsible.

Know-how, trade secrets and confidential information are protected through contract law and under the common law tort of breach of confidential information. In the case of a franchise business model, Section 26 of the Act provides that a franchisee is required to provide the franchisor with a guarantee that the franchisee, including its directors, their spouses and immediate family, and its employees, may not disclose any information contained

24 Section 46(1) of the Trade Marks Act 1976.

25 Section 65(1)(b) of the Subordinate Courts Act 1948.

26 Sections 65(1)(c) and (5)(a) of the Subordinate Courts Act 1948 and Section 25(2) of the Courts of Judicature Act 1964.

27 Section 38 of the Trade Marks Act 1976.

28 Section 8 of the Trade Descriptions Act 2011.

in the training or operation manual or information obtained from the franchisor during the term of the franchise agreement. Failure to provide such a guarantee is tantamount to an offence under the Act.

Where these obligations of confidence are set out in the franchise agreement or a confidentiality agreement or undertaking, a franchisor will also have recourse to a civil action for breach of confidentiality under contract and common law.

While there is no compulsory registration system for copyright in Malaysia, it is possible to provide voluntary notification of copyright ownership to the MyIPO. A work is eligible for copyright protection upon the fulfilment of certain conditions, which include labour, skill and judgement to make the work original, where the work is reduced in material form, written down or recorded and the author is a Malaysian or the work is produced or made in Malaysia. Works that are protected under copyright include literary, musical artistic or dramatic works.²⁹

When a copyright work is infringed, the proprietor of the copyrighted work may initiate a civil action and seek injunctive reliefs similar to the standard reliefs and, in addition, may seek statutory damages of not less than 25,000 ringgit for each work and not more than 500,000 ringgit on aggregate.³⁰ The copyright owner may also have recourse to criminal remedies provided under the Copyright Act 1987³¹ by lodging a complaint with the Enforcement Division of the MDTCC to request that a seizure action be carried out in respect of the infringing activities.

Similarly, if other IPRs, such as patents³² or industrial designs,³³ registered in Malaysia are concerned, the registered proprietor will have similar recourse to the civil remedies discussed above for such infringements.

iv Data protection, cybercrime, social media and e-commerce

The Personal Data Protection Act 2010 (PDPA) and regulations made thereunder, including the Personal Data Protection Regulations 2013, regulate personal data that is processed and maintained in relation to commercial transactions.

Personal data encompasses information in relation to commercial transactions that relates directly or indirectly to a data subject who is identified or identifiable from that information or other information in the possession of the data user, and includes any expressions of opinion relating to the data subject. 'Data subject' refers to an individual who is the subject of the personal data.

Commercial transactions are defined as any transaction of a commercial nature, whether contractual or otherwise, which includes any matter relating to the supply or exchange of goods or services, agency, investments, financing, banking and insurance. The PDPA applies to the operation of a franchise, as personal information of the franchisors' employees, customers, clients, suppliers and contractors that is collected will be in relation to a commercial transaction.

'Processing', in relation to personal data, means collecting, recording, holding or storing personal data or carrying out any operation or set of operations on personal data,

29 Section 7 of the Copyright Act 1987.

30 Section 37 of the Copyright Act 1987.

31 Section 41 and Part VII of the Copyright Act 1987.

32 Section 60 of the Patents Act 1983.

33 Section 35 of the Industrial Designs Act 1996.

including organisation, adaptation or alteration; retrieval, consultation or use; disclosure by transmission, transfer, dissemination, or otherwise making available; and alignment, combination, correction, erasure or destruction of personal data.

Although the personal data may be processed outside Malaysia, the PDPA will apply to such processing if the personal data is intended to be further processed in Malaysia.³⁴ Accordingly, the PDPA may also apply to the foreign franchisor as a joint data user if it is involved in and has some form of control over the processing of such data by its Malaysian franchisee.

A data user who belongs to any of the following class of data users as specified in the Schedule to the Personal Data Protection (Class of Data Users) Order 2013 is required to be registered under the PDPA:³⁵

- a* communications;
- b* banking and financial institutions;
- c* insurance;
- d* health;
- e* tourism and hospitality;
- f* transportation;
- g* education;
- h* direct selling;
- i* services;
- j* real estate;
- k* utilities;
- l* pawnbroker; and
- m* moneylender.

To process personal data, a data user must comply with the following Personal Data Protection Principles (collectively, the PDP Principles):³⁶

- a* General Principle;
- b* Notice and Choice Principle;
- c* Disclosure Principle;
- d* Security Principle;
- e* Retention Principle;
- f* Data Integrity Principle; and
- g* Access Principle.

The General Principle requires a data user to obtain the consent of its data subjects, which in this case would include the franchisor's employees, customers, clients, suppliers and contractors, prior to processing their personal data.³⁷ There is no specific form in which the consent must be obtained as long as the consent is capable of being recorded and maintained properly by the franchisor.³⁸

34 Section 3(2) of the Personal Data Protection Act 2010.

35 Section 14(1) of the Personal Data Protection Act 2010.

36 Section 5(1) of the Personal Data Protection Act 2010.

37 Section 6(1) of the Personal Data Protection Act 2010.

38 Regulation 3(1) of the Personal Data Protection Regulations 2013.

Under the Notice and Choice Principle, franchisors must give written notice in Malay and English to the data subjects with the following information when they first collect, or before they use, personal data:³⁹

- a* a statement that personal data of the data subject are being processed by or on behalf of the franchisor and a description of the personal data;
- b* the purposes for which the personal data are being or is to be collected and further processed;
- c* the sources of the personal data;
- d* the data subject's right to request access to and correction of the personal data, and how to contact the franchisor with any enquiries or complaints in respect of the personal data (i.e., by providing the designation of the contact person, phone number, fax number (if any), email address (if any) and such other related information);⁴⁰
- e* the class of third parties to whom the franchisor discloses or may disclose the personal data;
- f* the choices and means the franchisor offers the data subject for limiting the processing of personal data;
- g* whether it is obligatory or voluntary for the data subject to supply the personal data; and
- h* where it is obligatory for the data subject to supply the personal data, the consequences for the data subject if he or she fails to supply the personal data.

Under the Disclosure Principle, franchisors are prohibited from disclosing the personal data of their employees, customers, clients, suppliers and contractors for any purpose or to any party other than for the purposes that were made known to the data subjects at the time the personal data were collected, unless further consent is obtained.⁴¹

The Security Principle requires franchisors to take practical steps to protect personal data from any loss, misuse, modification, unauthorised or accidental access or disclosure, alteration or destruction.⁴² Franchisors must develop and implement a security policy that complies with the security standard set out in the Personal Data Protection Standard 2015 (the Standard). If the franchisor engages a third party (data processor) to process the personal data on its behalf, it must ensure that the data processor provides sufficient guarantees in respect of the technical and organisational security measures governing the processing to be carried out, and takes reasonable steps to ensure compliance with those measures.⁴³

Under the Retention Principle, franchisors must not keep personal data longer than is necessary for the fulfilment of the purposes for which they were collected. If the personal data are no longer required, the franchisor must take reasonable steps to ensure that the personal data are permanently deleted.⁴⁴ There is no specific retention period or destruction timeline under the PDPA for the storage of personal data and this may be subject to requirements of other legislation, such as employment laws, company laws and tax laws, which may require personal data to be retained for a specific period. The data retention must comply with the Standard.

39 Section 7 of the Personal Data Protection Act 2010.

40 Regulation 4 of the Personal Data Protection Regulations 2013.

41 Section 8 of the Personal Data Protection Act 2010.

42 Section 9(1) of the Personal Data Protection Act 2010.

43 Section 9(2) of the Personal Data Protection Act 2010.

44 Section 10 of the Personal Data Protection Act 2010.

The Data Integrity Principle requires franchisors to take reasonable steps to ensure that the personal data of their employees, customers, clients, suppliers and contractors are accurate, complete, not misleading and kept up to date, and this must be carried out in accordance with the Standard.

The Access Principle gives data subjects the right to access and correct their personal data where the personal data are inaccurate, incomplete, misleading or not up to date.⁴⁵ Franchisors should implement a system that allows their employees, customers, clients, suppliers and contractors controlled access to their personal data for purposes of updating the personal data.

The PDPA allows a data subject to withdraw his or her consent to the processing of personal data by written notice to the data user. Accordingly, data users must, upon receiving such notice, cease processing the personal data. Failure to comply is an offence and, on conviction, the data user is liable to a fine of up to 100,000 ringgit or imprisonment for a term not exceeding one year, or both.⁴⁶ In view of the fact that processing includes storage, a request to delete arguably amounts to a withdrawal of consent to process personal data. Therefore, a request to delete must be complied with.

Franchisors are prohibited from transferring any personal data to places outside Malaysia except to places specified by the Minister of Communications and Multimedia and notified in the Gazette or unless it meets one of the conditions set out below:⁴⁷

- a* the data subject has given consent;
- b* the transfer is necessary for the performance of a contract between the data subject and the franchisor;
- c* the transfer is necessary for the conclusion or performance of a contract between the franchisor and a third party that:
 - is entered into at the request of the data subject; or
 - is in the interests of the data subject;
- d* the transfer is for the purpose of any legal proceedings, for obtaining legal advice, or exercising or defending legal rights;
- e* the franchisor has reasonable grounds to believe that in all circumstances of the case:
 - the transfer is for the avoidance or mitigation of adverse action against the data subject;
 - it is not practicable to obtain the consent in writing of the data subject to that transfer; and
 - if it were practicable to obtain that consent, the data subject would have given his or her consent;
- f* the franchisor has taken all reasonable precautions and exercised due diligence to ensure that the personal data will not, in that place, be processed in any manner that, if that place is Malaysia, would be a contravention of the PDPA;
- g* the transfer is necessary to protect the vital interests of the data subject; and
- h* the transfer is necessary as being in the public interest.

In addition to obtaining the general consent for the processing of personal data, franchisors should also obtain consent from their employees, customers, clients, suppliers and contractors

45 Section 12 of the Personal Data Protection Act 2010.

46 Sections 38(1), 38(2) and 38(4) of the Personal Data Protection Act 2010.

47 Sections 129(1) and 129(3) of the Personal Data Protection Act 2010.

to transfer the personal data to places outside Malaysia. Alternatively, franchisors may transfer the personal data if they are able to show that they have taken all reasonable precautions and exercised all due diligence to ensure that the personal data of the data subjects will not, in that place outside Malaysia, be processed in any manner that, if that place is Malaysia, would contravene the PDPA. In this connection, data users may consider entering into an agreement with the recipient of the personal data outside Malaysia and conducting regular audits to ensure that the recipient complies with the PDPA.

A data user who transfers personal data outside Malaysia in breach of the PDPA commits an offence that carries a fine of up to 300,000 ringgit or imprisonment of up to two years, or both.⁴⁸

The Malaysian Personal Data Protection Commissioner has issued a public consultation setting out jurisdictions that it is considering recommending to be approved under the PDPA as places to which personal data may be transferred outside Malaysia.⁴⁹ If the proposed jurisdictions are specified by the Minister under the PDPA, franchisors may transfer personal data to the following places: the European Economic Area (EEA) member countries; the United Kingdom; the United States; Canada; Switzerland; New Zealand; Argentina; Uruguay; Andorra; Faeroe Islands; Guernsey; Israel; Isle of Man; Jersey; Australia; Japan; Korea; China; Hong Kong; Taiwan; Singapore; Philippines; and Dubai International Financial Centre (DIFC).

There is no requirement under the PDPA to appoint a designated data protection officer to oversee compliance and administration of the PDPA within the organisation. However, under the Notice and Choice Principle, the written notice must specify how the data subject can contact the data user with any inquiries or complaints in respect of the personal data. For this purpose, franchisors must provide in the written notice at least the designation of the contact person, with phone number and fax number, if any; email address, if any; and such other related information.

In addition to the PDPA, franchisors should generally be aware of other Malaysian legislation that regulates matters relating to cybercrime, e-commerce and social media. In brief:

- a* the Computer Crimes Act 1997 sets out offences relating to the misuse of computers, including unauthorised access to a computer, unauthorised access with intent to commit other crime and also the communication of information, such as passwords, to unauthorised persons;
- b* the Electronic Commerce Act 2006 provides a legal framework for and recognises the use of electronic messages in commercial transactions and the use of such messages to fulfil legal requirements and to enable and facilitate legal transactions; and
- c* the Communications and Multimedia Act 1998 and the Malaysian Content Code regulate the provision of content, including online content, and apply to persons within and outside Malaysia if the content is made available in Malaysia. Compliance with the Content Code is generally voluntary unless the Communications and Multimedia Commission issues mandatory compliance directions.

48 Section 129(5) of the Personal Data Protection Act 2010.

49 Public Consultation Paper No. 1/2017 entitled Personal Data Protection (Transfer of Personal Data to Places Outside Malaysia) Order 2017, by the Personal Data Protection Commission; see http://www.pdp.gov.my/images/pdf_folder/PUBLIC_CONSULTATION_PAPER_1-2017_.pdf

IV FRANCHISE LAW

i Legislation

The Act provides a dedicated legislative framework relating to the franchising industry. It provides for the registration of franchises and regulates franchises, including setting out mandatory terms and conditions that have to be contained within a franchise agreement. Contravention of the Act may render a franchise agreement void or expose a franchisor or franchisee to criminal penalties.

Apart from complying with the Act, franchisors and franchisees should also be aware of other relevant legislation such as the Contracts Act 1950, the TMA (and legislation relating to the protection of other IPRs as set out above), the Employment Act 1955 and the Competition Act 2010.

ii Pre-contractual disclosure

Specific pre-contractual disclosure is covered within the Act and it may also generally fall within the scope of the Contracts Act 1950 and common law.

The Act requires a franchisor to provide disclosure documents to a prospective franchisee at least 10 days before the franchisee signs the franchise agreement.⁵⁰ The information required to be disclosed to the franchisee includes:

- a* description of the franchise business;
- b* details of intellectual property rights, fees and payments required from the franchisee;
- c* financial obligations;
- d* whether the franchisee is required to purchase or obtain supplies or materials from a designated source;
- e* territorial rights;
- f* franchise terms, including terms for renewal and termination, obligations upon termination; and
- g* audited accounts of the franchisor's business (at present, the Franchise Registry requires a minimum of the latest three years' audited accounts).

In the event that the information within the disclosure documents is false or misleading, the franchisor may be liable to both criminal and civil action under the Act. It is a criminal offence under the Act to make false statements or omissions that render the information within the disclosure documents misleading.⁵¹

Section 39 of the Act sets out the applicable penalties if a person is found guilty of an offence under the Act where no express penalties have been specified. Upon conviction, a person will be liable:⁵²

- a* for the first offence under the Act, to pay a fine of not less than 5,000 ringgit and no more than 25,000 ringgit or to imprisonment of no more than six months; and
- b* for the second or any subsequent offences, a fine of not less than 10,000 ringgit and no more than 50,000 ringgit or imprisonment of no more than one year.

50 Section 15(1) of the Franchise Act 1998.

51 Section 37 of the Franchise Act 1998.

52 Section 39(1)(b) of the Franchise Act 1998.

If the alleged offender is a body corporate, it will, upon conviction, attract:⁵³

- a* for the first offence under the Act, a fine of not less than 10,000 ringgit and no more than 50,000 ringgit; and
- b* for the second or any subsequent offence, a fine of not less than 20,000 ringgit and no more than 100,000 ringgit.

Further, the court has the power to declare the franchise agreement null and void and may order the franchisor to refund any payments made by the franchisee, and the court may further prohibit the franchisor from entering into any new franchise agreements or from appointing any new franchisees.⁵⁴

In addition to the Act, an aggrieved party may also bring an action for damages for misrepresentation under tort law and, if proven, the court may rescind the franchise agreement. The Contracts Act 1950 also expressly provides for misrepresentation, which potentially renders the contract or agreement voidable at the option of the franchisee.⁵⁵

The franchisor should therefore seek to expressly protect its position within the franchise agreement by ensuring that all projections of profits and revenue and pre-contractual information, where provided to the franchisee pursuant to the disclosure documents under the Act or during the course of negotiations leading to the franchise agreement, do not amount to legally binding representations, guarantees or warranties, to avoid any potential action for misrepresentation or a criminal prosecution under the Act.

iii Registration

There are four categories of registration under the Act, namely registration by:

- a* a local franchisor or master franchisee of a foreign franchisor before offering to sell its franchise to any party;
- b* a foreign franchisor intending to sell its franchise in Malaysia or to Malaysian citizens;
- c* the franchisee of a local franchisor; and
- d* the franchisee of a foreign franchisor.

Local franchisor or master franchisee

Section 6 of the Act requires a local franchisor or a master franchisee of a foreign franchisor to register its franchise with the Franchise Registry before operating a franchise business or offering to sell its franchise to any party. A breach of this Section is an offence under the Act and a person will upon conviction, be liable:⁵⁶

- a* for the first offence under the Act, to pay a fine not exceeding 100,000 ringgit or to imprisonment of no more than one year; and
- b* for the second or any subsequent offence, to pay a fine not exceeding 250,000 ringgit or to imprisonment of no more than three years.

53 Section 39(1)(a) of the Franchise Act 1998.

54 Section 39(2) of the Franchise Act 1998.

55 Section 19(1) of the Contracts Act 1950.

56 Section 6(2)(b) of the Franchise Act 1998.

If the alleged offender is a body corporate, it will, upon conviction, attract:⁵⁷

- a* for the first offence under the Act, a fine not exceeding 250,000 ringgit; and
- b* for the second or any subsequent offence, a fine not exceeding 500,000 ringgit.

The local franchisor is required to submit its application for registration together with all supporting documents, which include the disclosure documents, a sample of the franchise agreement, operation manual, the training manual, its latest audited accounts,⁵⁸ financial statements and the auditors' or directors' reports and any other information required by the Registrar.⁵⁹

The Registrar may approve, impose conditions or reject the application, and all such decisions are communicated in writing to the applicant. In the case of an adverse decision, the applicant may submit an appeal to the Minister within one month of the date of communication of the decision. The Minister's decision is final.⁶⁰

Foreign franchisor

Section 54 (read together with Section 6) of the Act requires a foreign franchisor to apply for prior approval before making an offer to sell its franchise in Malaysia or to any Malaysian citizen. The Registrar may approve, impose conditions on or refuse such an application, and the rights of appeal are set out above.⁶¹

Franchisee of a local franchisor

Pursuant to Section 6B of the Act, a franchisee who is granted a franchise by a local franchisor is required to register the franchise with the Registrar within 14 days of the date of signing of the franchise agreement between the franchisor and the franchisee.

Franchisee of a foreign franchisor

Upon entering into a franchise agreement with a local franchisee and prior to the commencement of operations, the franchisee of a foreign franchisor is required to make an application to register its franchise with the Registrar pursuant to Section 6A of the Act.

iv Mandatory clauses

The Act provides for the inclusion of certain mandatory clauses in a franchise agreement pursuant to Section 18 of the Act, failing which a franchise agreement will be void. Section 18 provides that a franchise agreement will include:

- a* the name and description of the product and business of the franchise;
- b* the territorial rights granted to the franchise;
- c* the franchise fee, promotion fee, royalties, or any other related payment that may be imposed on the franchisee;
- d* the obligations of both the franchisor and franchisee;

57 Section 6(2)(a) of the Franchise Act 1998.

58 The Franchise Registry presently requires a minimum of the latest three years' audited accounts to be submitted in support of such applications.

59 Section 7 of the Franchise Act 1998.

60 Section 17 of the Franchise Act 1998.

61 Ibid.

- e* the franchisee's right to use the intellectual properties belonging to the franchisor;
- f* the conditions under which the franchisee may assign the rights given under the franchise;
- g* a statement confirming a cooling-off period of at least seven working days during which the franchisee may terminate the agreement and seek the refund of any franchise fee paid to the franchisor subject to reasonable expenses incurred in the preparation of the franchise agreement that may not be refundable;
- h* a description pertaining to the mark or any other intellectual property owned or related to the franchisor that is used in the franchise;
- i* if the agreement is related to a master franchisee, the franchisor's identity and the rights obtained by the master franchisee from the franchisor;
- j* the type of assistance to be provided by the franchisor to the franchisee;
- k* the duration of the franchise (minimum five years) and the terms of renewal; and
- l* the effect of termination or expiration of the franchise agreement.

Further, the franchisor is required to set up a promotion fund, managed under a separate account, if the franchisee is required to make any payment for the promotion of the franchise.⁶²

v Guarantees and protection

The Act provides for the following written guarantees to be provided by a franchisee:

- a* the franchisee, including its directors, their spouses and immediate family, and its employees must not disclose any information contained in the operation manual or any information obtained while undergoing training organised by the franchisor during the whole of the franchise term and for a period of two years after the expiration of the agreement;⁶³ and
- b* the franchisee, including its directors, their spouses and immediate family, and its employees must not carry out any other business similar to the franchised business for the whole of the franchise term and for a period of two years after the expiration of the agreement.⁶⁴

Failure to provide the above guarantees amounts to an offence under the Act and the penalties are set out above (see Section IV.ii).

In addition, any written guarantees given by a party will also be enforceable under contract and common law. In the event of failure to provide the guarantees, the franchisor or the aggrieved party may have the option of terminating the agreement and suing for damages for breach of the guarantees given. Alternatively, depending on the nature and extent of the guarantees, the aggrieved party may choose instead to continue with the contractual relationship and claim for damages to put them in such a position as if the guarantees had been performed and fulfilled.

62 Section 22 of the Franchise Act 1998.

63 Section 26 of the Franchise Act 1998.

64 Section 27 of the Franchise Act 1998.

V TAX

i Franchisor tax liabilities

Tax liabilities generally arise in relation to any income derived within Malaysia. For a franchisor, this would include income arising from royalties, financial gains arising from dividends or profits paid. Capital payments, such as lump-sum payments for the grant or acquisition of a franchise, are normally not taxable. 'Capital payment' represents a payment made for the purchase of a capital asset for the enduring benefit of the business of the franchisee. Taxable income is defined within Section 4 of the Income Tax Act 1967.⁶⁵

Different tax rates will apply depending on whether the franchise business is managed and owned through a company (thus attracting corporate tax rates) or if it is being managed as a sole proprietorship (which attracts rates payable by individuals).

Royalty payments and interest arising from within Malaysia and payable to non-residents will be subjected to withholding tax at the rate of 10 per cent and 15 per cent, respectively, and must be paid within one month of paying or crediting the royalty.⁶⁶

Apart from income taxes, the franchisor may also be subject to other general tax liabilities such as stamp duties arising from the execution of the franchise agreement, real property gains tax, excise duty and goods and services tax (GST).

GST is introduced under the Goods and Services Tax Act 2014, which came into force on 1 April 2015, replacing the current sales and services tax. GST is levied and chargeable at the rate of 6 per cent on the taxable supply⁶⁷ of goods and services by a taxable person and any importation of goods and services into Malaysia in the course of furtherance of any business carried by him or her.⁶⁸ Any person whose total value of taxable supplies for a period of 12 months or less exceeds the prescribed threshold of 500,000 ringgit shall be a taxable person and hence is required to be registered under the Goods and Services Tax Act 2014 to charge or collect GST on the supply of goods or services.⁶⁹

ii Franchisee tax liabilities

Franchisees are similarly required to pay tax on taxable income;⁷⁰ apart from the income tax, the franchisee may also be subject to other general tax liabilities such as GST as explained above (see Section V.i).

The expenses incurred by a franchisee in undertaking the franchise business – royalty payments, promotion fees, advertising costs, training fees and services fees – are tax deductible. Any franchise fee paid to a foreign franchisor is, however, not tax deductible. Franchise fees paid to a local franchisor, on the other hand, are tax deductible pursuant to the Income Tax (Deduction for Expenditure on Franchise Fee) Rules 2012.

65 Classes of income on which tax is chargeable pursuant to Section 4 of the Income Tax Act 1976 are gains or profits from a business; gains or profits from an employment; dividends, interest or discounts; rents, royalties or premiums; pensions, annuities or other periodical payment not mentioned and other gains and profits not mentioned under Section 4.

66 Section 109 of the Income Tax Act 1976.

67 'Taxable supply' is defined under Section 2(1) of the Goods and Services Act 2014 as 'a supply of goods or services which are standard-rated supply and zero-rated supply and does not include an exempt supply'.

68 Section 9 of the Goods and Services Tax Act 2014.

69 Sections 19 and 20 of the Goods and Services Tax Act 2014.

70 Ibid. at 48.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Section 29(1) of the Act requires both franchisor and franchisee to act in an honest and lawful manner and requires them to endeavour to pursue the best franchise practice of the time and place. However, the Act does not expressly stipulate any penalties for non-compliance. For the aggrieved party to bring an action for the breach of this statutory provision or duty, they must prove that the alleged breach has resulted in actual damage and that the damage was a type contemplated as a foreseeable consequence of the breach.

The Malaysian courts do not recognise any duty of honesty or good faith in a contract where both parties are free to negotiate terms at arm's length. The courts will recognise the principle of freedom of contract and uphold the terms in an agreement unless there are vitiating factors such as coercion, undue influence, misrepresentation or mistake. This was recently confirmed in *Aseambankers Malaysia Berhad & Ors v. Shencourt Sdn Bhd & Anor*⁷¹ and was subsequently adopted in *SCOMI Transit Projects Sdn Bhd v. Prasarana Malaysia Berhad*.⁷² In *Aseambankers*, the court held that if it were to allow the defendant's counterclaim on the grounds that there is a general duty of good faith, the court would effectively be creating new law.

ii Agency distributor model

Section 29(3) of the Act requires the franchisee to operate its business separately from the franchisor and specifies that the relationship between the franchisee and the franchisor will not at any time be regarded as a partnership, service contract or agency. Thus, the agency model has no role to play in a franchise system in Malaysia. A franchisee may, however, distribute a franchisor's products as this is not prohibited under the Act, and such an arrangement may be subject to a separate distribution agreement.

iii Employment law

The Employment Act 1955 applies to employees whose wages do not exceed 2,000 ringgit a month and to all manual labourers (irrespective of wages).⁷³ All other employees are governed by their employment contracts and common law principles developed through case law. Given the express provision within the Act that franchises are not regarded as service contracts, there will be no presumption of an employer–employee relationship between a franchisor and a franchisee.

iv Consumer protection

Franchisees are not treated as consumers under existing laws in Malaysia or pursuant to the Consumer Protection Act 1999, which principally governs consumer rights and protection.

v Competition law

Franchise agreements commonly incorporate provisions that restrict or prevent competition; for instance, selective or exclusive distribution provisions and restrictions on the use of IPRs

71 [2014] 4 MLJ 619.

72 [2016] MLJU 622.

73 Section 2(1) of the Employment Act 1955.

licensed under the franchise agreement. These provisions are permissible if they can be justified as proportionate and can be shown to be necessary to safeguard the goodwill that has been built up into a brand by the franchisor.

The Competition Act 2010 expressly prohibits anticompetitive agreements, which include horizontal and vertical agreements, between enterprises that have the object or effect of significantly preventing, restricting or distorting competition in any market for goods or services.⁷⁴ The franchise agreement, being a form of vertical agreement, is prohibited if it has an anticompetitive object or effect that is significant in the relevant market unless:

- a* the parties to the agreement are competitors who are in the same market and their combined market share does not amount to more than 20 per cent; or
- b* the parties to the agreement are not competitors and, individually, each party has less than 25 per cent of shares in any relevant market.⁷⁵

The Competition Commission of Malaysia (MyCC) will generally take a strong stance against resale price maintenance and will deem any form of maximum pricing or recommended retail pricing that serves as a focal point for price determination to be anticompetitive.⁷⁶

As the Competition Act 2010 has only come into force relatively recently, MyCC has, as yet, not issued any guidelines to address the competing tensions between the IPRs or franchise agreements on the one hand and free competition on the other. Resale price maintenance is one area of potential conflict. If a recommended price sought to be provided in a franchise agreement is a genuine recommendation and does not become a focal point for price determination, it is likely that it will be permitted.

vi Restrictive covenants

Non-compete clauses and restrictive covenants are generally upheld as contractual terms and enforceable for the duration of the agreement. Breach of these covenants entitles the aggrieved party to sue for damages and specific reliefs and may also form the grounds of a complaint to the Franchise Registry. Breach of restrictive covenants set out in the Act is tantamount to an offence under the Act.⁷⁷

vii Termination

When introduced in 1998, the Act prohibited only the franchisee from terminating a franchise agreement before expiration of the franchise term. Following amendments made in 2012, a similar a similar prohibition now applies to franchisors.⁷⁸

In any event, either party may not terminate a franchise agreement before the expiration date except for good cause as stipulated in the Act. 'Good cause' is defined to include failure

⁷⁴ Section 4 of the Competition Act 2010.

⁷⁵ Guidelines on Chapter 1 Prohibition: Anti-competitive Agreements (2012) by the MyCC; see http://www.myc.gov.my/sites/default/files/handbook/MYCC-4-Guidelines-Booklet-BOOK1-10-FA-copy_chapter-1-prohibition.pdf.

⁷⁶ Ibid.

⁷⁷ Section 27 of the Franchise Act 1998.

⁷⁸ Section 19 of the Franchise (Amendment) Act 2012 and Section 31 of the Franchise Act 1998.

of the franchisee or franchisor to comply with the terms of the franchise agreement or any other relevant agreement between the parties and their failure to remedy the breach within a specified period, which may not be less than 14 days.⁷⁹

Termination without the requirement of notice and the opportunity to remedy the breach is also permissible in certain specified circumstances such as bankruptcy or insolvency, voluntary abandonment of franchised business, assignment of franchise rights for the benefit of creditors or a similar disposition of the assets to any other persons, conviction of a criminal offence that substantially impairs the goodwill associated with the franchisor's mark or other IPRs, and repeated failure to comply with the terms of the agreement.⁸⁰

Non-compete clauses are expressly permitted under the Act for a period of two years post-termination of the franchise⁸¹ and they form an exception to contract law principles, which generally hold a restraint of trade clause post-contract as void.⁸²

Apart from pursuing a civil action for a breach, the covenant may also be enforced by the franchisor by lodging a complaint with the Franchise Registrar, and this may potentially lead to a criminal prosecution.⁸³

Nothing in the Act prevents the franchisor from taking over the franchise business granted to the franchisee upon termination of the franchise term; however, in a non-renewal of the franchise agreement, the franchisor is under an obligation to compensate the franchisee either by a repurchase or other means of compensation at a price agreed between the franchisor and franchisee in consideration of the diminution in value of the franchised business caused by the expiration of the franchise where:

- a* the franchisee is barred by the franchise agreement or by the refusal of the franchisor to waive any portion of the franchise agreement that prohibits the franchisee from continuing with the business; or
- b* the franchisee has not been given written notice of the franchisor's intent not to renew the agreement at least six months prior to the expiration date.⁸⁴

viii Anti-corruption and anti-terrorism regulation

The Anti-Money Laundering and Anti-Terrorism Financing Act 2001 (AMLA) is the primary legislative framework combating money laundering and terrorist financing. The AMLA not only criminalises money laundering and financing of terrorism, but also imposes various obligations on reporting institutions. Any person who engages in, or attempts to engage in or abets the commission of money laundering, commits an offence under the AMLA.

Anti-corruption is governed by the Anti-Corruption Act 1997, which was enacted to make further and better provision for the prevention of corruption.

79 Section 31(2) of the Franchise Act 1998.

80 Section 31(3) of the Franchise Act 1998.

81 Section 27 of the Franchise Act 1998.

82 Section 28 of the Contracts Act 1950.

83 Section 27(3) of the Franchise Act 1998.

84 Section 32 of the Franchise Act 1998.

In addition, in the absence of any specific legislation, regard must also be had to the Malaysian Penal Code, which covers fraudulent and dishonest acts such as criminal breach of trust,⁸⁵ cheating⁸⁶ and criminal misappropriation of property.⁸⁷

ix Dispute resolution

Litigation can be an expensive, lengthy and complex process especially where foreign law is applied within a franchise agreement. Civil proceedings may be initiated in the Sessions or High Court depending on the proposed cause of action and quantum of damages sought.

It is a usual practice for parties, particularly where a foreign party is involved, to include a law and jurisdiction clause within their franchise agreement. Generally, the local courts will recognise and uphold a choice of foreign law or jurisdiction clause; however, the choice of foreign law may only cover the interpretation of the terms and conditions of the franchise agreement and may not exclude compliance with other Malaysian laws, such as the Act, which may still continue to apply and which may, in some instances take precedence over the terms of the franchise agreement.

Parties may also opt for arbitration or mediation as the preferred method of resolving disputes. Arbitration is governed by the Arbitration Act 2005 and mediation is governed by the Mediation Act 2012. Mediation is, however, not a mandatory form of alternate dispute resolution and there are no costs or other penalties that can or may be imposed if a party refuses to pursue mediation and decides instead to initiate a court action.

Parties are generally encouraged by the Franchise Registry to resolve disputes informally, through good faith negotiations or mediation. The Franchise Registry may, at the request of the parties, act as a mediator. Mediation is, however, not a mandatory form of dispute resolution.

Where informal dispute resolution mechanisms fail, the court process remains the primary means of enforcement.

Injunctive relief, both interim and permanent, is available to restrain the infringement of any IPRs or a breach of a restraint of trade covenant.

Where a contract is breached, the injured party is entitled to initiate a civil action for damages. Calculation of damages in a breach of contract action (including misrepresentation) depends on whether the injured party is claiming for expectation loss or reliance loss. Expectation loss aims to put the injured party in such a position as if the contract had been fully performed and where the injured party would have made certain profits or earnings; any such losses will have to be proven on a standard of balance of probabilities. If the injured party is claiming for reliance loss, the injured party must prove the expenses incurred arising from his or her reliance on the contract. In any event, the loss must not be too remote such that it must arise as a natural consequence of the breach or the parties must be aware of the loss.⁸⁸

Under the Contracts Act 1950, the parties must also restore or compensate for any advantage received where the injured party rescinds a contract that is void or has become

85 Sections 405-409 of the Malaysian Penal Code.

86 Sections 415-424 of the Malaysian Penal Code.

87 Sections 403-404 of the Malaysian Penal Code.

88 Section 74 of the Contracts Act 1950.

voidable as a consequence of the breach.⁸⁹ The Contracts Act 1950 also requires that an injured party takes all reasonable steps to mitigate the loss and must not incur unreasonable expenses in the act of doing so.⁹⁰

An injured party may also seek to pursue a claim under tort. Damages under tort are calculated to place the claimant in such a position as if the breach or tort had not taken place. They are generally quantified under two headings, namely general and special damages.

To successfully recover any damages, a claimant must prove on a balance of probabilities that the losses were caused by the defendant's actions or breach and there has been no break in the chain of causation leading to the losses suffered. Losses that are too remote are not recoverable.

Litigation costs usually follow the event and are awarded to the successful party. There are no capped costs and in the absence of agreement between parties, the quantum of costs will be determined by the court through taxation proceedings.

The registration and enforcement of foreign court judgments is governed by the Reciprocal Enforcement of Judgments Act 1958 (REJA). REJA is limited to final judgments⁹¹ awarded by a superior court from a country listed in its First Schedule, and they are Brunei, Hong Kong, India, New Zealand, Singapore, Sri Lanka and the United Kingdom. If the foreign judgment is from another jurisdiction, the only method of enforcement would be to initiate fresh proceedings and secure a Malaysian court judgment.

Malaysia is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) and therefore Malaysian courts will recognise foreign arbitral awards made in a New York Convention contracting state unless any of the grounds for refusal of recognition stated under Section 39(1) of the Arbitration Act 2005 are successfully established.

The most recent decision concerning franchising was delivered by the High Court in *La Kaffa International Co Ltd v. Loob Holdings Sdn Bhd and another case*⁹² on the issue of construction of Sections 26(1) and 27(1) of the Act. The dispute between both parties involved the Chatime bubble tea franchise, which was to be resolved through arbitration in Singapore. The dispute arose because of the termination of the franchise agreement (which had 24 more years to go) by the plaintiff on the grounds that the defendant failed to purchase all raw materials from the plaintiff; failed to allow the plaintiff to inspect and audit the defendant's accounts and books; and failed to pay for raw materials purchased from the plaintiff. Pending the disposal of the case in arbitration proceedings, both parties filed applications for interim injunctions under Section 11(1) of the Arbitration Act 2005. The plaintiff sought, among other things, to restrain the defendant, including its directors, their spouses and immediate family, and its employees (the Related Parties), from carrying on business that is identical or similar to Chatime franchise business under Section 27(1) of the Act, and to prohibit them from disclosing, using and converting confidential information procured from the plaintiff under Section 26(1) of the Act. The issue was whether the written guarantees under Sections 26(1) and 27(1) of the Act, which purport to bind the Related

89 Section 66 of the Contracts Act 1950.

90 Explanation to Section 74 of the Contracts Act 1950.

91 Section 2 of the REJA 1958. Judgments capable of registration are judgments or orders given or made by a court in any civil or criminal proceedings for the payment of a sum of money in respect of compensation or damages.

92 [2017] 1 LNS 1234; [2017] MLJU 1234.

Parties, were incorporated into the franchise agreement. The High Court, in construing the provisions, has adopted a strict interpretation in favour of the Related Parties and was of the view that the guarantees were not incorporated into the franchise agreement. Alternatively, even if it were assumed that the provisions had incorporated the guarantees into the franchise agreement, the court is not bound to grant interim injunctions as it is a matter of discretion. In this case, in the absence of any guarantee being given to the plaintiff, there was no question to be tried in respect of whether the defendant has breached the provisions. Further, the High Court found that the balance of convenience lies against the granting of the interim injunction in view of the fact that it carries a higher risk of injustice than a refusal of the interim injunction. As such, the plaintiff's claim was refused. It remains to be seen how, in future cases, the courts will apply the non-competition and confidentiality provision, which has not been tested.

VII CURRENT DEVELOPMENTS

The Franchise Development Division of the MDTCC is committed to ensuring the continued growth of the franchising industry, raising awareness of the potential of franchise systems and promoting local franchise brands in foreign markets. In conjunction with the aim of establishing Malaysia as a franchise hub in South East Asia by 2020, the government has launched and widely promoted the Enhanced Franchise Development Programme under the 11th Malaysia Plan.⁹³ The objective of the programme is to assist and support local franchise brands in penetrating international markets. The government has formulated and implemented strategies to enhance the capabilities of local franchisors for international expansion and these include developing facilities to support international expansion activities, providing up-to-date market research reports on international markets to local franchise players, developing holistic training programmes on international franchising and providing financial assistance in obtaining registration of intellectual property rights and procuring franchise agreements abroad.

The government has also introduced and developed plans and schemes by providing loans, incentives and support intended to help local entrepreneurs venture into franchise businesses, attract franchise opportunities and promote local franchise businesses in foreign markets. These include the Franchise Development Programme, Micro-Franchising Scheme, Franchise Development Assistance Fund, Local Franchise Product Development Programme and Franchise Financing Scheme.

93 See <https://www.nst.com.my/news/2016/05/144366/efdp-could-become-catalyst-towards-malaysia-becoming-franchise-hub>.

MEXICO

*Eduardo Kleinberg*¹

I INTRODUCTION

Franchises in Mexico constitute one of the most dynamic sectors of the economy, since it is considered to be a very successful business model with minimum risks. Up until 2016, around 11,800 new stores belonging to franchise systems had been opened in Mexico, with approximately 1,500 franchise brands, creating around 75,000 points of sale and over 890,000 direct employment positions.²

The Mexican Franchise Association (AMF) is a private entity, dedicated to the development of franchising in Mexico, providing support to commercial organisations working with the private and public sectors. There is no legal obligation for a franchise system to be affiliated with the AMF. However, according to the AMF, the associated franchises nationwide have generated more than 700,000 jobs and until this year 6.5 per cent of GDP in Mexico.

The franchise sector was expected to grow 7 to 10 per cent in 2017, generating 230 to 250 points of sale,³ and to continue to have a huge potential to generate jobs and wealth in Mexico.

II MARKET ENTRY

i Restrictions

Mexico's Foreign Investment Law and its regulations impose some restrictions on foreign investment in Mexico, and while these have been relaxed considerably in recent years, they still have an impact upon foreign investors in Mexico. For example, an initial registration with the National Foreign Investment Registry is required for foreign investments to be made in Mexico and thereafter periodic filings must be submitted.

The Foreign Investment Law may, in some cases, prohibit or restrict certain types of investments, partially or completely, although these are not usually of concern to most franchisors since they only apply to a narrow range of business operations.

1 Eduardo Kleinberg is a partner at Basham, Ringe y Correa, SC. The author would like to thank the following colleagues for their valued contributions to this chapter: Zarina Beltran, Teresa Espinosa, Jesus Colunga, Jose Massas, Julio Copo, Sara Gutierrez, Francisco Matus, Mónica Roldan, Alvaro Gonzalez and Rodolfo Barreda.

2 <https://www.economista.com.mx/empresas/En-2016-cada-hora-se-abrio-una-franquicia-en-Mexico-20170427-0122.html>

3 <http://expansion.mx/dinero/2016/12/08/franquicias-un-sector-que-resistira-embates-en-2017>

Subject to any limitations imposed by the Foreign Investment Law, there is no restriction in Mexico on the nationality of shareholders or members. Nevertheless, Mexican law requires that all companies have in their articles of incorporation either a provision prohibiting foreign shareholders or members, or a clause by which they agree to consider themselves as Mexican nationals with respect to their interest in the company, and not to invoke the protection of their own government in the event of a dispute, under penalty of forfeiting their interest to the state for violation of the clause.

ii Foreign exchange and tax

Mexico does not have foreign currency exchange restrictions. The considerations agreed under a franchise agreement could be either in Mexican pesos or a foreign currency. There are certain rules applicable to the actual payment of the consideration. If it is agreed to carry out payment within Mexican territory, the payer could elect to pay with the elected foreign currency or with Mexican pesos using the exchange rate published by the Central Bank of Mexico on the day of payment.

Mexico follows the Organisation for Economic Co-operation and Development (OECD) international tax standards. Thus, all transactions carried out with foreign residents (related parties or not), should fulfil the requirements of the arm's-length principle.

Income earned by foreign residents from a Mexican source is, in general, subject to withholding tax at various rates, which will depend on various factors, such as type of income (royalties, technical assistance), the tax residence of the receiving party, among other circumstances, but, in general, the withholding rate is 25 per cent over gross income. In the case of royalties, the withholding tax rates are between 25 per cent and 35 per cent, depending on the type of royalty paid to the foreign resident.

Foreign residents are subject to tax in Mexico for income earned from a source of wealth located in Mexico.

Mexico currently has over 50 tax treaties in force with other countries, including the United States, the United Kingdom, Canada, Japan, Germany and Switzerland. Mexico is currently negotiating tax treaties with several other countries. Tax treaties can reduce taxation or even completely remove the withholdings described above.

III INTELLECTUAL PROPERTY

i Brand search

Clearance word searches may be conducted online through the Mexican Institute of Industrial Property (IMPI) database. The word search will provide trademarks that are identical, similar or have a word in common. The results are mostly reliable, but, given that the IMPI takes approximately two days to update the database, the provided information may not include a trademark that could constitute a legal impediment or data corresponding to possible designations to which Mexico could be subject, pursuant to the Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks.

The information contained in the search result does not constitute an official communication in terms of the Industrial Property Law.

ii Brand protection

In Mexico, it is not possible to file multi-class applications; rather individual applications, per mark per class, should be filed. If a trademark application has been previously submitted in another jurisdiction, priority may be claimed within six months of the filing date of the foreign application.

The approximate time frame for obtaining the registration of a trademark is three to six months. However, if an opposition is filed by a third party or if the trademark examiner issues an office action to clarify the listed goods or services, or citing an identical or confusingly similar trademark or otherwise objecting to the registrability of the proposed mark, the registration process will be extended up to a year or in some cases even more than a year.

Once the application is filed, it is published for opposition and will be examined by the examiner. In the event that a similar prior application or registration is found or the mark is considered not to be distinctive, the examiner issues an office action communicating the objection. At that point, the applicant is given an opportunity to file arguments to try to overcome the citation or objection.

The trademark should be used by the owner or by the recorded licensee to distinguish the products or services for which it was registered. If the trademark registration is used only by a licensee or franchisee, the licensee or franchisee should be recorded with the IMPI. If the owner, licensee or franchisee does not use the trademark during three consecutive years, a third party could request a non-use cancellation action based on lack of use.

iii Enforcement

Article 213 of the Mexican Industrial Property Law (IPL) establishes several types of conduct that constitute administrative infringements, such as the unauthorised use of a registered trademark or not providing the franchise disclosure document (FDD) when requested. Administrative infringements can be sanctioned with: (1) a fine up to 20,000 times the current minimum wage approved in Mexico City; (2) an additional fine of up to 500 days' worth of the current minimum wage approved in Mexico City for each day that the infringement persists; (3) temporary closure of up to 90 days; (4) permanent closure; and (5) administrative detention of up to 36 hours. The infringement action is filed with the IMPI, which conducts an investigation and imposes any fines.

Additionally, breach of obligations stipulated in the agreement, such as payment of royalties, will incur civil liabilities.

iv Data protection, cybercrime, social media and e-commerce

Data protection

Following constitutional amendments that included the right to data protection as a basic right of individuals, in 2010 the Federal Law on Protection of Personal Data held by Private Parties was enacted, followed, in 2011, by its Regulations (together the Data Protection Law). These pieces of legislation – which are complemented by guides issued by Mexico's data protection authority, the National Institute for Transparency, Information Access and Personal Data Protection – apply at a federal level and make up the Mexican data protection legal framework.

The Data Protection Law applies to all processing of personal data by private entities or individuals, except when it is processed for personal or domestic use or by credit bureaus.

Franchisors and franchisees will be data controllers with respect to certain personal data they process; for example, franchisees will be controllers of their employees' personal data and, in some cases, a franchisor is a data controller of customer data.

In this regard, when processing personal data or any information concerning identified or identifiable individuals, both franchisors and franchisees need to be aware of their obligations and responsibilities, which are more onerous for data controllers. Some of the obligations of data controllers are: (1) to maintain appropriate physical, technical and organisational security measures, (2) to provide a privacy notice to all data subjects, (3) to collect consent from data subjects, where necessary, and (4) to allow data subjects the exercise of their rights (access, rectification, cancellation, objection, etc.).

Personal data can be transferred to third countries regardless of the level of protection a country provides if transfers are covered by an agreement that is in compliance with the Data Protection Law and with the privacy notice that was made available to data subjects. Consent from data subjects for the transfer of their personal data is sometimes required.

Failure to comply with the provisions of the Data Protection Law may result in hefty fines and, if personal data is processed deceitfully or for profit, penalties of imprisonment may be imposed.

Cybercrime

Although Mexico intends to ratify the Budapest Convention on Cybercrime, it has not done so and it is not clear when it will be ratified.

Notwithstanding this, under the Federal Criminal Code, illicit accessing of systems and destruction or causing the loss of information are crimes, along with the disclosure of trade secrets and confidential information. Because of the lack of specific provisions, the police treat certain other cybercrimes as fraud.

Social media and e-commerce

There are no specific regulations or provisions applying to franchises and social media, nor codes of conducts in this regard; however, social media activity is mainly governed by the Data Protection Law and consumer protection legislation.

E-commerce is regulated in Mexico by several laws, including the Code of Commerce and the Federal Law on Consumer Protection, which protects consumers in Mexico, regardless of location of providers.

IV FRANCHISE LAW

i Legislation

In Mexico, the franchise agreement will be governed, and subject to the terms agreed, by the parties, as well as by the provisions set forth in the Industrial Property Law (IPL) and its Regulations and, for aspects not regulated in the IPL, the general rules of the Federal Civil Code and the Commercial Code. The government agency in charge of applying the IPL is the IMPI. Additionally, depending on the franchise, other laws may apply, such as the Data Protection Law.

A franchise is defined in Article 142 of the IPL, which establishes that a franchise exists when, with a licence to use a trademark granted in writing, technical knowledge is transmitted or technical assistance is provided, for the licensee to produce or sell goods or

render services in a uniform manner and with the operating, commercial and administrative methods established by the owner of the trademark, to maintain the quality, reputation and image of the products or services distinguished by the trademark.

ii Pre-contractual disclosure

Prior to granting a franchise, and at least 30 business days before executing the franchise agreement, the franchisor must provide the prospective franchisee with the relevant company information in the FDD.

Article 65 of the Regulations of the IPL establishes that the FDD must contain at least the following technical, economic and financial information:

- a* name, corporate name or business name, domicile and nationality of the franchisor;
- b* description of the franchise;
- c* seniority of the original franchisor and, where applicable, of the master franchisee of the business object of the franchise;
- d* intellectual property rights involved in the franchise;
- e* amounts and types of payment that the franchisee must make to the franchisor;
- f* types of technical assistance and services that the franchisor must provide to the franchisee;
- g* definition of the geographical area in which the business exploiting the franchise operates;
- h* franchisee's right to grant sub-franchises to third parties and, if applicable, the requirements the franchisee must satisfy to do so;
- i* obligations of the franchisee with respect to the confidential information provided by the franchisor; and
- j* obligations and rights of the franchisee arising from the execution of the franchise agreement.

After timely delivery of the FDD, no additional requirements must be met before executing the agreement. There is no obligation to register the FDD with the IMPI.

A lack of veracity in the information disclosed in the FDD will entitle the franchisee, in addition to demanding the nullity of the agreement, to claim for losses and payment of damages. This right to claim payment of damages may be exercised by the franchisee within the first year of the execution of the agreement, and the franchisee must be able to prove that the damages arose as a consequence of the lack of veracity in the information contained in the FDD.

Failure to provide the FDD upon request by the prospective franchisee is considered an administrative infraction of the IPL. The IMPI may sanction this conduct with an economic fine, temporary or permanent closure of the premises or administrative arrest.

iii Registration

The franchise agreement should be registered with the IMPI to be binding to third parties. In Mexico, trademark owners must prove use to prevent a cancellation action by any third party, and recordal of the franchise agreement with the IMPI would serve as proof of use, granting the owner protection of the trademark. However, although recommended, there is no legal obligation to record the franchise agreement. To maintain certain aspects confidential, a short version of the franchise agreement may be recorded with the IMPI.

iv Mandatory clauses

According to Article 142 *bis* of the IPL, franchise agreements must be in writing and contain at least the following minimum provisions:

- a* the geographical zone;
- b* the location, minimum size and investment characteristics of the infrastructure, relating to the premises in which the franchisee shall carry out the activities deriving from the agreement;
- c* if applicable, the inventory, marketing and advertising policies, and the provisions relating to the merchandise supply and to contracting with suppliers;
- d* the policies, procedures and terms for any reimbursement, financing and other considerations that fall within the parties' charge in the terms agreed in the agreement;
- e* the criteria and methods applicable to determining the franchisee's commission and profit margins;
- f* the characteristics of the technical and operational training of the franchisee's personnel and the manner in which the franchisor shall provide technical assistance;
- g* the criteria, methods and procedures of supervision, information, evaluation and valuation of the performance and quality of the services under the responsibility of the franchisor and the franchisee;
- h* the terms and conditions governing sub-franchising, in the event that it is agreed by the parties;
- i* the reasons for termination of the franchise agreement;
- j* the assumptions under which the terms or conditions relating to the franchise agreement may be reviewed and, if applicable, modified by mutual agreement;
- k* unless otherwise agreed, the absence of an obligation for the franchisee to sell its assets to the franchisor or whoever the franchisor designates at the end of the agreement; and
- l* any provisions regarding the franchisee's obligation to sell or transfer the shares of its company to the franchisor or to make the franchisor a partner in the company.

v Guarantees and protection

Mexican law contemplates real and personal guarantees. Real guarantees allow creditors to enforce a payment obligation by recourse to the debtor's real estate or personal property, as the case may be. Personal guarantees bind the guarantor to fulfil an obligation (normally payment of money owed) in the event of the debtor's breach. In both cases, the guarantees are aimed at enforcing the creditor's interest by way of a right exercisable over the debtor's property or that of the guarantor.

Each guarantee is specifically regulated. For instance, joint obligors and sureties, as well as mortgages, are regulated by the Federal Civil Code and local civil codes; pledges are regulated by the General Credit Instrument and Transactions Law; and bonds are dealt with under the Insurance and Bonding Institutions Law.

Each guarantee has a specific implementation and in some cases a specific enforcement procedure. The convenience of adopting a determined guarantee in a contract should be assessed on a case-by-case basis, in light of the specific covenants to be secured and any other particularities, especially those that might impact the guarantee's enforcement. In Mexican franchise legal practice, the most used guarantee is the personal guarantee.

V TAX

i Franchisor tax liabilities

A franchisor resident for tax purposes in Mexico is required to pay income tax on its worldwide income. A legal entity is deemed to be a Mexican resident for tax purposes if its main administration or seat of effective management is located in Mexico. Mexican residents are subject to income tax on their profits at a rate of 30 per cent.

Regarding income from foreign sources, Mexico allows legal entities to credit direct and indirect foreign income taxes capped at the Mexican corporate tax rate, provided the income is subject to tax in Mexico.

Franchisors may deduct only expenses that are strictly necessary to fulfil their corporate purpose, and these include business expenses, certain local taxes and social security contributions, among others.

Mexico has controlled foreign corporation rules, whereby income derived from foreign investments must be taxed in Mexico when accrued in the foreign jurisdiction, even if it has not been distributed to the investor. The foregoing applies where income subject to foreign taxation is taxable a rate of less than 75 per cent of the applicable income tax rate in Mexico or not taxed at all.

Mexican transfer pricing rules apply to business transactions entered into by and between related parties. These provisions are based on the arm's-length standard, as Mexico has adopted most of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Franchisor foreign resident for tax purposes

Domestic law provides that foreign residents obtaining income arising from a source of wealth located in Mexico are required to pay income tax in Mexico. In the case of income arising from royalties or technical assistance (if the technical assistance qualifies as a royalty (know-how)), the source of wealth shall be considered to be in Mexican territory when the goods or rights for which the royalties or the technical assistance are paid are used in Mexico, or when the royalties or the technical assistance are paid by a Mexican resident or by a foreign resident with a permanent establishment in Mexico. The income tax must be withheld by the person making the payments if this is a Mexican resident (Mexican franchisees).

The income tax withheld or paid by the foreign franchisor may be creditable in its country of tax residency.

If the income for royalties is earned by a foreign franchisor whose income is subject to a preferential tax regime, the income for royalties shall be subject to a 40 per cent withholding tax rate, without any deductions, rather than at the tax rates indicated above.

ii Franchisee tax liabilities

Pursuant to domestic law, the income tax associated with royalties paid to foreign residents must be withheld by the person making the payments if this is a Mexican resident (Mexican franchisees) or even a foreign resident.

If the payment is made by a franchisee Mexican resident, the franchisee should withhold the income tax and pay it directly to the Mexican tax authority.

In practice, it could be complicated for the foreign withholding party to pay the relevant tax in Mexico, since there is no an easy mechanism for foreign residents to pay the relevant tax directly.

Mexican franchisees should determine whether the payments for royalties fulfil the Mexican requirements to be deducted as expenses for tax purposes, including in relation to transfer pricing rules.

iii Tax-efficient structures

Mexico has adopted the OCDE international tax standards, including recommendations made in relation to base erosion and profit shifting actions. Thus, the tax efficiency of franchising structures should be analysed carefully before any implementation.

Mexico currently has over 50 tax treaties in force with other countries. While these vary considerably in scope and conditions, several grant relief on royalty payments.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The Mexican Federal Civil Code provides that contracts are perfected by, and binding on, the parties by their mere consent (except for those contracts that require the fulfilment of certain formalities). Once perfected, the parties are bound not only by the covenants expressly agreed, but also by the consequences that, according to the nature of the contract, are consistent with good faith, usage and the law. Similarly, Article 6 *bis* of the Mexican Commercial Code, obligates individuals and entities engaged in commercial activities to act in accordance with honest practices.

These articles, applicable to the IPL, incorporate the principle of good faith in contracts, which entitles the affected party to claim for damages and lost profits under general liability provisions set forth in Mexican Federal Civil Code.

ii Agency distributor model

Mexican Law is very specific as to what constitutes a franchise, therefore, agency or distribution agreements that contain the elements of a franchise will be subject to the IPL, and to the civil or commercial laws applicable to contracts. The government agency in charge of enforcing the IPL is the IMPI.

iii Employment law

In Mexico, the Federal Labor Law (FLL) defines an employment relationship as the rendering of a subordinated personal service by one person to another in exchange for the payment of a wage. The main element of an employment relationship is subordination, which the Fourth Chamber of the Supreme Court of Justice of Mexico has defined as the employer's legal right to control and direct the employee and the employee's corresponding duty to obey the employer. Once an employment relationship exists, all the rights and obligations under the FLL apply automatically, regardless of how the agreement is characterised by the parties, and regardless of the nationality of the employee.

From an employment standpoint, a franchisee in Mexico should not be considered or treated as an employee. Even if the franchise agreement includes certain instructions or obligations charged to the franchisee, they should not be considered work-related instructions but merely the obligations deriving from a commercial agreement.

The franchise agreement should state that both parties are independent contractors and that franchisees are responsible for complying with local employment law by paying employees at the least the minimum statutory benefits afforded by law.

iv Consumer protection

In Mexico, consumer protection is regulated by the Federal Consumer Protection Law (FCPL) and its Regulations. The FCPL applies to both domestic and foreign companies rendering services or providing goods in Mexico.

According to the FCPL, in general terms, a consumer is considered the final beneficiary of the products or services rendered by a supplier; thus, a supplier is someone who offers, distributes, or sells a product or renders a service to a consumer.

In principle, franchisees cannot be treated as consumers, since their activities correspond to the provisions and regulations established for suppliers; however, the FCPL does contemplate an exception and authorises claims by individuals or entities that acquire, warehouse, use or consume goods or services to incorporate them in a productive process, as long as such claims do not exceed 488,736.58 Mexican pesos.

v Competition law

The economic competition framework in force in Mexico is grounded in Article 28 of the Federal Constitution, and further regulated by the Federal Economic Competition Law (FECL). The agency in charge of enforcing the FECL is the Federal Economic Competition Commission (FECC), although it is enforced by the Federal Telecommunications Institute in the broadcasting and telecommunications sectors.

The FECL applies to economic agents, construed as individuals, legal entities, economic groups and in general any private or public agent involved in economic activity.

The FECL regulates four main types of anticompetitive behavior, namely: (1) absolute monopolistic practices, including hardcore cartel behaviour; (2) relative monopolistic practices, which refer to abuses of a dominant position in the market; (3) anticompetitive concentrations or mergers; and (4) barriers to competition.

There are no specific provisions or exceptions applying specifically to franchises (or e-commerce) in terms of competition enforcement and as such, these will be governed by general provisions. Because of their nature, however, it is common for franchise agreements to include provisions that will be relevant in terms of antitrust assessment and enforcement, as outlined below.

Single-firm conduct and vertical restraints

Pursuant to Articles 54 to 56 of the FECL, exclusive distribution, exclusive supply and, in general, exclusivity clauses, along with product ties, full-line forcing or vertical price-fixing (a common practice in franchise agreements) and other vertical restraints or single-firm conduct⁴ can qualify as illegal relative monopolistic practices if: (1) the parties have substantial

⁴ e.g., refusal to sell, price discrimination, raising rivals costs, margin squeeze and so on.

market power in the relevant market;⁵ (2) the agreement has the object or effect of unduly displacing or restricting third-party market access; and (3) the parties are not able to prove efficiencies outweighing any negative effects of the practice.

These provisions are assessed for their overall impact on competition and thus, while they are not illegal *per se*, if the effects assessment is negative, the FECC will order the alleged wrongdoers to cease the conduct and is empowered to impose fines of up to 8 per cent of the wrongdoer's annual accruable income.

Horizontal agreements

Although less common in the context of franchises, competition provisions in Mexico will actively investigate and penalise agreements between competitors that have the object or effect of fixing prices, restricting output, allocating markets or bids, or the exchanging of information with any of these effects. Such behaviour is *per se* illegal and will incur not only large administrative fines, but also criminal liability for employees.

In the context of franchises, it is important to bear in mind that franchisees within the franchise might be competitors in the same market; as such, parties within the franchise that are acting as competitors in any market should be careful to avoid such agreements or information exchanges.

vi Restrictive covenants

As general rule, the will of the parties is the governing law of the agreement. That is to say, the parties are free to agree on the terms and conditions to be included in an agreement, provided they are not contrary to law.

Accordingly, any contractual covenants will be governed and subject to the terms agreed by the parties, as well as, in specific cases, provisions set out in the IPL and civil and commercial principles.

Notably, Article 5 of the Mexican Constitution grants all persons the right to develop the activity, industry, commerce or job they choose as long as it is legal. However, according to the criteria sustained by the Supreme Court of Justice, restrictive agreements or clauses (e.g., non-compete clauses) may be enforceable as long as they are subject to a determined term and territory, and a consideration is paid in exchange. Nevertheless, enforceability may be subject to a court proceeding, which may be time sensitive and, as in any proceeding of this nature, results cannot be anticipated.

vii Termination

Mexican law differentiates termination and rescission of an agreement. Termination is the consequence of the expiration of the term, or achievement of its subject matter, while rescission is the consequence of a breach, which might be declared by the non-breaching party without judicial intervention if this possibility is expressly agreed in the contract. In the case of both termination and rescission, under Mexican law and based on the freedom to contract, the parties can validly agree on restrictive covenants that would survive the termination or rescission of the contract and can be enforced at the request of the interested party.

⁵ The capacity to fix prices or restrict the supply in the relevant market without competitors being actually or potentially capable of counteracting this capacity.

The Mexican legal system forbids the parties to take matters into their own hands. Following this principle, agreements allowing the franchisor to unilaterally 'de-identify' the franchise facilities, or to take over a franchisee's leases, premises or business are unenforceable and carrying out these actions might trigger criminal and civil actions against the franchisor.

Pursuant to the provision of the IPL, the franchisor and the franchisee cannot terminate the agreement unilaterally, unless it has been executed for an indefinite time, or there is a just cause for it. Should the franchisee (or franchisor) wish to terminate the agreement in advance, whether this happens by mutual agreement or rescission, the franchisee (or franchisor) must comply with the requirements and procedures established in the agreement. In the case of a violation of the provisions, the early termination of the agreement made by the franchisor or franchisee will result in payment of the conventional penalties established in the agreement or in lieu of compensation for the damage caused.

Post-termination of the agreement, certain specific provisions will continue in full force and effect. According to the IPL, both during the term of the agreement and after its conclusion, the franchisee must maintain the confidentiality of any information of that character, and of the operations and activities of the franchise.

viii Anti-corruption and anti-terrorism regulation

Mexico has several regulations on fraud, anti-corruption and anti-money laundering. Fraud is included in the Federal Criminal Code (FCC); anti-corruption is regulated by the Federal Constitution, as well as in secondary laws relating to the recently created National Anti-Corruption System, which is the law applicable to corrupt practices by private parties; anti-money laundering is regulated by the Federal Act to Prevent and Identify Illegally Funded Transactions (the Anti-Money Laundering Law).

Fraud is classified as a criminal offence under the FCC. Companies in Mexico have a legal duty to create internal mechanisms to avoid, prevent or detect this kind of illegal activity; thus, franchisees must be aware what such criminal activity entails and its implications for doing businesses in Mexico.

As part of the National Anti-Corruption System, Congress enacted the General Administrative Liabilities Law (GALL), which contemplates several sanctions for public officials, individuals and companies involved in acts of corruption such as bribery, unlawful participation in public bids, misuse of public resources and unlawful contracting with former public officials. Sanctions range from onerous fines to the dissolution of the infringing company for particularly serious offences.

The Anti-Money Laundering Law is a federal law and aims to protect the financial system and the economy of the country by providing means and procedures to detect and prevent activities or transactions involving illegally obtained funds. This Law establishes a catalogue of activities considered to be 'vulnerable activities' in that they may facilitate the dispersion of illegally obtained funds. If a company or a franchisee performs any of these activities habitually, it could be subject to the provisions and regulations of the Anti-Money Laundering Law, and thus would have certain additional obligations.

ix Dispute resolution

In Mexico, when a dispute in relation to a franchise agreement exists, the parties can choose to resolve their disputes through the courts (litigation) or by alternative dispute resolution mechanisms, such as arbitration.

If the parties to the franchise agreement have agreed to submit any resulting disputes to the jurisdiction of any of the local courts of the states of Mexico to be decided under Mexican law, the judicial proceeding will be heard by a local court, generally referred to as a first level or first instance court, which will be responsible for resolving the dispute through a final judgment. This judgment may be challenged through an appeal, which will be decided by a higher-level court, generally referred to as a second instance court. The parties can file a writ of *amparo* against a final judgment from a second instance court whenever they consider fundamental or constitutional rights to have been violated by an unlawful act or omission by the local courts. The writ of *amparo* will be heard and resolved by a federal court, which will issue a final judgment.

In the event that the parties agree to arbitrate, either through an arbitration clause in the agreement or after the controversy has arisen, the parties will be forced to honour the terms of the arbitration agreement and have their dispute decided by an arbitral tribunal. There are two types of arbitration: *ad hoc* arbitration and institutional arbitration. It is fairly common for parties to agree to institutional arbitration for commercial and business matters. By submitting to arbitration, the parties agree that their dispute will be decided by an impartial adjudicator, identified as the arbitrator, whose decision will be final and binding to the parties (the award).

Foreign judgments and arbitral awards that do not contravene Mexican law (public order) are enforceable through a procedure of recognition and enforcement that is carried out before a first instance court. As one of the 157 states contracting to the New York Convention, Mexico is obliged to enforce arbitral awards.

Mediation, is a non-binding alternative dispute resolution mechanism available to any of the parties in a franchise dispute, either through any of the mediation centres of the Superior Court of Justice or through other institutions that have certified mediators. Mediation will not proceed if the counterparty does not agree to mediate and resolve the dispute through a settlement agreement between the parties.

In Mexico, as the administrative authority in matters of industrial property, the IMPI is in charge of resolving any claim of administrative infringement initiated by a franchisor against any person who violates the provisions of the IPL. In this regard, the IPL provides for an administrative conciliation process, in which a neutral intermediary (the IMPI), at the request of one or both parties and at any time during the dispute, will strive to provide an alternative solution. However, this conciliatory process is not common in practice.

VII CURRENT DEVELOPMENTS

There are no developments of particular relevance for franchising in Mexico at present.

NETHERLANDS

*Martine de Koning*¹

I INTRODUCTION

Franchise fulfils an important role in the Dutch economy. Approximately 800 franchisors are active on the Dutch market. Together, they have almost 31,000 franchise outlets, employ almost 300,000 people and generate a turnover of over €32.5 billion.² The biggest franchise formulas in the Netherlands are: RegioBank (bank), Primera (convenience store) and Jumbo (supermarket).³

The Netherlands Franchise Organisation acts as the umbrella branch organisation for franchise businesses and is responsible for the healthy development of franchising in the Netherlands. The Netherlands Franchise Organisation has more than 200 members (franchisors) and is affiliated with the European Franchise Federation and the World Franchise Council.⁴

II MARKET ENTRY

i Restrictions

In the Netherlands, there are neither restrictions on a foreign entity granting a master franchise nor restrictions on foreign franchisors owning equity in a local business or owning real property. However, companies incorporated under foreign law that are not located in a country that is a member of the European Economic Area can be subject to the Companies Formally Registered Abroad Act if they want to operate on the Dutch market. On the basis of this Act, companies have to comply with statutory and registration requirements that are applicable to Dutch companies, such as registration in the Business Register.

ii Foreign exchange and tax

No specific tax rules apply for a foreign franchisor who wants to set up a franchise chain in the Netherlands. Foreign franchisors or franchisees qualify as Dutch resident for tax purposes if they are established in the Netherlands as a Dutch liability company (for example, a private or a public limited liability company, BV or NV respectively). In that event, foreign franchisors and franchisees will be treated in the same way as Dutch residents for tax purposes.

1 Martine de Koning is a partner at Kennedy Van der Laan. The author thanks Renske Sinke and Isabel van Tuyll van Serooskerken for their valuable input on this chapter.

2 <http://www.nfv.nl/userfiles/Statistiek%202017%20DEF.pdf>.

3 <https://denationalefranchisegids.nl/franchisenieuws/regiobank-grootste-franchiseformule-van-nederland/>.

4 www.nfv.nl/.

III INTELLECTUAL PROPERTY

To exploit a franchise formula successfully, it is, of course, necessary for a franchisee to be entitled to use the franchisor's store concept, business name and logo, and the franchisor's know how. In the paragraphs below we will outline different ways for a franchisor to protect its intellectual property rights. Know-how is not protected by intellectual property law.⁵ Know-how can be protected by putting in place contractual non-disclosure and non-compete obligations.⁶

i Brand search

Trademarks can be looked up online in databases. A franchisor can check if a trademark is already registered at EU level on the website of the European Union Intellectual Property Office (EUIPO).⁷ Moreover, registered Benelux intellectual property rights can be looked up on the website of the Benelux Office for Intellectual Property (BOIP).⁸ International trademark registrations can be looked up in the database of the World Intellectual Property Organization.⁹

ii Brand protection

Trademarks have to be registered to receive trademark protection. In the Netherlands there are no Dutch national trademarks, but one can apply, through the BOIP, for registration of a Benelux trademark, which is protected under the Benelux Treaty for Intellectual Property. If a trademark is registered in the Benelux trademark register, the registrant has exclusive trademark rights in the Netherlands, Luxemburg and Belgium. Moreover, a trademark can be registered as an EU trademark in the EU trademark register. If the franchisor decides to do so, he or she has the exclusive right to the trademark in the European Union.

The procedure for definitive trademark registration takes about three months at the BOIP and six months at the EUIPO and the registration is valid for a period of 10 years and subsequently can be renewed for an unlimited number of successive 10-year periods. In principle, therefore, a trademark can be protected indefinitely. The registration process consists of the following steps:¹⁰ online application and payment of a fee, publication of the application, examination of the application, possible opposition by third parties and formal registration of the trademark (on condition that no successful opposition was made, possible objections were rejected and the application fulfils the registration requirements).

Formal registration for copyright is not required (and not possible) in the Netherlands. Copyright is granted automatically to works that meet the criteria for copyright protection

5 The Directive on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure was adopted by the European Parliament (No. 2016/943) and will be implemented in the Dutch Civil Code (DCC) by 9 June 2018 at the latest.

6 See, for example, European Court of Justice, 28 January 1986, NJ 1988, 163, par. 16 (*Pronuptia*); District Court Overijssel 22 June 2016, ECLI:NL:RBOVE:2016:2914, par. 5.4. (*X/FBD Franchise*); Court of Appeal of 's-Hertogenbosch 28 December 2005, ECLI:NL:GHSHE:2005:AU8610 (*Multicopy*).

7 <https://euipo.europa.eu/ohimportal/en/search-availability>; known as the European Union Office for Harmonization in the Internal Market (OHIM) until 23 March 2016.

8 See <https://register.boip.int/bmbonline/intro/show.do>.

9 See www.wipo.int/madrid/en/romarin.

10 For the correct order of steps for EUIPO and BOIP, see <https://euipo.europa.eu/ohimportal/en/registration-process> and <https://www.boip.int/wps/portal/site/trademarks/register/how-procedure/>.

under the Dutch Copyright Act, because the Netherlands is party to the Berne Convention.¹¹ A franchise formula can be protected by copyright if the formula qualifies as a product of art, science or literature.¹² Under the Dutch Copyright Act only the original application of a franchise formula is protected. The imitation of a franchise formula does not automatically entail that the similar franchise formula infringes the imitated franchisor's copyright. To determine this, a judge will take into account the degree of similarity between the formulas, the development of the franchise formula and the possibility that imitated elements of the protected formula could be derived independently, were public or previously known.

A trade name does not have to be registered to be protected under the Dutch Trade Names Act; protection is granted to a trade name that is actually used. It is prohibited to use a trade name that is (nearly) identical to an older trade name, if this use can lead to a risk of confusion among the public. The greater the extent to which companies conduct different types of business or conduct business at different geographical locations, the less likely the risk that confusion will be established.

iii Enforcement

A franchise agreement usually licenses the franchisee to use the intellectual property rights (usually trademarks) of the franchisor. In the event that a dispute arises regarding this right of use, parties may bring legal action against each other, which means that parties can also start summary proceedings to obtain provisional measures. If the trademark licensee (franchisee) is registered in the trademark register, the franchisee is able to step in on counterfeit actions initiated by the franchisor. The franchisee is in this event entitled to bring a claim for compensation or remittance for profit.¹³ This enables the franchisee to obtain compensation for damage it has suffered because of the infringement. This is only possible if the franchisor has given the franchisee the authorisation to start these proceedings.¹⁴

Moreover, in cases of major urgency and evident infringement (i.e., where delay would cause irreparable harm), an intellectual property (IP) owner can request an *ex parte* injunction from a judge in summary proceedings; this is an injunction granted without notice being given to the infringer.¹⁵

iv Data protection, cybercrime, social media and e-commerce

Data protection

Many franchisors collect, use and often share with their franchisees or other parties large amounts of consumer data; for example, in the context of loyalty programmes or (digital) marketing. These large datasets can be analysed with data management programs and big-data applications to improve the franchisor's services and marketing.

This handling of data falls within the scope of Dutch data protection law, under which consumer data qualifies as 'personal data'. Until 25 May 2018, Dutch data protection legislation will be laid down in the Dutch Data Protection Act (DDPA). The DDPA includes the EU-wide recognised data protection principles and regulates – in a nutshell – whether

11 Berne Convention for the Protection of Literary and Artistic Works.

12 Article 10 Copyright Act.

13 Article 2.32 (4) Benelux Convention on Intellectual Property. Note that a licensee is not entitled to start an injunction.

14 Article 2.32 (5) Benelux Convention on Intellectual Property.

15 Article 1019e Civil Procedure Code.

and under which conditions personal data may be used, which precautions need to be taken (e.g., information, consent, notification and pre-authorisation obligations), which rights of the data subject need to be respected (e.g., rights to access, objection, deletion and correction) and which arrangements the parties involved in the processing of the data have to make (e.g., entering into a data processing agreement or implementing data transfer mechanisms).

As of 1 January 2016, two important amendments of the DDPA entered into force. First, the DDPA, as of that date, includes a legal requirement to notify (serious) data breaches to the Dutch Data Protection Authority (DPA) and to the individuals concerned (the data subjects).¹⁶ Second, the competence of the DPA to fine organisations for violating the DDPA was extended.

As of 25 May 2018, the General Data Protection Regulation (GDPR)¹⁷ will apply throughout the EU. Under the GDPR, for each violation the DPA can impose fines of a maximum of €20 million, or 4 per cent of the controller's total worldwide yearly revenue. The aim of the new legislation is to enforce similar, strict data protection rules in all EU Member States, especially in light of new privacy-intrusive technologies (profiling, big-data applications, etc.). For example, franchisors will have to give consumers more control over their personal data by providing them with more extensive information about the processing of their data, and will have to grant consumers additional rights.¹⁸ Further, franchisors no longer have to deal with all local data protection authorities where they are established but instead will mostly be supervised by a single lead authority. The Dutch government intends to adopt a new act to smooth the implementation of the GDPR. The Dutch government published a draft of this act and provided stakeholders with the opportunity to comment. In its opinion,¹⁹ the DPA advised the government to follow the usual 'policy neutral' approach, meaning that no rules will be included other than those strictly necessary for implementation of the GDPR and to retain the current privacy practice. At the moment of writing, no final act has yet been published or adopted.

According to the Dutch Franchise Code (DFC), the franchise agreement should include arrangements or agreements regarding the collection, use and exploitation of consumer data.²⁰

Cybercrime, social media and e-commerce

In the Netherlands statutory laws apply to cybercrime, social media and e-commerce, but none of these are franchise specific. However, if franchisees or franchisors sell products

16 Article 34a(2) DDPA.

17 Regulation (EU) 2016/679 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) will enter into force on 24 May 2016 and will apply from 25 May 2018. The Regulation is directly applicable and aims to ensure the same rules in all Member States. However, the Regulation includes many open norms. It is too early to indicate how these norms will be applied by the different Member States, such as the Netherlands.

18 Such as the right to data portability (Article 20 GDPR) and the right to be forgotten (Article 17 GDPR).

19 https://autoriteitpersoonsgegevens.nl/sites/default/files/atoms/files/advies_uitvoeringswet_avg.pdf.

20 Article 4.6 sub. j DFC.

or services through a website to consumers, they are subject to disclosure requirements for distance contracts,²¹ requirements for concluding contracts by electronic means²² and requirements for service providers²³ as set out in the Dutch Civil Code (DCC).

IV FRANCHISE LAW

i Legislation

In the Netherlands, there is no statutory law on franchising. There is a wide range of case law on franchising from which it is clear that civil law applies, including statutory and case law on contracts, as well as the specific rules on trademarks, trade names, and Dutch and European competition law. In addition, franchisors who are members of the Netherlands Franchise Association have to comply with the European Franchise Federation's European Code of Ethics for Franchising.²⁴ Efforts have been made to draft – and provide a statutory basis for – self-regulation guidance, but this is at present unlikely to succeed in its current form (see Section VII).

ii Pre-contractual disclosure

There are currently no statutory pre-contractual disclosure obligations for franchisors. Based on the general rules of error, a franchisee can annul a franchise agreement if he or she was in error about relevant circumstances on the basis of a statement or information provided (or omission to provide the same) by the franchisor, and if he or she would not have concluded the agreement without that information.

From general contract law, it follows that the franchisor has an obligation to provide relevant information to a franchisee and a franchisee also has a duty to ask questions to get information. The scope of these duties depend on the power and specific position and knowledge of each party. Nevertheless, the duty to inform the other party of relevant information generally outweighs the duty to investigate.

In *Paalman/Lampenier*,²⁵ the Dutch Supreme Court determined that the doctrine of reasonableness and fairness does not, in principle, place an obligation on franchisors to provide a financial prognosis to a prospective franchisee except in special circumstances. It follows from lower court case law that if the franchisor does provide a profitability assessment to the franchisee, the franchisor has a special duty of care. A financial assessment has to be diligently prepared. This means that the financial assessment must be based on a careful and thorough location survey and market investigation, and must contain a clear substantiation of the figures.²⁶ If the franchisor, for instance, provides the franchisee with a financial prognosis and is aware that the prognosis contains serious flaws but does not notify the franchisee of those flaws, the franchisor may be found to have acted wrongfully and be held liable

21 Article 6:230m Book 6 DCC.

22 Article 6:227b and 6:227c DCC.

23 Article 6:230a–230f DCC.

24 See the Dutch Franchise Association website: www.nfv.nl/juridisch-franchisegevers/. See the European Franchise Federation website at www.eff-franchise.com/77/regulation.html.

25 Supreme Court 25 January 2002, ECLI:NL:HR:2002:AD7329 (*Paalman/Lampenier*).

26 Court of Appeal Amsterdam 14 March 2017, ECLI:NL:GHAMS:2017:821 (*Albert Heijn/X*), District Court Overijssel 8 June 2016, ECLI:NL:RBOVE:2016:2172 (*Speeleiland Tholen/Otto Simon*).

for damages.²⁷ This was recently confirmed by the Supreme Court in the *StreetOne* case, and it was clarified that if the franchisor prepared the forecast him- or herself, he or she is responsible if it was not diligently prepared.²⁸ If the franchisee relies on incorrect information (regardless of whether the franchisor knew it was flawed), and proves that he or she would not have entered into the agreement without that information, he or she may nullify the agreement afterwards.²⁹ Consequently, the franchisee must be placed in a position as if the agreement had not been concluded.³⁰

If the revenues of the franchisee turn out lower than the financial prognosis of the franchisor, this does not automatically mean that the financial prognosis was not of the required quality. Disappointing results may also result from unexpected circumstances (i.e., flaws in the exploitation of the store by franchisee or an economic recession).³¹ The franchisee is also obliged to independently investigate the proposition.³² Case law confirms that a candidate franchisee must have a critical attitude towards information provided by the franchisor regarding future revenues of a new franchise concept.³³ However, it has also been decided that there is no duty on the franchisee to investigate the correctness of the prognosis in the event that the franchisor is a big professional party, who ensured that the prognosis was conducted with ‘great care’, and where the franchisor put the franchisee under time pressure to sign the agreement.³⁴

According to the DFC, a franchisor should provide the franchisee with ‘written, complete and accurate information’ within a reasonable time (four to six weeks) before the conclusion of the franchise agreement, so that the franchisee does not feel rushed into the deal.³⁵ The DFC includes an extensive list of specific information a franchisor has to provide to its (prospective) franchisees.³⁶ The DFC does not include an obligation to provide a financial prognosis. The DFC states that it is preferable to supply a prognosis and that the prognosis has to be careful and transparently substantiated. As stated earlier, the DFC currently has the status of a self-regulation code.

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- 27 District Court Breda 14 April 1998, Prg 1998/4967 (*Aviti/Kinderparadijs*) and District Court Arnhem, 18 June 1999, Prg. 1999/5211 (*Brown Fashion*); Supreme Court 25 January 2002, ECLI:NL:HR:2002:AD7329 (*Paalman/Lampenier*); Court of Appeal ‘s-Hertogenbosch 15 September 2015, ECLI:NL:GHSHE:2015:3583 (*ToFuel/Tofuel B.V.*).
- 28 Supreme Court 24 February 2017, ECLI:NL:HR:2017:311 (*StreetOne*).
- 29 District Court Limburg 15 March 2017, ECLI:NL:RBLIML:2017:2344.
- 30 Article 6:228 DCC.
- 31 District Court Overijssel 8 June 2016, ECLI:NL:RBOVE:2016:2172 (*Speeleiland Tholen/Otto Simon*).
- 32 District Court Overijssel 9 March 2014 and 6 June 2015, ECLI:NL:RBOVE:2014:1985 and ECLI:NL:RBOVE:2015:2907 (*X/Otto Simon*); District Court Den Bosch 29 May 2013 (LJN CA1429); District Court Arnhem 15 June 2011 (LJN BR0232).
- 33 Court of Appeal Amsterdam 14 February 2017, ECLI:NL:GHAMS:2017:455 (*X/Tot Straks*).
- 34 District Court Noord-Holland 3 December 2014, ECLI:NL:RBNHO:2014:11564.
- 35 Article 3.4 Dutch Franchise Code.
- 36 This includes, for example, information on the financial position of the franchisor, published annual reports and profit and loss accounts, complete and recent overview of all franchisees including their contact information, whether there has been an earlier franchise business on the location, the reasons for termination of previous franchise agreements and accompanying documents, etc. See Article 3.6. Dutch Franchise Code.

iii Registration

There are no specific Dutch registration requirements for franchises in the Netherlands. All companies are obliged to register in the trade register of the Dutch Chamber of Commerce. Zoning and other administrative law requirements may apply depending on the type of franchised business.

iv Mandatory clauses

Currently, no franchise-specific legislation has been adopted. For this reason, there are no mandatory clauses that must be included in franchise agreements. Efforts have been made to draft – and provide a statutory basis for – self-regulation guidance, but this is at present unlikely to succeed in its current form (see Section VII).

v Guarantees and protection

In general, a franchisor can enforce a surety that is provided by a franchisee. Based on Dutch family law, a surety provided by a franchisee may be subject to the approval of the franchisee's spouse. This approval is not needed in the event it is performed by a director of a private company with limited liability who alone or jointly with his or her co-directors holds a majority of shares, provided it is made in the normal conduct of the business of the company. Under normal circumstances, this will be the case when a director commits himself or herself as surety or joint and several co-obligor under a franchise agreement.³⁷

V TAX³⁸

i Franchisor and franchisee tax liabilities

First, franchisors and franchisees established in the Netherlands are subject to Dutch corporate income tax. The Dutch corporate income tax is 20 per cent for the first €200,000 taxable profit and 25 per cent for the profit that exceeds €200,000.³⁹

Second, under Dutch tax law dividend payments and other distributions of profits made by a franchisor or a franchisee are subject to 15 per cent dividend withholding tax. An exemption may be available with respect to distributions to companies that (1) own at least 5 per cent of the shares in the distributing franchisor or franchisee; (2) are resident (also based on tax treaties between its jurisdiction of residence and third countries) in the EU, EEA or a jurisdiction that has concluded a tax treaty with the Netherlands that covers dividends; (3) do not have a function similar to a Dutch exempt investment institution or a (zero per cent taxed) fiscal investment institution as defined in the Dutch Corporate Income Tax Act; and (4) the anti-abuse rule is met. The Dutch government plans to abolish the dividend withholding tax, except for abuse situations, starting from 2020.

Third, Dutch wage tax is levied against progressive rates and is combined with the levy of social security contributions, which together comprise income tax. The combined tax rate starts at 36.55 per cent for a taxable income up to €20,142, a tax rate of 40.85 per cent applies for a taxable income up to €68,507, and for higher incomes a maximum rate of

37 Article 1:88 DCC.

38 The author thanks Crowe Horwath Foederer, Amsterdam, the Netherlands, for their valuable input on this Section.

39 Rates are based on financial year 2018 and will be subject to change in subsequent years.

51.95 per cent is applicable. However, the social security contributions are capped at €33,994 for individuals and the tax rate is a flat rate of 27.65 per cent. Individual entrepreneurs can benefit from various tax facilities such as a tax deduction for entrepreneurs and tax advantages for start-ups. Moreover, if a franchisor or franchisee holds more than 5 per cent of the shares in a company, a Dutch income tax of 25 per cent applies to dividends and capital gains received from these shares. If a party holds less than 5 per cent of the shares in a company, 30 per cent income tax applies over a deemed return that changes based on the average value of the parties' investments and savings above the threshold of €25,000.

Fourth, the salary paid by franchisors or franchisees to their employers is subject to Dutch wage withholding tax and Dutch social security premiums. Notably, in the Netherlands, tax that is deducted from the salary of an employee can be fully credited against the individual income tax. Moreover, in the Netherlands, attractive tax benefits apply for foreign employers with highly qualified workers with specific, scarce skills.

Fifth, when an undertaking provides services or supplies goods in the Netherlands, it will be subject to Dutch value added tax (VAT). There are three VAT tariffs: 21 per cent, 6 per cent or zero per cent. The general VAT tariff is 21 per cent, which applies to most products and services. Certain services are exempted from VAT, such as insurance. Undertakings whose services or goods are subject to VAT can deduct VAT that is charged. In 2019, the Dutch government plans to raise the lower VAT tariff from 6 per cent to 9 per cent.

Finally, the Dutch government proposes to introduce a withholding tax (15 per cent) on interest and royalty payments from a Dutch taxpayer to a low-tax jurisdiction. Currently, it is uncertain when this will be formalised in a legislative proposal.

ii Fiscal climate

The Dutch tax system has a number of features that may be very beneficial in international tax planning, which, for various multinationals, has made the Netherlands a prime location in which to establish their franchise or financing company. One of the most attractive features is the participation exemption. Under this exemption capital gains derived from a qualifying shareholding (generally, holdings of 5 per cent or more) are fully exempt from Dutch corporate income tax. Other advantages are the absence of withholding taxes on interest and royalty payments (although this will change, as noted above in Section V.i), the absence of a capital contribution tax, creditability of foreign withholding taxes, the low level of taxable profits and the possibility of obtaining advance certainty in that respect by concluding advance pricing agreements with the Dutch tax authorities. The Netherlands has also entered into a comprehensive network of tax treaties that in most cases reduce withholding taxes on dividend, interest and royalty income received by a Dutch franchisor or franchisee from foreign countries and on dividend distributions made by a franchisor or a franchisee.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

There are three important and regularly invoked legal principles that play a prominent role in Dutch contract law:

- a* the principle of contractual freedom (i.e., the principle that parties are free to draw up a contract according to their own wishes);

- b the principle of *pacta sunt servanda* (i.e., the principle that each contract, as a rule, must be respected); and
- c the principle of reasonableness and fairness.⁴⁰

According to the last of these, a contractual provision in a franchise agreement can be set aside if, based on the principle of reasonableness and fairness, the effect of this provision in the circumstances of the case is considered to be unacceptable.⁴¹ Courts adopt a reticent approach to deviating from a written contract based on the principles of reasonableness and fairness, and should always make an assessment on a case-by-case basis.⁴² For example, regarding termination of distribution (or franchise) agreements, courts consider a long duration and a high degree of dependency relevant indicators to set aside a (too) short contractual notice period. A limitation of liability, for instance, cannot be invoked if damages arise as a consequence of wilful misconduct or gross negligence of the debtor itself. Furthermore, it is possible that an exclusivity clause granting the territory to the franchisee could be set aside in the event of economic necessity on the part of the franchisor.⁴³

A franchisor can have a duty of care towards its franchisees, the presence and level of which depends on a variety of circumstances, such as the type of franchise, the experience of the franchisor, etc. For example, the extent to which the franchise concept covers the total business can be relevant; whether the franchise concept is to be followed strictly (hard franchise); how much the franchisee can influence the operation of his or her own business; and how dependent he or she is in the relationship. The less influence the franchisee has over his or her own business decisions, the higher the level of the duty of care the franchisor will owe to the franchisee. And the higher the level of duty of care, the more quickly the franchisor would need to offer assistance, advice and possibly make changes in the franchise (or retail) concept to overcome any problems the franchisee may face, to avoid responsibility and thus liability for negative results and damages.

ii Agency distributor model

Unlike franchising or distribution, commercial agency is governed by statutory law, including certain mandatory provisions, implemented on the basis of Council Directive of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents (86/653/EEC). While franchisees and distributors are, as a rule, not entitled to goodwill compensation upon termination, an agent may claim compensation for goodwill provided that the following conditions are met:

- a the agent has brought the principal new clients or has significantly increased the volume of business with existing clients;
- b the principal continues to derive substantial benefits from the business with those clients; and
- c the payment of this compensation is equitable.

⁴⁰ Article 6:2(1) DCC.

⁴¹ Article 6:248(2) DCC.

⁴² Supreme Court 9 January 1998, ECLI:NL:HR:1998:ZC2540 and JB 1998/27, NJ 1998, 363, RvdW 1998, 17 (*Apeldoorn/Duisterhoff*).

⁴³ District Court Noord-Holland 30 January 2017, ECLI:NL:RBNHO:2017:688 (*Intertoys/franchisenemer*) and District Court Amsterdam 24 March 2017, ECLI:NL:RBAMS:2017:1860.

The amount can never exceed the equivalent of one year's compensation, based on the average of the previous (five) years, as this is taken to provide an indication of the maximum exposure foreseeable. The commercial and financial risks rest with the principal under an agency agreement.

If, in reality, the franchisee acts not for his own account and risk, but for the franchisor's account and risk, and in particular if it can be said the franchisee concludes contracts with customers in the name of the principal, the agreement may in reality be an agency relationship, which would trigger the applicability of mandatory provisions on termination, commission and goodwill.⁴⁴ Therefore, it is important that a franchisee clearly indicates on or in his or her premises both the franchisee's identity (legal entity name) and that the franchisee operates the franchised business in his or her own name and for his or her own account and risk. Usually, a sign in the store and a clear indication on, for example, the receipts that the customer receives upon payment are sufficient.

iii Employment law

There are three key requirements to qualify as an employment agreement under Dutch law. The employee (1) has to perform work for a period, (2) in the service of the employer (relationship of authority), and (3) in exchange for a salary.⁴⁵ This is mandatory law, which means that if – based on all the circumstances of the case – an agreement between parties meets these three requirements, there is an employment agreement (even if the parties expressly agree otherwise).⁴⁶ In most cases, a franchise agreement is not an employment agreement, because the authority relationship is missing. A franchisee is often an independent entrepreneur who runs his or her business at his or her own expense and risk. However, the franchisor can be in a relationship of authority to the franchisee if the franchisee is obliged to comply with detailed (and regular or individual) instructions from the franchisor; for example, with regard to the set-up and execution of the franchisee's business activities or the working hours of the franchisee. As a basic rule, no relationship of authority exists if the compelling instructions of a franchisor only relate to the preservation of the uniformity and quality of the franchise concept.⁴⁷ Most franchise manuals would thus not create a relationship of authority.

In the event that the relationship between the parties does not correspond with the franchise agreement and qualifies as an employment agreement, the franchisee (employee) will be granted all the rights of an employee under Dutch law. This means (among other things) that the franchisor (employer) is obliged to withhold taxes and national insurance contributions from the employee's salary. Moreover, employees are entitled to salary during the first two years of illness, the accrual of a minimum number of holidays per year and an annual holiday allowance. In most cases, the employer also requires the permission of the Employee Insurance Agency or the subdistrict court to terminate the employment agreement unilaterally.

Following the entry into force of the Employment Relationship (Deregulation) Act as of 1 May 2016, parties can use the 'model agreements' on the website of the Dutch tax

44 Article 7:431, 7:432 and 7:442 DCC.

45 See Section 7:610 of the DCC, which includes the definition of an employment agreement under Dutch law.

46 Although the intent of the parties may play a role in the assessment as to whether there is an employment agreement. Supreme Court, 14 November 1997, ECLI:NL:HR:1997:ZC2495.

47 Asser/Houben 7-X 2014/155.

authorities to ensure that the relationship between parties will not qualify as an employment agreement. If the work is being carried out in accordance with the model agreement, there is no employment agreement. The use of model agreements is not mandatory. Parties can also submit their own agreement and let the Dutch tax authorities assess the agreement. Because there is a lot of uncertainty regarding the use of these model agreements, the enforcement of the Employment Relationship (Deregulation) Act 2016 has been postponed until 1 January 2018. In the coalition agreement, published on 10 October 2017, it has been announced that the Employment Relationship (Deregulation) Act will be replaced.

The risk of qualification of the relationship as an employment agreement is limited if the franchisee contracts with the franchisor through the franchisee's Dutch limited liability company. As soon as a franchisee hires his or her own personnel, the risk that the franchisor can be seen as the employer of the franchisee's personnel is further reduced. In addition, there is no concept of 'joint employment' under Dutch law. The risk that the employees of the franchisee could be considered to be employees of the franchisor, even though in theory possible, rarely occurs. It could apply if there were a lot of direct contact (instructions, authority, payment of salary) between the franchisor and the employees of the franchisee, and, for example, if for some reason the franchisee could not be held liable (for example, if the franchisee went bankrupt).

iv Consumer protection

The DCC defines a 'consumer' as '[a] natural person who does not act in the course of his professional practice or business'.⁴⁸ This means that there is a negligible risk that a franchisee will be considered a consumer. However, under the DCC, small businesses may benefit from certain rules that also benefit consumers; for example, relating to the question of whether one's general terms and conditions have been validly declared applicable and have been provided. Based on settled case law and literature, a kind of reflex effect is accepted for small businesses for the lists of terms and conditions that are deemed, or likely to be, unreasonably burdensome (and therefore voidable), meaning that small franchisees or franchisors could also benefit from rules intended to protect consumers under Dutch law.

v Competition law

Franchise agreements in the Netherlands are subject to EU and Dutch competition law. The Dutch equivalent of Article 101 of the Treaty on the Functioning of the European Union (TFEU) is included in Article 6 of the Dutch Competition Act (DCA).⁴⁹ The European Commission's Guidelines on Vertical Restraints⁵⁰ also apply – through a clause in the DCA – to trade in the Netherlands that has no cross-border effect, and include a description of franchising. Specific freedoms (contractual restrictions on the franchisee) in franchising fall outside the cartel prohibition, while outside the context of franchising these are to be assessed under competition law and some are even likely to be impermissible. Furthermore,

48 Article 6:193a(1a) DCC.

49 The European Court of Justice (ECJ) has decided in the *Eco Swiss/Benetton* case (ECJ 1 June 1999, C-126/97) that Article 101 TFEU is considered to be a rule of European public policy. By contrast, the Dutch Supreme Court stated that Article 6 of the Dutch Competition Act cannot be qualified as a rule of Dutch public policy (Supreme Court 16 January 2009, LJN BG3582, NJ 2009 (*Gemeente Heerlen/Whizz Croissanterie*)).

50 European Commission, Guidelines on vertical restraints, 2010/C 130/01.

the European competition laws as set out in the Block Exemption on Vertical Agreements⁵¹ and Article 101 TFEU are relevant to assess the enforceability of exclusivity, pricing, product ties and certain internet sales provisions in franchise agreements. In *Coty/Akzente*⁵² the European Court of Justice ruled on whether a contractual clause prohibiting distributors in a selective distribution network for luxury goods from using online third-party platforms was permissible under Article 101 TFEU.

vi Restrictive covenants

Non-compete provisions during the term of a franchise agreement are generally considered to fall outside Dutch and European competition law⁵³ if they are necessary to protect the know-how and goodwill of the franchisor that is licensed to the franchisee, and to maintain the common identity and reputation of the franchised network.⁵⁴

Franchisees often try to escape from non-compete obligations by arguing that the provision constitutes a restriction on competition and is therefore null and void. Dutch courts, however, appear to have adopted a reticent approach. In the *ANVR c.s./IATA-NL* case,⁵⁵ the Dutch Supreme Court ruled that the burden of proof is high. Civil franchise cases such as *Yarden franchise/XI*⁵⁶ and *Top 1 Toys/Vedes*⁵⁷ show that it is essential that a plaintiff invoking competition law supports his or her arguments with a thorough market definition of the relevant product and geographic market and an in-depth analysis of the market shares of the parties to fulfil the burden of proof, otherwise he or she will not succeed with the claims.

However, a franchisee can also argue that a non-compete provision is unenforceable because the effect of the provision is unacceptable on the basis of the principle of reasonableness and fairness. Relevant circumstances in relation to the enforceability of a post-term non-compete provision (or limitation of the duration thereof) are the duration of the franchise relationship, the duration and the territorial scope of the non-compete provision and the specific situation (knowledge, transfer of know-how,⁵⁸ background and bargaining power) of the franchisee.⁵⁹ The consequences of the non-compete provision for the franchisee may be taken into account when assessing the enforceability. The mere fact that the franchisee will not be able to generate revenues for some time is not sufficient to render

51 Commission Regulation (EU) No. 330/2010 of 20 April 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices (European Commission, VBER 2010/330).

52 See ECJ judgment, 6 December 2017, ECLI:EU:C:2017:941 (*Coty/Akzente*).

53 European Commission, VBER 2010/330, Article 5 and Guidelines on vertical restraints, 2010/C 130/01, No. 190(b); ACM Guidelines on vertical restraints www.acm.nl.

54 European Court of Justice, 28 January 1986, NJ 1988, 163, par. 16 (*Pronuptia*); District Court Overijssel 22 June 2016, ECLI:NL:RBOVE:2016:2914, par. 5.4. (*X/FBD Franchise*); Court of 's-Hertogenbosch 28 December 2005, ECLI:NL:GHSHE:2005:AU8610 (*Multicopy*).

55 Supreme Court 21 December 2012, NJ 2013, 155, ECLI:NL:HR:2012:BX0345 (*ANVR c.s./IATA-NL*).

56 District Court of Midden-Nederland 11 June 2014, ECLI:NL:RBMNE:2014:7395 (*Yarden franchise/X*).

57 Court of Appeals Arnhem-Leeuwarden 15 October 2013, ECLI:NL:GHARL:2013:7702 (*Top 1 Toys/Vedes*).

58 District Court Overijssel 22 June 2016, ECLI:NL:RBOVE:2016:2914, par. 5.5. (*X/FBD Franchise*).

59 Note that a post term non-compete that applies for the entire territory of the Netherlands is not by definition invalid or unenforceable (we note, however, that competition law may set boundaries); see District Court of Breda 18 April 2012, ECLI:NL:RBBRE:2012:BW4396 (*FietsNed*), confirmed by Court of Appeals Den Bosch, 21 August 2012, ECLI:NL:GHSHE:2012:BX5661 (*FietsNed II*) and District Court Arnhem 5 October 2009, ECLI:NL:RBARN:2009:BK1781 (*Bruna*).

the provision unenforceable. Moreover, if the franchisee has chosen to terminate the franchise agreement, he or she is less likely to be protected against a contractual non-compete provision than in a case where the franchise agreement has been terminated by the franchisor, or the termination has been caused by the franchisor's behaviour.⁶⁰ In general, and particularly if the clause does not violate competition law (for example, if the clause is block exempted), courts are reluctant to set aside a non-compete provision.

vii Termination

Long-term franchise agreements for a definite term end on expiry and can only be terminated earlier if agreed. If an agreement has been concluded for an indefinite term and the parties have not provided for a contractual regime for termination, the guiding principle is that the agreement can be terminated for convenience. However, taking the nature and content of the agreement into consideration, the principle of reasonableness and fairness may provide that such a termination requires sufficiently compelling grounds, a certain notice period or an offer of a certain compensation.⁶¹ The fact that the termination has a negative impact on the other party plays a role but of itself does not make compelling grounds necessary.⁶² If the agreement provides for a contractual regime for termination, in the event of certain circumstances the principle of reasonableness and fairness may still play a role or require there to be compelling grounds, or may prevent termination at a certain moment or without an offer of compensation.⁶³ Although a goodwill or severance payment is normally not required in the event of the termination of a long-term agreement (except for commercial agency), a party can be held liable for, among other things, certain investments made by the terminated party if the franchisee made the investments at a point when he or she could not have foreseen the termination and it is unlikely that these investments can be recouped before the end date of the collaboration.⁶⁴

In the event that a franchise agreement also contains provisions regarding the lease of premises, the franchisee is protected by Dutch mandatory provisions on rental law. A lease agreement regarding commercial premises (such as restaurants) may be terminated only through a dissolution by the subdistrict court. It is crucial that the franchisor is entitled to terminate the lease when the franchise agreement has ended – and the other way around.⁶⁵ Any divergence requires the prior approval of the subdistrict court.⁶⁶ This permission can only be granted if the rights of the tenant will be respected and it does not weaken the tenant's position.⁶⁷ A clause in which a breach of the franchise agreement also qualifies as a breach of the lease agreement (and on the basis of which the lease agreement may be terminated) is not a divergence that requires the prior approval of the subdistrict court.⁶⁸

60 District Court Maastricht 17 November 2011, ECLI:NL:RBMAA:2011:BU5153 (*EZL*), District Court Utrecht 23 December 2011, ECLI:NL:RBUTR:2011:BV3058 (*Super de Boer*).

61 Supreme Court 28 October 2011, ECLI:NL:HR:2011:BQ9854 (*De Ronde Venen/Stedin*) and Supreme Court 14 June 2013, ECLI:HR:2013:BZ4163 (*Auping/Beverlaap*).

62 Supreme Court 14 June 2013 (*Auping/Beverlaap*).

63 Supreme Court 10 June 2016, ECLI:NL:HR:1134 (*Alcatel*).

64 Supreme Court 21 June 1991, ECLI:NL:HR:1991:ZC0291 and NJ 1991, 742, RvdW 1991, 169 (*Mattell/Borka*).

65 Asser/Houben 7-X 2014/176.

66 Asser/Houben 7-X2014/178; Article 7:291(2) DCC.

67 Asser/Houben 7-X2014/178; Article 7:291(3) DCC; see also Article 5(2) VBER.

68 Supreme Court 21 April 2017, ECLI:NL:HR:2017:752 (*Kippersluis/Jumbo*).

viii Anti-corruption and anti-terrorism regulation

The Dutch Fiscal Information and Investigation Service (FIOD) and the Tax and Customs Administration are in charge of the detection of fraud. The FIOD also has supervisory responsibility regarding anti-money laundering and is able to start criminal investigations together with the Public Prosecution Service.

The Act to Limit Fraud in Acquisitions came into force on 1 July 2016. Based on this Act, fraud in acquisitions is subject to a prison sentence of a maximum of two years.⁶⁹ Moreover, the Act states that:

A person who makes public or causes to be made public information regarding goods or services which he, or the person for whom he acts, offers in the conduct of a profession or business (i.e., a franchisor) acts unlawfully towards another person acting in the conduct of his business (i.e., a franchisee) if this information is misleading in one or more of the following respects.⁷⁰

Thus, based on the Act, acquisition materials that refer, directly or indirectly, to numbers, results or expected income for the franchisee should be always objective, verifiable and not misleading.

ix Dispute resolution

Forum choice and choice of law clauses

A Dutch court will apply a choice of law clause in a franchise agreement if it meets the requirements for a valid and applicable choice of law as set out in the Rome I Regulation.⁷¹ The same applies for a forum clause, if it meets the requirements as set out in the Brussels I *bis* Regulation.⁷² It is not uncommon for Dutch franchisees to initiate summary proceedings in cases of (alleged) unlawful termination. Article 35 Brussels I *bis* provides for the possibility of initiating summary proceedings in the Netherlands,⁷³ even if the parties agreed that another court has 'exclusive' jurisdiction. In Dutch summary proceedings a franchisee can, among other things, claim continuation of the agreement arguing that it has been unlawfully terminated. The possibilities of awarding damages as a consequence of an unlawful termination of an agreement in summary proceedings are limited.

Mediation and arbitration

Mediation is not mandatory in the Netherlands, but is widely available. For example, the Netherlands Franchise Association has established its own dispute settlement rules for mediation. Members and non-members of the Netherlands Franchise Association are able to invoke these rules. Moreover, the Netherlands Franchise Association has selected qualified persons to whom parties can be referred when they wish to select a mediator.⁷⁴ Moreover,

69 Article 326d Dutch Criminal Code.

70 Article 6:194 DCC.

71 Regulation 593/2008 on the law applicable to contractual obligations.

72 Council Regulation (EC) No. 1215/2012 of 12 December 2012 on jurisdiction and recognition and enforcement of judgments in civil and commercial matters (recast).

73 Provided that a party has sufficient connection with the Netherlands.

74 www.nfv.nl/geschillen/.

during a court case, a court can recommend (but not oblige) parties to try to mediate their dispute with help of the mediation bureau of the court. During the mediation the court case will normally be put on hold.

Arbitration is a recognised form of dispute resolution in the Netherlands. If a legally valid arbitration agreement is in place, a Dutch judge is not competent to handle the case.⁷⁵ However, an arbitration agreement does not preclude a party from requesting protective measures from a judge, or starting summary proceedings to obtain provisional measures (on condition that the requested decision cannot be granted promptly in arbitration).⁷⁶ Arbitration proceedings are generally much more expensive than normal litigation before a Dutch court. If the franchisee and franchisor are established in countries that are party to the New York Convention⁷⁷ – and to which the Netherlands is a party – arbitral awards are easily enforced.⁷⁸ The Netherlands Franchise Association, together with the Netherlands Arbitration Association, has established a list of ‘franchise arbitrators’ from which parties can select an arbitrator to settle a franchise dispute.⁷⁹

Procedure

Civil procedural law in the Netherlands is known for its pragmatic, predictable and expeditious approach. Proceedings in a court of first instance normally take between one and two years. A bill is pending that will establish the Netherlands Commercial Court (NCC). The NCC will specialise in ruling on international trade disputes. The proceedings before the NCC will be conducted in the English language. It is, however, unclear when, or whether, the bill shall be adopted, although it is clear that the envisaged date of 1 January 2018 shall not be met.

Remedies

Provisional injunctions in summary proceedings and permanent injunctions in proceedings on the merits can be obtained to prevent a former franchisee from continuing to trade in breach of a non-compete clause or from using a franchisor’s trademarks or other IP rights. A claim in summary proceedings requires an urgent interest, and if the case is too complex to handle in summary proceedings, a judge can deny the claim. However, Dutch courts tend to hear all sorts of cases in summary or injunction proceedings, including claims of a terminated franchisee that rejects the termination. It is – compared with certain other countries – relatively easy to obtain a court order in the Netherlands to seize property (including bank accounts) in the Netherlands, even prior to a court case. Such a seizure must, however, be followed by regular proceedings.

In the event of damages for breach of contract, the court will determine the damage in the way that is most consistent with the nature of the damage caused. Where the extent of the damage cannot be assessed exactly, it shall be estimated.⁸⁰ Under Dutch law, the only types of damage eligible for compensation are loss to property and other prejudice.⁸¹ Loss to property

75 Article 1022 Civil Procedure Code.

76 Article 1022a and 1022c Civil Procedure Code.

77 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 10 June 1958).

78 Note that it is necessary to request a declaration of enforcement – the *exequatur*.

79 www.nfv.nl/geschillen/.

80 Article 6:97 DCC.

81 Article 6:95 DCC.

comprises both the loss incurred and the profit deprived.⁸² In commercial cases, the losing party will normally be ordered to pay compensation of the legal costs of the other party. These costs are, however, fixed by the court and are generally much lower than the actual legal costs.

VII CURRENT DEVELOPMENTS

From 2013 onwards, franchisees pressured Dutch lawmakers to adopt mandatory rules on franchising to better protect the rights of franchisees. For this reason, the Minister of Economic Affairs established in 2014 a committee with representatives of franchisors and franchisees to draft self-regulatory rules. As a result, after a consultation round, the final version of the DFC was published on 17 February 2016.

The DFC is based on a ‘comply or explain’ principle, which indicates that the parties should express why they do not apply certain parts of the DFC. The DFC includes a chapter with definitions, three chapters with obligations of the parties (obligations regarding acquisition, publicity and mutual information facilities, preliminary contracts and the franchise agreement itself) and a chapter regarding dispute resolution. The DFC contains many ‘open standards’. This is common in Dutch contract law and, for many of these, case law has already developed a clear meaning. Most of the ‘rules’ in the DFC are not well drafted⁸³ but are largely similar to the rules that currently apply. For example, a franchisor is required to protect and develop the franchise concept, and to provide advice to a franchisee if it is needed and requested, etc. However, the DFC also includes obligations that are clearly not in line with freedom of contract; for example, the franchisor cannot adopt clauses that permit changes to be implemented unilaterally or that permit changes to be adopted if no agreement can be reached with a ‘franchisee representative’ on the matter. Furthermore, the franchisor is obliged not to reject on unreasonable grounds the conclusion of a ‘second’ or ‘following’ franchise agreement with a franchisee. The DFC also states that the agreement has to be drafted in the national language of the franchisee’s place of residence. In a country where most people speak English or other foreign languages, this is currently not common practice if the franchisor is foreign (nor is it included anywhere else in the DCC, not even for employment or agency contracts).

Many large franchisors and the Dutch Franchise Association rejected the DFC as ‘imbalanced’ and in violation of the principle of freedom of contract. Since many franchisors refused to declare the DFC applicable to their agreements, on 12 April 2017 the Minister of Economic Affairs published a draft bill to give the DFC a statutory basis. The draft bill introduces an article into the DCC providing a legal basis for an order in council (AMvB) that will declare a ‘code of conduct’ binding for franchise relationships. The DFC is not mentioned, but it is clear that the DFC is intended to be designated in the AMvB as the applicable code of conduct.

There was a public consultation of six weeks in which to respond to the draft bill. Of the 359 submissions, the majority (mostly from individual franchisees) were supportive. Most positive responses lacked any substantiation. Many of the critical submissions were substantiated and often even academic in nature. Franchise organisations such as the

82 Article 6:96 DCC.

83 See, for example, the definitions, lack of a logical order in which the topics are placed, the overlap between clauses and mixing of rules and explanatory comments, and overall vagueness in the descriptions of obligations.

International Franchise Association and the Dutch Franchise Organisation, as well as other institutions such as the American Chamber of Commerce, and franchisors, academics and private practitioners indicated their objections to the draft bill.

The first article of the draft bill includes definitions of the following concepts: the franchise formula, franchisor, franchisee and franchise agreement. It is noteworthy that payment by the franchisee of monetary compensation for use of the concept is included in the definition of a 'franchise agreement'. The explanatory memorandum makes clear that this compensation may be direct or indirect; for example, an additional amount on the purchase price the franchisee pays for products he or she buys from the franchisor.

The second article of the draft bill lists rules that should be included in the code of conduct. These include rules about recruitment and selection of franchisees, preliminary agreements, providing essential information during the performance of the agreement, collective consultations, alternative dispute resolution, purchase obligations, non-competition after the end of the agreement, and unilateral termination by the franchisor. However, the draft bill does not give any direction as to what the content of such rules could be. Nevertheless, the draft bill does state which information must be provided to a franchisee before concluding the franchise agreement; for example, information regarding the financial position of the franchisor, the expected profits, costs and investments, the place of exploitation of the franchise formula, other franchisees, etc. Further, it is stated that it is possible to deviate from the mentioned code of conduct, although explicit reasoning has to be given in writing in the franchise agreement, detailed rules for the form and content of which may be included in an order in council. If a deviation is not explained properly, the franchisee may nullify the relevant clause of the agreement. Finally, the third article of the draft bill provides for a transition period of five years for existing franchise agreements.

As stated above, the draft bill introduces an article into the DCC that provides a legal basis for an AMvB that will declare a code of conduct (i.e., the DFC) binding for franchise relationships. An order in council is a royal decree, a rule of lower standing that the government can adopt and that does not need to be approved by the Dutch parliament. The actual rules of the code of conduct are not included in the draft bill but in the code of conduct itself. However, only the draft bill must be adopted by the parliament. Consequently, the normal legislative process only concerns the text of the bill, not the code of conduct. This means that the order in council and the code of conduct are not subjected to a full review by the parliament. This is most regrettable, since support in the sector – on the part of the franchisors – seems to be scarce.

Even if the draft bill were to be adopted, the legal status of the code of conduct (i.e., the DFC) would not be 'law' in the sense of a generally binding rule.⁸⁴ This means that franchisors that were not part of the negotiation and drafting process of the DFC, or that officially distanced themselves from the outcome, or non-Dutch franchisors (or Dutch franchisors operating outside the Netherlands), could take the position that they are not bound by the DFC (e.g., not bound to comply or explain), even if the draft bill were to be adopted.

However, at the moment it is not certain whether the draft bill will be adopted. The Dutch coalition agreement – published on 10 October 2017⁸⁵ – indicates that there will be

84 Art. 79 Act on the Judicial Organisation (Wet RO).

85 Coalition agreement, 'Vertrouwen in de toekomst', VVD, CDA, D66 en ChristenUnie. 10 October 2017 <https://www.kabinetformatie2017.nl/documenten/publicaties/2017/10/10/regeerakkoord-vertrouwen-in-de-toekomst>, p. 35.

additional legislation to strengthen the position of franchisees in the pre-competitive phase. The wording of this phrase is a signal that the new government wants to take a different direction (I guess 'pre-contractual' is meant, and not 'pre-competitive'). Since the date of publication of the coalition agreement, the government website that publishes the draft bill, the consultation responses and the status of the legislative process has stated that the draft bill is on hold in view of the reference in the coalition agreement.⁸⁶ In the market, it is generally understood that the draft bill is unlikely to be adopted in its current form. In other words – to be continued!

86 <https://www.internetconsultatie.nl/franchise/berichten>.

NEW ZEALAND

*Stewart Germann*¹

I INTRODUCTION

Franchising in New Zealand is developing at a very fast rate and is becoming more sophisticated. It is often said that New Zealand is one of the most deregulated countries in the world in which to conduct small to medium-sized businesses, and the fact that we have no franchise-specific legislation is also of great assistance.

The following international franchisors have a presence in New Zealand (although this list is not exhaustive): Anytime Fitness, Bakers Delight, BB's Café, Brumby's Bakeries, BurgerFuel, Cafe2U, Cartridge World, Cash Converters, Civic Video, Cheesecake Shop, Coffee Club, Domino's Pizza, Esquires, Gloria Jean's Coffees, Jamaica Blue, Jani-King, Jim's Mowing, Just Cuts, Kip McGrath, Kwik Kerb, LJ Hooker, LJS Seafood Restaurants, Lone Star, McDonald's, Midas Car Care, Mini Tankers, Mr Rental, Muffin Break, Oporto, PappaRich, Pita Pit, Pizza Hut, Quest Serviced Apartments, RE/MAX, Smallprint, Snap-on Tools, Snap Printing, Specsavers, Speedy Signs, Subway, SumoSalad, The Athlete's Foot, Toni&Guy, VIP Home Services, Xpresso Delight and Zambro.

The following local franchisors operate in New Zealand (although this list is not exhaustive): AA Auto Centre, Active Plus, Armstrong, At Your Request, Baby on the Move, Bedpost, Business Buddy, Cleancorp, Clean Planet, Coffee Guy, Colourplus, Columbus Coffee, Cookie Time, Cookright, Corporate Cabs, CrestClean, Crewcut, Green Acres, Guthrie Bowron, Hardy's Health Stores, Hire A Hubby, Hollywood Bakery, Just Cabins, Kitchen Studio, Landmark Homes, Laser Electrical, Laser Plumbing, Liquorland, Mad Butcher, MathZwise, Meticulous Home Services, Mexicali Fresh, Mike Pero Mortgages, Mr Plumber, Mr Whippy, New Zealand Natural Ice Cream, Night 'n Day Foodstores, Number Nurses, Palmers, Paper Plus, Para Rubber, Paramount Services, Pit Stop, PostShop Kiwibank, Refresh Renovations, Robert Harris Coffee Roasters, Rodney Wayne, Shoe Clinic, Sierra Coffee, Signature Homes, Small Business Accounting, Stirling Sports, Streetwise Coffee, Super Liquor and Super Shuttle.

The Franchise Association of New Zealand (FANZ) was formed in 1996 and it has Rules, a Code of Practice and a Code of Ethics. The following are the three principal types of franchisors in New Zealand:

- a* those franchisors who belong to the FANZ, publish a disclosure document and have very high standards;
- b* those franchisors who do not belong to the FANZ, do not publish a disclosure document but have high standards; and

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- c* those franchisors who do not belong to the FANZ, do not publish a disclosure document and do not have high standards nor a good reputation.

Category (c) is diminishing because of the growing interest in and effect of the FANZ, which as at December 2017 had 139 franchisor members, one franchisee member, one individual and 71 affiliates, including attorneys, accountants and banks, for a total of 212 members (see www.franchiseassociation.org.nz).

i Survey of franchising

The latest survey of franchising in New Zealand, in 2017, showed the following key results:

- a* 631 business format franchisors in New Zealand in 2017, compared with 446 in 2012, which leads the world on a per-system-per-head-of-population basis;
- b* the number of units operating with business format franchise systems has also increased: with an estimated 37,000 units compared with 22,400 in 2012;
- c* franchised businesses are estimated to contribute around NZ\$27.6 billion to the New Zealand economy;
- d* 124,200 people are employed in New Zealand franchises;
- e* dominant sectors include retail trade (23 per cent), 'other services' (20 per cent), accommodation and food retail (18 per cent) and administration and support services (8 per cent).
- f* 72 per cent of franchises are New Zealand-founded;
- g* the median initial franchise fee is NZ\$35,000 for retail and NZ\$28,750 for non-retail;
- h* the median total start-up cost is NZ\$308,500 for retail and NZ\$87,550 for non-retail;
- i* 50 per cent have been franchising since before 2000; and
- j* the median time before franchising is 4.5 years and 36 per cent are franchised within the first year.

There are other reliable franchise-specific reports available, and Statistics New Zealand has a number of statistics relevant to commerce and population in general.

II MARKET ENTRY

i Restrictions

Foreign franchisors who wish to enter New Zealand must be aware of a range of legislation including, but not limited to, the Commerce Act 1986, the Companies Act 1993, the Fair Trading Act 1986, the Financial Reporting Act 2013 and the Overseas Investment Act 2005 plus any amendments. From May 2015, new registration requirements were introduced by the Companies Amendment Act 2014 in relation to the formation of a company, and important changes included the following:

- a* all companies incorporated in New Zealand must have a director who lives in New Zealand, or lives in Australia and who is also a director of an Australian incorporated company; and
- b* all directors must provide their place and date of birth.

This is a departure from the previous position whereby a director resident anywhere in the world could be appointed as a director of a New Zealand company.

If a foreign business entity holds 25 per cent or more of the shareholding in a company, the company must be audited and must file financial statements pursuant to the Financial Reporting Act 2013. In relation to foreign investment, there are no barriers for funds coming into New Zealand. If a foreign entity wishes to buy land in New Zealand and the land is greater than five hectares in area, an application must be made to the Overseas Investment Office for consent to the purchase before it can proceed. There are no restrictions on a foreign entity granting a master franchise or development rights to a local entity, and there are no restrictions on foreign franchisors owning equity in a local business.

However, if a foreign franchisor who is deemed to be an overseas person, or an associate of an overseas person, wishes to acquire sensitive land or an interest in sensitive land (for example, by buying shares in a company that owns sensitive land) or business assets worth more than NZ\$100 million, or a fishing quota or an interest in a fishing quota, an application must be made to the Overseas Investment Office for consent to such a purchase before it can proceed. Land will be sensitive if it comes within the types of land and area thresholds detailed in Part 1 of Schedule 1 of the Overseas Investment Act 2005 (OIA). Generally, consent under the OIA must be obtained in the two scenarios set out below:

- a* Where there is an overseas investment in significant business assets. This includes:
 - the acquisition of rights or interests in securities of a person (A) where, as a result of the acquisition, the overseas person has a 25 per cent or more ownership or control interest in A or an increase in an existing 25 per cent or more ownership or control interest in A and where, in each case, the value of the securities or the consideration provided, or the value of the assets of A or A and its subsidiaries where A has a 25 per cent or more ownership or control interest, exceeds NZ\$100 million;
 - the establishment of a business in New Zealand where the business is carried on for more than 90 days in any one year (whether consecutively or in aggregate) and the total expenditure expected to be incurred in setting up the business exceeds NZ\$100 million; or
 - the acquisition of property (including goodwill and other intangible assets) in New Zealand used in carrying on business in New Zealand where the total consideration paid or payable for the assets exceeds NZ\$100 million.
- b* Where an overseas person (or an associate of an overseas person) wishes to acquire 'sensitive land' or an interest in 'sensitive land'. A schedule to the OIA sets out the definition of 'sensitive land' to include several types of land, including non-urban land of an area over five hectares, and any foreshore and seabed land, irrespective of the size of the area.

ii Foreign exchange and tax

Non-resident withholding tax (NRWT) is payable in respect of any income such as interest, dividends and royalties paid to non-residents in New Zealand when such income is repatriated overseas. NRWT is deductible from gross income and no expenses can be deducted. New Zealand has a double-taxation treaty with a number of countries and it is important to check the relevant double-taxation treaty for any specific rates that might apply. Further information can be obtained from www.ird.govt.nz.

III INTELLECTUAL PROPERTY

i Brand search

If a foreign franchisor owns any trademarks and wishes to register them in New Zealand, a search must be made of the trademark register, which is administered by the Intellectual Property Office of New Zealand (IPONZ). The Trade Marks Act 2002 governs registration of all marks capable of registration including trademarks or service marks. A search can be made at www.iponz.govt.nz, but it is wise to instruct a trademark and patent attorney in New Zealand to undertake a thorough search at IPONZ to ensure that the way is clear for registration of a foreign franchisor's trademark.

ii Brand protection

Assuming that the trademark is available, protection for it is afforded by filing an application and paying the requisite fee. IPONZ issues an application number, which is the unique trademark registration number for New Zealand. In relation to manuals and other intellectual property owned by a foreign franchisor, except for patents that are restricted, there is copyright protection under the Copyright Act 1994 and copyright exists at law with no registration required.

iii Enforcement

If trademarks have been registered, registration prevents any competitor from lawfully using the same or similar mark on any goods or services in New Zealand. Trademark registration would also prevent a subsequent registration of an identical or confusingly similar mark. If a third party breaches a registered trademark, action would be taken pursuant to the Trade Marks Act 2002 and the Fair Trading Act 1986. There are also remedies for breaches of the intellectual property of a franchisor that are not governed by the Trade Marks Act 2002 but are found in common law.

iv Data protection, cybercrime, social media and e-commerce

With the increasing use of e-commerce and social media in franchise businesses, franchisors must ensure that they observe the privacy principles contained in separate codes and in the Privacy Act 1993, which outlines how businesses should collect, use, store and disclose information about clients and customers. Other relevant law includes the Crimes Act 1961, which deals with crimes involving computer systems, and the Unsolicited Electronic Messages Act 2007.

IV FRANCHISE LAW

i Legislation

As stated earlier, there is no franchise-specific legislation in New Zealand. There are a number of statutes and laws that affect franchising including (but not limited to) the Building Act 2004, Commerce Act 1986, Companies Act 1993, Contract and Commercial Law Act 2017, Copyright Act 1994, Fair Trading Act 1986, Financial Reporting Act 2013, Health and Safety at Work Act 2015, Income Tax Act 2007, Overseas Investment Act 2005, Privacy Act 1993, Resource Management Act 1991 and the Trade Mark Act 2002. Any franchise or master franchise agreement is a contract and there are robust legal principles affecting

the law of contract and its enforceability. Also, a recent amendment to the Commerce Act 1986, under Part 2: Restrictive Trade Practices (known as the cartel provisions), should be considered carefully in relation to franchise agreements (see Section VI.v).

ii Pre-contractual disclosure

There are no mandatory pre-contractual disclosure requirements in New Zealand. However, if a franchisor or a master franchisee is a member of the FANZ, a disclosure document that complies with the FANZ Code of Practice must be given to any prospective franchisee at least 14 days before the franchise agreement, or master franchise agreement as the case may be, is executed. If a disclosure document contains misrepresentations, the franchisor or master franchisee will most likely be liable to action under the Fair Trading Act 1986. The key elements to prove a claim of misrepresentation include that the facts are false or misleading, the potential franchisee relied upon those facts and the potential franchisee has suffered a loss.

Being an English common law country, the law of torts including equitable estoppel is applicable in addition to promissory estoppel and unconscionability. However, while every case will be dealt with on its own facts, the Court of Appeal has commented that it would be unreasonable for a party to claim misrepresentation on pre-contractual disclosure where they were independently advised and that independent advice ought to have explained the meaning of the contract (*David v. TFAC Limited*;² see also *PAE (New Zealand) Limited v. Brosnahan & Ors*).³ Remedies may include damages for loss and general damages, and cancellation of the agreement; it is thus imperative that franchise agreements are properly drafted to mitigate any losses against the success of any misrepresentation claims.

iii Registration

There are no registration requirements for franchises. All franchise systems must comply with New Zealand laws, so if a particular franchise is in a special industry such as the medical industry, for example, or uses controlled products such as drugs, those franchises would need to comply with the relevant statutes and regulations. Great care should be taken rather than assuming that there are no restrictions in New Zealand.

iv Mandatory clauses

If a franchisor belongs to the FANZ mandatory clauses include: a seven-day cooling-off period whereby a prospective franchisee can 'cool off' or change its mind after signing the franchise agreement; a clause saying that the FANZ Rules, the Franchising Code of Practice and Code of Ethics must be adhered to and followed by both franchisor and franchisee; and that the franchise agreement must contain a dispute resolution clause with the recommended mode of resolving a dispute being mediation or arbitration. If a franchisor does not belong to the FANZ, no mandatory clauses apply.

v Guarantees and protection

The law of contract governs guarantees and it includes both statute and case law. It is common for a franchisor to require personal guarantees of all shareholders and directors of the franchisee company. Guarantees executed by individuals and companies are enforceable

2 *David v. TFAC Limited* [2009] NZCA 44.

3 *PAE (New Zealand) Limited v. Brosnahan & Ors* [2009] NZCA 611.

by the franchisor. Where there is more than one guarantor, liability should be joint and several in all cases. It is prudent for franchisors to require that all personal guarantors obtain independent legal advice evidenced by a solicitor's certificate to mitigate against possible future claims that the guarantors misunderstood the effect of the guarantee that they executed or that they suffered any duress.

V TAX

i Franchisor tax liabilities

Tax is governed by the Income Tax Act 2007 and the corporate tax rate for both resident and non-resident companies is 28 per cent. New Zealand has tax treaties with many countries and NRWT must be deducted from all interest and royalty income before funds are repatriated. The NRWT rate in relation to the United Kingdom, China, Taiwan and Canada is 10 per cent; for Fiji, Indonesia, Malaysia and the Philippines the rate is 15 per cent; and for Singapore, Japan, Australia and the United States the rate is 5 per cent. The overseas entity should be able to claim a tax deduction in the relevant country because a NRWT certificate will be provided. If dividends are repatriated, NRWT at 15 per cent must be deducted.

ii Franchisee tax liabilities

Franchisees and master franchisees will be required to deduct NRWT before remitting any royalties, dividends or interest income to a foreign franchisor. The liability to deduct NRWT is on the franchisee who must obtain a NRWT certificate from the Inland Revenue and provide it to the franchisor or master franchisee. Failure to deduct NRWT will render a franchisee liable to a late payment penalty of 1 per cent after the due date plus a further 4 per cent penalty after seven days. Franchisees also have the requirement to deduct pay-as-you-earn tax from all employees and to pay goods and services tax at the rate of 15 per cent to the Inland Revenue.

iii Tax-efficient structures

The most common business structure used for franchise businesses in New Zealand is an incorporated company. A company can be formed by filing relevant documentation to the Companies Office (www.companiesoffice.govt.nz/companies). The Companies Act 1993 applies and Part 18 applies for overseas companies. It is wise to have a separate constitution governing a company's operation.

There are other structures used to conduct franchise businesses such as sole traders, limited partnerships, traditional partnerships and trading trusts. It is essential to obtain expert legal advice and accounting advice from an experienced tax accountant prior to entering the market.

Foreign franchisors typically use one of three methods: direct franchising between the foreign franchisor and local franchisees; forming a subsidiary company that acts as the franchisor; or appointing a local master franchisee and the latter two are the most common.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

New Zealand courts have been reluctant to recognise that there is a general duty of good faith implied in all commercial agreements. Courts have been more willing to accept that there is an implied duty of good faith in contracts of a 'relational' character or that when there is a 'clear lacuna' in contracts it is necessary to imply a duty of good faith to achieve the purpose of the contract. While some overseas courts have classified franchise agreements as relational, the Court of Appeal in New Zealand ruled that a franchise agreement is indistinguishable from a commercial transaction in which a full disclosure is made and parties are independently advised.⁴ Franchisees are considered to be experienced business persons and the courts generally respect the sanctity of a contract entered into by informed parties.⁵

Unlike New Zealand, Australia has franchising regulation that explicitly includes an obligation to act in good faith.⁶ The Code of Practice prepared by the FANZ, and revised in August 2016,⁷ does not explicitly impose any good faith obligations on the parties but the Code of Ethics published by the FANZ does stipulate that each member must act in an honourable and fair manner.⁸

It remains to be seen how New Zealand law will develop in this area, but in my opinion good faith will keep developing and may be recognised by the Courts soon. It is noted that there are similar trends in the United Kingdom.

ii Agency distributor model

The general rules of agency law apply. Notwithstanding the fact that franchisees are separate legal entities, it remains possible for a franchisor to be pursued in claims for damages or otherwise by a person claiming reliance through agency.

The consequences of a franchisor or a master franchisee being found to be a principal for the actions of its franchisee that have caused loss to another person may result in a claim for those losses and possibly exemplary damages.

It is imperative for a franchisor to have appropriate contractual considerations within its franchise agreement prohibiting a franchisee from holding itself out as the franchisor or an agent, and acknowledging that the franchisee is not an agent, partner or otherwise legally connected to the franchisor; and to ensure that its manuals and initial and continuing education materials set out specific requirements to be followed by the franchisee so that the public is aware that the franchisee is a separate legal entity.

In addition there may be circumstances where franchisors find themselves liable for breaches of the workplace health and safety regime, which has undergone significant reform

4 *David Anor v. TFAC Limited* [2009] NZCA 44 at 23 and 61.

5 Maree Chetwin, 'The Seven Secret Herbs and Spices of Franchise Regulation: Some Suggested Options?' (2009), 15 *NZBLQ* 151 at 156.

6 Trade Practices (Industry Codes – Franchising) Regulations 1998 (AU), 23A.

7 Code of Practice of the FANZ (revised August 2016): 'The purpose of the Code is to promote high standards of Franchising conduct and procedure in accordance with the objects of the Association.'

8 Code of Ethics of the FANZ: 'Each Member of the Association will: [. . .] Act in an honourable and fair manner in all its business dealings and in such a way so as to uphold and bring credit to the good name of the Franchise Association of New Zealand Inc.'

and the Health and Safety in Employment Act 1992 has been replaced by the Health and Safety at Work Act 2015 as from 4 April 2016, with extensive changes and increased penalties for breaches of the new Act.

iii Employment law

Franchisees conduct their own independent businesses and franchisors are not liable in any way for the actions of franchisees and their employees except for vicarious liability in some cases. As the law stands at present, franchisees cannot be treated as employees by the courts and all employment law is governed by the Employment Relations Act 2000. Franchisors must, however, ensure that they are not acting as employers in respect to a franchisee's employees.

iv Consumer protection

New Zealand's current consumer law may cover business-to-business relationships and accordingly franchisors must contract out of consumer protection legislation such as the Consumer Guarantees Act 1993 and the Fair Trading Act 1986 to the fullest extent possible.

The Fair Trading Act 1986 (FTA) was amended by the Fair Trading Amendment Act 2013. The FTA has new obligations and restrictions relating to unfair contract terms, unsubstantiated representations, extended warranties, shill bidding, unsolicited goods and services, uninvited direct sales and lay-by sales, consumer information standards, product safety and product recalls, internet sales and auctions and auctioneers. The FTA also has a new right to contract out of certain provisions of the FTA in business contracts. Penalties for contravening the FTA go up to NZ\$200,000 for individuals and NZ\$600,000 for companies.

The Consumer Guarantees Act 1993 (CGA), which was amended by the Consumer Guarantees Amendment Act 2013, includes new guarantees relating to delivery and the supply of electricity and gas. It also has new obligations and restrictions relating to:

- a* contracting out of the CGA;
- b* collateral credit agreements; and
- c* indemnification of gas and electricity retailers.

v Competition law

The Commerce Act 1986 provides the regulatory framework relating to anticompetitive conduct and the Commerce Commission is charged with policing that framework. The Commerce (Cartels and Other Matters) Amendment Act 2017 entered into force on 14 August 2017. For existing franchise agreements and franchising generally, the Act will not apply until 14 May 2018, but the new Act will apply immediately to all new franchise agreements. This means that some additional clauses must be inserted into franchise agreements and there must be explanations, in plain language, as to why certain clauses are necessary. Consideration must be given to cartel clauses in franchise agreements; for example, clauses that set or influence prices, restrict output or allocate markets will be caught. The possibility that alternative arrangements might achieve the same or a similar commercial outcome as a cartel clause should also be considered. Another consideration is whether the collaborative activity exemption or the vertical activity exemption would apply. Expert legal advice should be obtained in relation to the new Act.

There will not be a cartel arrangement in place where parties are not in competition with each other. In most franchise systems the franchisor will not be in competition with its own franchisees but that is not always the case. For example, a franchisor that owns its own outlet might be found to be in competition with franchisees. Similarly, where a franchisor

sells online direct to the end consumer, yet at the same time has franchisees who sell to those consumers, it may also be in competition with its franchisees. There may also be instances where the franchisees are in competition with each other. Where a franchisor is in competition with a franchisee or where franchisees are found to be in competition with each other, there will be a competitive relationship, so the franchisor needs to be cognisant that there may be provisions in its franchise agreements that amount to cartel provisions.

There is no prohibition or law around third-line forcing or full-line forcing in relation to franchising.

vi Restrictive covenants

The New Zealand courts have recognised that it is reasonable for a person in the position of a franchisor to impose a contractual restraint upon competitive conduct by a franchisee or an ex-franchisee, but such agreements must not exceed the boundaries of the court's notion of reasonableness. The first principle is that it is reasonable for a person to stipulate that if he or she is willing to disclose all secrets of how to establish a particular business enterprise, then the recipient of the information cannot immediately terminate the contract and set up a competitive business using the information received during the course of the relationship. If the courts did not provide protection to franchisors in such situations, there would be no incentive for the owners of established businesses to share their secrets with others and enhance their business skills. The second principle is that it is important for the well-being of the community that every individual should, in general, be free to advance his or her skills and earning capacity.

The Contract and Commercial Law Act 2017 in New Zealand gives the courts authority to rewrite a restrictive covenant and to allow an excessive covenant to be enforced at a lesser level. Section 83 of the Act states as follows:

8 Restraints of trade

- (1) *The court may, if a provision of a contract constitutes an unreasonable restraint of trade –*
 - (a) *delete the provision and give effect to the contract as so amended; or*
 - (b) *so modify the provision so that, at the time the contract was entered into, the provision as modified would have been reasonable, and give effect to the contract as so modified; or*
 - (c) *decline to enforce the contract if the deletion or modification of the provision would so alter the bargain between the parties that it would be unreasonable to allow the contract to stand.*
- (2) *The court may modify a provision even if the modification cannot be effected by deleting words from the provision.*

The ability of the courts to modify excessive restraints is constrained by the principle that terms that could never have been considered reasonable will not be modified, as to do so would be contrary to the public interest. This is the doctrine of restraints that are *in terrorem*, which translates into 'contracts that terrorise a contracting party'. If a franchisor could only ever have reasonably sought a two-year restraint within a 5-kilometre radius of the business in which the person established goodwill, then a nationwide restraint for 10 years could never be regarded as reasonable; and in that case the courts would refuse to rewrite the clause to determine that the period of 10 years should be two years and the area of the restraint should be 5 kilometres rather than the entire country. What then is a reasonable restraint? There are two factors – area and time. So the message is clear in New Zealand – for a restraint to be enforceable, it must be reasonable.

There have been a number of restraint-of-trade cases in the franchising sector in recent years. Some recent New Zealand restraint-of-trade franchising cases include the following: *Dorn Investments Ltd v. Hoover*;⁹ *Mike Pero (New Zealand) Ltd v. Heath*;¹⁰ *Video Ezy International Pty Ltd v. Red Bond Ltd*;¹¹ *Mike Pero Real Estate Ltd v. Tauranga Realty Ltd*;¹² and *Green Acres Franchise Group Ltd v. Reube*.¹³

Non-compete and other restrictive covenants need to be included in the relevant franchise agreement to be enforced during the term of the agreement. The type of clause that I often include is as follows:

The franchisee covenants that it shall not during the term except with the prior written approval of the franchisor carry on or be directly or indirectly engaged or concerned or interested whether as principal, agent, partner, shareholder, investor, financier, lender, director, employee, consultant, independent contractor or otherwise howsoever in any business conducted in competition with the [particular franchise business], the franchisor or any of its other franchisees.

In other words, a franchisor and a franchisee have a relationship for the term of the franchise agreement. During that period the franchisee must not compete with the particular franchise system and must not divulge confidential information to any third party outside the system without the consent of the franchisor. A breach of these covenants will usually give rise to an event of termination allowing a franchisor to terminate the franchise agreement with the particular franchisee plus it will allow the franchisor to enforce the personal covenants given by the directors and shareholders of the franchisee in relation to the restraint.

vii Termination

The courts have recognised that it is reasonable for a person in the position of a franchisor to impose a contractual restraint upon the competitive conduct of franchisees and that contractual restraints are known as restrictive covenants or agreements in restraint of trade. The case of *SKIDS v. McNeill*¹⁴ reached our Court of Appeal, which determined that a 90-day restraint was reasonable under the circumstances. Such agreements must not exceed the boundaries of the courts' opinion of reasonableness and there are two competing principles that govern the courts' decision-making process.

The first principle is that it is reasonable for a person to stipulate that if he or she is willing to disclose all secrets of how to establish a particular business enterprise, the recipient of the information cannot immediately terminate the contract and set up a competitive business using the information received during the course of the educational process. If the courts did not provide protection to franchisors in such situations, there would be no incentive for the owners of established businesses to share their secrets with others and to enhance their business skills.

9 *Dorn Investments Limited v. Hoover* [2016] NZHC 1325.

10 *Mike Pero (New Zealand) Limited v. Heath & Ors* [2015] NZHC 2040.

11 *Video Ezy International Pty Ltd v. Red Bond Ltd* [2015] NZHC 1636.

12 *Mike Pero Real Estate Ltd v. Tauranga Realty Ltd* [2015] NZHC 1162.

13 *Green Acres Franchise Group Ltd v. Reube* [2014] NZHC 402.

14 *Skids Programme Management Limited & Ors v. McNeill & Ors* [2013] 1 NZLR 1; (2012) 98 IPR 324.

The second principle is that it is important for the well-being of the community that every individual should be free to advance his or her skills and earning capacity. The way these two conflicting principles are resolved is to require that a restrictive covenant must be 'reasonable' in its terms before it will be enforced.

The recent case of *Dorn Investments Limited v. Hoover*¹⁵ is worthy of mention. Paul Hoover, who was 60 years old and had a background as a rigger and truck driver, was the defendant and Dorn Investments Limited was a franchisee of Green Acres Franchise Group Ltd (Green Acres), which had an exclusive licence to operate the Green Acres Lawnmowing and Garden Care Services in a mapped territory in the Waikato region. Paul Hoover had some medical issues and he entered into a sub-franchise agreement with Dorn Investments. The relationship between the parties was not good and in the course of his work for the franchise Mr Hoover had been performing lawn mowing and gardening services for an entity called Spotless. In September 2015, Dorn Investments became dissatisfied with the way in which Mr Hoover was carrying out the Spotless work, so it took the contract off him and gave it to another franchisee. Following that, Mr Hoover made the decision to give up the franchise and to commence trading on his own account and he did so by rebranding as the Lawn Ranger. He destroyed the Green Acres business cards and signage and never had a manual. When Dorn Investments found out it terminated the sub-franchise agreement and sought an undertaking that Mr Hoover would not provide lawn and gardening services in competition with the Green Acres businesses in New Zealand. Mr Hoover provided no such confirmation, so injunction proceedings were served in late January 2016. Justice Asher dismissed the application for an interim injunction and stated that, on the balance-of-convenience argument, the result of granting an injunction would be severe for Mr Hoover, as he would have to stop his business. The judge said that Dorn Investments acted too quickly in taking Spotless as a customer from Mr Hoover, and in issuing the proceedings. The judge said that damages would not be great in any event. What really swayed the judge to decline the injunction was, in my opinion, 'the peremptory removal of one-third of Mr Hoover's custom in September 2015 by Dorn Investments when it took the Spotless contract away from him'. This case goes to show that in restraint-of-trade cases there is no certainty that the court will grant an injunction.

The Contract and Commercial Law Act 2017 gives the courts authority to rewrite a restrictive covenant and to allow an excessive covenant to be enforced at a lesser level. For example, if an agreement provided for a three-year period of restraint when a two-year period was considered to be reasonable, the covenant would be enforced to the extent that it could be rewritten by the courts as being confined to a two-year term. The ability of the courts to modify excessive restraints is constrained by the principle that terms that could never have been considered reasonable will not be modified. The reason for this is that it is considered to be contrary to the public interest that a person should be able to intimidate a contracting party by stipulating for a wholly unreasonable constraint and then have the court come to its rescue and rewrite the agreement so that it falls within the boundaries of reasonableness. This is the doctrine of restraints that are 'in terrorem', that is agreements that 'terrorise' a contracting party. When would a restraint be reasonable? There are many factors to consider – time and area, nature of the rights to be protected, and public interest.

The courts view breaches of restrictive covenants very seriously. Whether or not the franchisor could take over the business of the franchisee who breaches a restrictive covenant

15 *Dorn Investments Limited v. Hoover* [2016] NZHC 1325.

depends on the circumstances and materiality of the breach. Well-drafted franchise agreements would always allow a franchisor to seek injunctive relief. In relation to the shareholders of a franchisee company, there is normally a restriction that shares cannot be transferred to any third party without the franchisor's knowledge and consent and contravention of this will be deemed to be an illegal transfer. Similar provisions apply to leases where a franchisee has leased premises.

The ability of any franchisor to take over a franchisee's business post-termination must be a matter of contract. Usually franchise agreements provide the right of a franchisor to purchase the assets of a franchisee at an agreed value or, failing agreement, to be determined by arbitration.

Franchisors are often empowered to take over the leases of franchisees by express provision in the franchise agreement but this will always depend upon the exact wording of the clause.

viii Anti-corruption and anti-terrorism regulation

The Fair Trading Act 1986 applies to any misrepresentations (unsubstantiated or false or misleading representation) made by a party to a franchise agreement.¹⁶ The Crimes Act 1961 and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the AML/CFT Act) apply to offences involving fraud and money laundering.¹⁷ The government is considering the Organised Crime and Anti-corruption Legislation Bill to enhance New Zealand's anti-corruption legislative frameworks by implementing amendments to the AML/CFT Act and the Crimes Act 1961. The AML/CFT Act, which places obligations on New Zealand's financial institutions and casinos to deter and detect money laundering and terrorism financing, is being implemented in phases. Phase One applied to banks, casinos and a range of financial service providers. Phase Two, which will be implemented from July 2018 will extend the AML/CFT regime to lawyers, conveyancers, accountants, real estate agents, sports and race betting, and businesses that deal in certain high-value goods.

ix Dispute resolution

Franchise agreements usually include a dispute resolution clause. Some clauses favour arbitration, but franchisors who belong to the FANZ normally include the dispute resolution clause from the Code of Practice, which favours mediation in the first instance; if this is the case, mediation will be mandatory.

A foreign judgment has no direct operation in New Zealand. However, some foreign judgments may provide the basis upon which a New Zealand court will grant a judgment that will then be enforced in the same way as any New Zealand judgment. At common law a New Zealand court may grant judgment to enforce a money judgment given against a defendant by a foreign court whose jurisdiction over the defendant is recognised by New Zealand's Rules of Private International Law provided the judgment is for a debt, or definite sum of money other than a sum payable in respect of taxes or other charges of that nature, or in respect of a fine or other penalty; and the foreign judgment is final and conclusive.

¹⁶ Sections 9–16.

¹⁷ Sections 243–245.

There are certain types of judgments given in foreign courts that, as a matter of public policy, a New Zealand Court will decline to enforce. Examples are attempts to enforce foreign revenue and penal law; judgments obtained by fraud; and judgments given overseas in breach of the rules of natural justice as applied in New Zealand.¹⁸

As recently mentioned, mediation is the favoured mode of resolving disputes. Normally the parties to a dispute must meet and are given 21 days to resolve it, failing which one party can issue a mediation notice to the other party. The parties have 10 days to agree on the appointment of a mediator and failing agreement a third party will determine who the mediator is. Once the mediator has been appointed the mediation must take place within 14 days so the process is swift and time-effective.

If a franchise agreement has been terminated and the previous franchisee conducts a new business in breach of a non-compete provision or uses the franchisor's trademarks or other intellectual property rights, injunctive relief is available from the High Court of New Zealand. A plaintiff who succeeds in a claim for breach of contract is entitled to recover losses on an 'expectation' basis (i.e., the loss is the sum that the person expected to make (profits) if the contract had been fulfilled). If a party is successful in court, costs are awarded pursuant to a court scale and in special circumstances exemplary damages or costs are awarded.

A careful drafting of a dispute resolution clause is required in an international franchise agreement as it affects the franchisor's ability to enforce the agreement across other jurisdictions.

Parties to a franchise agreement should also note that some disputes may not be submitted to arbitration. It is crucial that any subject matter of a potential dispute is capable of being settled by arbitration under the law of the country where enforcement of the arbitral judgment and award are likely to be sought and that enforcement is not contrary to the public policy of that country.¹⁹

New Zealand is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958. An arbitration award rendered in another Convention country is generally enforceable in New Zealand unless there is a ground for non-enforcement that relates to grave procedural errors or conflicting public policy. International courts have taken a restrictive view of this exception²⁰ and have required fraud or corruption in procuring a foreign arbitral award or a violation of international public policy, not domestic public policy.²¹ New Zealand courts would be likely to apply a similar standard.

A franchising dispute involving a franchisor called Hire Intelligence International Limited resulted in proceedings being issued in the High Court and the reported decision is *Cityside Asset Pty Limited & Ors v. 1 Solution Limited & Ors*.²² The High Court proceeding involved discovery, the destruction of vital evidence and legal privilege. The dispute was subsequently resolved after a two-day mediation and the High Court proceedings were discontinued by consent.

18 *Connor v. Connor* [1974] 1 NZLR 632.

19 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958, Article V(2) (a) and (b).

20 Kerry Bundy, Marco Hero and Pascal Hollander, 'Choice of Law, Venue and Jurisdiction, Arbitration v. Litigation' (2012) 10 *Int'l J. Franchising L.* 3 at 6 and 10.

21 *Id.*, at 6.

22 *Cityside Asset Pty Limited & Ors v. 1 Solution Limited & Ors* [2012] NZHC 3075.

VII CURRENT DEVELOPMENTS

A very important change is the Commerce (Cartels and Other Matters) Amendment Act 2017, which was mentioned above (see Section VI.v on competition law).

The franchise market remains buoyant and active, and during the past 12 months there have been a number of overseas franchisors entering the New Zealand market together with new local franchisors. Membership of the FANZ continues to grow, with more franchisors agreeing to comply with the Code of Practice and Code of Ethics.

NIGERIA

Ngozi Aderibigbe and Chinweizu Ogban¹

I INTRODUCTION

In recent years, the Nigerian franchising market has grown impressively, thriving on the combined effect of the country's large population, its burgeoning middle class and an evolving retail industry. With a population of over 170 million, Nigeria is clearly the largest human population in Africa, accounting for a sixth of the continent's entire population. From a product and service consumption perspective, this statistic translates to a ready market for consumer-facing products and services, and a huge economic potential for retailers. The prospect of such a huge population combined with the fact of a rapidly growing middle class, characterised by their increasing purchasing power and a corresponding appetite for well-known brands, makes the country an attractive destination for reputable international and local brands.

According to data sourced from the African Development Bank, the Nigerian middle class accounts for up to 23 per cent of the Nigerian population,² an upsurge from previous figures. The demand by this class of the population for high-quality products and services is matched by the requisite purchasing power and is influencing a shift from the traditional unstructured retail system to modern retailing systems. In a country where manufacturing is at its lowest ebb, the increased demand for high-quality goods and services creates a conducive environment for the franchise market.

Product franchises were the first franchising format introduced in Nigeria in the 1960s and were common to sectors such as beverages (Coca-Cola, etc.), petroleum (Texaco, Mobil, etc.) and automobiles (Peugeot, Toyota, Ford, etc.). Recent years have, however, witnessed the significant growth and emergence of business format franchising in several areas, including the fast-food, fashion, health and beauty, hospitality and retail sectors. The presence of international franchisors became apparent in the fast-food and fashion sectors around 2001 with the emergence of fast-food brands such as Chicken Licken, Steers, Debonairs Pizza, Barcelos, etc. Today, the Nigerian franchise landscape features several international brands including KFC, Sheraton Hotels, Raddison Blu, Avis, Hertz, Western Union, Nike, Shoprite, Ermenegildo Zegna, etc.

Local franchisors are not left out in the jostle for a place in the Nigerian franchise market. From about 2003, indigenous franchise systems were developed by a few operators in the fast-food sector. Mr Bigg's, a major brand owned by a Nigerian conglomerate, UAC of Nigeria Plc, is one of the earliest Nigerian companies to adopt the franchising mode of

1 Ngozi Aderibigbe and Chinweizu Ogban are senior associates at Jackson, Etti & Edu.

2 The African Development Bank Group, 'Market Brief – The Middle of the Pyramid: Dynamics of the Middle Class in Africa' (20 April 2011).

expansion. As at 2013, the company had over 170 outlets across Nigeria, of which 110 are franchise units. Tantalizers and Chicken Republic in the fast-food sector and SLOT in the electronics and telecommunications sector are also examples of successful local franchises.

The potential of the Nigerian market for franchisors is perhaps best illustrated with the TM Lewin retail franchise. The first TM Lewin franchise unit opened for business in Nigeria in August 2013. Presently, out of the 48 franchise outlets in Africa, Nigerian franchises are among the top-performing franchises, recording 150 per cent growth year on year in 2005. In 2013, the TM Lewin Ikeja (Lagos) franchise outlet ranked number two worldwide, surpassed only by the brand's flagship store on London's Jermyn Street.³

The Nigerian International Franchise Association (NIFA) is a trade association with a commitment to develop and promote franchising in Nigeria. Its membership consists mainly of companies and stakeholders in the Nigerian franchise industry.

II MARKET ENTRY

i Restrictions

A foreign franchisor is at liberty to invest and participate in the operation of any Nigerian enterprise excluding sectors contained in the 'negative list', which is a list of sectors in which Nigerian and non-Nigerian investors are prohibited from participating. Also, the Immigration Act (Chapter I1 2004) prevents a foreign franchisor from practising any profession or establishing or taking over any trade or business whatsoever, solely or in partnership with another person, without the consent in writing of the Minister of Internal Affairs. The consent takes the form of a business permit, which is obtainable upon application to the Ministry of Internal Affairs.

There are also no restrictions that prevent a foreign franchisor from entering into a franchise agreement with a local franchisee. However, the enterprise with which a foreign licensor enters into a franchise agreement must be registered or incorporated with the Corporate Affairs Commission before it may commence business in Nigeria.

The foreign franchisor is free to grant a franchise in Nigeria in relation to any business or product except for those contained in the negative list. Also, franchise agreements between a foreign franchisor and a local franchisee are caught by the provisions of the National Office for Technology Acquisition and Promotion (NOTAP) Act, which regulates transfer of technology to Nigeria. By the provisions of this Act, all franchise agreements are to be registered with NOTAP within 60 days of the execution of the agreements.

A foreign entity may not grant a master franchise or development rights to a local entity in respect of the any of the matters contained in the negative list. The negative list includes the following:

- a* the production of arms and ammunition;
- b* the production of and dealing in narcotic drugs and psychotropic substances;
- c* the production of military and paramilitary clothing and accoutrements including those of the police and the customs, immigration and prison services; and
- d* other items as the Federal Executive Council may from determine time to time.

3 UK Trade & Investment, 'Webinar – Opportunities in Franchising in Nigeria' (29 October 2015).

A foreign franchisor may invest in the operation of any enterprise in Nigeria (except, as indicated above, in relation to matters contained in the negative list) and may buy shares of any Nigerian enterprise in any convertible foreign currency. While a foreign investor may buy the shares of any Nigerian enterprise in any convertible foreign currency,⁴ certain industries, especially in the energy sector, have local content regulations that regulate foreign participation. Specifically, under the Nigerian Oil and Gas Industry Content Development Act, 2010, foreign franchisors cannot own more than 49 per cent equity in the oil and gas industry.

Additional requirements for local Nigerian franchisees with foreign participation include obtaining a business permit from the Ministry of Interior and registration of the foreign shareholding at the Nigerian Investment Promotion Corporation.

With regards to owning real property, in many states in Nigeria, foreigners (and Nigerians alike) cannot generally acquire any interest or right in or over land unless the governor of the state approves in writing the transaction that seeks to alienate the interest in the real property. The governor's consent is customarily granted upon the payment of prescribed fees and satisfaction of certain other conditions.

ii Foreign exchange and tax

Section 15 of the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act requires a licensed bank through which foreign exchange is imported into Nigeria to issue a Certificate of Capital Importation (CCI) within 24 hours of the inflow of the funds into Nigeria and to make returns to the Central Bank of Nigeria within 48 hours thereafter. The CCI serves as evidence of the inflow of foreign currency and is required to be tendered to obtain foreign exchange for remittance of the proceeds of the importation of foreign currency.

It is important to note that the currency control regime in Nigeria has over the past year been subject to a high level of volatility. It would be advisable before entering into a Franchising agreement to evaluate the currently prevalent currency regime.

III INTELLECTUAL PROPERTY

i Brand search

Databases of registered trademarks, patents and designs are maintained at the Nigerian Trademarks, Patents and Designs Registry, an arm of the Commercial Law Department of the Ministry of Trade and Investment. Conflict searches may be conducted at the Trademark, Designs and Patents Registry with respect to any of these intellectual property rights. Searches of the records at the Registry may be conducted manually or electronically.

ii Brand protection

Trademark registration procedure

Upon receipt of a trademark application by the Registry and payment of the prescribed fee, an acknowledgment notice is issued. The acknowledgment notice informs the applicant that the application is now on the Registry's records and also stipulates the application date and number allocated to the mark. Thereafter, the application undergoes examination to

⁴ Section 21 Nigerian Investment Promotion Commission Act 1995.

determine whether the mark meets the registration requirements of the Trademarks Act, following which the mark is either accepted or refused as the case may be. An acceptance notice or a notice of refusal is issued as appropriate.

In the event that the application is accepted, the mark is advertised in the Trademarks Journal to provide interested third parties with the opportunity to oppose the application, if necessary. The marks are open for opposition for a two-month period. Upon expiration of the two-month opposition period, and in the event that the mark is unopposed, final registration fees become payable. Upon payment of the registration fees, the trademark certificate is issued.

Patent registration procedure

An application is made in the prescribed form and accompanied by the requisite documents to the Registrar, who issues a filing receipt to the applicant, acknowledging that the application has been filed and received at the Registry. The date reflected on the filing receipt is considered to be the official filing date of the patent. This acknowledgement notice details the title of the patent, the name of the applicant and the agents on record, if any.

Thereafter, the patent is examined to ensure its conformity with the documentary requirements under the Patents and Designs Act. It is important to note that substantive examinations of patent applications are not carried out in Nigeria.

Where the application satisfies the prescribed requirements, an acceptance notice is issued to the applicant. Where, however, the application fails in any respect to conform to the prescribed requirements, the Registrar will not issue the acceptance form until these requirements are met.

The Registry issues the letters patent shortly after the issuance of the acceptance notice.

Design registration process

The registration process for a design is materially similar to the process for registration of a patent. An application is made in the prescribed form and accompanied by the requisite documents to the Registrar, who issues a filing receipt to the applicant, acknowledging that the application has been filed and received at the Registry. The date indicated on the notice of acknowledgment is the official filing date of the design. This acknowledgement notice details the title of the design, the name of the applicant and the agents on record, if any.

The design is examined to ensure its conformity with the provisions of the Patents and Designs Act. Where the examination shows that the application satisfies the prescribed requirements, an acceptance notice is issued to the applicant. Where, however, the application fails in any respect to conform to the prescribed requirements, the Registrar will not issue the acceptance form until these requirements are met.

The Registry issues the design certificate shortly after the issuance of the acceptance notice.

iii Enforcement

Trademarks, patents and designs

Trademark, patent and design registrations may be enforced by the following means.

Trademark, patent or design infringement action

An action for trademark, patent or design infringement must be predicated on the existence of a trademark, patent or design registration certificate, respectively, issued in favour of the claimant.

Action in passing off

This action may be used to enforce trademarks and design rights. It is based on the common law tort of passing off, which prevents a person from misrepresenting its business as those of another. To succeed with this action, the claimant must show that it has acquired goodwill and reputation in the country through the use of its trademark or design.

Criminal actions

The Merchandise Marks Act (Chapter M10, LFN 2004) makes it a criminal offence for anyone to deal with goods that bear a false trade description. On the basis of this provision, criminal proceedings may be instituted against trademark infringers by an appropriate enforcement agency.

Regulatory enforcement

Using the machinery of appropriate enforcement agencies, an intellectual property (IP) rights holder may succeed in enforcing its IP rights against offenders.

Copyright enforcement

Copyrights in Nigeria may be enforced by the following means:

Action for infringement

An infringement action may be initiated before the Federal High Court of Nigeria for the enforcement of the copyright.

Criminal action

The Copyright Act (Chapter C28, LFN 2004) imposes criminal liability on copyright infringers. Thus, criminal proceedings may be instituted against infringers by an appropriate enforcement agency.

Administrative action

The Copyright Act empowers the Nigerian Copyright Commission to appoint copyright inspectors, who have the power to carry out seizures of copyright infringing materials and to arrest infringers.

Trade secrets

There is no legislation governing the enforcement of trade secrets in Nigeria. The courts protect trade secrets and know-how by enforcing contractual agreements that restrict the disclosure of trade secrets and know-how (e.g., non-disclosure agreements, confidentiality agreements and other similar agreements).

iv Data protection, cybercrime, social media and e-commerce

The Cybercrimes (Prohibition, Prevention, Etc.) Act 2015 criminalises offences such as cybersquatting and hacking. It defines cybersquatting as the act of intentionally taking or making use of a name, business name, trademark, domain name, etc. that is owned or in use by any individual, body corporate on the internet or any other computer network, without authority or right, and for the purpose of interfering with their use by the owner, registrant or legitimate prior user.

Also, the National Information Technology Development Agency Act of 2007 established the National Information Technology Development Agency (NITDA), a regulatory body responsible for the development of framework rules for the governance and monitoring of the exchange of data and conduct of transactions online. In line with this obligation, NITDA has, since its creation in 2007, issued a number of guidelines for the purpose of regulating the e-commerce industry. Among these guidelines are the Guidelines on Data Protection 2013,⁵ which cover the processing, safety and protection of personal data and privacy of natural persons with respect to the processing of personal data. The Guidelines provide that personal data must be processed fairly and lawfully and in accordance with the purpose for which it was collected.

IV FRANCHISE LAW

i Legislation

Nigeria does not have any legislation specifically governing franchising. Franchise relationships in the country are therefore governed by general contract law, as well as a host of other legislation that addresses issues relevant to the franchise relationship, including the following:

- a* the Trademarks Act 1965 (Chapter T13, LFN 2004);
- b* the Patents and Designs Act 1970 (Chapter P2, LFN 2004);
- c* the Copyright Act 1988 (Chapter C28, LFN 2004);
- d* the National Office of Technology Acquisition and Promotion Act (Chapter N62, LFN 2004);
- e* the Nigerian Investment Promotion Commission Act (Chapter N117, LFN 2004);
- f* the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act (Chapter F34, LFN 2004); and
- g* the Companies Income Tax Act (Chapter 60, LFN 1990; Chapter C21, LFN 2004).

ii Pre-contractual disclosure

Owing to the absence of a franchise law in Nigeria, there is no specific mandatory legal regulation of pre-contract disclosures. The concept of misrepresentation as provided under the general common law principles of contract would apply to franchise relationships.

Under common law, while a misrepresentation or false statement by the franchisor will render the franchise agreement voidable, a failure to disclose does not constitute misrepresentation and would not generally render the agreement voidable. However, as an exception to the aforesaid rule, non-disclosure would be actionable in the following circumstances:

⁵ Available on the NITDA website: www.nitda.gov.ng/download/dataprotection.pdf.

- a* partial non-disclosure: a partial non-disclosure will render the contract voidable if what the franchisor holds back or fails to disclose has the effect of distorting the information disclosed;
- b* misrepresentation by conduct: where the manner of the franchisor's conduct suggests that a particular state of affairs exists, the franchisor would be guilty of misrepresentation if the state affairs in fact did not exist;
- c* contracts *uberrimae fidei*: these are contracts where one party of necessity possesses full knowledge of the material facts, in which case the party with the full knowledge is under a legal duty to show *uberrima fides* (good faith) by making necessary disclosures; and
- d* fiduciary relationships: in fiduciary relationships, the law imposes on the party in the superior position a duty to disclose material facts to the other party. Certain relationships in the business world have been qualified as fiduciary relationships including those between principal and agent, partners, a company and its promoters, etc. Although there is a dearth of judicial pronouncements on the nature of franchise agreements, there seems to be a basis for the court to consider a franchise agreement as creating a fiduciary relationship between the franchisor (the party with the superior position) and the franchisee. Note that the fiduciary duty in these latter cases (pertaining to the business world) is not so stringent and does not extend beyond the duty to disclose.

iii Registration

The NOTAP Act provides that every agreement that provides for the use of a trademark, patent invention, supply of technical expertise, etc., and that is entered into by any person in Nigeria with another person outside Nigeria, shall be registered with NOTAP not later than 60 days from the execution of the agreement. Franchise agreements by their nature fall within the purview of agreements for which registration is required under the NOTAP Act.

Section 6(2) (a)–(r) of the NOTAP Act makes provision for registration relating to franchises. It provides that the Director of NOTAP shall not register any contract or agreement that the Director is satisfied falls within any of the specifications listed in the NOTAP Act, such as:

- a* where the purpose of the agreement is the transfer of technology that is freely available in Nigeria;
- b* where the price or other valuable consideration is, therefore, not commensurate with the technology acquired or to be acquired;
- c* where there is an onerous or gratuitous obligation on the transferee of the technology to assign to the transferor patents, trademarks or technical information obtained by the transferee with no assistance from the transferor; and
- d* where there is an obligation therein to acquire equipment, tools, parts or raw materials exclusively from the transferor or any other person or given source.

It is imperative to note that the aforementioned provisions may be waived should the Director of NOTAP believe it to be in the national interest to do so.

Trademarks Act

The Trademarks Act makes provision for the registration of a franchisee as a registered user of a trademark in respect of the goods for which the trademark was registered. To proceed in this regard, a copy of the franchise agreement is required to be deposited at the Registry.

iv Mandatory clauses

The NOTAP Guidelines provide that the content of a technology transfer agreement must be clearly spelt out and should include any or a combination of the following;

- a* utilisation of local content or inputs;
- b* plans by the company to substitute imported inputs;
- c* plans for skill-building and development for absorption, diffusion and domestication of the technology to be acquired; and
- d* export potential of products or services involved in the agreement.

Also, the scope of the agreement must specify the following;

- a* the object of the agreement;
- b* obligations and services to be rendered by the technical partner;
- c* training and capacity-building; and
- d* detailed information of technical experts.

The agreement is also expected to include the technology fees to be paid to the technical partner and a breakdown of the fees and associated milestones; and the names and signatures of signatories to the agreement, etc.

v Guarantees and protection

There is no specific legislation relating to guarantees and protection under franchise agreements in Nigeria. Such guarantees are defined and regulated by the terms of the contract. Under contract law, guarantees from individuals and companies to the franchisor are binding and enforceable.

V TAX

i Franchisor tax liabilities

The Companies Income Tax Act imposes withholding tax on royalty payments to non-resident (foreign) franchisors at the rate of 10 per cent, and this shall be the final tax paid by the non-resident franchisor. The withholding tax is required to be withheld by the franchisee from income for services rendered and then remitted periodically to the relevant tax authority.

ii Franchisee tax liabilities

Where the franchisee is a corporate entity it would be subject to 30 per cent income tax and 2 per cent tertiary education tax on its profit. Royalties paid under a franchise arrangement are usually deducted in computing the profit of the franchisee that would be subject to tax.

Value added tax (VAT) is charged at a flat rate of 5 per cent for the supply of goods and services. Under the VAT Act, both resident and non-resident companies engaged in 'VATable' activity in Nigeria are required to register for the tax, and to include VAT on invoices to customers.

With respect to franchisors and franchisees that are related parties, it is also important to ensure that the royalties paid on the franchise agreement are priced at arm's length, to ensure compliance with Nigeria's transfer pricing regulations.⁶ There is, however, a possibility

⁶ The Income Tax (Transfer Pricing) Regulations No. 1, 2012.

that an arm's-length pricing in accordance with the transfer pricing regulations may be in excess of the benchmark royalty permissible under the NOTAP Guidelines. Consequently, fixing of royalties between related parties should take cognisance of the transfer pricing regulations and the NOTAP Guidelines.

iii Tax-efficient structures

Section 80 of the Companies Income Tax Act provides that where any dividend or other such distribution becomes due from or payable by a Nigerian company to any other company, or to any person to whom the provisions of the Personal Income Tax Act apply, the company paying the dividend or making the distribution shall, on the date when the amount is paid or credited (whichever occurs first), deduct tax at the rate prescribed and pay the deducted amount to the relevant tax authority forthwith. This reduces the burden on the franchisor in remitting tax directly.

A foreign franchisor will be able to take advantage of the benefits of a double-taxation agreement if the licensor is resident in a country that has such an agreement with Nigeria. These countries include the United Kingdom, Northern Ireland, Canada, France, Belgium, the Netherlands, Pakistan and Romania.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Contracts in Nigeria are largely guided by the common law principles on the subject. Under the common law system, good faith is, generally speaking, not considered as a condition for the validity of contracts. Therefore, generally, no duty of good faith is implied into contracts between parties.

However, good faith is relevant in certain contracts, described as contracts *uberrimae fidei* (of utmost good faith). Contracts within this category are those in which one party of necessity possesses full knowledge of the material facts. Under such contracts, the law requires that the party with full knowledge of material facts show utmost good faith by making full disclosure so that the other party is not put in a position of acute disadvantage. Certain contracts are considered to fall within this category: insurance contracts, family arrangements in matters in matters of inheritance and succession, etc.

ii Agency distributor model

Nigerian courts have held that agency relationship exists whenever one person, called the 'agent', has authority to act on behalf of another, called the 'principal', and consents to act in that capacity. Whether an agency relationship exists in any situation depends on the exact circumstances of the relationship between the parties and not on the terminology employed by the parties to describe their relationship.

Parties to a franchise agreement are at liberty to determine the terms of the franchise agreement, and to agree on whether the franchisee is to act as an agent of the franchisor. However, in practice, most franchise agreements are considered to be arm's-length agreements between independent entities that are not bound to each other by an agency relationship.⁷

⁷ *Nigeria Progress Ltd. v. NEI Corp.* (1989) 3 NWLR Pt. 102 68 @ 92.

iii Employment law

Under Nigerian laws, an employee is defined as a person employed by an employer under oral or written contract of employment whether on a continuous, part-time, temporary, apprenticeship or casual basis. A franchise relationship is considered to be an arm's-length commercial relationship between business entities. It is not founded on a contract of employment and therefore a franchisee is not treated as an employee by the courts.

iv Consumer protection

A consumer is defined under the Consumer Protection Act⁸ as an individual who purchases, uses, maintains or disposes of products or services. While this definition suggests that a franchisee who purchases products from a franchisor would qualify as a consumer, franchisees are typically business entities rather than individuals.

However, Section 38 of the Companies and Allied Matters Act, which gives registered companies the powers of natural persons of full capacity, may be interpreted to mean that a franchisee company is a consumer under the Consumer Protection Act.

v Competition law

Nigeria has no comprehensive competition or antitrust legislation. Issues relating to competition, exclusivity, pricing, restraint of trade, etc. are regulated by reference to common law principles and various pieces of legislation that touch on the subject.

A few of these principles and pieces of legislation include:

- a Common law principles: English common law rules with respect to covenants in restraint of trade form part of the Nigerian Law of Contract and have been recognised by the Nigerian courts. Covenants in restraint of trade are generally considered to be *prima facie* void unless they are reasonable with respect to the parties concerned and the public as a whole.
- b The NOTAP Act: the NOTAP Act, which prevents the transfer of obsolete technology to Nigeria, prohibits exclusive dealing, resale price maintenance, excessive pricing, tying clauses, grant-back clauses and sourcing restrictions. It is imperative to note that the aforementioned provisions may be waived should the Director of NOTAP believe it to be in the national interest to do so;
- c The Price Control Act: the Price Control Act (Chapter P28, LFN 2004) vests in the Minister of Trade and Commerce the power to approve resale price maintenance with respect to certain commodities;
- d The Patents and Designs Act: the Patents and Designs Act (Chapter P2, LFN 2004) renders null and void any clause in a patent licence contract that imposes on the licensee in the industrial or commercial field restrictions that do not derive from the rights conferred by the relevant patent or design or are necessary for the safeguarding of those rights;
- e The Nigerian Communication Commission Act and the Competition Practices Regulation 2007, made pursuant thereto: these prohibit tying agreements, price-fixing and market-sharing. The Regulation also deems conduct such as failure to supply

8 Chapter C25, LFN 2004.

interconnection or other essential facilities, bundling of communication services, discriminatory terms and conditions with respect to licensees, resale price maintenance and exclusive dealing as conduct that substantially lessens competition; and

f The Air Transport Economic Regulations 2012 made pursuant to the Civil Aviation Act 2006: these regulations prohibit and void contracts or arrangements that restrain competition in the civil aviation sector, such as discriminatory terms and conditions, tying arrangements, direct or indirect price-fixing, market division, limiting development investment in the aviation sector, etc.

g The Terrorism (Prevention) (Amendment) Act 2013: the Act, which was created in response to the waves of terrorist attacks witnessed in the country, criminalises the direct or indirect aiding, abetting, counselling, inducing or financing of terrorists or terrorism-related activities. A franchisor will be found culpable if caught engaging in any of the above listed acts, and should take reasonable steps to ensure that the franchisee company at all times is neither a terrorist front nor in affiliation with any terrorist organisation. Franchisors are also obliged by law to inform the security agencies of any information they know of that will aid the prevention or apprehension of terrorist or a terrorist attack.

vi Restrictive covenants

As a general common law rule, non-compete covenants and covenants in restraint of trade are enforceable only to the extent that such covenants are justifiable having regard to the interest of the parties concerned and the public. The courts have, however, differentiated between contracts that are in restraint of trade and those that merely regulate the normal commercial relations between the parties during the existence of the contract. Ordinary commercial contracts for the regulation and promotion of trade during the existence of the contract are *prima facie* enforceable provided that the restriction is directed towards the absorption of the parties' services and not their sterilisation.

Non-compete and restrictive covenants that apply only during the term of the agreement are generally considered to be valid and may be enforced against a franchisee, provided that the restrictive terms are in furtherance of the franchise agreement.

vii Termination

The termination of franchise agreements is governed by English law and by contract between the parties. With regards to post-term restrictive covenants, the law is that covenants for restraints of trade are generally unenforceable but would be enforced if proven to be reasonable with reference to the interest of the parties concerned and of the public. Reasonableness in this regard is a question of fact to be decided on the basis of each case. The onus of proving that a restrictive covenant is reasonable is on the party seeking its enforcement (i.e., the franchisor).

Unless expressly provided for by contract, there is no basis in legislation or legal framework for a franchisor to take over a franchisee's business.

There are certain restrictions on the shareholdings of Nigerian independent operators and indigenous service companies in the oil and gas sector. The Nigerian Oil and Gas Industry Content Development Act 2010 requires that to take advantage of certain concessions certain companies must show at least a 51 per cent equity share by Nigerians. Therefore, franchises that are to take advantage of concessions in the oil and gas industry must show the foregoing minimum shareholding.

viii Anti-corruption and anti-terrorism regulation

The legal regime against fraud, anti-corruption and money laundering consists of several pieces of legislation that touch on franchise relationships, including the following:

- a* The Advance Fee Fraud and other Fraud related offences Act 2006: this Act makes it an offence for any person, with intent to defraud, to obtain any benefit through the medium of a contract induced by false pretences. Thus, a franchisor or franchisee who, by making fraudulent misrepresentations induces a franchisee or franchisor (as the case may be) to enter into a franchise agreement and thereby obtains any benefit, commits an offence.
- b* The Economic and Financial Crimes Commission Act (Chapter E1, LFN 2004): this Act makes it an offence for any person to acquire or use property knowing at the time of its acquisition, possession or use that the property was derived from any financial fraud. A franchisee would be guilty under this provision if its franchised unit is located on a property that, to its knowledge, is derived from financial fraud.
- c* The Miscellaneous Offence Act (Chapter M17, LFN 2004): under this Act, any person who imports, sells, exposes or offers for sale, buys, stores (or induces any other person to carry out any of these acts in relation to) goods prohibited by any law in force in Nigeria shall be guilty of an offence. Parties to a franchise agreement are by these provisions prevented from making any prohibited product the subject of the franchise.
- d* The Money Laundering (Prohibition) Act 2011: this Act prohibits money laundering in Nigeria and makes it an offence for any person or corporate body to make or accept cash payment of a sum exceeding 5 million naira or its equivalent in the case of an individual, or 10 million naira or its equivalent in the case of a body corporate, except through a financial institution. The Act also makes it an offence for any person or corporate in or outside Nigeria to acquire, use, retain or take possession or control of any fund or property knowing the fund or property forms part of the proceeds of an unlawful act.

ix Dispute resolution

Parties to a franchise agreement may agree by contract on the forum of dealing with disputes arising from the franchise agreement. It is becoming regular for parties to international franchise agreements to opt for international arbitration rather than litigation.

Mediation is a recognised form of alternative dispute resolution (ADR) in Nigeria. While mediation as well as other forms of alternative dispute resolution is not mandatory in Nigeria, it is greatly encouraged. Where parties to a franchise agreement have prescribed mediation as the forum for resolving disputes under the agreement, the court would, generally, uphold that agreement. In the event that a party approaches the court in breach of the agreement, the court is entitled to stay proceedings upon an appropriate application by the other party.

Also, under the Lagos State Civil Procedure Rules, disputes that, in the opinion of the court, are suitable for any of the alternative dispute resolution mechanisms are referred to the court-connected ADR centre – the Lagos Multi-Door Courthouse – or other appropriate ADR institutions for resolution.

Local courts do recognise and uphold contractual provisions on foreign jurisdiction clauses or choice of law. Thus, where a contract specifically provides for the venue of litigation, the courts are bound to give force to the contract by so construing it. Where a party in breach

of the agreement on foreign jurisdiction approaches the local court to determine a dispute, the court has a discretion to grant a stay of proceedings. However, this discretion is to be exercised by granting a stay unless a strong cause for not doing so is shown by the plaintiff.

Procedure

There is no specific procedure for franchising disputes. They are treated like other disputes encountered in the course of business, and redress may be sought at the appropriate court or ADR forum, depending on the subject matter of the dispute.

However, NIFA, the franchise association in Nigeria, does not offer mediation or arbitration rules or services.

Court proceedings for resolving franchise disputes are generally instituted by filing a writ of summons. However, where the issue to be resolved hinges solely on the interpretation of the construction of the franchise agreement or other document, the action may be instituted by way of an originating summons.

An action instituted by writ of summons typically lasts between 18 and 36 months or more, depending on the complexity of the issues to be determined by the court. The writ of summons to be filed must be accompanied by the claimant's statement of claim, list of witnesses to be called at trial, written statements on oath of the witnesses (except witnesses on subpoena), and copies of documents to be relied upon.

The court procedure subsequent to the filing of the writ of summons is determined by reference to the civil procedure rules of the specific court. For instance, under the Lagos State Civil Procedure Rules 2012, upon commencement of the action, the matter may be referred to mediation or negotiation if the court registrar is of the opinion that the matter is one that can be settled amicably. Where, however, that is not the case, the matter proceeds to pretrial conference, wherein it may also be amicably resolved. Where settlement falls through once again, it proceeds to trial.

Actions commenced by originating summons are typically determined within 12 to 18 months, barring any unforeseen delays. The originating summons is used in cases where the facts are not in dispute and these are usually determined by affidavit evidence rather than pleadings or oral testimony. An originating summons is required to be accompanied by an affidavit setting out the facts and exhibits to be relied upon and a written address in support of the application.

Remedies

Depending on the surrounding facts, agreement between the parties and fulfilment of the prerequisites for granting the application, it is possible to obtain an interim, interlocutory or perpetual injunction preventing a former franchisee from continuing to breach a non-compete provision or from using the franchisor's trademarks or other IP rights. Note that a former franchisee would be prevented from breaching a non-compete provision only upon proof by the franchisor that the non-compete provision is reasonable with regard to the interest of the parties and the public.

Damages for breach of contract are determined by reference to the principle enunciated in the English case of *Hadley v. Baxendale*⁹ (i.e., damages for breach of contract should be

9 (1845) Exch 341.

such that may arise naturally; that is, according to the usual course of things from such a breach of contract itself) or may reasonably be supposed to have been in the contemplation of both parties at the time they entered into the contract, as a probable result of the breach.

In calculating damages for breach of contract the court would merely seek to compensate the injured party and restore it to the position it would have been in had the breach not occurred. The court will not award general damages where breach is alleged and proved.

Litigation costs (including solicitors' fees) are considered to be special damages and have to specifically pleaded and proven before they can be awarded by the court.

Costs are not capped; however, there is a tendency for Nigerian courts to grant awards that are inadequate to indemnify the successful party as the costs granted are usually far less than the substantial amounts involved in the litigation.

Enforcement

The statutory framework for the enforcement of foreign judgments consists of the following laws:

- a* The Reciprocal Enforcement of Judgments Ordinance (Chapter 175, LFN 1958): this Ordinance, which has its roots in English law, applies only in relation to money judgments and arbitral awards that have been elevated to the status of a judgment for the purpose of its enforcement. To be enforceable, such judgments or arbitral award must originate from the United Kingdom or other Commonwealth country. For an arbitral award to be enforceable as a judgment, the award debtor must apply to the court in the originating country for leave to enforce the award as a judgment. Applications for the enforcement of judgments or arbitral awards under this Ordinance are required to be filed at a High Court in Nigeria within 12 months of the date of the judgment, subject to any extension of time that the Court may grant.
- b* The Foreign Judgment (Reciprocal Enforcement) Act (Chapter F35, LFN 2004): this Act provides that a judgment creditor of a foreign judgment may, within six years of the date of the judgment, apply to a superior court in Nigeria for the registration of the judgment. However, for the above provision to apply in respect of judgments from a foreign country, the Minister of Justice must have exercised the powers under Section 3 of the Act to extend the application of the Act to judgments given in superior courts of an originating country on the basis of a reciprocal treatment for judgments of superior courts in Nigeria. To date, there is no evidence that the Minister of Justice has exercised this power in favour of any country.

Notwithstanding the foregoing, the Supreme Court has held that judgments from any foreign country may be registered pursuant to Section 10(a) of the Act within 12 months of the date of the judgment or such a longer period as a superior court may allow.

Nigeria is a signatory to the New York Convention and the provisions of the Convention apply by virtue of Section 54 of the Arbitration and Conciliation Act (Chapter A18, LFN 2004). Nigerian courts therefore readily recognise foreign arbitral awards from other Convention countries.

VII CURRENT DEVELOPMENTS

There is currently a wave of franchise awareness spreading through small and medium-sized enterprises in Nigeria. Recent years have seen an increase in the number of local Nigerian

brands adopting microfranchising as a means of business expansion. For example, Vitafoam, a home-furnishing collection store, joined the league of local franchisors using what is called the 'Igbo Boy Franchise Model'. Through this model, it recruits graduates that market and manage outlets as CEOs. These employees are paid a percentage of the profits. Also, Nairabet, a sport betting outlet, is one of the new utilisers of franchising for expansion and now boasts over 800 outlets across Nigeria.

The Africa Franchise Centre (AFC) was set up in Lagos, Nigeria on 21 November 2017 to 'rescue African small and medium enterprises and create prosperity on the continent', by acting as a recruiting centre and promoting franchising as an alternative means of growth that eliminates major risks and uncertainty associated with starting up new brands.¹⁰

10 <http://venturesafrica.com/african-franchise-centre-opens-in-lagos>.

POLAND

*Kuba Ruiz*¹

I INTRODUCTION

According to the experts, the Polish franchise and distribution network market will continue to grow in the coming years. At the end of 2016, there were more than 1,160 different franchise models in Poland, of both Polish and foreign origin, with 68,000 franchise outlets. Since 2015, the franchise market has increased by 52 new franchise brands. The most popular franchises are chain stores (ABC Sklepy po sąsiedzku, Delikatesy Centrum, Żabka), restaurant chains (Telepizza, KFC), clothing retailers (Vistula & Wólczanka, KappAhl) and cosmetics retailers (Inglot, Yves Rocher). Currently, a franchise remains one of the main ways of development for small entrepreneurs, and provides jobs for up to 460,000 people in Poland.

The latest trend in the franchise market is the move from classic shops to providing services online, where the franchisors create online central sales platforms for clients and then orders are delivered by local franchisees. This new solution has already been successfully adopted by Telepizza, with online orders delivered by local restaurants, and Intermarché, with online orders being picked up by clients at selected pickup points in local stores.

We can observe both the increasing presence of international franchises in Poland, and the achievements of Polish export brands abroad. The biggest Polish players on the international franchise market are companies such as Inglot (whose stores can be found on all continents, in 74 countries, including Dubai, Ivory Coast, Kazakhstan, the Philippines, Peru, Nepal and the United States), Gino Rossi, 4F and Organique. Polish producers have also started expanding into different directions, gaining recognition, for example, in B2B markets.

Franchising is perceived as a safe business concept by Polish entrepreneurs. The growing number of 'multi-franchisees' (entrepreneurs who own more than one branch) is evidence of the high levels of confidence in the franchise system. Companies belonging to the Polish Franchise Organisation use the Franchising Code of Ethics adopted by the European Franchise Federation.

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II MARKET ENTRY

i Restrictions

Non-EU companies are obliged to establish a branch or subsidiary company to operate a business in Poland. Ownership of real estate is restricted for non-EEA franchisors and requires government approval.

Conducting business activity in Poland requires registration. Apart from registering, there are, in general, no strict rules on starting a business in Poland.

ii Foreign exchange and tax

There are no exchange controls in force. The standard Polish withholding tax rate due on franchise fees and dividends is 20 per cent. If a double-taxation agreement (DTA) applies, both franchise fees and dividends payable to foreign entities are subject to tax established thereunder. The Polish franchisee is a remitter of withholding tax in Poland and remains liable for payment of amounts due to the Tax Office.

III INTELLECTUAL PROPERTY

i Brand search

A brand search allows assessment of the availability of a mark in the light of earlier registrations and applications. When conducted prior to filing, a brand search avoids the undesired costs of potential infringement proceedings or the unexpected necessity of changing the brand because of earlier registration of an identical or similar trademark.

The Polish Patent Office (PPO) provides online access to all published trademark applications and registrations, and can thus be used as a database for brand searches. Adequate appreciation of the potential risk of confusion with earlier trademarks usually requires some level of proficiency. The assistance, therefore, of trademark or patent attorneys is strongly recommended when analysing search results.

As of 15 April 2016, the PPO examines absolute refusal grounds only. Conflicts with earlier trademarks are not examined *ex officio*. The holders of earlier trademarks may oppose conflicting applications before their registration. This requires ongoing scrutiny and monitoring of new trademark applications in relevant classes.

Brand searches are usually limited to earlier trademark applications and registrations; however, to identify all potential risks connected with the launch of a new brand, it is also worthwhile conducting a 'freedom to operate' search. This search concerns non-trademark prior rights, such as company names, trade names, unregistered trademarks and all other designations used on the relevant market. The simplest way to conduct it is by using an internet search engine.

ii Brand protection

In Poland, a trademark application can be filed either in paper or electronic form. The scope of protection is determined by the list of goods and services attached to the application, classified in accordance with the Nice Classification. Application proceedings can take as long as between 10 and 12 months, provided the application is not opposed.

Individuals and entities that have a domicile or a business seat in Poland, or on EEA territory, do not have to be represented in trademark registration proceedings by a professional

representative. Individuals or entities from outside the EEA must be represented in trademark registration proceedings by a Polish-qualified professional (i.e., trademark attorney or attorney-at-law).

Information on trademark applications is published within two months of filing. If there are no absolute refusal grounds, the application is published in the official bulletin, and from this time any third parties may file their observations regarding absolute refusal grounds, regardless of the PPO's primary positive assessment. On the basis of these submissions, the PPO might change its view and dismiss the trademark application.

For published trademark applications, the PPO automatically runs an informative search of earlier identical or similar trademarks registered for identical or similar goods, for the purpose of registration.

Within three months of publication of the application, the holders of earlier trademarks, as well as the holders of earlier personal and economic rights, may oppose the trademark application. The opposition deadline is not extendable. The parties have two months (extendable to six months) to settle the case (cooling-off period). Following this, the PPO will proceed with the opposition. The likelihood of confusion is determined in cases of identical or similar registered trademarks applied in relation to identical or similar goods or services. The trademark applicant may raise a non-use claim against the earlier registration. The PPO is bound by the grounds of the opposition indicated by the opponent. Letters of consent are acceptable.

If no opposition is filed, the PPO issues a decision on trademark registration. Otherwise, the PPO also grants registration to the extent an opposition was dismissed by a final, non-appealable decision. Registration is conditional upon payment of the relevant registration and publication fees.

Trademark protection initially lasts for 10 years, with the possibility of unlimited extensions for subsequent 10-year periods.

A motion for invalidation of a trademark may be filed at any time after the registration based on absolute and relative refusal grounds. However, relative refusal grounds may only be raised by the holders of earlier trademarks, or earlier personal or economic right holders. Non-use cancellation is acceptable after five years of non-use, as long as there are no reasonable grounds for non-use. A non-use cancellation request may be filed by any person.

Brand protection is complementary to other intellectual property (IP) rights. A figurative or 3D mark can also be protected by copyright law or as an industrial design.

iii Enforcement

Poland has a bifurcated system, in which trademarks can be invalidated only in proceedings before the PPO, while infringement cases are decided by the courts. Accordingly, invalidity arguments may not be raised as a counterclaim defence in court proceedings (except in EU trademark infringement proceedings). There are no specialist IP courts in Poland, apart from the court dealing with EU trademarks and Community designs.

In the case of a pending infringement case a court would usually stay the proceedings if a request for invalidation were filed before the PPO; however, as there is no legal provision addressing this particular issue, it is not obligatory, and in principle the decision to stay the infringement proceedings is left to the court's discretion.

In Poland, preliminary injunction (PI) requests are decided in *ex parte* proceedings (i.e., defendants are not informed about the PI request and generally have no opportunity to defend their rights until the decision on the grant of the PI is issued and served upon

them, unless a court schedules a hearing to consider the PI request). There is also no formal way of submitting 'protective letters' (common in Germany), as they are generally not legally recognised in Poland. To obtain an injunction, the trademark holder has to prove that infringement is probable and that the trademark holder has a legitimate interest in the injunction (e.g., the lack of an injunction may cause the trademark holder irreparable damage). In the event that a PI is granted, a claim should generally be filed within 14 days of receipt of the PI decision.

In general, an action should be brought before the district court of the defendant's seat. However, if the infringing product is available throughout the whole territory of Poland (e.g., through an online shop), a PI request or the claim itself may be filed with any of the 45 district courts in Poland. This is because the jurisdiction *ratione loci* can be determined by the place of an alleged infringement.

In an infringement action the claimant may claim cessation of infringement, return of unlawfully obtained profits, publication of the final judgment (or information about it) and – in cases where the infringement is culpable – compensation for damage. Moreover, the court may also decide on the destruction, withdrawal from the market or transfer of ownership of the infringing goods.

In practice, seeking damages in trademark cases may be quite difficult from an evidential perspective. It is for the claimant to prove the actual damage it suffered and the adequate causal relation between the infringement and the damage. Damages can also be calculated based on the criterion of 'reasonable royalty', but this is very seldom used as there are serious doubts regarding its interpretation. Obviously, the most credible point of reference for a 'reasonable royalty' would be the licence fee charged by the claimant in a similar case based on an existing licence agreement. This is, however, very rarely the case. Most typically, the rights holder rather claims the handing over of profits unlawfully obtained by the defendant, meaning revenues gained from sales of infringing products, as it is much easier to calculate this figure, and obtain reliable data on sales volumes and prices.

As a result of incorrect implementation of the Enforcement Directive into Polish law, requests for disclosure of information can be made only for the purpose of securing a particular claim (e.g., cessation claim, damages or return of unlawfully obtained profits). These are proceedings similar to a PI action. In the request for disclosure of information, the claimant has to indicate the claims that would be 'secured' by the request. In other words, it would have to be shown that the requested information was necessary to establish the scope of the claims (e.g., the amount of damage or amount of unlawfully obtained profits).

The period of limitation for all claims is three years, counted separately for each infringement from the time the right holder became aware of the infringement and the infringer; not later, however, than five years from when the infringement took place.

iv Data protection and e-commerce

Data protection

The EU data protection rules have been fully implemented in Poland.

In the context of franchising relationships, the franchisor or franchisee can be considered the data controller (the data owner) or the data processor (entity acting on behalf of a controller), or both. If the franchisor as data controller outsources processing to a franchisee (or vice versa), both parties must conclude a data-processing agreement indicating at least the scope and purpose of processing.

The franchisee or franchisor (as controller) needs to have a legal basis for processing. In the context of its activity several legal bases for processing are possible, in particular, consent, legitimate interest of the data controller or data recipient, and performance of the contract with the data subjects (the latter would only be reserved to franchisees as a party to the agreement). For marketing purposes, the franchisee or franchisor can rely on legitimate interest to promote its own products or services (except for e-communication, where an opt-in is required). If, however, the franchisor would like to use the franchisee's clients' data for marketing purposes, it must first obtain an appropriate consent.

If the franchisee or franchisor, acting as a data controller, wants to transfer data to third countries that do not provide adequate levels of personal data protection, an additional legal basis is required. In practice, the most reliable legal basis would be entering into standard contractual clauses² between the Polish franchisor or franchisee and the data importer from the third country. Standard contractual clauses have been issued by the European Commission as data transfer contract models. Following the decision in *Schrems* (C-362/14) invalidating EC decision 2000/520/WE on the Safe Harbor Framework, it is no longer possible to rely on Safe Harbor as a legal basis for data transfer to the United States. Its successor, the Privacy Shield Framework, entered into force in 2016; however, its validity is already being challenged.

E-commerce

Polish law provides mandatory provisions protecting consumers in business to consumer (B2C) relations. The protection exists regardless of whether the business is located in Poland. For example, if the business is located in Germany, it is obliged to follow Polish mandatory provisions protecting consumers.

As an EU Member State, Poland has implemented the New Consumer Directive,³ which provides consumers with, *inter alia*, the right to withdraw from distance sales agreements within 14 days of signing and imposes obligations on e-businesses to appropriately inform consumers of relevant information.

B2C companies have to be mindful of 'abusive clauses', which cannot be included in standard agreements with consumers. Abusive clauses concern, for instance, limitation of liability of the service provider or seller towards consumers and exclusive jurisdiction of the court applicable to B2C e-business. Clauses that have been held abusive by courts are contained in a register of abusive clauses, which currently contains almost 6,200 clauses. Until recently, it has been a practice that associations would sue businesses for the use of each abusive clause separately to profit from the suits. In April 2016, a legislative amendment comes into effect whereby the competition and consumer protection authority, rather than civil courts, will be competent to decide if specific clauses are abusive. The rationale behind the amendment is, *inter alia*, to curb the practice of suing entities as a form of a business model. The regulator will also have the authority to impose fines amounting to 10 per cent of the business's turnover.

2 Commission decision of 5 February 2010 on standard contractual clauses for the transfer of personal data to processors established in third countries under Directive 95/46/EC of the European Parliament and of the Council.

3 Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council.

IV FRANCHISE LAW

i Legislation

Franchise contracts are not subject to specific regulation and the general principle of freedom of contract applies.

ii Pre-contractual disclosure

There is no mandatory pre-contractual disclosure requirement in Polish law, but there are some general rules that Polish law recognises, such as the pre-contractual principle of good faith (*culpa in contrahendo*) and certain other rules of the Civil Code.

V TAX

i Polish tax system

The Polish tax system is a complex combination of direct and indirect taxes based on Polish regulations, international treaties and EU law.

Poland has been a member of the Organisation for Economic Co-operation and Development (OECD) since 1996. The OECD issued and systematically updates the Model Tax Convention on Income and on Capital, as well as the commentary to the Convention. Most DTAs to which Poland is a party are based on the Model Convention.

Individuals and companies receiving income sourced in Poland are subject to Polish income tax, personal and corporate, respectively. Within this scope, Polish law applies unless any international agreements – including DTAs – provide otherwise.

DTAs significantly affect the tax treatment of cross-border transactions, but privileges under a DTA apply if a taxpayer submits a valid tax residency certificate issued by its local tax authority. Foreign tax residency certificates remain valid for Polish tax authorities throughout the validity period provided in the document. If a tax certificate does not include an expiry date, from 4 January 2015, it will be valid for 12 months following its issuance date unless the taxpayer changes its domicile within this period.

Poland is a member of the EU and thus is also a member of the harmonised VAT system.

ii Franchise taxation

Franchising is not expressly regulated under Polish contract and tax laws (mixed contract). Therefore, income and costs derived from franchising are taxed in a manner applicable to the taxation of those contracts to which franchising contracts are similar.

Under Polish law, following OECD guidelines, income derived from franchising should be divided for income resulting from certain sub-arrangements covered by the franchising relation, including provision of know-how, licensing and provision of services. Each part is then subject to the different tax treatment applicable to each particular type of income.

Moreover, in the event that any business arrangement – including a franchising contract – is set up between related parties (affiliates), transfer pricing regulations apply. If applicable, parties should draft and store transfer pricing documentation reflecting the market value of any payments made between parties under contract; any lack of relevant transfer pricing documentation may be challenged by the Polish tax authorities. Parties may also be required to pay increased tax as a result.

As of 1 January 2015, partnerships, in the same way as companies and individuals, are required to comply with transfer pricing regulations.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Parties to a contract are expected to act in good faith and the courts will take this into account.

ii Agency distributor model

Although Polish courts have not yet awarded franchisees the protection provided under the Polish Civil Code,⁴ it is possible that this may happen in the future.

iii Employment law

Franchising is commonly regarded as a form of business activity.

The franchisee cannot be treated as an employee, and operates under its own name, bearing the economic risk of its own activities. The relation between franchisee and franchisor can be described as cooperation, not as employee–employer subordination. Also, the franchisor receives remuneration under a franchising agreement, while the employee receives remuneration in accordance with an employment agreement. Franchisees are not entitled to the same social protection as employees.

iv Consumer protection

As franchisees are considered businesses, they are not protected by Polish consumer law, even in the case of sole traders.

v Competition law

A franchise agreement is a type of distribution (vertical) relationship between independent entities. Under certain circumstances, such a relationship may affect trade by restricting or distorting competition in the relevant market, as it usually contains a combination of different vertical restraints. The Polish Competition Authority has issued a number of decisions regarding franchising. In June 2013, it issued its most notable decision, concerning the fixing of resale prices by Sphinx Polska, which is one of the largest restaurant chains operating in the casual dining sector in Poland.⁵

Franchising is defined as a distribution system in which the franchisee is directly or indirectly obliged to resell goods that have been bought from the franchisor, and to use intellectual property rights and know-how that have been licensed from the franchisor. Since the scope of this definition is fairly broad it is common in practice to apply a more specific definition made under EU rules.

Provided that the franchise agreement contains some restrictive clauses it can be exempted from the prohibition of anticompetitive agreements as long as the aggregate market share of competitors on the relevant market does not exceed 5 per cent, or the market share of each non-competing entity on the relevant market does not exceed 10 per cent. This provision constitutes the *de minimis* principle, but it is not commonly applied to franchise agreements as they tend to contain ‘hardcore restrictions’, particularly clauses that are perceived as price-fixing or market-sharing between the parties.

4 Chapter XXIII of the Civil Code – Agency agreements.

5 Decision of 25 June 2013, No. DOK-1/2013.

If the *de minimis* principle cannot be applied, the franchise agreement can be exempted under the national and EU Block Exemption Regulations (VBER), which apply only to agreements that do not contain hardcore restrictions and where the market share of the franchisor and the franchisee on the relevant market, as a rule, does not exceed 30 per cent.⁶

The VBER lists the hardcore restrictions that will cause a franchise agreement to fall outside the scope of the VBER. This list includes price-fixing or resale price management. A franchisor may impose maximum or recommended resale prices. Nevertheless, a franchisor is only able to set fixed or minimum prices for low-price campaigns of up to six weeks (in most cases). It also includes restrictions on territories or customers to which a franchisee can sell or provide services, such as bans on passive sales outside an exclusive territory or customer group.

The VBER also lists grey restrictions, which are invalid themselves, but do not result in the invalidation of the entire agreement. One of these is the non-compete clause (see Section VI.vi).

Other provisions that should be analysed from a competition law perspective concern intellectual property rights licensing, approving the franchisee's advertising campaigns, and combining selective and exclusive distribution systems.

If the VBER market-share thresholds are exceeded or the franchise agreement contains hardcore restrictions, the agreement is not exempted under the VBER. Nevertheless, entities can apply the individual exemption arguing that the franchising system has more advantages than anticompetitive effects in the relevant market. In such cases the burden of proof lies on the entities.

Franchise agreements may also be examined under the prohibition of abuse of a dominant position and merger control rules. In both cases the general competition law rules apply.

vi Restrictive covenants

The VBER defines non-compete clauses as the franchisee's obligation to buy more than 80 per cent of goods from the franchisor or its supplier, and the franchisee's obligation not to deal with goods that are substitutes for those offered by franchisor.

To be exempted under the VBER rules, in-term non-compete clauses have to be limited to five years or to the duration of the sublease if the franchisor owns the franchisee's premises. Non-compete clauses that are concluded for longer periods can be exempted under an individual exemption if certain conditions are met.

To protect the franchisor's know-how, parties can conclude a post-termination non-compete clause that may last no longer than one year after the agreement's termination. Within that period the franchisee must agree not to deal with goods that are substitutes for those offered by the franchisor from the premises in which the franchisee operated during the franchise agreement under the national VBER.

If the franchisor provides the franchisee with know-how that is not in the public domain, the parties may consider concluding a post-termination non-compete clause for a longer period.

6 Note that the national and EU block exemption regulations should be interpreted in conjunction with the results of the European Commission's sector inquiry into e-commerce; the European Commission's preliminary report on the e-commerce sector inquiry, as announced on 15 September 2016, is currently available at: http://ec.europa.eu/competition/antitrust/sector_inquiry_preliminary_report_en.pdf.

vii Termination

The franchise agreement is a long-term form of cooperation concluded for a fixed term (usually five, 10 or 20 years) or an indefinite period. There are two ways of terminating the agreement early under the Polish Civil Code: termination upon notice and rescission.

Termination upon notice occurs especially in the case of legal relations concluded for an indefinite period. The agreement can be terminated only upon notice *ex nunc*, which means that the notice is valid only for the future and not the past. Termination upon notice applies only to the relation expended in time. Generally, there is a notice period after which the agreement terminates (it might be a contractual, statutory or a customary term period). If a termination period is not provided, the agreement expires immediately after the termination notice is delivered.

Rescission is a remedy to a breach of contract – if one party commits a qualified delay in performing the contract, the other party may rescind it provided that the affected party notifies the defaulting party in writing of the intention to rescind, granting appropriate additional time for proper performance. If the set time limit lapses, the affected party is entitled to rescind the contract.

As mentioned in Section VI.vi, post-termination non-compete clauses of up to one year for franchise agreements are permitted under Polish law. A longer term for post-termination non-compete clauses can be established if the franchisor provides the franchisee with know-how that is not in the public domain.

It is advisable to include provisions on termination in the franchise agreement, including provisions concerning rescission. Explicit provisions can minimise the risk of confusion between the parties.

viii Anti-corruption and anti-terrorism regulation

Under Polish law, bribery is a crime committed by an individual giving or accepting a bribe. A person giving a bribe can avoid criminal liability if he or she informs the appropriate law enforcement institution of the circumstances of a crime before proceedings are initiated by that institution.

Organisations can be subject to criminal liability for crimes committed by employees or representatives only if the individuals have been convicted and the organisation failed to properly choose its executives, and at the same time the organisation benefited from the crime. Therefore, from a practical point of view, bribery committed by a franchisee will most likely not result in criminal liability of the franchisor.

ix Dispute resolution

In franchise disputes, the parties can choose between litigation and alternative dispute resolution (arbitration or mediation).

Arbitration is the most common form of alternative dispute resolution. Arbitration clauses are enforceable in Poland, unless otherwise specified. To refer the dispute to the arbitration court, the parties are required to provide an agreement specifying the subject matter or the legal relationship out of which the dispute arose or may arise.

Mediation can be conducted on the basis of a mediation agreement or court order directing the parties to mediation.

The Polish court system remains slow, with litigation proceedings before the Warsaw courts statistically the most lengthy. In the agreement, parties can decide which court has jurisdiction to decide in the event of a dispute.

If the parties include an arbitration clause in the agreement, they usually determine which arbitration court will decide in the event of a dispute. In Poland, permanent arbitration courts do exist, the most established being the Court of Arbitration at the Polish Chamber of Commerce. Parties can choose between permanent arbitration courts or indicate in the agreement that the arbitration court be established *ad hoc*. Usually, the arbitration court is one instance, unless the parties agree otherwise in the contract. This means that, unlike in ordinary courts, sentencing is faster. Arbitration courts are not bound by proceedings rules, and so less complex procedures can be used. The average length of arbitration proceedings is nine months.

Either party can file an appeal against the court's verdict if it is not favourable. It is also possible to challenge the arbitration court's award before the appellant court, but only on technical grounds – the merits of the case will not be examined.

Arbitration fees are usually higher than court fees, but the total cost of proceedings is usually lower in arbitration, as arbitration is statistically quicker and more specialised.

In Poland, the losing party is obliged to return the costs of lawyers to the successful party, but only within statutory limits that are not significant. So, in practice, in lengthy, complicated or high-value proceedings each party bears most of its legal costs.

From an international franchisor's perspective, it is important to note that Poland is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards and so foreign arbitral awards are enforceable in Poland. Also, since Poland is an EU Member State, Polish courts will recognise and enforce court judgments from other EU Member States (in accordance with the Brussels Regulation).⁷

VII CURRENT DEVELOPMENTS

In recent years the rapid development of franchising has been noticeable, and its popularity is constantly growing. Experts predict that the Polish franchise market will maintain its dynamic growth in the coming years. It is anticipated that by the end of 2016, the number of franchise systems could reach 1,170 and the number of franchise outlets to reach 71,000.

More and more Polish companies are deciding on international expansion. The leader in terms of the number of owned foreign sales outlets is still LLP Group (clothing brand owner), but other Polish companies have also increased their international expansion significantly (e.g., CCC and Wittchen).

Customer support for domestic brands is a new visible trend on the Polish market. The increased interest of Polish consumers in Polish products is a chance for domestic franchises to compete successfully with foreign franchise systems, and to expand Polish brands on international markets.

⁷ Council Regulation (EC) No. 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

PORTUGAL

*Magda Fernandes, José Maria Montenegro, Vasco Stilwell d'Andrade
Dzhamil Oda and Diogo Pinto¹*

I INTRODUCTION

The Portuguese Franchising Association and the Institute for Information in Franchising (IIF) were created to provide information about franchising and to help overcome difficulties resulting from the lack of specific rules applicable to franchising. Both entities encourage contact between the various groups with an interest in franchising, namely franchisors, companies looking for business partners, franchisees, potential investors and suppliers of goods and services for networks.

The IIF monitors the development of franchising in Portugal through its franchising census, which it carries out regularly. According to the twenty-second franchising census, in 2016, Portugal has experienced marked growth in the franchise market, with a significant increase in the number of brands and the diversification of business areas. In 2016, 22 new business concepts were developed in the national franchise market, which now consists of 574 franchise brands (70 per cent of them from Portugal).

II MARKET ENTRY

i Restrictions

Foreign investment is permitted in almost all economic sectors open to private investment in general, there being virtually no barriers to foreign-owned or foreign-directed enterprises.

Foreign investment operations do not need to be registered with, or authorised by, the Portuguese central or local authorities. Administrative requirements concern only specific matters such as trademarks, intellectual property rights and certain sector-specific regulation. However, for EU-based investors these requirements cannot constitute restrictions to the right of establishment set out in the Treaty on the Functioning of the European Union (TFEU).

In addition, the Portuguese government may grant benefits to large investment projects – to both national and foreign investors – such as financial incentives and tax benefits or public funding. AICEP Portugal Global is the government business entity entrusted to manage and attract foreign investment, and it is entitled, on behalf of Portugal, to receive, assess, negotiate and contract large investment projects eligible to benefit from state aid.

¹ Magda Fernandes is a partner, José Maria Montenegro is a senior lawyer, Vasco Stilwell d'Andrade is a senior associate, Dzhamil Oda is an associate and Diogo Pinto is a junior lawyer at Morais Leitão, Galvão Teles, Soares da Silva & Associados. Parts of this chapter originally appeared in Dennis Campbell (ed.), *International Franchising* (Huntington, New York 11743: Juris Publishing, Inc, 2012).

Nevertheless, as member of the EU, the Portuguese government must comply with state aid rules established in the TFEU; thus, the award of such benefits may require prior approval by the European Commission.

ii Foreign exchange and tax

Corporate income tax (IRC) is applicable to income obtained both by resident and by non-resident entities. Portuguese law taxes non-resident entities only on the income obtained in Portugal, and taxes resident entities on global income, either from internal or external sources.

Resident entities are normally taxed on the basis of the relevant periodic tax return on their global income. Non-resident entities may be taxed either by means of a definitive withholding tax or, in some situations (i.e., capital gains), are required to submit a periodic tax return on income. For non-residents, the following rates are applicable:

- a* capital gains, 25 per cent;
- b* dividends, 25 per cent;²
- c* interest, 25 per cent;³
- d* royalties, 25 per cent;⁴
- e* other services, 25 per cent, except for transport, communications and financial services;⁵ and
- f* investment income (including dividends, interest and royalties) paid to an entity domiciled in a tax haven listed in the Portuguese blacklist of offshore jurisdictions is taxed at 35 per cent.

Portugal has signed double-taxation treaties with 79 countries and three others are pending ratification.

III INTELLECTUAL PROPERTY

i Brand search

There are currently millions of registered trademarks in the world and several hundred thousand of them are in force in Portugal. Determining the ability to use a trademark in the Portuguese market is essential before large investments are made in marketing and packaging.

Registered trademarks can be searched in a number of public databases or, alternatively, it is possible to hire specialised companies to conduct in-depth clearance searches. Two of the most popular public databases used in Portugal are TMview and the database of the National Institute of Industrial Property (INPI).

In performing a trademark clearance search, it is necessary to bear in mind the criteria used for assessing the likelihood of confusion, namely issues of priority, similarity of goods and services and similarity of the marks from visual and phonetic perspectives. One should remember that no search provides a 100 per cent guarantee that the trademark application will proceed to grant nor that there will be no third-party opposition.

2 This tax rate may, however, be reduced, to as little as 5 per cent, according to double-taxation treaties.

3 This tax rate may, however, be reduced, to as little as 5 per cent, according to double-taxation treaties, and under Directive 2003/49/CE payments to qualifying EU recipients are exempt.

4 See footnote 3.

5 This tax may be reduced or eliminated according to double-taxation treaties.

Indeed, in assessing the viability of a trademark application, it is important to remember that, *inter alia*, company names may be used as basis for opposition and that foreign trademarks often benefit from a six-month priority period, during which they can claim protection in Portugal. Unregistered trademarks that are used in commerce also have limited protection for an initial period of six months and may be invoked in opposition proceedings.

Furthermore, given that Portugal is a Member State of the Madrid Agreement and Protocol and of the EU, it is necessary to remember that Community and international trademarks may also be in force in Portugal.

Whereas the process of searching and clearing a trademark is a well-understood and common procedure, verifying the non-existence of conflict in other areas (image rights, business process, etc.) is highly complex and carries with it significantly more risk. These risks should be duly taken into consideration in franchise agreements.

ii Brand protection

The relevant authority for registering Portuguese trademarks or patents is the INPI. The request to register a trademark is filed and subsequently published in the official Industrial Property Bulletin. There is a two-month period in which the application may be challenged by any interested party. The applicant has a further two months in which to contest the challenge, as provided by Article 17 of the Industrial Property Code.

INPI will only start examining the application after the two or four-month period referred to above; the purpose of the examination being to ascertain and confirm whether the application meets the criteria foreseen in the law (the 'absolute grounds of refusal') and that the trademark is not likely to be confused with an already existing registered trademark (the 'relative grounds of refusal'). The application is only approved following this examination, after which it is registered and published in the official Industrial Property Bulletin. These decisions can be appealed to the Intellectual Property Court, currently seated in Lisbon, or, if all interested parties agree, to an arbitral court set up at the ARBITRARE centre.

Decree-Law No. 125/2006 of 29 June 2006 created the 'on-the-spot trademark' regime, according to which it is possible to buy a pre-approved trademark equivalent to the company name chosen at the same time that an 'on-the-spot company' is incorporated.⁶

Article 316 of the Industrial Property Code establishes that industrial property benefits from the same protections as those established for property in general. An owner of a registered trademark may file a claim against anyone infringing the owner's trademark rights, namely using, without authorisation, in the course of trade, a mark that is identical or similar to the one registered, on products and services identical or similar to those included in the aforementioned registration and, as a consequence, causing a risk of confusion in the market.

Special protection exists in Portugal for well-known or prestigious marks. An owner of an unregistered trademark also may file a claim under the unfair competition chapter of the Industrial Property Code or under the general rules of non-contractual or contractual liability set forth in the Civil Code.

6 Decree-Law No. 318/2007 of 26 September 2007 established the possibility of obtaining an on-the-spot trademark independently of the incorporation of a company. All the relevant administrative services start and finish the procedural formalities on the same day, and just one personal visit is required. A registered trademark also can be bought online, via a public-access website.

Article 317 of the Industrial Property Code establishes that certain behaviour by competitors may be considered unfair competition, including any acts that mislead consumers as to the identity of the company and origin of the products or services.

Furthermore, Article 318 establishes that the unlawful acquisition, disclosure or use of a competitor's trade secrets is considered illegal.

As with Portuguese trademarks, which are registered in a manner almost identical to that seen in other European Union countries, other intellectual property rights such as patents and designs also follow approval procedures closely based on EU legislation or international treaties.

iii Enforcement

The types of action available to a foreign trademark holder will largely depend on the circumstances of such a trademark being registered or in force in Portugal. If the trademark is in force in Portugal, the foreign trademark holder may file a civil trademark infringement proceeding against the infringer, requesting that the infringement cease and, additionally, requesting compensation in cases where damage has occurred. In situations of great urgency, it is possible to request a preliminary injunction for the cessation of the infringing activity.

The foreign trademark holder may instead or in addition file a criminal complaint against the infringer, given that trademark infringement constitutes a crime under Portuguese law. Such a complaint would be investigated by the Portuguese public prosecutor and it is for the latter to decide to bring a case to court. The plaintiff also can request compensation under this procedure. The criminal complaint would have to be filed by the trademark owner within six months of him or her becoming aware of the infringing actions.

Furthermore, a foreign trademark holder may file a complaint of unfair competition, which is considered a misdemeanour under the Industrial Property Code. The complaint is filed with the Economic and Food Safety Authority, a police agency, and it is then decided by the INPI. In the context of franchise agreements, the improper use of a trademark generally gives rise to a breach of contract, the consequences of which are typically resolved by either a judicial court action or arbitration (depending on what is stipulated in the agreement).

iv Data protection, cybercrime, social media and e-commerce

Personal data is often a vital component of a franchise agreement. Indeed, customer lists and supplier contacts are often valued information that the franchisee wishes to access when entering into a franchise agreement.

The importance of personal data protection has been growing considerably in Europe and, naturally, also in Portugal. Great care should be taken to ensure that personal data are collected in a legal manner and that any transfers of personal data (particularly across borders) are done lawfully. Direct marketing is also tightly regulated and it is necessary to ensure that the legal criteria for sending marketing materials are in place. The main law regulating personal data processing in Portugal is Law No. 67/1998 of 26 October, which will be largely replaced by the entry into force of the General Data Protection Regulation in May 2018.⁷

⁷ Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation).

Another important aspect of franchising deals is the access to common IT systems or databases. This access should be regulated since unlawful access to these IT systems may constitute a crime. Law No. 109/2009 of 15 September approved the Cybercrime Law, transposing into Portuguese law Council Framework Decision 2005/222/JHA of 24 February on attacks against information systems, and it has also adapted Portuguese law to the Council of Europe Convention on Cybercrime. Pursuant to Law No. 109/2009 of 15 September, several software infringements are punishable as criminal offences. These include, by way of example, computer sabotage and unlawful hacking or unlawful copying of a protected program. Companies and any equivalent legal entities may be held liable for the crimes established in this legislation.

The protection of software and the general consequences for software infringement are foreseen in the Copyright and Neighbouring Rights Code (as amended) and also in Law-Decree No. 252/94 of 20 October (as amended). E-commerce is regulated in Portugal primarily under Law-Decree No. 7/2004 of 7 January (as amended).

IV FRANCHISE LAW

i Legislation

In the area of commercial distribution, only agency agreements are specifically regulated. Neither distribution nor franchise agreements are subject to specific regulation in Portugal, even though certain legal provisions are especially relevant to franchise agreements. Considering the lack of a specific legal regime applicable to franchise agreements, no licence is required for franchise salespersons.

In the absence of imperative legal provisions, the parties are free to determine their own governing rules and clauses as long as these are consistent with generally applicable contractual principles.⁸ In particular, when interpreting and applying contractual rules, Portuguese courts will give due consideration to pre-contractual liability principles that require parties to act in good faith during negotiations.

ii Pre-contractual disclosure

Portuguese courts have often decided in this area that parties are required to provide all necessary information prior to execution of a franchise agreement, failing which statutory civil liability may arise under Portuguese law, in particular under Article 227 of the Civil Code. Notwithstanding the fact that there is no specific legislation applicable to franchising, general rules of trademark law, company law, product liability law, standard contract terms law, agency law, employment law and consumer protection law are fully applicable to franchise agreements. Franchising is also subject to national and EU competition rules.

General contractual principles prohibit the use of false and misleading expressions concerning one's own business operations or those of another party that are of a character tending to affect the supply of, or demand for, a commodity. These principles also may be regarded as applying to franchise agreement negotiations (i.e., the franchisor must provide an accurate description of its operations). If a franchisor infringes this requirement and gives

⁸ The principle of freedom of contract is generally established in the Civil Code, Article 405.

a prospective franchisee an untrue or misleading impression, this may constitute grounds for rescinding or terminating the entire agreement based on pre-contractual liability established in the Civil Code.

iii Registration

Apart from the acquisition of a Portuguese company, establishing a company or a branch is the most common method of business organisation employed in Portugal. The most common types of company in Portugal are the limited liability company (SA) and the limited liability partnership (SQ), which have in common the fact that shareholders' liability is generally limited to their interest in the capital share of the company.

Although less often used, there are other ways of investing in Portugal (e.g., through joint ventures and partnerships). A franchisor may directly license franchisees where it is not necessary to control or supervise franchisees' activity in depth. This has the advantage of reducing the franchisor's set-up costs in the franchisee's location.

A limited liability company is, in principle, required to have at least five shareholders, but a single shareholder is allowed when such a shareholder is itself an SA. Registration with fiscal and commercial registry authorities is required for such a company. The minimum capital share is €50,000, which may be paid in cash or in kind.

An SQ tends to be used for smaller investments, with no capital share minimum required by law. A minimum of two shareholders is required, although it is also possible to set up an SQ with only one shareholder, which is designated as a *sociedade unipessoal por quotas*, or SUQ. Registration with the commercial registry and fiscal authorities is also required for such a partnership.

iv Mandatory clauses

Imperative rules and essential principles of Portuguese law are mandatory and thus also applicable. Franchising operations in Portugal are also bound by directly applicable EU legislation governing franchising.

v Guarantees and protection

In franchise agreements drafted in Portugal, the shareholders of the corporate franchisee often guarantee its obligations, by bank guarantee or, alternatively, by personal guarantee secured against particular assets of the guarantor or against all the guarantor's assets.

Article 6 of the Industrial Property Code establishes that the rights from patents and utility models, as well as designs or models and other trademarks, are subject to seizure and attachment and can be pledged or subject to other seizure of property.

A lender may seek a collateral assignment of the franchise agreement itself that enables the lender to succeed in the rights and interests of the franchisee upon the loan's default.

To avoid such a result, franchisors should object to the use of collateral assignments, whether by generally forbidding such an assignment of the franchise agreement, or by imposing specific conditions on such an assignment. The franchisor may not be left in a position where the lender continues to run the franchisee's business.

Therefore, it is useful to include in the franchise agreement clauses providing for the prohibition of the assignment of rights without the prior consent of the franchisor.

V TAX

i Franchisor and franchisee tax liabilities

In Portugal there is no specific tax legislation regarding franchising contracts and relationships between franchisors, franchisees and other parties who may be involved. Therefore, the general tax system is applicable to franchisor and franchisee liabilities.

Since the franchisor and the franchisee can opt to act as an individual or a corporation, it is important to summarise the most common and relevant taxes of the Portuguese tax system.

Tax on corporations

Company profits are subject to IRC, which is supplemented by a municipal surtax levied on the IRC by some municipalities, and by a state surtax.

IRC is levied on profits derived by resident entities or non-resident entities with a permanent establishment in Portugal. Moreover, non-residents that obtain Portuguese-sourced income are also subject to IRC (see Section II.ii). To qualify as a Portuguese resident, a company or other entity must have its head office or its place of effective management in Portugal. Any corporation or other entity that does not fulfil these requirements is treated as a non-resident company for IRC purposes (including offshore companies). Non-resident companies that have a permanent establishment in Portugal are liable not only to IRC, but also to state and municipal surtaxes, and all taxes with respect to income and gains attributable to the permanent establishment. Portuguese subsidiaries of non-resident companies are also considered resident for tax purposes and, consequently, taxed on their worldwide taxable income in the same way as any other Portuguese-resident legal entity.

The taxable base is defined as the net annual profit (the difference between the income and gains and costs and losses), plus certain positive and negative asset variations during the tax year that are not included in the net annual profit, plus some tax adjustments (additions or deductions). The general rule on business expenses is that a deduction is allowed for all expenses incurred for the purpose of generating or guaranteeing the taxable income. Furthermore, to be deductible, expenses must be substantiated.

Capital gains realised by resident companies, including non-resident companies with Portuguese permanent establishments, are generally included in taxable income and are subject to the normal tax rate. Capital gains include both voluntary capital gains (i.e., gains realised from the sale or exchange of fixed assets or the appropriation of a company's fixed assets for any purpose unrelated to the operation of the business) and involuntary capital gains (i.e., gains realised on compensation for expropriation and on compensation claimed for a disaster or theft). Fifty per cent of the capital gains on the disposal of tangible fixed assets, intangible assets and biological assets (which are not consumable) held for more than one year are exempt from IRC if the total amount received is reinvested the year before or within two years of such a disposal in the purchase, manufacture, or construction of other tangible fixed assets, intangible assets, or biological assets (which are not consumable), provided that they are not purchased by related entities. Beyond that, a full exemption is applicable to capital gains derived from the sale of shares in the capital of a company if the shares are held uninterrupted for a minimum period of 12 months, the taxpayer owns at least 10 per cent of the share capital or voting rights of the company and does not reside in a blacklisted jurisdiction and is subject to – and not exempt from – corporate income tax.

Tax losses can be offset against tax profits of the next five periods or, for companies that carry on primarily an activity of a commercial, industrial or agricultural nature, of the next 12 years (special rules apply to tax losses deduction for companies under a tax group special regime or in the event of business reorganisations).

The general IRC rate for resident companies and non-resident companies with Portuguese permanent establishments is 21 per cent for taxable amounts exceeding €15,000 and 17 per cent for taxable amounts under that value. In addition, a municipal surtax of 1.5 per cent can be levied on taxable profit prior to the deduction of carry-forward tax losses in certain municipalities. Furthermore, a state surtax also applies prior to the deduction of available carry-forward tax losses at the following rates: 3 per cent applicable to taxable profit above €1.5 million up to €7.5 million; 5 per cent applicable to taxable profit above €7.5 million up to €35 million; 7 per cent applicable to taxable profit above €35 million.

Tax on individuals

Individuals are subject to personal income tax (IRS) levied at a national level throughout the Portuguese territory. Other taxes are imposed on individuals, such as the 10 per cent stamp duty on inheritances (although transfers in favour of spouses, descendants, and ascendants are tax exempt) or gifts, and the annual municipal real estate tax. Resident employees and self-employed individuals are required to pay social security contributions.

The tax rates applicable to overall income for 2017 are progressive (from 14.5 per cent – for results above €7,091 – up to 48 per cent – for results above €80,640).⁹ Moreover, an additional ‘solidarity’ income tax rate applies at the following rates: 2.5 per cent on the part of the taxable income exceeding €80,000; 5 per cent on the part of the taxable income exceeding €250,000.

Value added tax

Value added tax (VAT) is regulated by the Portuguese VAT Code, which was introduced to bring Portuguese legislation into line with the Sixth VAT Directive¹⁰ and subsequently with the recast VAT Directive.¹¹

VAT is an indirect tax on the consumption of goods and services and is normally paid by the final consumer. VAT also applies to the importation of goods by any person. In any event, a taxable person may be able to treat VAT as an input tax and offset it against the output tax payable on any subsequent supply of those goods.

The standard VAT rate in Portugal is 23 per cent (the standard VAT rate in Madeira and the Azores is 22 and 18 per cent, respectively). In addition, an intermediate rate of 13 per cent and a reduced rate of 6 per cent are currently applicable to a specific range of goods and services (in the Azores the intermediate and reduced rates are levied at 10 per cent and 5 per cent, while in Madeira these two rates are levied at 12 per cent and 5 per cent respectively on the same supplies).

In general terms, any person who independently carries out any economic activity in any place, whatever the purpose or results of that activity – including all the activities

9 Resident individuals must include 50 per cent of the gross domestic dividends received in their taxable income for progressive income tax purposes (partial imputation system).

10 Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes.

11 Directive 2006/112/EC on the common system of value added tax.

related to franchising agreements – is taxable for VAT purposes. According to the Portuguese VAT Code, any individual or corporate entrepreneur subject to IRC or IRS on their business or professional activities is also a VAT taxable person. Additionally, such entities (franchisors or franchisees) are also taxable persons for VAT purposes whenever they acquire intra-Community goods and services from a VAT taxable person with no headquarters, permanent establishment, or domicile in Portuguese territory and that has not appointed a tax representative in Portugal.

VAT liability is incurred on supplies of goods and services by an entrepreneur within the Portuguese territory in the course of his or her business enterprise or during the exercise of his or her professional practice or artistic activity. VAT liability is also incurred on the importation of goods into Portugal by any person (i.e., importation is in itself a taxable event and is liable to VAT regardless of whether or not the importer of the goods is an entrepreneur).

VAT liability is also incurred on intra-Community acquisitions of goods and services by a taxable person.

As regards common franchising agreements, the distinction between the supply of services and the supply of goods could be relevant in determining the location of the operation for VAT purposes. However, some current activities (intellectual property rights, technical assistance, general assistance services) are considered as services supplied for that purpose.

Both residents and non-residents without a permanent establishment in Portugal are subject to some formal procedures related to VAT payment and compliance obligations.

Customs regulation and excise taxes

After joining the EU in 1986, Portugal adopted the EU common customs tariff, which required the removal of all tariff and non-tariff barriers with other Member States and the setting up of the common customs duties uniformly applied in the European Economic Community (EEC). Portugal also adopted Commission Regulation (EEC) No. 2454/93 of 2 July 1993, which laid down provisions for the implementation of the Regulation establishing the Community Customs Code. Furthermore, the implementation of the internal Community markets led to free movement within the EU territory of manufactured tobacco, alcohol, alcoholic beverages and petroleum, although these products are subject to excise taxes. The EU harmonisation of legal provisions concerning the holding, movement and control of products subject to excise taxes has led to the establishment in Portuguese law of the juridical-fiscal notion of 'tax or excise warehouse' to be applied to any place where the taxable products are produced, processed, held, received or dispatched by the authorised depositary in the exercise of his or her activity, under the excise tax procedure scheme and according to the conditions established in the Portuguese Excise Taxes Code.

Products will be chargeable to tax from the start of production or from their importation into the Portuguese territory or the territory of another Member State, provided that, in the latter case, they are dispatched into the Portuguese territory.

Also subject to tax within the domestic territory are those products that have already entered into consumption channels in another Member State and that were purchased for one's own use or for commercial purposes. The free movement of such products between the territory of other Member States and the domestic territory will require an accompanying document.

Liability to tax will occur within the domestic territory upon the entry of the products into consumption channels or once goods that should be taxed are reported to be lost.

Local taxes

The main local taxes – which should also apply to the parties in a common franchising agreement – are the municipal tax on real estate, municipal tax on real estate transfer and municipal vehicle tax.

ii Tax-efficient structures

For tax purposes, as mentioned, there is no specific tax legislation regarding franchising contracts and relationships between franchisors, franchisees and other parties who may be involved.

Therefore, tax incentive schemes are totally applicable to franchising investments, provided they comply with the legal requirements.

Investment incentives

Incentives for investments in less developed regions

An incentive programme is available to qualifying companies, such as those involved in agriculture, fisheries, the coal industry or tourism, for the setting up of operations in listed, less developed areas in mainland Portugal. To benefit from these incentives, a company must, *inter alia*, create net permanent jobs attached to the underlying investment and not be deemed to be in 'financial difficulties'.¹² The incentive programme includes a corporate income tax deduction of 25 per cent of capital expenditures up to €5 million and 10 per cent of capital expenditure over that amount in investment conducted in areas where the standard of living is abnormally low or where there is serious underemployment.

Also included in the incentive programme is an annual municipal real estate tax exemption or, at least, a reduction related to immovable property held within the scope of the investment for a period of up to 10 years, and also a real estate transfer tax exemption or reduction and a stamp duty exemption on all immovable property acquisitions that constitute capital expenditure.

Contractual tax incentive

Contractual tax incentives are granted for industrial investment projects carried out before 31 December 2020 if they involve an investment of at least €3 million and are deemed to be of strategic interest to the domestic economy and encourage job creation, technological innovation, and domestic scientific research. These incentives are granted by the central government on a case-by-case basis for a maximum period of 10 years, and include a 10 per cent to 25 per cent investment tax credit and an exemption.

Incentive scheme for Madeira and Azores free zones

Portugal has two free trade zones (International Business Centres): Madeira and Santa Maria (Azores). Under the state-aid rules of the EU, Portugal was authorised to enact a socio-economic programme aimed at overcoming the structural underdevelopment of the autonomous regions of the Azores and Madeira.

12 As defined in the Commission communication published in the Official Journal of the European Union No. C 249, of 31 July 2014.

Qualifying industrial, shipping and international services, and financial entities licensed to operate in the Madeira free trade zone or within the Santa Maria Island (Azores) free trade zone are eligible for specific tax exemptions and low taxation.

Patent Box

In the context of the corporate tax reform that came into force in 2014, a Patent Box regime was created for certain industrial property rights, such as patents, designs and registered industrial models. According to the regime, only 50 per cent of income arising from the temporary assignment or use of the rights is taxable, while costs are fully deductible.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Because of the lack of specific law applicable to franchise agreements, the means of protection available to the franchisee are those established by general statutory regimes. Therefore, rules on the freedom to contract,¹³ principles of good faith¹⁴ and public order should generally apply to franchise agreements.

ii Agency distributor model

In the absence of particular law applicable to franchising, courts and doctrine have widely considered that the agency regime should be applicable to franchise agreements in relation to termination of the contract.¹⁵

iii Employment law

Franchising contracts clearly state that the franchisee is legally independent from the franchisor and that, consequently, the franchisor cannot be held liable for actions or omissions of the franchisee.

Employees may hold only their employers liable, which means they cannot sue the franchisor for actions or omissions of the franchisee.

iv Consumer protection

Because of the lack of specific law applicable to franchise agreements, franchisees have commonly resorted to the protection available under the Agency Law (i.e., as to the rights applicable to the franchisee upon termination of a franchise agreement). In addition, Portuguese courts have provided that unreasonable, abusive or unfair clauses, or entire contracts may be modified or be declared null and void. This may happen when the contract has not been negotiated but rather presented by the franchisor to the franchisee as a standard form.

13 Civil Code, Article 405.

14 Civil Code, Articles 227, 334, and 762.

15 Decree Law No. 178/86 of 3 July 1986, as amended (the Agency Law).

The Law of General Contractual Clauses¹⁶ applies to all contracts that include general conditions (i.e., clauses not subject to negotiation). Thus, a franchisor presenting the franchisee with an agreement containing general conditions that are not expressly negotiated between them may be subject to the Law of General Contractual Clauses.

The Law of General Contractual Clauses sets out a number of items that are not permitted under national law and others that must be included or expressed within the agreement. For example, an agreement cannot exclude the right to damages or include penalty provisions for defaults that are disproportionate to the damage or loss suffered.¹⁷ As indicated above, these types of clause may be deemed unreasonable and modified or rejected by Portuguese courts. Furthermore, such general provisions in franchise agreements may be subject to competition law, in particular rules on the abuse of economic dominance.

Finally, other general aspects of Portuguese civil law may be applicable, such as that relating to usury, which considers voidable any contract under which a party takes advantage of the other party's inexperience, weakness or dependency.¹⁸

v Competition law

Franchise agreements often contain restrictions to competition (e.g., exclusivity, selectivity and non-compete clauses) that may raise issues under competition law. Breach of national competition law results in the nullity of the agreement (or the anticompetitive clauses), in addition to potential imposition of fines on the parties in the agreement pursuant to antitrust proceedings conducted by the Portuguese Competition Authority.

From a competition point of view, there are no major substantive differences between national and European law applicable to franchise agreements and to its specific contractual provisions, such as price- and quantity-fixing, territorial and customer provisions, exclusive dealing, tie-in and other restrictive clauses.

In principle, territorial restrictions are banned by Article 9(1) of the Competition Act, which prohibits the division of markets and supply sources, as well as other anticompetitive conduct such as price-fixing and limiting production and technical development of investment.

Although clauses may be justified when the conditions set out in Article 10 of the Competition Act¹⁹ are fulfilled, prohibition of parallel imports, passive sales or the ban of cross-supplies between distributors are considered to eliminate intra-brand competition and, therefore, do not fulfil the exemption conditions.

Resale price maintenance provisions, which are commonly used under franchise agreements, may also be caught under Article 9 of the Competition Act, especially since

16 Decree-Law No. 446/85 of 25 October 1985 (the Law of General Contractual Clauses).

17 Law of General Contractual Clauses, Articles 18 and 19.

18 Civil Code, Article 282.

19 Notably in the case of agreements that contribute to improving the production or distribution of goods or services, or promoting technical or economic progress, if cumulatively they: (1) allow the users of these goods or services an equitable part of the resulting benefit; (2) do not impose on the undertakings concerned any restrictions that are not indispensable to the attainment of these objectives; and (3) do not afford the undertakings the possibility of eliminating competition from a substantial part of the market for the goods or services at issue. Also, *prima facie* prohibited agreements that do not affect trade between Member States but fulfil all the other requirements provided for in block exemption regulations adopted in accordance Article 101(3) of the Treaty on the Functioning of the European Union may also be considered justified by the Portuguese Competition Authority.

the article prohibits any agreement, concerted decision or practice whose effect is directly or indirectly to set prices or to interfere in price determination, whether to increase or decrease them.²⁰

vi Restrictive covenants

It is common in franchise agreements to include a restriction that prevents the franchisee from developing a similar or competitive business while the agreement is in force and for a certain period after its termination. The validity of such clauses is not, in general, contested in Portuguese courts, as long as the clauses do not entail a violation of competition rules.

According to the Agency Law, the principal may establish a clause of non-competition to last a maximum of two years after termination, limited to the area in which the contract has been executed, but such a clause will entail a right of indemnity for the non-competition covenant.²¹ The clause also should provide for payment of a non-compete indemnity.

vii Termination

In general terms, franchise agreements contain a clause specifying the circumstances in which such an agreement may be terminated before the contract term, which will normally include events such as insolvency proceedings, failure to meet payment obligations, criminal convictions or a relevant breach of contractual obligations set forth in the franchise agreement.

In the event of a breach of contract, termination is permitted without a right to an indemnity beyond general contractual principles of damages for losses and what has been contractually agreed between the parties.

Some legal commentators have, however, argued that the rules on termination of agency agreements should apply to franchise agreements, arguing that the goodwill indemnity payment due to the agent on termination of the contract is also due under the same conditions (where new clients or business has been generated) on termination of a franchise agreement.²²

There is some case law to support this view in other EU countries; however, Portuguese courts have generally rejected it. The view taken by the courts has been that the franchisee is generally participating in an existing organisation, thereby benefiting from an established client base or following its name, brand, know-how, methods and marketing, and should not be entitled to a goodwill indemnity on termination.

With regard to the consequences of termination, the franchise agreement will normally establish that, upon termination, the franchisee will no longer be entitled to use the licensed trademarks or other intellectual property rights and will be obliged to immediately return all manuals and other confidential documents provided by the franchisor.

20 As recently observed by the Portuguese Competition Authority in a case involving a retailer in the context of the relationship with its franchisees, Case No. PRC 2014/03.

21 The Agency Law, Articles 9 and 13(g).

22 Several court decisions have held that, in the event of termination, prior notice given by the franchisor to the franchisee to terminate the franchise agreement should be similar to that established in agency law (decisions of the Appeal Court of Lisbon, of 18 May 2004, Case Number 3589/2004-7, and of 2 February 2006, Case Number 9219/2004-6). However, other court decisions have held that adequacy of prior notice should be determined on a case-by-case basis, so that agency law provisions may not be applied as such (decision of the Appeal Court of Lisbon, of 25 March 2004, Case Number 497-2004-2). The Supreme Court of Justice ruled, on 9 January 2007, Case Number 06 A 4416, that, in a franchise agreement, the loss of clientele is subject to indemnity only when the franchisee shows that it has contributed in a significant way to an increase in the number of the clients of the franchisor.

Regarding expiration of the agreement, it is a matter left for the parties to agree upon. Portuguese doctrine and case law have, however, been of the understanding that the length of the franchise agreement should be enough to enable the franchisee to recover its investments. Furthermore, there are a substantial number of court decisions, based on the principle of good faith and cooperation, that have established a right of indemnity for the franchisee when a franchisor has not given a reasonable notice period prior to the termination of contracts of undetermined length. Competition rules may also be of importance in this matter, in particular Article 12 of the Competition Act (Law No. 19/2012 of 8 May 2012), which establishes the prohibition of abuse of economic dependence in cases of unjustifiable termination of the agreement.

viii Anti-corruption and anti-terrorism regulation

In 2008, Law No. 25/2008 of 5 June was enacted establishing measures to combat money laundering and the financing of terrorism, transposing into Portuguese law Directive 2005/60/EC of the European Parliament and the Council of 26 October and Commission Directive 2006/70/EC of 1 August on the prevention of the use of the financial system, and of activities and specially designated professions, for the purpose of money laundering and terrorism financing.

In Portuguese law, money laundering is a criminal offence (Article 368-A of the Portuguese Penal Code), as is terrorism financing by virtue of the provisions laid down in Article 5-A of Law No. 52/2003 of 22 August (as amended by Article 62 of Law No. 25/2008 of 25 June).

ix Dispute resolution

In practice, a franchise agreement will determine the party's choice of law and jurisdiction, which will govern the rights and obligations of the parties and settle any disputes that arise out of or in connection with the franchise agreement. Portuguese civil procedure law establishes that parties are free to agree on the jurisdiction that will decide on their disputes. According to the Civil Procedure Code,²³ choice of jurisdiction must be contained in a written jurisdiction clause and the following cumulative prerequisites should be met:

- a* the election of a given jurisdiction must relate to a dispute over available rights;
- b* it must be accepted by the law of the designated court;
- c* it must be justified by a serious interest of both parties or one of them, as long as it does not involve major inconvenience to the other;
- d* it may not fall under the exclusive competence of Portuguese courts; and
- e* it should be contained in a written agreement or confirmed in writing, making explicit mention of the competent jurisdiction.

EU Council Regulation (EC) No. 44/2001²⁴ will also be applicable if one of the parties in the contract is domiciled in a contracting state. Often, a franchise agreement will provide for mediation or arbitration as an alternative method of resolving the dispute, since it provides

23 Civil Code, Article 99.

24 Council Regulation (EC) 44/2001 of 22 December 2000.

a greater flexibility and expertise. Furthermore, according to civil internal rules, Regulation (EC) No. 44/2001 and the 1958 Rome Convention, Portuguese courts will enforce a foreign judgment or foreign arbitral award.

As long as mandatory arbitration national rules are respected, foreign arbitral awards will be recognised by the Portuguese courts.

VII CURRENT DEVELOPMENTS

According to the conclusions of the 22nd annual IIF franchise census, franchising was responsible for the creation of around 117,450 jobs in Portugal, about 2.25 per cent of employment generated in 2016.

By sectors, services was the dominant sector, going from 41.5 per cent in 2014 to 57.3 per cent in 2016 and becoming the most important segment in the national franchising market.

RUSSIA

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I INTRODUCTION

Franchising presents a double advantage. On the receiving side (the franchisee), it is a quick way to start a business under the umbrella of a renowned brand. The emerging business is backed by the solid commercial experience and positive reputation of the prominent company (the brand or franchise owner). On the giving side, the owner (franchisor) expands the brand and franchise to other markets and obtains a new platform for further business development, and this is achieved with the money being paid to, rather than by, the owner.

Unsurprisingly, international franchisors have already sought to secure franchising investments in the Russian jurisdiction. Global corporations such as Marriott, Hilton, McDonald's, Starbucks, Subway and many others have offered and successfully sold their franchises to local companies (franchisees). Local companies are also catching up and establishing their own franchise businesses in various sectors, including retail, services, restaurants, bars and hotels.

There are several national franchise associations operating in Russia. While membership of a national franchise association is not mandatory, it may be commercially advisable to a certain extent. There is a local non-profit public organisation called the Russian Franchise Association (RFA), established back in 1997, which helps its members to promote franchising activities in Russia. Although the RFA does not have any regulatory power, it provides useful practical advice on doing franchising business on the Russian market. More information about the RFA can be found on its official website, at www.rusfranch.ru.

From the legal standpoint, cross-border transactions are structured differently in the context of franchising. Many companies prefer direct franchising, while others engage master franchisees. In certain cases, franchise grants are mixed with development rights in one and the same contract. In rare instances, joint ventures are created when the franchise relationship involves a Russian element.

According to the relevant provision of Russian law,² under a franchise agreement, the rights holder (franchisor) grants the user (franchisee), for consideration and for a definite or indefinite term, the right to use a set of the franchisor's intellectual property (IP) rights, including trademarks and other contracted IP rights, for the operation of the franchisee's business, in particular, trade names and trade secrets (know-how). The key element of the franchise agreement is a protected (registered) trademark. In the absence of a registered trademark, the contract may not be treated or interpreted as being a franchise agreement.

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2 Article 1027 (1) of the Russian Civil Code (Part II).

Other IP rights, including but not limited to, trade names, know-how, copyrights, patents and software, may be added to the scope of the franchise agreement in addition to, but not instead of, the registered trademark.

In Russia, the principal rule of franchising is that the parties to a contract must be commercial entities. Non-commercial companies or governmental agencies may not enter into franchise agreements. Therefore, limited liability companies will normally represent franchisors in regular franchise deals. Sometimes, joint-stock companies are used in complex franchise transactions involving joint ventures.

II MARKET ENTRY

i Restrictions

For the most part, there are no legal restrictions on foreign franchisors in respect of local equity ownership or real estate ownership in Russia. When entering the Russian market by way of granting a master franchise or development rights to a local entity, foreign companies should comply with all relevant national laws and regulations governing conclusion of franchise contracts, performance of obligations and the general civil law principles applicable to business operations.

At the same time, certain areas of investment are of strategic importance and the Russian government seeks to secure state defence and national security in these areas. Hence, a special licence or permission from the government has to be obtained before investing into certain industries or transacting in certain assets (e.g., encryption, weaponry, space and aviation). The media and telecoms sectors also have certain restrictions in terms of corporate ownership and control.

In general, a foreign company is free to offer and sell a franchise or development rights directly or indirectly to a local entity. In other words, the foreign franchisor may enter into a franchise agreement directly with the Russian franchisee to develop the franchised business in Russia, or engage another partner (sub-franchisor) who will grant sub-franchises to different local entities (sub-franchisees) under the effective sub-franchise agreements. Indeed, there is no legal requirement to set up a new local entity or own equity in the Russian company as a condition precedent for carrying on franchising activities in Russia.

ii Foreign exchange and tax

Generally, with regard to foreign exchange issues, there are no legal restrictions on the repatriation of franchise fees to an overseas franchisor.

As a general rule, the Russian franchisee is required to open a 'transaction passport' with a competent bank to remit the payment of the franchise fees to a foreign franchisor. The above rule applies only to the corresponding franchise operation for contracted amounts of US\$50,000 (or more). The bank will issue the document (transaction passport) if the underlying franchise agreement (the original document) is properly translated into Russian and the granted franchise is registered with the Federal Service for Intellectual Property (Rospatent). Without the transaction passport, franchise fees cannot be sent to an overseas franchisor.

Basically, Russian currency control law does not prohibit the use of a foreign currency in the context of international franchising.

With regard to the issue of taxes, there is no special franchise tax applicable to cross-border franchising.

Usually, all franchise fees payable to the foreign franchisor will be subject to value added tax (VAT) and corporate income tax (CIT), which need to be withheld by the Russian franchisee from the relevant contract price. Importantly, there are certain VAT exemptions and CIT reliefs that should be considered when structuring franchise operations in Russia.

III INTELLECTUAL PROPERTY

i Brand search

Generally, the Rospatent online databases are publicly available to conduct IP searches and to obtain any related information on registered IP rights and published applications. The online databases of the Eurasian Patent Organisation are publicly available to conduct patent searches and obtain relevant information on Eurasian patents and published Eurasian applications. Information on international trademarks registered in Russia is also available in ROMARIN, the World Intellectual Property Organization online database. Information on Russian registered trademarks is available in the TMview online database system of the European Union Intellectual Property Office (formerly the Office for Harmonization in the Internal Market), while information on Russian registered designs is available in the same organisation's DesignView online database system.

In addition, different fee-based search tools are also available. For example, Rospatent provides trademark search and trademark proprietor search services. Different turnaround times are prescribed according to the Rospatent schedule of fees. Official search results may be obtained on an urgent basis, even within one day, but the associated costs are relatively high.

Other IP or franchise-related searches, including for image rights and business processes, may be conducted on the internet.

If there is conflict, it is possible to file oppositions, cancellations or even bring an infringement claim, depending on the situation at issue.

ii Brand protection

Trademarks

Trademark registration will be the very first and key element for every franchise transaction targeted at Russia. A trademark may not be granted for use within the scope of a franchise, unless it is properly protected (registered) in Russia. Therefore, a foreign trademark, or mark-in-use, or pending trademark application cannot be licensed by way of a franchise agreement.

Trademarks may be protected on a national or international basis. National marks will have to be filed and registered with Rospatent. Russia is a signatory to the Madrid Agreement and the Madrid Protocol, therefore, an international trademark registration (designating Russia) will also be protected in Russia.

The duration of the national trademark registration procedure is approximately one year. The examination procedure includes formal and substantive examination. In the course of substantive examination, Rospatent runs absolute and relative grounds tests to allow or refuse trademark registration.

Any words, pictures, three-dimensional configurations and other marks may be registered as trademarks. The registration of non-traditional marks, such as sounds, colours and smells, is permitted.

To be registered, a mark has to be new and distinctive. Distinctiveness may be inherent or acquired. A trademark can acquire distinctive character through intensive and actual use in commerce.

In general, use of the mark does not have to be claimed before registration. Further, no proof of use has to be submitted before the trademark application is filed. At the same time, the owner must start using the trademark within three years of registration. If the mark is not used during any three-year term following trademark registration, any interested person may apply for cancellation of the trademark protection on the grounds of its non-use.

When the trademark is registered, it is entered into the Russian Trademark Register and will be valid for 10 years. Trademark registrations can be renewed for 10-year periods an unlimited number of times.

Copyright

Most often, franchisees will be granted access to certain business standards, operations manuals and proprietary software. As a result, copyright vested in these works may be included (along with trademarks) in the content of the underlying franchise agreement.

Copyright subsists in scientific, literary and artistic works fixed in any tangible medium of expression, regardless of benefits, purposes or methods of their expression. To be copyrightable, a work of authorship must satisfy two fundamental criteria. It must (1) represent a result of creative input, and (2) be fixed in any tangible medium of expression (e.g., paper, CD-ROM).

Generally, the following examples of works of authorship can obtain copyright protection in Russia:

- a* literary works;
- b* dramatic works;
- c* musical works;
- d* choreographic works and pantomimes;
- e* audio-visual works;
- f* sculptural, graphic and design works;
- g* photographic works;
- h* architectural works;
- i* pictorial works;
- j* computer programs; and
- k* databases.

Essentially, copyright vests in a work of authorship from the moment of its creation. There is no need to register or comply with any other formalities to acquire, exercise, transact, franchise, protect or enforce copyright in Russia. However, there is a unique national system of registration available for computer programs and databases. This registration may give an 'irrebuttable' presumption of copyright ownership and protection.

Basically, the standard duration of copyright protection, which is applicable to all works of authorship, is the lifetime of the author plus 70 years after her or his death.

Know-how

Many franchise agreements will incorporate know-how licences, as the transfer of proprietary and confidential information is usually regarded as the most critical aspect of every franchise business.

Any piece of confidential information may be protected as know-how. Know-how is not to be registered or deposited; nevertheless, the owner must undertake certain reasonable measures to maintain the confidentiality of the relevant data. If these measures are not implemented, know-how protection will not be afforded to the confidential information.

One of the legal ways to acquire know-how protection would be to set up a 'trade secrets regime', as it is described in the law. More specifically, the owner has to properly identify and list the confidential information, limit access to the confidential information by establishing an appropriate procedure for dealings with the same, affix the notice 'trade secret' to the medium in which the confidential information is stored (along with the owner's details) and follow up with other required steps. If one of these steps is ignored or omitted by the owner of the confidential information, the trade secrets regime will not be considered as having been introduced and, as a result, the know-how protection will not be afforded to the trade secret. At the same time, there are other reasonable measures, which can be undertaken in due course, to achieve know-how protection.

Know-how will be protected for as long as it is kept secret by its owner. When the confidentiality is lost, the exclusive rights lapse immediately.

iii Enforcement

The IP enforcement system is well developed in Russia. IP rights, whether franchise-related or not, are enforced quite actively and efficiently. Enforcement actions can be brought by IP owners or their registered exclusive licensees.

Infringement of IP rights may primarily be prosecuted through administrative, civil or criminal proceedings. Furthermore, a special quasi-judicial procedure based on unfair competition is available. Finally, cease-and-desist or warning letters are a mandatory pre-judicial remedy for companies wishing to sue infringers in court and claim damages or monetary compensation.

Administrative proceedings

In accordance with the applicable administrative law, unlawful use of a patent, trademark or copyrighted subject matter entails both an administrative fine, which has to be paid into the state budget, and confiscation of the counterfeit goods for the purpose of destruction.

Administrative proceedings usually begin with a complaint, which the IP owner has to file with the police office or customs authority, so that the latter can organise a raid or take any other necessary action.

Administrative action may take about three to five months to be completed, unless the decision of the first instance court is appealed by the infringer.

Practically, in the context of importation of counterfeit goods into Russia, an administrative procedure proves to be the most effective enforcement option to stop the IP infringement at the border. This measure is also applied when small shops offer for sale and sell fake products on the internal market.

Civil proceedings

In the framework of civil proceedings IP owner (or its registered exclusive licensee) is normally entitled to seek the following legal remedies: (1) injunctive relief (preliminary and permanent injunctions); (2) monetary relief (damages or monetary compensation); (3) seizure and destruction of counterfeit goods and related equipment or materials; and (4) publication of a court order.

Civil proceedings begin with a statement of claims (lawsuit), which is to be filed with the competent court. Russia does not support the discovery system at the pretrial stage, therefore, all pieces of evidence must be collected and secured in advance of the lawsuit. If it is not possible to obtain certain evidence from the infringer before the action, or the latter refuses to disclose the evidence, the plaintiff may discover the evidence through the agency of the court during the civil procedure.

The duration of civil action will vary depending on the IP subject matter involved and specifics of the case at issue. Typically, the decision of the court may be obtained within six to 12 months, unless appealed.

Practically, civil procedure is widely used as enforcement option to tackle parallel imports and grey market goods, including those offered on the internet. This measure is also applied when terminated or former franchisees continue doing business using the franchisor's trademarks, copyrights, know-how and other IP assets after termination of the underlying contractual relationship.

Criminal proceedings

Illegal use of IP rights may also lead to criminal prosecution.

In accordance with the applicable criminal law, unlawful use of a patent, trademark and copyrighted subject matter entails criminal liability only in the event of a substantial amount of damage being caused to the IP owner, or if the IP infringement is repeated.

The typical statutory criminal sanctions are the following: (1) criminal fine; (2) forced labour; (3) correctional works; and (4) imprisonment. In the course of criminal procedure, the IP owner is also entitled to file a civil lawsuit to recover damages.

The total duration of criminal proceedings is usually hard to predict, although the approximate timing is about one to two years, unless the decision of the first instance court is appealed by the infringer.

In practice, criminal procedure is applied against large-scale or gross infringers who are manufacturing and distributing counterfeit goods in large quantities.

Unfair competition action

IP infringement may be a matter of unfair competition, which is prohibited. Unfair acquisition and use of IP rights is not allowed either. Passing off and imitation of trade dress are also treated as unfair behaviour, which may be prosecuted.

The Russian Federal Anti-monopoly Service (FAS) is empowered to consider disputes related to unfair competition through a special quasi-judicial procedure. This type of procedure starts on the basis of a complaint filed by the injured party (e.g., the IP owner or local distributor).

Should the action on unfair competition be eventually successful, the respondent (infringer) would be forced to cease the established illegal activities and pay the administrative fine in favour of the state budget (which may be up to 0.15 per cent of the corresponding infringer's profits).

This procedure usually lasts about six to 10 months, although it can take longer if the binding order of the FAS is appealed in court.

Cease-and-desist letter

Cease-and-desist or warning letters are mandatory with regard to monetary claims in Russia. In other words, it is not possible to sue the infringer in court and claim damages or monetary compensation if a demand letter has not been dispatched in advance of the civil action.

In accordance with the applicable law, the infringer has 30 days to respond to the cease-and-desist letter. Failure to respond, or receipt of a negative reply, provides the IP owner (or its registered exclusive licensee) with legal standing to sue and seek monetary relief.

If the main goal is stop IP infringement, a cease-and-desist letter will not be a prerequisite for starting an action in court. Sending a demand letter to the alleged infringer asking for a voluntary cessation of IP infringement may be the easiest out-of-court enforcement option in many practical situations.

iv Data protection, cybercrime, social media and e-commerce

Data protection

In the context of franchising, if the parties deal with processing of personal data, especially in relation to Russian individuals (data subjects), the applicable data protection law has to be considered.

More specifically, the franchisor or franchisee (as applicable) can be considered as the data operator (data controller) or the data processor (person acting and processing data under the instructions of the data operator), or even both. If the franchisee outsources data processing to a franchisor, for example, both parties must enter into a data-processing agreement, conditional on the data subject's consent. If the franchisor would like to use the franchisee's clients' data for certain advertising or marketing purposes, the consent of the respective data subjects (addressees) must also be obtained.

In general, the data subject's consent must be specific, informed and conscious. Unless otherwise provided by the law, the data subject's consent can be obtained in any form, including online. In cases where the law requires the data subject's consent to be given in writing (e.g., biometric data), implied or inferred consent will not be regarded as valid. The burden of proof that the data subject's consent has been received remains with the data controller. In addition, a data controller that is processing personal data of Russian individuals must notify the Russian IT regulator (Roskomnadzor), provided it is not exempt from the notification obligation. The notification can be submitted by the data controller on paper or electronically.

In the event of cross-border data flow, it is essential to ensure that the rights and interests of data subjects are fully protected in an adequate manner in the corresponding foreign jurisdiction. International data transfer to a country that does not provide a level of adequate protection is only permitted if the written consent of the data subject concerned has been obtained, or the data transfer is made for the performance of a contract to which the data subject is a party.

Importantly, if the franchisor or franchisee (being the data controller) collects, systematises and accumulates any personally identifiable information on Russian citizens, that data will need to be stored in data centres or databases located in Russia.

Finally, the data controller must take necessary and sufficient measures, including from the technical, organisational and legal perspectives, to protect personal data that is being processed from unauthorised disclosure, access, use, distribution, theft, etc.

Social media and e-commerce

Generally, under the franchise agreement, the franchisee may be permitted to or prohibited from developing the franchised business on social media or in the digital arena. If the franchisee is permitted by the franchisor to advertise the franchised brand on social media and conduct e-commerce by offering the franchised products online to customers, the relevant national laws regarding telecommunications, data protection, advertising and online trade will apply and must be complied with.

Furthermore, pursuant to the provisions of Russian franchise law, it is possible to create an obligation for the franchisee to offer and sell goods exclusively within its contracted territory. At the same time, the relevant clause in the franchise agreement obliging the franchisee to sell goods solely to the customers located or residing in the contracted territory, shall be null and void.³ Hence, as long as the franchisee restricts its activities to the franchised territory, it is free to sell goods to different customers, especially by way of an online platform, from all over the world.

Finally, any use by the franchisee of the franchise trademark (or similar mark) on the internet or in its domain name after termination or expiration of the franchise agreement may lead to trademark infringement and other sanctions established by the applicable law and the contract. Unless assigned in an amicable (non-judicial) manner, which may be agreed between the parties, the conflicting domain name may be recaptured in the course of civil procedure (litigation) with the competent national court. Uniform Domain-Name Dispute-Resolution Policy (UDRP) proceedings are not effective for .ru, .su and .рф domains, although the Russian courts do recognise and apply the widely known UDRP principles (criteria) when establishing trademark infringement in the course of local domain-name dispute-resolution practice and litigation.

IV FRANCHISE LAW

i Legislation

There is no dedicated franchise act in Russia. Franchising activities are specifically regulated by the Russian Civil Code (Chapter 54 of Part II). In addition, the general provisions of the national civil law, especially those that govern the law of contracts and performance of obligations (Part I of the Russian Civil Code) and intellectual property law (Part IV of the Russian Civil Code), may also apply to franchise operations. Finally, the ongoing franchise relationship may also be affected by local laws on competition and commercial law, labour and employment, real estate and property law, tax and currency control, information technology and data protection, advertising and consumer protection, as well as other effective Russian laws and regulations.

ii Pre-contractual disclosure

Pre-contractual disclosure is not mandatory under Russian law. Nor does Russian law require the franchisor to provide disclosure updates within the term of the franchise agreement. The law only states that the franchisor shall provide technical and commercial documentation and any other necessary information for the franchisee to be able to develop the franchised

3 Article 1033 (2) of the Russian Civil Code (Part II).

business, and to instruct the franchisee and its employees on the aspects associated with franchising activities. However, this does not necessarily mean 'pre-contractual disclosure' in the sense understood in international franchise practice.

The foregoing disclosure obligations may be established by the parties on the basis of the doctrine of *culpa in contrahendo* and the principle of good faith at the stage of negotiations pertaining to a prospective franchise transaction.

The format of disclosure is not prescribed by Russian law or published by any governmental agency. Hence, the parties to a contract are free to use and be guided by the documentation normally used in overseas franchising deals.

iii Registration

Every franchise agreement has to be made in writing. In addition, the grant of franchise contemplated by the underlying franchise agreement must be registered with Rospatent. A franchise that is not registered with Rospatent will be invalid.⁴ As a result, the parties will not be able to enforce the contracted rights or obligations against third parties in the event of a non-registered franchise grant. Hence, registration shall not be waived, whether in the context of domestic or cross-border franchising.

Russian law does not set a specific limitation period within which the franchise grant has to be registered with Rospatent. Unless there is an agreement to the contrary, the registration obligation vests with the franchisor, who must prepare and file the appropriate set of documents with Rospatent.

There are various options regarding documents that may be submitted to Rospatent in support of the concluded transaction in addition to the power of attorney authorising the local representative (e.g., a trademark attorney) to make the filing. It is, therefore, possible to provide: (1) the original franchise agreement; (2) a notarised excerpt from the same; or (3) the statement of franchise (notification), executed by the parties. Before filing, it is essential to ensure that the document that has been chosen for submission to Rospatent contains all essential elements (mandatory clauses) required by Russian law and dictated by local practice. Importantly, if the parties do not wish to disclose the original contract along with stated financial information or any other sensitive data, the best option would be to make and file an excerpt from the agreement, or present the notification.

In practice, the registration process may take about two to three months in the absence of office actions or Rospatent enquiries.

iv Mandatory clauses

The franchise agreement may contain various terms and conditions depending on the transaction structure and the parties' negotiations.

In general, a contract of this type will usually contain a section on the parties and a statement of their intentions, definitions and interpretation, the franchise or licence grant, term and renewal, franchise fees and payment order, the franchisor's and franchisee's duties, site selection or construction and approval, training and education, inspections and audits, accounting and records, advertising and promotion, protection of franchised assets and

⁴ Article 1028 (2) of the Russian Civil Code (Part II).

confidential information, default and termination, the franchisee's rights and obligations upon termination, franchise transfer and sub-franchising, and governing law and dispute resolution, as well as other general clauses.

As regards Russian law and registration, the franchise agreement must address the following essential elements (points):

- a* parties (i.e., corporate names and addresses);
- b* subject matter (i.e., registration numbers of the franchised trademarks and description of the other franchised IP rights (e.g., copyrights, know-how));
- c* franchised products (i.e., goods or services for which the licensed trademark is protected and licensed);
- d* scope of franchised rights (i.e., permitted manners of IP use and distribution of franchised goods or services);
- e* franchisee's duties and covenants (i.e., compliance with standards or manuals, quality compliance, confidentiality obligations, non-compete, site selection and approval, customers' support, etc.);
- f* consideration (i.e., franchise entrance fee, lump sum, royalties, etc.);
- g* type of franchise (i.e., sole versus exclusive versus non-exclusive);
- h* term (i.e., term of protection of franchised IP or certain specific period);
- i* territory (i.e., whole of Russia or certain specific areas);
- j* sub-franchising (i.e., permitted or prohibited, how many versus to whom, etc.);
- k* franchise renewal (i.e., franchisee's right of first refusal);
- l* termination (i.e., mutual or unilateral, for cause or convenience, etc.);
- m* post-termination (i.e., franchisee's rights, obligations and liabilities following termination); and
- n* signatures (i.e., names and titles of signees).

v Guarantees and protection

In the context of franchising, a franchisee can resort to different types of guarantees and protection measures to secure its contractual obligations to a franchisor. First of all, the franchisee can obtain insurance coverage from an insurance company for the risks associated with the development of the franchised business. Second, the franchisee may guarantee the performance of its duties through the agency of a third party, including the director general or company owner. In addition, the franchisor can be secured by way of engagement of a bank or other commercial organisation providing an independent guarantee over the transaction. Finally, the parties may negotiate the payment of security deposits or default interests to ensure the payment of franchise fees. Other guarantees and protection can be agreed in the course of parties' negotiations.

V TAX

There is no specific franchise-related tax in Russia. A foreign franchisor must take into account VAT and CIT on the contracted franchise fees, while the local franchisee, as the franchisor's tax agent, is responsible for withholding the corresponding taxed amounts. In addition, the parties should observe certain local transfer pricing rules.

i Franchisor tax liabilities

Foreign franchisors must add 18 per cent VAT on to franchise fees payable by Russian franchisees under the franchise agreement.

The licensing of patents, industrial designs, know-how, computer programs, databases and mask works are exempt from VAT, while trademark and copyright licences will be taxed under the underlying franchise agreement.

In addition, franchise fees payable to a foreign franchisor by a Russian franchisee are subject to 20 per cent CIT, unless there is a special double-tax treaty in place between Russia and the foreign state where the franchisor resides, as this would provide certain tax reliefs.

ii Franchisee tax liabilities

If the foreign franchisor does not have a permanent establishment or a representative office in Russia, the Russian franchisee acts as a tax agent for the foreign franchisor. Therefore, the Russian franchisee must withhold the corresponding VAT amount from corresponding franchise fees related to trademark and copyright licences set forth by the franchise agreement and remit that amount to the state budget.

In addition, the Russian franchisee, acting as a tax agent for the foreign franchisor, shall withhold the corresponding CIT amount from the contracted franchise fees and remit this to the state budget, unless there is a special double-tax treaty in place between Russia and the foreign state where the franchisor resides, as this would provide certain tax reliefs.

Also, the franchisee will be able to deduct the VAT-able amount as well as the amount of franchise fees when paying its own CIT to the government.

iii Tax-efficient structures

In terms of tax-efficient franchising operations, the following best practices can be recommended.

VAT exemption

There should be separation of the underlying IP licence grants, documentation and pricing under the franchise agreement in relation to VAT-able items (i.e., trademarks, copyright) and non-VAT-able items (i.e., patents, industrial designs, know-how, computer programs, databases, mask works).

Double tax treaty

If the foreign franchisor is established in and operates under the laws of a foreign state that has a special and effective double-tax treaty with Russia, a zero or reduced CIT rate may be applied; to enjoy that tax relief, the foreign franchisor must provide the Russian franchisee with valid and certified documentary proof of its tax residency in the relevant foreign state.

Special tax clause

It is possible to include a special tax clause in the franchise agreement related to the calculation of all withholding taxes without affecting the amounts (franchise fees) payable to the foreign franchisor.

Transfer pricing

The amount of contracted franchise fees should be in compliance with the corresponding market price level to avoid additional taxes and penalties.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

There is a specific provision in Russian law to the effect that contracting parties, while exercising their rights and performing their obligations, should be acting in good faith. There is also a general civil law principle that actions of persons carried out with the sole purpose of causing damage to other persons are prohibited. Hence, abuse of rights and unfair behaviour are prohibited, while the duty of good faith shall always be guaranteed, especially in terms of making transactions. The concepts of good faith and fair dealing are supported and enforced by the Russian courts in contractual disputes, including franchise-related ones.

ii Agency distributor model

Franchise and commercial agency are two different contractual arrangements. Specifically, the functions of the franchisor or franchisee may not be compared with the functions of the principal or agent according to Russian law.

Even though the franchise agreement may sometimes be a 'blended' contract, with many elements incorporated in it, the risk that a franchisor will be treated purely as a principal and the franchisee treated purely as the franchisor's agent is very low.

Usually, agency relations are mixed with distribution, but not with franchising, in Russia. And, importantly, in Russian civil law there is no such contractual model as the distribution contract.

iii Employment law

The franchisor and the franchisee are separate legal or commercial entities operating under the concluded franchise agreement. Therefore, they have their own labour and employment obligations in relation to their own employees, but not in relation to each other. The terms and conditions of the franchise agreement are primarily governed by civil law (i.e., the Russian Civil Code), while the labour and employment relations of entities doing business in Russia are regulated by the Russian Labour Code.

According to the Russian Labour Code, employment relations between the employer and the employee may arise only under a labour agreement. The applicable labour law also stipulates that the conclusion of civil law agreements, which *de facto* govern the relationship between the employer and the employee, are not allowed.⁵

Therefore, there is no risk or likelihood that the franchisee (or even the employees of the franchisee) will be treated as the employees of the franchisor in Russia.

iv Consumer protection

In Russia, franchisees cannot be treated as consumers under any circumstances. The Russian Law on Protection of Consumers' Rights covers the protection of rights of individual

5 Article 15 of the Russian Labour Code.

consumers acting as physical persons (not business entities). In other words, the applicable consumer protection law governs business-to-consumer relations, while the franchise relationship may only be created in the business-to-business sphere.

v Competition law

Generally, the applicable law, or competition law, prevents monopolistic (anticompetitive) activities, 'cartels' and abuse of dominance. The law also prohibits unfair competition. In this regard, dissemination of false information or unfair advertising that may damage an operating business entity is not allowed. Passing off and unauthorised IP acquisition and use may be treated as unfair behaviour and, therefore, sanctioned. Importantly, competition law allows 'vertical' contracts, including franchise agreements, whether made between foreign or domestic companies.

According to Russian law, a franchise agreement may impose different obligations and covenants on the franchisee, particularly those listed in Section VI. Theoretically, these covenants, to the extent they are incorporated in the franchise agreement, may be declared invalid by the FAS (or other interested person) if they are found to be contradictory to anti-monopoly laws, subject to the relevant market conditions and economic status of the parties. In practice, the standard contractual restrictions provided in franchise agreements and made in line with relevant provisions of Russian law, including non-compete covenants, are acceptable from the antitrust standpoint.

Importantly, a franchise granted to the franchisee may be sole, exclusive or non-exclusive. If the granted franchise is sole, the franchisor loses its right to use the franchised set of IP rights in the franchised territory on its own and loses the right to offer and sell the same franchises to third parties in the franchised territory. If the granted franchise is exclusive, the franchisor may reserve the right to use the franchised set of IP rights in the franchised territory on its own, but nonetheless loses the right to offer and sell the same franchise to third parties in the franchised territory. If the franchise is granted on a non-exclusive basis, the franchisor is free to franchise the already franchised set of IP rights in the franchised territory to others.

There is no maximum permitted term within which a franchise agreement may be effective. The franchise agreement may be concluded within a definite or indefinite term. If the franchise agreement is made for a definite term, the contract may provide for a specific term (e.g., 10 years), or clearly state that it stays valid during the period of protection of the franchised set of IP rights that has been licensed under the franchise agreement. If the term of the franchise agreement is not defined by contract, the franchise will be regarded as granted and effective for five consecutive years (starting from the corresponding registration date).

As follows from Russian law, the franchisee may be obliged by contract to sell the franchised goods under prices fixed by the franchisor. However, fixing of prices, including minimum resale prices, may fall under the supervision of the FAS. The agency may, within the scope of its competence, tackle any anticompetitive practices if they entail or may entail the fixing or support of prices (tariffs). Therefore, if the Russian Federal Anti-monopoly Service finds the contractual provision on pricing or minimum resale price to be in contravention of anti-monopoly laws, subject to the relevant market conditions and economic status of the parties, the clause may be deemed invalid by the agency.

The franchised territory (region, city, street, address, etc.) may or may not be specified in the contract. If the contract is silent on the territory, the franchise will be regarded as granted and effective in the whole territory of Russia. If the contract specifies certain boundaries or territory, the franchise will be valid in the contracted territory.

vi Restrictive covenants

The franchise agreement may contain different restrictive covenants imposed on the franchisee as allowed under the Russian law.⁶ The scope of the same will usually depend on the parties' negotiations and arrangements.

More specifically, the franchisor may elect for the following covenants to be incorporated into the contract: (1) the franchisee's covenant not to compete with the franchisor in the franchised territory in relation to the franchised business and franchised set of IP rights; (2) the franchisee's refusal to accept analogous rights under franchise agreements from competitors (potential competitors) of the franchisor; (3) the franchisee's covenant to distribute and sell the manufactured or purchased goods, perform works or provide services by using the franchised rights and applying the prices fixed by the franchisor; (4) the franchisee's covenant to refrain from distribution of analogous goods, performing analogous works and providing analogous services using the trademarks or trade names of other franchisors; (5) the franchisee's covenant to sell goods, perform works or provide services exclusively within the boundaries of certain territory; and (6) the franchisee's covenant to obtain approval from the franchisor for the location (as well as the exterior or interior design) of the commercial premises used for implementation of the franchised rights under the contract.

The above restrictive covenants are allowed under relevant provisions of Russian law and may be enforced if not complied with, especially during the term of the franchise agreement. The Russian court system has already tested a few cases in which non-compete covenants were prosecuted in favour of the cases' respective claimants (franchisors).

vii Termination

The franchisor and franchisee are free to use the wording of Article 1037 of the Russian Civil Code to create a valid termination clause in the franchise agreement.

More specifically, according to Russian law, any party may terminate a contract at any time if the franchise agreement has been concluded for an indefinite term. Six months' prior written notice is required in this case, unless the contract indicates a longer term for the advance termination notice. If the contract provides for a specific period of validity, the parties shall be guided by the terms of the franchise agreement.

Either of the parties to the contract concluded for a definite or indefinite term may terminate the franchise agreement by sending a written notice to the other party 30 days in advance. This option will be available only if the contract provides for the release of certain monetary compensation.

The franchisor may terminate the franchise agreement if the franchisee produces goods of inferior quality, or the quality of its services does not correspond to what has been set out in the contract. The franchisor may also repudiate the franchise agreement if the franchisee does not follow the franchisor's instructions and guidance aimed at ensuring compliance with

6 Article 1033 (1) of the Russian Civil Code (Part II).

the contractual provisions related to the terms and conditions of use of the franchised set of IP rights. Finally, the franchisor may cancel the franchise agreement if the franchisee fails to settle the franchise fees on the terms set out by the contract.

Termination by the franchisor is available if the franchisee has failed to remedy the breach within a reasonable term, or has committed another breach within a year of receipt of the written notice from the franchisor.

If the franchisor's right to the franchised trademark or franchised trade name (included in the franchised set of IP rights) is lost for any reason, the franchise agreement will be terminated, unless any similar (effective) IP asset is granted (substituted) by the franchisor.

If the franchisor or the franchisee becomes insolvent (bankrupt), the franchise agreement shall be dissolved.

Termination of the franchise agreement is subject to registration with Rospatent. In the absence of registration, the termination will not be effective.

As to post-term restrictions, especially the non-compete covenant, these may be deemed enforceable, provided it is clearly stated in the contract that they survive the termination. Moreover, the franchisee will be regarded as infringer if he or she continues using the franchised set of IP rights following the termination of the franchise agreement.

Although in practice it might be very difficult to take over the franchisee's business, this issue is negotiable and subject to contract. Sale and purchase arrangements, preliminary agreements, call options and conditional instruments are available under Russian law and may be implemented by the parties.

The franchisee's entity may be owned by the franchisor and the latter may corporately restrict any transfer of the ownership interest in the franchisee's entity to a third party.

The sale of stakes in the franchisee can only be limited if the franchisor owns some or a majority of the same in the franchisee's company.

In the context of commercial property, there are no restrictions on foreign companies holding an ownership or lease interest in Russian real estate. Therefore, the question of taking local leases or premises shall be discussed between the parties. Relevant amendments to lease contracts, or the associated assignments, will have to be registered with the Russian State Register of Real Estate Rights and Transactions. Finally, the parties can make the lease agreement conditional on the franchise agreement, hence allowing the lease agreement to be terminated as soon as the franchise agreement is terminated.

viii Anti-corruption and anti-terrorism regulation

Russia is a party to a number of international treaties governing anti-corruption, including the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (dated 1997). There are a few national laws prohibiting terrorism, corruption, money laundering and fraud, namely the Russian Law on Terrorism Resistance (dated 2006), the Russian Law on Combating Corruption (dated 2008) and the Russian Law on Combating the Legalisation of Proceeds of Crime and Terrorist Financing (dated 2001), as well as other local acts and subordinated regulations in this field. The Russian Code on Administrative Offences and the Russian Criminal Code set out strict administrative and criminal liabilities for failure to comply with anti-bribery and anti-money laundering rules, and provide various sanctions for corresponding violations, for entities and individuals. Therefore, potentially susceptible businesses, including those of franchisors and franchisees, are obliged to abide by these laws and the national law enforcement agencies are vigilant in monitoring compliance.

ix Dispute resolution

Generally, franchise-related claims, certain unfair competition conflicts and IP infringement disputes that involve the Russian market, or are targeted at Russia, tend to be litigated through local courts. The system of commercial courts has basically four instances: (1) the first instance courts, (2) the appellate courts, (3) the cassation courts, (4) the Russian Supreme Court. There is also a special Russian Intellectual Property Court operating as the court of first instance or court of cassation and empowered to hear IP-related cases and unfair-competition disputes. Franchising disputes may fall under the jurisdiction of the Russian IP Court at the cassation stage (third level).

Compared with other jurisdictions, Russia may be a jurisdiction to consider in terms of timing, costs, remedies and enforcement proceedings associated with dispute resolution. For example, it may take about six months for an IP infringement claim or contractual breach matter to reach the stage of the decision of the first instance court and then four months to accomplish the enforcement procedure, if it has not been appealed. Remedies can include preliminary and permanent injunctive reliefs, as well as monetary reliefs (e.g., statutory damages). To obtain statutory damages it is sufficient to prove the fact of the IP infringement having occurred. To obtain lost profits it is necessary to demonstrate: (1) the amount of the damages arising, (2) the method of calculation of the asserted damages, and (3) the nexus between the damages claimed and the illegal activities of the respondent. Cases may be settled at any stage of the civil procedure. Settlement agreement will be approved by the competent court if the agreed provisions do not affect the rights and legitimate interests of third parties. Attorneys' fees may be capped by the clients' respective lawyers and are recoverable from the losing party. If the case is being settled, the parties are free to allocate the attorneys' fees in whatever proportions they want. The general limitation period for the case to be brought to trial is three years and the same period applies for the commencement of the enforcement procedure, when the court decision becomes effective.

There has been rather a large number of noteworthy franchising disputes resolved in front of national courts. A few of them reached the Supreme Court, while many were concluded in the Russian IP Court. These conflicts concerned different issues, including the trademark grant and infringement, contract validity and termination, franchisees' non-compete obligations and non-performance of their financial obligations. In the majority of cases, franchisors prevailed in these civil actions.

Instead of resorting to litigation in local courts, the franchisee and franchisor can contractually agree on arbitration. Arbitration may be conducted in any jurisdiction and in any forum chosen by the parties. If there is no arbitration clause in the contract, the contract may not be submitted to arbitration. Russia is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (dated 1958) (the New York Convention). Hence, an arbitral award received from another jurisdiction that is a signatory to the New York Convention may be enforceable in Russia.

The local courts will also enforce orders granted by foreign courts. Indeed, a court judgment issued by another jurisdiction may be enforceable in Russia, provided that recognition and enforcement of the foreign court judgment is stipulated by the relevant international treaty, and to which Russia is a party, and federal law. Russia is a signatory to many multilateral and bilateral international treaties for recognition and enforcement of foreign judgments.

The Russian Civil (Commercial) Procedure Code provides certain formal or mandatory requirements for recognition and enforcement of foreign judgments. These include, *inter*

alia, the following significant aspects: (1) effectiveness of the court judgment under the law of the jurisdiction in the territory on which it has been issued; (2) compliance with the statutory three-year term for filing a motion for recognition and enforcement of the foreign court judgment; and (3) consistency of the foreign court judgment with Russian public policy. If these requirements are not met, a Russian court may refuse to recognise and enforce a foreign judgment.

In the absence of a relevant international treaty, a Russian court may recognise and enforce a foreign judgment on the basis of the international principle of reciprocity and comity (*comitas gentium*). Although not in the franchising sphere, there have been at least a couple of successful landmark cases in which foreign judgments were enforced on the basis of the *comitas gentium* principle in Russia.

Mediation is also available as an alternative method of dispute resolution. Franchising conflicts are rarely mediated in Russia.

VII CURRENT DEVELOPMENTS

The business of franchising is growing internationally and apparently will continue to develop, from both an economic and a legal perspective. There are a lot of attractive segments and unexplored areas of the global market where the franchising model will fit perfectly and integrate well, and the Russian market does not represent an exception to this pattern.

Indeed, the Russian legal system has already adapted to the global franchise practice and currently provides great, legitimate investment opportunities for market participants and their brands, technologies, trade secrets, systems, reputation and other assets. There have already been several packages of civil law amendments recently submitted, discussed and implemented by the government to 'close the gaps' in certain areas of national contract law, including franchise law. With these amendments in force, Russia is now welcoming new franchise business entrants to the country.

SAUDI ARABIA

*Melissa Murray*¹

I INTRODUCTION

The Kingdom of Saudi Arabia continues to prove very appealing to franchisors. Among the factors that encourage potential franchisors are its large population, residents' high income, ease of brand recognition and government support.

Saudi Arabia is the most populated country in the Gulf Cooperation Council (GCC) with a population of approximately 32 million people. Among those, an estimated 50 per cent are under the age of 25. The World Bank Group categorises Saudi Arabia as a 'high income' state, with a gross national income of US\$26,200 per capita.² According to the country's Central Department for Statistics and Information, its gross domestic product (GDP) at the end of 2014 was over US\$751 billion, with an annual increase of US\$1,307 in GDP per capita per year over the past 11 years.³ Additionally, Saudi Arabia's residents have an affinity for western brands, so the value of a brand's goodwill is preserved, if not enhanced, as it is introduced into the country. According to YouGov's BrandIndex, only one local brand makes the country's top 10 most popular brands in 2015.⁴ Finally, Saudi Arabia's government has incentivised local and foreign investment within the country to facilitate a nation-wide economic shift from reliance on oil revenues to other sources of income. The government supports the private sector, and has issued billions of dollars in capital to a 'credit bank' to provide national investors with 'long-term loans at very low interest rates'.⁵

Local statistics show that Saudi Arabia's franchise sector is expected to grow up to 12 per cent on average per year, and reports indicate that paid fees and royalties exceeded US\$323 million in 2014.⁶ The food and beverage sector has proven very successful, while the retail sector continues to gain popularity. It must be noted that franchising opportunities within Saudi Arabia are not limited to foreign brands. The past few years have seen an increase in the number of local concepts being franchised within Saudi Arabia, among them the Al Baik fast-food restaurant chain, which has expanded to 50 locations in five cities.

1 Melissa Murray is a partner at Bird & Bird (MEA) LLP.

2 World Bank Group, 'Doing Business: Ease of Doing Business in Saudi Arabia' (revised in 2015), available at: www.doingbusiness.org/data/exploreconomies/saudi-arabia/.

3 Arab News, 'KSA population is 30.8 m; 33% expats' (31 January 2015), available at: www.arabnews.com/news/697371.

4 YouGov BrandIndex, '2015 – Mid-Year Rankings: Saudi Arabia Top Buzz Rankings' (January 2015), available at: www.brandindex.com/ranking/saudi-arabia/2015-mid/top-buzz-rankings.

5 Samir Ali, 'Franchising's Appeal: Market Growth in Saudi Arabia', *Franchising World* (November 2008), available at: www.franchise.org/franchising%E2%80%99s-appeal-market-growth-in-saudi-arabia.

6 US Department of State, Bureau of Economic and Business Affairs, '2014 Investment Client Statement – Saudi Arabia' (June 2014), available at: www.state.gov/e/eb/rls/othr/ics/2014/230692.htm.

II MARKET ENTRY

i Restrictions

There are a few legal restrictions on local and foreign franchisors in Saudi Arabia. Franchisors, franchisees and developers are subject to foreign investment laws. Pursuant to the Economic Agreement between the GCC States, nationals of other member countries of the GCC⁷ are not considered 'foreign investors' under the law, therefore the Saudi franchise market is permeable to foreign brands operating with non-Saudi but 'GCC nationals'.

For those franchisors looking to set up their own official business, or for franchisees looking to trade direct in Saudi, restrictions on foreign investment vary according to how the activity is classified. The Saudi Arabian General Investment Authority's (SAGIA) requirements also depend on the classification. Non-GCC investors wishing to engage in 'service-based' activities have the option of establishing a local branch office or 100 per cent owned limited liability company (LLC). For entities engaged in service-based activities, such as restaurants and maintenance operations, no minimum paid-up capital is imposed by SAGIA. Non-GCC investors wishing to engage in 'trading-based' activities have to (1) establish an LLC with at least 25 per cent of the company owned by a Saudi national or company; (2) hire and train Saudi nationals to make up 15 per cent of their employees; and (3) restrict their activity to one store per district. SAGIA imposes a minimum capital requirement of around 27 million Saudi riyals for such companies – 20 million Saudi riyals of which is imposed on the foreign investor as a minimum contribution. This figure is only imposed on the company's non-Saudi shareholders. Note in mid to late 2015 there were discussions within the Saudi legislature on potentially reducing this 25 per cent figure.

Foreign investors may also set up local manufacturing facilities that manufacture and distribute products to franchisees within Saudi Arabia. SAGIA imposes a minimum share capital requirement of 1 million Saudi riyals for such entities.

Certain activities such as oil exploration, drilling and production, manufacturing civilian explosives and security services are restricted to Saudi nationals.⁸

ii Foreign exchange and tax

Although there is no exchange control in Saudi Arabia, transactions are generally made in Saudi riyals. Saudi Arabia has a corporate tax and *zakat* (Islamic wealth tax), but no individual income tax.

As with most countries, tax depends on the entity's structure. *Zakat* is set at the flat rate of 20 per cent, and is obligatory for all legal persons who make any payments to foreign individuals. Additionally, a withholding tax of 5 to 20 per cent is imposed on companies engaging in specific activities.

III INTELLECTUAL PROPERTY

i Brand search

Trademark searches, including company name registrations, are made in the trademark office at the Ministry of Commerce and Industry (MOCI).

7 GCC member countries consist of: Saudi Arabia, Qatar, the United Arab Emirates, Bahrain and Oman.

8 SAGIA Business Center list of businesses prohibited for foreign investments, available at: www.sagia.gov.sa/Documents/Download%20center/Business_not_permitted.pdf.

ii Brand protection

The MOCI allows the registration of distinctive marks that are not contrary to shariah (Islamic) law and are not names of geographic locations. In cases of globally recognised brands, only a rightful owner or their authorised representative can register their trademark in Saudi Arabia. Saudi Arabia operates on a 'first to register' basis, giving priority and ownership to the first legal person to register the mark.

To register a trademark for a franchise, the owner of the mark or an authorised representative must submit an application that sets out a list of the goods or services and their class, along with a copy of the mark's foreign registration certificate. Each class of goods and services requires a separate application. The MOCI generally decides whether a trademark is granted within 60 days of filing. The MOCI notifies the applicant if it requires changes to be made to the application. The applicant is then given 90 days to amend the application in accordance with the MOCI's instructions.

If approved, trademark protection is granted for a period of 10 years and may be renewed up to six months after the registration expires.

If the trademark application is not approved, the applicant can appeal the MOCI's decision with the MOCI within 60 days of the rejection date. If the MOCI rejects the appeal, then the applicant may appeal to the Board of Grievances, an independent administrative judicial commission, within 30 days of the date of the rejection being issued.

iii Enforcement

The MOCI and the Board of Grievances have enforcement authority over trademark infringement. Upon receiving evidence of possible counterfeiting activity, the MOCI conducts an investigation and passes its findings on to the Board of Grievances. The latter may then bring both civil and criminal claims against alleged perpetrators. If the trademark owner can prove the existence of an imminent need for protection, the Board has the authority to issue injunctions.

iv Data protection, cybercrime, social media and e-commerce

Privacy rights are protected under the Basic Law of Governance, which is essentially Saudi Arabia's constitution. The Basic Law of Governance generally prohibits the confiscation, delay, eavesdropping and surveillance of communications. Breaches of privacy or confidentiality are punishable offences under the Basic Law of Governance, and the non-breaching party may be awarded compensation for damage caused by such unlawful disclosure. Non-economic punitive measures, such as sanctions, may also be imposed on the breaching party.

Saudi Arabia does not have a specific code tailored towards data protection, but data protection is derived from other codes such as the Anti-Cyber Crime Law. The Anti-Cyber Crime Law protects 'information, commands, messages, voices and images' that are or can be 'saved, processed, transmitted or constructed by computers'.⁹ Breaches of the Anti-Cyber Crime Law can result in fines of over US\$800,000 and prison sentences of up to four years. In the absence of any relevant legislation, courts will apply relevant shariah law principles, which place a high value on privacy.

⁹ KSA Bureau of Experts at the Council of Ministers, Anti-Cyber Crime Law (August 2010), available at: <https://www.saudiembassy.net/announcement/announcement03260701.aspx>.

IV FRANCHISE LAW

i Legislation

Saudi Arabia does not currently have a law that specifically governs franchising, but the MOCI has issued Commercial Agency Regulations that govern the principal agent relationship between a franchisor and a franchisee. The Commercial Agency Regulations also set out the procedure for registering a franchise in Saudi Arabia, as well as the rights and obligations of all involved parties.

ii Pre-contractual disclosure

Under shariah law, parties must deal in good faith and fully disclose all material facts to each other. Parties may seek judicial remedies if a party is alleged to have failed to disclose or fraudulently disclosed any pertinent facts and the other party sustained damage from the disclosure or non-disclosure.

iii Registration

Within six months of effecting a franchise agreement, the franchisee must register the agreement with the MOCI. Non-Saudi nationals, including GCC nationals may not register franchises or agencies – only Saudi national legal persons are permitted to do so.

The MOCI requires the following documents to register a franchise agreement:

- a* a standard application;
- b* a certified Arabic translation of the agreement, as well as all other foreign-language documentation;
- c* a copy of the franchisee's commercial registration and chamber of commerce certificate; and
- d* a declaration, in writing, that the franchisee's capital is Saudi-owned and its authorised representative is a Saudi national.

Franchise agreements must be registered with the MOCI to be recognised and enforceable under the Saudi agency law and therefore consideration should be given as to whether this is in the interests of the various parties. There is an element of local protectionism in this registration requirement. Registration of an exclusive agreement offers greater protection to franchisees, as it prevents the franchisor from appointing another franchisee upon termination of the franchise agreement. Franchisor and franchisee must resolve all their pending issues, such as mutually acceptable remuneration, before the franchisor is allowed to appoint legally another franchisee.

iv Mandatory clauses

While a franchise agreement does not have to follow a specific template, it must include the following elements for the agreement to be enforceable under Saudi law:

- a* the agreement must be executed directly with the franchisor in the franchise's country of origin;
- b* each party's rights and obligations must be explicitly set out;
- c* each party's obligations to the consumer must be stated;
- d* each party's capacity and nationality must be stated;
- e* the subject of the franchise must be stated;
- f* the services, works and goods covered by the franchise must be stated;

- g* the territory must be specified;
- b* the duration of the agreement and the terms of renewal must be stated;
- i* the termination procedure must be stated; and
- j* the agreement must establish that any dispute will be settled according to Saudi arbitration law.

v Guarantees and protection

Franchise agreements generally include guarantees. Guarantees are enforceable depending on their level of conformity with the elements of shariah law. Guarantees may be enforceable against entities, and personal guarantees may be enforceable against individuals.

V TAX

i Franchisor tax liabilities

Saudi and GCC national franchisors are exempt from corporate tax. Instead, they pay *zakat* at the rate of 2.5 per cent. Non-Saudi and non-GCC nationals must pay a flat corporate tax at the rate of 20 per cent. If a company has GCC national shareholders as well as non-GCC shareholders, the GCC nationals would be responsible for *zakat* at the rate of 2.5 per cent on their interest in the company and non-GCC shareholders would be responsible for a 2 per cent corporate tax on their interest. A franchisor who is a Saudi resident individual or company must declare and pay withholding tax on payments made outside Saudi Arabia. Payments to non-residents are subject to a withholding tax of 5–20 per cent, depending on how they are classified. For payments outside Saudi Arabia, franchisors will be subject to a 5 per cent withholding tax.

ii Franchisee tax liabilities

Individual franchisees are not subject to tax obligations while franchisee entities will be subject to corporate tax or *zakat*. As with franchisors, GCC national franchisees will be subject to a 2.5 per cent *zakat*, while non-GCC franchisees will be subject to a 20 per cent corporate tax. These same flat tax rates apply to companies with GCC national shareholder and non-GCC shareholders respectively.

Franchisees will be subject to a withholding tax of 5 to 20 per cent on payments made to non-residents. Payments to the foreign franchisor, the head office or an affiliated company located outside Saudi Arabia are subject to a 15 per cent withholding tax. The franchisee must declare and pay the withholding taxes.

Saudi Arabia has no personal income tax, so individual franchisees will have no personal tax liability. They will, however, be required to pay *zakat* at the rate of 2.5 per cent.

VAT is in the process of being implemented in Saudi Arabia, with an anticipated start date of 1 January 2018 and set at a rate of 5 per cent, with a limited number of exemptions for certain items related to education and healthcare, and basic food items.

iii Tax-efficient structures

The Saudi Arabian government provides tax incentives to companies that establish entities in designated economic areas. Additionally, Saudi Arabia has tax treaties with China, Japan, Russia and the United Kingdom, among others, that may be channelled for tax incentives for foreign franchisors and franchisees.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Good faith dealings are deeply rooted in Saudi Arabia's moral code and practices. Saudi courts can hear cases where one or more parties did not behave in good faith. Courts will look to the intent of the party in question to amend or enforce agreements. To avoid allegations of having acted in bad faith, parties must set out their terms, rights and obligations explicitly, clearly and to a full extent.

ii Agency distributor model

As franchising in Saudi, under Saudi law, is governed by the Commercial Agency Regulations, it is regarded as a commercial agency. The franchisor–franchisee relationship is treated as a principal agent relationship with a key difference being that the franchisor is generally not vicariously liable for any torts that the franchisee commits unless the former is shown to have exercised direct control over the franchisee's everyday operations.

iii Employment law

Saudi law generally does not view a franchisor–franchisee relationship as an employment relationship, unless the franchisor is shown to have exercised direct control over the franchisee's day-to-day operations.

iv Consumer protection

The franchisee cannot claim any consumer protection rights as they are deemed to be the franchisor's agents.

In terms of protecting consumers, Saudi Arabia's Commercial Agency Regulations place an obligation on the franchisee to maintain their products at a reasonable cost, and to ensure that spare parts are available at reasonable prices throughout the term of the franchise agreement and up to one year thereafter. Franchisees must keep stock of integral spare parts, while spare parts that are not in stock must be made available to the consumer within 30 days of the latter's request. The franchisee is held to the same warranty periods that the franchisor provides, therefore the franchisor has an obligation to provide spare parts and necessary support to franchisee for the term of their agreement and for one year thereafter.

v Competition law

Saudi Arabia introduced a Competition Law in 2004 to facilitate fair competition and stimulate the economy by preventing the formation of monopolies. The Competition Law allows the market forces to decide prices of goods and services, which essentially gives the consumer more bargaining power.

vi Restrictive covenants

Saudi Arabia recognises restrictive covenants. Courts may enforce covenants, such as non-compete clauses, if they are provided for in the franchise agreement and so long as they represent the parties' intent and are in accordance with shariah law. Parties may restrict each other from conducting substantially the same business with third parties, and may also agree to geographic restrictions.

vii Termination

In the event of any disputes leading to or following termination, Saudi courts will refer to the agreement, the intent of the parties and whether the clauses are compliant with shariah law and all other relevant regulations. If disputes arise, the MOCI will not permit a new franchisee to register a new franchise agreement with the franchisor until the dispute is settled either by the parties or through the courts. Courts may issue an order to deregister the franchisee from the Commercial Agency Register if they find in favour of the franchisor. They may also award direct damages but are hesitant to award any indirect or consequential damages to either party.

viii Anti-corruption and anti-terrorism regulation

Corruption, bribery, manipulation, embezzlement, unlawful enrichment and money laundering are criminal offences in Saudi Arabia. Saudi Arabia has elected Nazaha, the National Anti-corruption Commission, whose aim is to eliminate corrupt practices and bribery. Additionally, an Anti-Bribery Law was introduced to combat the making or receiving of bribes.

ix Dispute resolution

Parties are free to select their means of dispute resolution. They can opt for their choice of governing law and jurisdiction. The Board of Grievances in Saudi has jurisdiction over franchising disputes for those disputes not referred to international or local arbitration.

Traditionally, parties have selected the Board as their redress, but arbitration clauses have become more common given that local arbitration regulations were enacted in 2012. Franchisors may prefer arbitration as an alternative to the Board, as the latter has been known to enforce its subjective interpretation of shariah law. Furthermore, the Board rarely, if ever, cites precedent cases, meaning the parties lack foresight as to the outcome of a hearing. Another worry for franchisors is that the Board may also exercise protectionism towards Saudi-national franchisees. An issue with arbitration is how or whether the Board will enforce awards. Despite the fact that Saudi Arabia is a party to the New York Convention and the Washington Convention, the Board has broad authority to dismiss arbitral awards. Foreign awards are subject to the same enforcement issues. In general, foreign judgment and arbitral awards may be enforced if the following conditions are met:

- a* jurisdiction: the Saudi courts do not have jurisdiction to hear the original matter decided by the foreign court, and the foreign court has the jurisdiction to adjudicate the matter and issue judgment;
- b* due process: the parties to the litigation are afforded their due process and (1) issue a summons and complaint; (2) are adequately represented; and (3) are able to defend themselves;
- c* reciprocity: there is reciprocity between the foreign jurisdiction that issued the judgment and Saudi Arabia to enforce each other's judgments. This is typically done through a treaty. The absence of such a treaty may not bar an enforcement action;
- d* consistency: the judgment being enforced does not contravene a judgment issued by a Saudi court or other governing body on a similar matter;
- e* finality: the foreign court's decision is final and binding and not subject to further appeal; and
- f* public policy: the judgment does not violate Saudi law or public policy.

VII CURRENT DEVELOPMENTS

While there continue to be talks of franchise-specific legislation, and a draft was circulated in 2017 for comment, no progress has been reported on the matter. Such legislation could see a hike in demand for franchising in Saudi Arabia, as potential franchisors may feel more at ease knowing that they are offered protection under a law specifically tailored to franchising.

Saudi Arabia now also allows goods to be imported by franchisees that have not registered their franchise agreements, and non-exclusive agreements can be registered at the MOCI.

SINGAPORE

Lorraine Anne Tay and Just Wang¹

I INTRODUCTION

Singapore is an attractive market for franchisors as it is an open economy with one of the most liberal trading regimes in the world. As of 2012, Singapore was estimated to have more than 600 franchise concepts and more than 40,000 franchisees, with the majority of them in the food and beverage, retail, business services and health-care industries.

The franchising and licensing industry accounts for 18 per cent of Singapore's total domestic retail sales volume, and generates a turnover of about S\$6 billion. In 2013, its estimated GDP contribution was 1.6 per cent of Singapore's GDP, and this is projected to expand rapidly to about 3 per cent by 2017.² In 2013, the nominal value added in these sectors was S\$5.1 billion and S\$3.3 billion respectively, with the franchising industry alone accounting for approximately S\$1 billion.³

The Franchising and Licensing Association of Singapore (FLA) serves as Singapore's national franchise body and seeks to promote and facilitate the growth of franchising both locally and abroad. Companies may choose to become members of the FLA. The FLA has released a Code of Ethics, which is binding only upon FLA's members.

Foreign franchises are warmly welcomed in Singapore and account for the bulk of franchise sales in the country. The United States is the dominant supplier of foreign franchises in Singapore. Australian franchises, as well as Japanese and Taiwanese franchises, primarily in the food and beverage industry, also enjoy a degree of presence in Singapore; however, with support from the local government as well as industry-led efforts, local players have grown rapidly in recent years, particularly in the food and beverage, child-related and training industries.

II MARKET ENTRY

i Restrictions

Singapore attracts many foreign franchises mainly because of its liberal, pro-business policies. Except in a small number of product areas, Singapore does not generally impose restrictive

1 Lorraine Anne Tay is a partner and Just Wang is an associate at Bird & Bird ATMD LLP.

2 Speech by Mr Teo Ser Luck, Minister of State for Trade and Industry, at the opening ceremony of Franchising & Licensing Asia 2013, 3 October 2013. See: www.news.gov.sg/public/sgpc/en/media_releases/agencies/mti/speech/S-20131003-2.

3 Opening address by Mr Teo Ser Luck, Minister of State for Trade and Industry, at the opening ceremony of Franchising & Licensing Asia 2014, 16 October 2014. See: <https://www.mti.gov.sg/NewsRoom/Pages/Mr-Teo-Ser-Luck-at-the-Opening-Ceremony-of-Franchising-and-Licensing-Asia-2014.aspx>.

trade or investment policies on foreign franchises. For example, foreign franchisors are not required to enter into private or official joint ventures, and do not need to relinquish management control to local entities. In addition, Singapore does not restrict foreign ownership of businesses and does not impose foreign exchange controls or taxes on capital gains on foreign franchisors.

ii Foreign exchange and tax

In Singapore, franchisees are not required to comply with any formalities nor seek any approval from any authority when paying royalties to a franchisor. Franchisees are also free to convert royalties to foreign currency for payment to a foreign franchisor, but local franchisees must pay withholding taxes to the Inland Revenue Authority of Singapore (IRAS) on royalties payable to a non-resident franchisor at the prevailing withholding tax rate of 10 per cent subject to variation by virtue of any avoidance of double-taxation agreement (DTA) between Singapore and the home country of the franchisor.

III INTELLECTUAL PROPERTY

i Brand search

Before a franchisor or franchisee enters the local market to seek to establish itself as a brand in Singapore, it should first conduct relevant searches to ensure that there are no conflicts with, or similarities to, existing brands. The following are the most important searches to be conducted.

Trademark searches

To minimise risk of infringement, franchisees should search the local trademark registry, administered by the Intellectual Property Office of Singapore (IPOS), for any existing registered or pending trademarks that could be in conflict with the franchisor's brand; however, such searches are not exhaustive as the local registry only has records of pending or registered trademarks. Unregistered trademarks are not reflected on these records and the owner of an unregistered trademark may be able to lodge an objection with IPOS against the franchisor's application for a trademark if the application mark is similar to the unregistered trademark. Further, unregistered trademarks are protected under the common law in Singapore and the owner of an unregistered trademark may be able to bring a civil action in passing-off against any person using a similar trademark.

Business and company name searches

The Accounting and Corporate Regulatory Authority of Singapore (ACRA) maintains a database of businesses and companies registered or incorporated in Singapore. A franchisor or franchisee intending to incorporate a company in Singapore to conduct its franchising business in the country must first reserve with ACRA a valid company name that does not conflict with an existing company name or any business name prohibited by law. ACRA usually takes two business days to approve a name reservation application, as it conducts its own conflict checks on the proposed company name.

Domain name searches

It is good practice to ensure that the desired domain names are available for registration by conducting domain name searches. Even though a particular domain name may be available for registration, that domain name may nevertheless be similar or identical to an existing registered or unregistered trademark. Cybersquatters often register domain names that are also popular trademarks or variants of popular trademarks. Trademark owners typically seek to enforce their rights against cybersquatters by alleging that those domain names were registered in bad faith. Such domain name disputes are usually resolved using the Uniform Domain Name Resolution Policy process developed by the Internet Corporation for Assigned Names and Numbers.

Copyright due diligence

Copyright generally automatically subsists upon creation of a work. There is no requirement for copyright to be registered and no registration system for copyright in Singapore. It is important, therefore, to conduct due diligence checks to ensure that the necessary copyright clearances, licences or assignments have been obtained with respect to any source materials used in the franchise's marketing and promotional materials.

Patent searches

A registered patent grants the patent holder the exclusive right to prevent others from making, using, importing or selling the patent without his or her permission. Therefore, use of a patent without the patent holder's permission could amount to patent infringement. To minimise the risk of infringement, franchisors and franchisees should carry out proper due diligence when engaging in business that involves inventions or new technology. To determine if a particular invention is protected by a patent, franchisors and franchisees can search the local patent registry administered by IPO, or engage a qualified patent attorney.

ii Brand protection

Trademark registration

There is no time limit for registering any trademark, therefore a trademark may be used by the owner without the need for registration; however, registration of a trademark confers a wider scope of protection on the trademark.

There are a number of advantages in owning a registered trademark. Unless a trademark is registered, the trademark owner cannot bring an action for registered trademark infringement or seek relief under the Trade Marks Act. A claim for infringement of a registered mark is generally easier to establish than a claim under the common law tort of passing-off. The registration of the trademark also serves as a notice to the public of the ownership of the 'proprietor' and interest and rights in the trademark, and potential competitors who conduct trademark searches will be alerted that the registered trademark is not available for their use. In addition, using a mark that is registered also serves as a defence against trademark infringement claims from proprietors who may allege that their trademarks are similar to the mark.

The process to apply for registration of a trademark in Singapore is fairly straightforward. An applicant is permitted to file for several classes of goods or services within the same

application. The applicant may also designate Singapore through the Madrid Protocol (an international registration system of marks administered by the International Bureau of the World Intellectual Property Organization), to which Singapore is a signatory.

Where an earlier claim for the same trademark has already been filed in another Paris Convention country or a World Trade Organization member country, there is a priority claim procedure in place in Singapore. The Singapore application must be filed within six months of the date of the first filing.

Typically, an application will be examined by IPOSS within about four to six months of the date that the application is filed. Thereafter, the applicant will be informed whether the application is in order for acceptance and publication, or if there are any objections to the application by third parties.

The trademark registration process is the same for both traditional trademarks such as word marks and logos, and non-traditional marks such as aspects of packaging, sound marks and shape marks. Franchisors may therefore also wish to expand the scope of protection of their brand by applying for the registration of both traditional and non-traditional trademarks.

Confidential information and trade secrets

Franchisors and franchisees should ensure that all parties who may have or have had access to confidential information or trade secrets have signed and are contractually bound by appropriate non-disclosure agreements that provide a sufficient scope of protection over the information.

iii Enforcement

Franchisees should ensure that they have obtained the necessary licences or assignments of intellectual property rights from the franchisor in accordance with the general intellectual property laws of Singapore. Failure to do so may attract civil or criminal sanctions.

Generally, the owner of the intellectual property may be entitled to take legal action against an infringing party by seeking relief in the form of an injunction to stop the infringing action, obtaining profits gained by the infringing party by virtue of the infringement, or seeking damages or compensation for loss suffered because of the infringement. In the event that an intellectual property infringement is committed deliberately and to a significant extent, this may attract criminal penalties such as a fine or imprisonment.

Generally, an exclusive licensee is entitled to bring infringement proceedings against any person in his or her own name, if his or her licence so provides. In such a situation, the exclusive licensee need not join the proprietor as a plaintiff in the action.⁴ However, for non-exclusive licensees, the right to enforce varies depending on the terms of the licence, as well as the governing law. For example, under the Trade Marks Act, a non-exclusive licensee is also entitled to bring infringement proceedings in his or her own name, unless the licence provides otherwise, but only if he or she has first called on the proprietor to institute infringement proceedings and the proprietor has refused or failed to do so within two months

⁴ Section 74 Patents Act, S. 45(2) Trade Marks Act and Section 124 Copyright Act.

of being called upon. In such a situation, the non-exclusive licensee must join the proprietor as a plaintiff in the action.⁵ Under the Copyright Act, however, a non-exclusive licensee has no right of action.⁶

iv Data protection, cybercrime, social media and e-commerce

Data protection

The Personal Data Protection Act 2012 (PDPA) came into force on 2 July 2014. While the PDPA regulates how organisations process the personal data of individuals, it is not intended to be overly burdensome.

In general, organisations may collect, use and disclose personal data solely with notice to and the consent of the individual. To obtain valid consent, the organisation must notify the individual of the purposes of the collection, use, or disclosure. The organisation must also limit its collection, use, or disclosure of personal data to purposes that would be considered reasonable in the given circumstances, and that the individual was notified by the organisation. If the organisation wishes to use personal data for new purposes, fresh consent must be obtained in respect of these new purposes.

An organisation may only transfer personal data to another country or territory in accordance with the requirements prescribed under the PDPA. This is to ensure that organisations abroad provide for a standard of protection that is equal or greater than that prescribed by the PDPA.

Under the PDPA, organisations that outsource the processing of data to a third party will be held responsible for the acts of that third party and should ensure that its contract with the third party requires the third party to comply with the requirements of the PDPA, whether locally or abroad.

Franchisees and franchisors have to ensure compliance with the requirements under the PDPA, as failure to comply with the PDPA amounts to an offence.

Cybercrime

On the other hand, there are some specific statutory laws that permit or require organisations to disclose data to law enforcement authorities, particularly where the disclosures relate to an offence. For example, under the Criminal Procedure Code of Singapore, depending on the suspected offence, law enforcement authorities may obtain a warrant to access certain decryption information for the purposes of investigation.

Additionally, the Computer Misuse and Cybersecurity Act seeks to protect computers, programs and stored data from unauthorised access, modification, interception and interference. The Computer Misuse and Cybersecurity Act is not technology-specific and defines ‘computer’ widely, thereby capturing offences committed in relation to cloud services or online platforms. Under the Computer Misuse and Cybersecurity Act, an aggrieved company may make a police report, which will then be investigated by the Technology Crime Division.

5 Section 44 Trade Marks Act.

6 *Alliance Entertainment Singapore Pte Ltd v. Sim Kay Teck and another* [2007] SGHC 43.

E-commerce

In relation to commercial communications, the Spam Control Act regulates the sending of unsolicited electronic mail in bulk. This may be relevant where an organisation's advertising or marketing strategy involves the sending of electronic messages in bulk to its recipients. The Spam Control Act prescribes certain requirements that may have to be met when unsolicited commercial electronic messages are sent. These requirements include the inclusion of an 'unsubscribe facility' or 'opt-out' function or mechanism, and labelling of the electronic message with '<ADV>' before the title in the subject field of the electronic message.

E-commerce is also regulated under the Electronic Transactions Act, which closely matches the provisions of the UN Convention on the Use of Electronic Communications in International Contracts signed and ratified by Singapore. The Electronic Transactions Act addresses issues that may arise specifically in the context of digital signatures and contracts that are entered into electronically.

In general, Singapore has well-developed laws that recognise and support electronic transactions, in recognition of the importance of technology and the internet as part of doing business. To keep pace with the developments in involving e-commerce, franchisors or franchisees should keep a lookout for any legal developments in this fast-moving industry.

Social media

While there is no legislation specifically and directly governing social media in Singapore, existing laws relating to data protection, cybercrime and e-commerce, as described above, will apply equally to the use of social media by organisations as part of the brand recognition and marketing strategy for their business.

Organisations would be prudent to take additional care when making use of social media. While the social media space continues to function in the traditional manner as an online 'phone book', thereby involving potential data protection and privacy issues, social media is also increasingly playing a dual role as a space for users to gather for the purposes of transacting and offering goods or services for sale, thereby effectively hosting an online marketplace where cybercrime and e-commerce issues may arise.

In August 2016, the Advertising Standards Authority of Singapore published the Singapore Code of Advertising Practice, which promotes high standards of ethics in advertising. This now addresses new advertising issues arising from online marketing platforms such as blogs, Facebook, Instagram, Twitter, etc. For instance, marketers cannot boost the user engagement of a website (e.g., the number of 'likes' on Facebook) through fraudulent means. Examples of fraudulent means include the purchase of bulk likes and creation of fake accounts. Marketers were required to have adhered to these guidelines by 29 September 2016.

IV FRANCHISE LAW

i Legislation

There is no separate jurisprudence or regime that relates specifically and solely to the context of franchising. The general laws of Singapore apply equally to franchise-related issues in Singapore.

The FLA, Singapore's national franchise association, has provided a Code of Ethics for franchising, binding only on FLA's members, and which contains provisions on disclosure

requirements, contracts regarding existing franchisees, proper selection of franchisees, provision of proper training and business guidance, standards of conduct, notice of breach, rights of termination and dispute resolution, among others.

Additionally, the general laws of Singapore apply to all franchisors and franchisees, regardless of whether they are members of the FLA, and may affect the enforceability of any franchise agreement.

Unfair Contract Terms Act

If any contractual terms are considered unfair under the Unfair Contract Terms Act, they will not be enforceable. Contractual terms are considered unfair if they exclude or restrict liability of any person for death or personal injury resulting from negligence. In the event of other losses or damage, it is also considered unfair if the contractual term provides for an unreasonable exclusion or restriction of liability for such loss or damage.

Misrepresentation under the common law

A franchise agreement may be rendered void on the grounds of misrepresentation under the common law; however, any false statement (whether innocently or fraudulently made) does not, by itself, give rise to a cause of action. It is an actionable misrepresentation only where the false statement has induced the other party to enter into the contract.

ii Pre-contractual disclosure

There are no pre-contractual disclosure regulations relating specifically to the context of franchising.

Apart from the common law rules against misrepresentation described above, which apply equally to franchise-related deals, the FLA's Code of Ethics also prescribes certain rules relating to pre-contractual disclosure.

For example, under the Code of Ethics, FLA's members are prohibited from offering, selling or promoting the sale of any franchise, product or service by means of any explicit or implied representation that has a tendency to deceive or mislead prospective purchasers of such a franchise, product or service.

The Code of Ethics also requires the investment requirements of a franchise to be set out in a detailed and specific manner to avoid being misleading. Additionally, the franchisor is required under the Code of Ethics to disclose to the franchisee at least seven days prior to the execution of the franchise agreement its current operations, the investment required, performance records and any other information reasonably required by the franchisee that is material to the franchise relationship.

iii Registration

Franchises and franchise agreements

There are no requirements in Singapore for franchises or franchise agreements to be registered. However, companies may choose to become registered members of the FLA, in which case they will be required to abide by the FLA's Code of Ethics.

Trademarks used in the franchise

Although there is no mandatory requirement to register any trademarks used in the franchise, it is advisable for the franchisor to do so. The various advantages of obtaining trademark

registration have already been discussed (see Section II.ii). More specifically, the trademarks embody the brand in the franchise system, and go a long way in creating the value of the system. Trademarks therefore form one of the key assets of any franchise system and as such would be closely scrutinised by the potential franchisees of the system.

Trademark licences

It is not compulsory for trademark licences to be recorded. However, it may be advantageous for franchisees or licensees to register a trademark licence with IPOS. Such a record serves as *prima facie* evidence of the grant of the licence. Additionally, a record of the trademark licence serves to put third parties on notice of the existence of the licence and the licensee's interest in the licensed mark. The Trade Marks Act provides for a presumption such that once a trademark licence is entered in the register, every person is deemed to have notice of it.

iv Mandatory clauses

Under general Singapore laws, there is no requirement for mandatory clauses to be included in franchise agreements, and parties are free to negotiate the terms of the deal.

The FLA's Code of Ethics, binding only on members of the FLA, contains certain requirements relating to the clauses in the franchise agreement. For example, a franchise agreement may be terminated only if there is a good cause, which includes the failure of a franchise to comply with any lawful requirements of the franchise agreement.

v Guarantees and protection

Guarantees from individuals and companies to the franchisor are generally enforceable. Under such a guarantee, the guarantor's liability is defined as having to procure that the franchisee performs its obligations, as well as having to perform him or herself if the franchisee fails to do so; however, it is not common practice for local franchisors to require a guarantee, except for in exceptional cases where the franchisor may have reservations about the franchisee's finances or ability to operate the franchise.

V TAX

i Franchisor tax liabilities

Franchisors (and franchisees) may choose to operate in any of the following business structures, among others, and must pay income tax as follows:

- a* sole proprietorship: a sole proprietor carries on business on his or her own behalf and is essentially self-employed (sole proprietors must pay income tax on their profits);
- b* partnership: profit and loss will be shared equally among partners and each partner will be taxed at personal income tax rates in each individual partner's name;
- c* limited liability partnership (LLP): each partner will be taxed on his or her share of the income from the LLP (where the partner is an individual or a company, its share of the income from the LLP will be taxed at the personal income tax rate or the tax rate for companies respectively); and
- d* company: regardless of whether it is a local or foreign company, a company is taxed at a flat rate on its chargeable income.

The Singapore government also offers numerous tax incentives and benefits to businesses as part of its pro-business economic strategy. For example, Singapore adopts a flat, single-tier corporate system that is often regarded as one of the most business-friendly in the world. Under the single-tier corporate tax system, tax paid by a company on its chargeable income is the final tax, and all dividends paid by a company are exempt from tax in the hands of the shareholders.

ii Franchisee tax liabilities

In addition to applicable income taxes, local franchisees must pay withholding taxes to the IRAS on royalties payable to a franchisor that is not resident in the country.

The prevailing withholding tax rate is 10 per cent and can be varied depending on the mutual DTAs between Singapore and the home country of the franchisor. Singapore is a party to comprehensive agreements for the avoidance of double taxation with numerous countries worldwide, including China, France, Germany, India, Italy, Japan, the Russian Federation, South Korea, Switzerland, the United Arab Emirates and the United Kingdom; and has limited treaties with countries such as Hong Kong and the United States.

iii Tax-efficient structures

There is no single most tax-efficient structure for a franchisor or franchisee. Much depends on the scope and level of operations of the franchise and, depending on the particular business entity, operational arrangements and corporate or investment structure that the organisation has adopted, the various tax and deductibility rules that the business can utilise to its advantage. Therefore, seeking professional tax advice to properly plan a business's financial and tax structures is recommended.

VI IMPACT OF GENERAL LAW

i Good faith

In Singapore, good faith has no general application in commercial relationships that are governed by the terms of a contractual agreement. Accordingly, franchisors and franchisees do not have an implied duty to act in good faith by virtue of the franchise agreement executed by them.

In the case of *Ng Giap Hon v. Westcomb Securities Pte Ltd*,⁷ the Court of Appeal held that the doctrine of good faith is very much a 'fledgling doctrine' in Singapore contract law, and therefore did not endorse an implied duty of good faith in commercial contractual relationships. The Court also found it unnecessary to imply a duty of good faith, on the principle that judges should not rewrite contracts based on their own sense of justice.

However, Singapore courts have upheld contracts that contain an express duty to negotiate in good faith in the recent case of *HSBC Institutional Trust Services (Singapore) Ltd (Trustee of Starhill Global Real Estate Investment Trust) v. Toshin Development Singapore Pte Ltd*.⁸ In so doing, the court also considered the public interest and broader impact of upholding a principle of good faith in contracts, and held:

7 [2009] 3 SLR (R) 518.

8 [2012] SGCA 48.

In our view, there is no good reason why an express agreement between contracting parties that they must negotiate in good faith should not be upheld. [. . .] Indeed, we think that such 'negotiate in good faith' clauses are in the public interest as they promote the consensual disposition of any potential disputes. We note, for instance, that it is fairly common practice for Asian businesses to include similar clauses in their commercial contracts [. . .] We think that the 'friendly negotiations' and 'confer in good faith' clauses [. . .] are consistent with our cultural value of promoting consensus whenever possible. Clearly, it is in the wider public interest in Singapore as well to promote such an approach towards resolving differences.

Therefore, where a franchise agreement governed by Singapore law expressly provides for a duty of good faith to operate, this duty is likely to be upheld and enforced by the Singapore courts. It is worth noting, however, that the Singapore Court of Appeal recently acknowledged in *The One Suites Pte Ltd v. Pacific Motor Credit (Pte) Ltd*⁹ that 'the law in this particular sphere (viz. good faith) continues to be in a state of flux'. After briefly examining recent decisions in other common law jurisdictions, the Court of Appeal stated that 'the question as to whether or not there is a duty on the part of the parties to cooperate and, if so, what its scope is and what its relationship is to doctrines such as good faith, are all matters that ought best to be decided in a definitive fashion only when they next come directly for decision before the courts'. Therefore, franchisors or franchisees who may be affected should continue to look out for legal developments in this area.

ii Agency distributor model

Agency

The general practice in Singapore is for the franchise agreement to expressly state that the parties are independent contractors and are not to be treated as being an agency relationship. Franchisees typically do not operate as agents, as they generally trade in their own name, obtain income for their own account and are ultimately and directly responsible for any goods or services supplied or sold.

Distributorship

Franchising is distinct from a distributorship arrangement because the former does not involve parties being considered as 'seller' or 'buyer' in the business relationship. Typically, franchisees are required to pay royalties for franchising rights. This contrasts with a distributorship relationship, in which the distributor's profits arise from the difference between the cost of manufacturing or obtaining the goods and the price at which the goods are sold.

iii Employment law

There are no reported cases to date where the franchisor–franchisee relationship has been treated as an employment relationship by the courts. However, franchisors may be held liable for the acts of franchisees on the basis of vicarious liability.

Generally, the courts will look at the franchisor's degree of control over the franchisee's business operations, products or supply of services, the extent to which customers are led to believe that the franchisor was responsible for or warrants the quality of the franchisee's goods or services, and the tangible financial or promotional benefits accruing to the franchisor. It

9 [2015] SGCA 21.

would therefore be prudent for franchisors to select their franchisees with care, maintain proper quality controls and provide for such controls in the franchise agreement, obtain appropriate insurance and seek indemnification from the franchisee in the franchise agreement.

iv Consumer protection

The provisions of the Multi-Level Marketing and Pyramid Selling (Prohibition) Act may apply to franchises. This statute was enacted in 1973 to prohibit objectionable features of pyramid selling. However, certain classes of schemes, such as master franchises, are exempted provided they satisfy certain conditions set out in the Multi-Level Marketing and Pyramid Selling (Excluded Schemes and Arrangements) Order.

Examples of these requirements, in relation to a master franchise arrangement or any arrangement where a person is given the right to sub-franchise a franchise, include the following:

- a* The benefits received by any person under the arrangement may not be a result of, or promoted to result from, the introduction or recruitment of other persons to be participants in the arrangement.
- b* Promoters of the arrangement may not knowingly make any misleading representation, omit any material particular relating to the arrangement or engage in conduct that is misleading to any material particular relating to the arrangement, and the promoter may not use fraud, coercion, harassment or other unconscionable means to promote the arrangement.

v Competition law

The Competition Act came into force in 2005 and has retrospective effect, applying equally to all agreements made before the effective date of the Act or the relevant provisions. In general, the Competition Act prohibits any agreement that has the object or effect of preventing, restricting or distorting competition within Singapore. Therefore, a franchise agreement will be rendered void to the extent that the franchise agreement prevents, restricts or distorts such competition.

Practices that may be considered anticompetitive include:

- a* directly or indirectly fixing prices of goods;
- b* limiting or controlling markets, technical development or investment;
- c* imposing different conditions to equivalent transactions with other trading partners such that one partner receives a competitive disadvantage; and
- d* subjecting the conclusion of a contract to supplementary obligations that have no connection with the subject matter of the contract.

The Competition Act provides certain exemptions to and exclusions from the strict application of the provisions in the Competition Act. If a franchise agreement meets all the criteria required for an exemptions or falls within any exclusions, it can be exempted from compliance with the Competition Act requirements.

vi Restrictive covenants

As a general rule, unreasonable restraint of trade clauses are against public policy and therefore void and unenforceable under Singapore law. In determining whether a restraint of trade clause is enforceable, the Singapore court will typically take into consideration the duration, extent, scope and nature of restraint, including the duration and geographical boundary of

the restriction compared with the term of the franchise agreement and the territory granted to the franchisee. Franchisors should therefore take extra care and diligence in crafting the parameters of a restrictive covenant to ensure that any restrictive clauses are reasonable and are necessary to protect the legitimate interests of the franchisor so as to avoid falling foul of public policy.

vii Termination

Restrictive covenants that place restrictions on the franchisee upon termination of the franchise agreement are subject to principles similar to those that apply to restrictive covenants in general, as described above.

viii Anti-corruption and anti-terrorism regulation

The general laws of Singapore relating to fraud, anti-corruption and money laundering, such as the statutory prohibitions in the Prevention of Corruption Act and the Penal Code, apply equally in the franchising context. There are no such laws specifically relating to franchises.

ix Dispute resolution

Dispute resolution mechanism

The FLA's Code of Ethics provides that a franchisor is required to make every effort to resolve disputes with its franchisees with good faith and goodwill through fair and reasonable direct communications and negotiation. If the franchisor and franchisee are unable to resolve the dispute by mutual negotiation, the parties shall seek to have the dispute resolved through conciliation, failing which the dispute may be resolved by whatever means agreed between the parties, whether by arbitration or litigation.

Apart from the Code of Ethics, which is binding only on FLA members, parties to franchise deals are free to opt to resolve disputes by voluntary mediation, arbitration or litigation. Where the deals involve foreign entities, arbitration may be a more favourable option depending on the ease of enforcement of arbitral awards in the country in which the foreign entity or its assets are located.

Many franchise agreements include an arbitration clause instead of resorting to court action immediately. From the franchisor's point of view, arbitration proceedings are valuable as they offer parties a private forum to settle disputes while maintaining confidentiality and privacy over any differences that may tarnish the image and goodwill of the franchise or the parties involved. Further, this confidentiality is desirable to the franchisor so that any decision or settlement reached will not form a precedent for future reference by its other franchisees.

Enforcement of foreign arbitral awards in Singapore

Singapore acceded to the New York Convention of 1958 and subsequently re-enacted most of its provisions in Part III of the International Arbitration Act of Singapore. As a result, Singapore is bound by international law to recognise arbitral awards made in countries that are also signatories to the New York Convention.

Additionally, as Singapore belongs to the Commonwealth of Nations, it has enacted the Reciprocal Enforcement of Commonwealth Judgments Act (RECJA). Therefore, Singapore will recognise judgments made in the United Kingdom, jurisdictions that are part of the Commonwealth and other countries with which Singapore has reciprocal arrangements to

mutually recognise and enforce judgments. Generally, an arbitral award from each of these countries will be enforceable in Singapore under the RECJA only if the award has become enforceable in that country in the same manner as a judgment given in its own courts.

The Singapore International Commercial Court

The Singapore International Commercial Court (ICC) was launched on 5 January 2015.

The ICC seeks to build on the existing success of Singapore as a global arbitration hub, and further boost Singapore as a leading centre for international commercial dispute resolution. As a specialised commercial court, the ICC offers litigants the option of having their disputes adjudicated by a panel of experienced judges comprising specialist commercial judges from Singapore and international judges from both common law and civil law jurisdictions. The ICC offers a well-designed court-based mechanism that will enable parties to avoid several problems that may be faced in international arbitration proceedings; for instance, the absence of appeals and the inability to join third parties in arbitration. On the whole, the ICC potentially offers franchisors and franchisees a further reliable and reputable option if they are seeking to have their disputes resolved in Singapore.

VII CURRENT DEVELOPMENTS

In July 2014, the FLA launched new membership categories to better meet the needs of current and future franchisees and licensees: franchisee membership, licensee membership and start-up membership. Franchisee and licensee members will have opportunities to attend educational workshops and networking events, and be exposed to best practices within the industry. Start-up membership will benefit aspiring entrepreneurs (with three business units or fewer) through expert guidance and workshops.

In addition to industry-led efforts, the Singapore government also continues to take a keen interest in promoting franchise development in Singapore, with several government agencies and statutory boards under the Ministry of Trade and Industry playing an active role in franchise development.

One example of this is Spring Singapore, which administers schemes that provide grants, tax incentives, and other financial assistance to small and medium-sized local enterprises to facilitate growth and enhance innovation and the use of technology within Singapore. For instance, the Capability Development Grant is a financial assistance programme that helps small and medium-sized local enterprises defray up to 70 per cent of various capability upgrading project costs, such as consultancy, training, certification and equipment costs.

In addition, International Enterprise Singapore (IE Singapore) also assists and supports local companies to franchise their concepts abroad. IE Singapore administers schemes that provide tax deductions to support various overseas growth activities, such as market preparation, market exploration, market promotion and establishing market presence. IE Singapore also provides financial support and funding to companies in areas such as manpower development, market access and capability building. In particular, the Market Readiness Assistance (MRA) Grant provides companies with funds to help with up to 70 per cent of costs incurred for overseas market set-up, covering activities such as intellectual property search and applications, drafting of franchising or distributorship agreements, and

other advisory or legal expenses. The MRA Grant also supports business-matching activities such as third-party costs incurred in identifying potential business partners in licensee or franchisee arrangements.

With the government's support, local franchises have expanded rapidly over the past few years and are expected to continue expanding, particularly in the food and beverage, child-related and private education industries.

SWEDEN

Elisabeth Vestin and Sara Heikfolk¹

I INTRODUCTION

Franchise arrangements are common in Sweden and the industry has been growing at a steady pace for many years. While there are no official statistics concerning the Swedish franchise industry, a survey conducted by HUI Research in 2016 on behalf of the interest group the Swedish Franchise Association (SFF),² found that there were 33,000 franchisees operating in Sweden in 2016 and that the number is estimated to increase by 3 per cent in 2017.

The greater part of franchise enterprises in Sweden operate within the retail sector. Furthermore, franchise arrangements providing installation services to companies, and arrangements within the restaurant and hotel industry are well represented.³

A few examples of Swedish franchisors are Make Up Store, Team Sportia, HusmanHagberg, O'Learys and IKEA. Among international franchisors operating in Sweden McDonald's, Starbucks and Subway can be mentioned.

The above-mentioned interest group, the SFF, is an organisation that during the past 40 years has been active in expanding and promoting ethical franchise practices in Sweden. Its Code of Ethics has been in force since 1994, and is binding for all members of the SFF, which include both franchisees and franchisors. Furthermore, the SFF has established an ethical committee that decides upon questions regarding the interpretation of ethical questions within the franchise industry.

II MARKET ENTRY

i Restrictions

There are no restrictions or approvals required for foreign franchisors entering the Swedish market. Being a member of the European Union, Sweden adheres to the principle of the right of free movement of goods, persons, services and capital. Accordingly, there are no franchise-related restrictions in respect of a foreign entity granting a master franchise right or development rights to a Swedish entity. Neither are there any restrictions in respect of foreign franchisors owning equity or real property in Sweden.

1 Elisabeth Vestin is a partner and Sara Heikfolk is an associate at Hannes Snellman Advokatbyrå AB.

2 Sw. Svenska Franchiseföreningen.

3 According to a survey conducted by HUI Research on behalf of the SFF in 2015.

ii Foreign exchange and tax

Payments to and from Sweden are not subject to any restrictions (i.e., there are no restrictions on taking banknotes and coins out of or into Sweden, nor are there restrictions on other external transactions, including loans from and deposits with foreign banks, or portfolio investments and direct investments). However, reporting requirements may exist for the intermediary (usually a bank or similar).

There are no tax regulations in Sweden dealing specifically with franchising.⁴

III INTELLECTUAL PROPERTY

i Brand search

Trademarks

Registered Swedish trademarks are found in the database kept by the Swedish Patent and Registration Office (PRV),⁵ EU trademarks can be searched using the register provided by the European Union Intellectual Property Office (EUIPO),⁶ and international trademarks can be identified using the search engine made available by the World Intellectual Property Organization (WIPO).⁷

Where protection of a Swedish trademark is based on the use of the trademark,⁸ the trademarks are not included in any registers.

Company names

Swedish company names can be protected either by registration or by means of the use thereof. Searches for registered company names can be conducted using a search engine supplied by the Swedish Companies Registration Office.⁹

Domains

In respect of domains, Swedish domain names (.se or .nu) can be identified using the search services provided by the Internet Foundation in Sweden (IIS).¹⁰

The process for ascertaining whether there is a conflict follows the standard procedures for determining whether there is an intellectual property infringement.

ii Brand protection

There are four ways by which trademark protection can be obtained in Sweden; these consist of:

- a* a company registering a Swedish trademark via PRV;
- b* a company registering an EU trademark via EUIPO (with or without the assistance of PRV);

4 See Section V.i.

5 PRV's register is available at www.prv.se.

6 EUIPO's register is available at <https://euipo.europa.eu/eSearch/>.

7 WIPO's register is available at www.wipo.int.

8 See Section III.ii.

9 The Companies Registration Office's search engine is available at www.verksamst.se.

10 The IIS register is available at www.iis.se.

- c* a company registering an international trademark via WIPO; and
- d* a company using the trademark in Sweden to such an extent that protection is granted by means of use.

Although protection of a trademark can be obtained by means of use, it is recommended that trademarks are registered, to minimise the risk of legal disputes regarding the rights to a trademark.

When applying for registration, the applicant shall attach a copy of the trademark and indicate the relevant services or goods, including classifications, for which it is to be registered. If registered, these indications will be important in determining the extent of the protection.

Company names are registered via the Companies Registration Office, and may be registered provided that neither an identical nor a very similar company name is already registered.

Domain names are registered via an IIS distribution agency.

iii Enforcement

A holder of an intellectual property right, or its licensors, as applicable, may assert the following remedies in the event of an infringement.

Court injunction

A court can impose an injunction requiring the allegedly infringing company to refrain from using the concerned right; such an injunction may also be accompanied by a fine. Where there is a risk that the value of the right may be derogated, a preliminary injunction may under certain circumstances be imposed.

Damages

In respect of claiming damages, the holder shall generally receive compensation for the use of the rights,¹¹ and may also claim for damages arising from the infringement.

Information request

A court may also issue an order requiring an allegedly infringing company to provide certain information. This information generally concerns the distribution chain of the relevant product, and may be very useful in future proceedings.

Criminal sanctions

In the event an infringement is made intentionally or by gross negligence, an infringing person may be sentenced to pay a fine or to imprisonment.

iv Data protection, cybercrime, social media and e-commerce

In processing personal data, franchisors and franchisees shall, where the processing is subject to Swedish law, comply with the Swedish Personal Data Act.¹² The current act will

11 To be set at an amount corresponding to an appropriate licence fee.

12 The Swedish Personal Data Act (SFS 1998:204).

be replaced by the General Data Protection Regulation (GDPR), which will enter into force on 25 May 2018 in all EU member states.¹³ In addition to the GDPR, there will be a new Swedish Data Protection Act with supplementing provisions. Main concerns include determining which of the parties is the data controller and the data processor respectively, as the franchise arrangement often necessitates common customer relationship management systems, and entail that the personal data collected are used for a variety of purposes. Securing the registered persons' consent to the processing is essential, and any processing to be carried out by a data processor on behalf of a data controller shall be regulated by a written contract entered into between the parties. Furthermore, there are strict provisions to be adhered to in terms of permitting transfers of personal data to countries outside the EU/EEA.

Where a franchisor or franchisee supplies information society services, the Swedish E-Commerce Act¹⁴ applies. Furthermore, in respect of sales to consumers where the agreement is entered into outside any business premises (e.g., in an e-commerce context), the Swedish Distance and Off-Premises Contracts Act¹⁵ applies. Both acts set forth detailed provisions on information to be provided to a consumer before an agreement is entered into.

Currently, there is no specific legislation in respect of cybercrime. However, the Swedish Penal Code¹⁶ contains certain provisions criminalising unlawful access, changes, deletions, additions or blocking of data for automatic processing.

Finally, the parties are obligated – in respect of any marketing activities throughout the franchise arrangement, including e-commerce – to abide by the Swedish Marketing Practices Act.¹⁷ In general, the Act prescribes that all marketing must comply with good marketing practices. In short, this means that all marketing shall be fair and not misleading, and there are, naturally, a number of specific principles that govern the various situations that companies face. The Act is based on an EU directive, but, in contrast to that directive, is applicable in respect of both business-to-business and business-to-consumer marketing activities.

IV FRANCHISE LAW

i Legislation

Other than the Swedish Franchise Disclosure Act¹⁸ (the Disclosure Act), which prescribes certain pre-contractual disclosures, there is no legislation in Sweden specifically regulating the franchise relationship.

As for other Swedish legislation, the general principle of the Swedish Contracts Act¹⁹ is freedom of contract, which entails that parties are free to enter into contracts in the way that they see fit. Accordingly, there are no formal requirements to be fulfilled for a franchising agreement to be valid.

In drafting a franchise agreement, the above-mentioned SFF Code of Ethics should, however, be observed, as it may be applied by a court not only in respect of SFF members, but in determining generally accepted business practices for franchise agreements.

13 The General Data Protection Regulation 2016/679/EU.

14 The Swedish Act (SFS 2002:562) on E-Commerce and other Information Society Services.

15 The Swedish Distance and Off-Premises Contracts Act (SFS 2005:59).

16 The Swedish Penal Code (SFS 1962:700).

17 The Swedish Marketing Practices Act (SFS 2008:486).

18 The Swedish Franchise Disclosure Act (SFS 2006:484).

19 The Swedish Contracts Act (SFS 1915:218).

ii Pre-contractual disclosure

The Disclosure Act

According to the Disclosure Act, the franchisor is under a mandatory obligation to provide the prospective franchisee with certain information. This obligation applies in respect of all agreements where the franchisee will operate in Sweden and, naturally, also where an existing franchise agreement is to be transferred to a new franchisee.

The franchisor shall provide clear, written information on the implications of the agreement and other matters that are relevant in the circumstances, which shall, at least, include:

- a* a description of the franchise that the franchisee is to run;
- b* information about other franchisees that the franchisor has entered into agreements with regarding the same franchise and the magnitude of their business;
- c* the remuneration that the franchisee shall pay to the franchisor and other economic conditions for the franchise;
- d* the intellectual property rights that are to be licensed to the franchisee;
- e* the goods or services that the franchisee is obligated to buy or rent;
- f* the prohibition of competition that applies during or after the franchise agreement has expired;
- g* details regarding the term of the agreement, the terms applied in respect of changes, extension and termination of the franchise agreement and the economic consequences of a termination; and
- h* details concerning the procedure for any future proceeding in connection to the agreement and the cost responsibilities in terms of such proceedings.

The information shall be provided well in advance, prior to the parties entering into an agreement. It is recommended that it is provided in writing and at least 14 days prior to the conclusion of the agreement.

Other pre-contractual obligations

Apart from the Disclosure Act, there is no legislation in Sweden that regulates pre-contractual disclosure requirements. However, the doctrine of *culpa in contrahendo* is a recognised principle of Swedish law, even though it is rarely applied by the Swedish courts.

iii Registration

There are no registration requirements in Sweden for franchises, nor any registration requirements in general law that impact franchising.

iv Mandatory clauses

Swedish law does not prescribe any mandatory clauses in respect of franchise agreements.

v Guarantees and protection

There is no specific legislation in Sweden that relates to guarantees in franchisor agreements. Since the general principle in the Swedish Contract Act is the principle of freedom of contract, guarantees given from individuals and companies are in general enforceable.

V TAX

i Franchisor tax liabilities

General

There are no rules in Sweden specifically dealing with franchising structures. Hence, the taxation of a franchise generally depends on whether the business is incorporated or not. Furthermore, there are also differences depending on where the company or individual is domiciled for tax purposes. Any double taxation arising may be ameliorated or eliminated by tax treaties, domestic law, or EU directives. The comments below focus on Swedish tax residents unless otherwise stated.

Taxation of companies

A company is tax domiciled in Sweden if registered with the Companies Registration Office. Companies are subject to 22 per cent tax on their net income (i.e., the taxable income is offset by expenses, depreciations and similar items). The most notable limitations apply in relation to interest deductions on group internal debt, which may often be denied on the basis of anti-abuse rules. Companies may also be subject to, *inter alia*, withholding taxes (WHT), value added tax, real estate taxes, stamp duty and social security contributions. The said tax liabilities may also, with certain limitations, apply if a foreign company is considered to have a permanent establishment in Sweden. However, Sweden does not levy a branch profit tax (or similar).

Sweden does not levy WHT on interest or royalties (including, *inter alia*, franchise fees), but this is the case in relation to dividends unless reduced or eliminated under tax treaties, domestic rules or EU directives. The most notable exception, much simplified, is that dividends paid to a foreign parent may be entirely exempt from WHT if the receiver is comparable to a Swedish limited liability company and the shares are held for business purposes. Furthermore, royalty payments are generally considered business income in Sweden for the receiver and taxed at the corporate income tax rate of 22 per cent. However, the tax liability may be eliminated by tax treaties or under an EU directive.

Taxation of individuals

An individual is subject to different tax rates depending the character of the income. In short, salary income is taxed at between 30 to 58 per cent on a progressive scale and capital income is in turn taxed at between 20 to 30 per cent. Business income is, much simplified, taxed at 22 per cent through a fairly complex set of rules. For all types of income, certain deductions may be allowed.²⁰

ii Franchisee tax liabilities

See Section V.i.

iii Tax-efficient structures

The structuring of a franchise business in Sweden is generally not driven by tax considerations. However, from both a tax and a liability perspective, respectively, it may be easier and prudent to conduct the business in incorporated form.

²⁰ In relation to WHT, see Section V.i, on taxation of companies (applicable *mutatis mutandis*).

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Good faith is a recognised principle of Swedish law. It is usually described as a duty to observe and attend to the other party's interests.²¹ However, the specific application of the principle is very unclear, as is the application of legal remedies if the principle is not respected. The uncertainty can be explained by the fact that the principle of good faith is not expressed in any general legislation in Sweden.

ii Agency distributor model

There is no specific distribution law in Sweden, instead general commercial contractual principles apply. Whether a franchisor–franchisee relationships shall be treated as one of principal and agent or principal and a commission agent depends on the actual arrangement between the parties. If the arrangement falls within the scope of either the Agents Act²² or the Commission Act,²³ the respective provisions of these acts apply, regardless of how the parties classify the agreement.

The Agents Act applies where an independent agent on a permanent basis, on behalf of a principal, buys or sells goods by receipt of offers made to the principal or enters into agreements in the name of the principal. Mandatory provisions of the Agents Act include provisions on good faith and the agent's rights to compensation.

The Commission Act applies where a commission agent buys or sells goods on behalf of the principal in its own name. The commission agent is obligated to follow the instructions of the principal, and receives a compensation for the goods sold. There are only a few mandatory provisions, most of which concern the termination of the agreement.

iii Employment law

In a genuine franchisor–franchisee relationship, franchisees are not and cannot be treated by the courts as employees.

iv Consumer protection

The franchisee is not seen as a consumer according to Swedish law.

v Competition law

General

In substance, Swedish competition law corresponds to the rules of EU competition law. Franchise agreements can, thus, become subject to the prohibition of anticompetitive agreements under the Swedish Competition Act.²⁴ Franchise agreements are categorised as vertical agreements (the franchisor and the franchisee operate at different levels in the production or supply chain) and can fall within the scope of the Swedish Vertical Block Exemption Regulation (SVBER).²⁵ An agreement that benefits from the SVBER will be

21 Jori Munukka, *SyJT* (2010), page 837.

22 The Swedish Act (SFS 1991:351) on Commercial Agents.

23 The Swedish Act (SFS 2009:865) on Commission.

24 The Swedish Competition Act (SFS 2008:579).

25 Which is identical to the Vertical Block Exemption Regulation at EU level (VBER).

exempted from the prohibition against anticompetitive agreements between undertakings. There are two essential conditions that a franchise agreement has to fulfil to enjoy the 'safe harbour' provided by the block exemption: (1) the market shares of the parties must be below the relevant market share thresholds and (2) the agreement may not contain any hardcore or excluded restrictions. Inclusion of just one hardcore restriction precludes the entire franchise agreement from benefiting from the VBER, while the inclusion of an excluded restriction will preclude that particular clause from enjoying the protection provided by the block exemption. An excluded restriction will not necessarily prevent the possibility of the remaining provisions of the franchise agreement from benefiting from the VBER. Even if the market-share thresholds are exceeded or if the agreement includes one of the hardcore restrictions, there is neither a presumption that the agreement infringes the prohibition against anticompetitive agreements nor that it may not satisfy the criteria for exemption from the Competition Act.

Hardcore restrictions

Price-fixing arrangements, such as resale price maintenance, and certain market partitioning by territory or customer group, are classified as hardcore restrictions and are thus prohibited. Franchisors are, however, permitted to set a maximum price or recommend a resale price to their franchisees.

Active and passive sales

The VBER distinguishes between 'active sales' and 'passive sales'. Active sales are sales where a franchisee individually approaches customers; for instance, by mailing, visiting or actively implementing advertisement or promotion efforts specifically targeted at a customer group; or approaches a customer group outside its designated territory. Franchisors are entitled to prohibit and restrict active sales outside the franchisee's designated territory.

Passive sales are characterised as sales where the customer approaches the franchisee and are typically made in response to unsolicited requests from customers. Sales over the internet are generally classified as passive sales and cannot be prohibited by the franchisor. However, a franchisor can include control mechanisms in the agreement; for instance, by requiring that a certain level of the franchisee's total sales shall be attributable to a physical store. A franchisor cannot prevent franchisees from operating their own websites, although the franchisor can impose quality standards relating to, *inter alia*, the general design and content of the website.

vi Restrictive covenants

If a non-compete obligation purports to last indefinitely or for a longer period than five years, it will be treated as an excluded restriction and will not receive the benefit of the VBER. In the Guidelines on Vertical Restraints issued by the European Commission, the Commission expresses that a non-compete obligation in a franchise agreement exceeding five years may still be acceptable if the non-compete obligation is necessary to maintain the common identity and reputation of the franchised network. In such circumstances, the duration of the non-compete obligation is immaterial provided that it does not exceed the duration of the franchise agreement itself.

vii Termination

There is no minimum period for termination notices applicable to franchise agreements. A very short period of notice could, however, be deemed unjust under the Swedish Contracts Act. If the agreement does not contain any notice period or is valid until further notice, the parties are obligated to observe a reasonable notice period. What constitutes a reasonable notice period depends on the circumstances of the particular case, including term, the size of the investments made, the possibilities of finding an appropriate substitute and trade practices. If the franchisee does not receive compensation for goodwill, that may result in a longer termination period.²⁶

There is no specific right or obligation for a franchisor to take over the franchisee's business at the termination of the agreement or for the franchisee to sell the business to the franchisor, if not stipulated in the agreement.

viii Anti-corruption and anti-terrorism regulation

Bribery

The Swedish Penal Code's prohibitions on giving and receiving bribes apply within the public and the private sectors, and include franchise relationships. Apart from the active and passive bribery prohibitions, the Penal Code stipulates that individuals or entities providing money or other assets to an intermediary and thereby promoting a bribe being given can be convicted for negligent financing of bribery. Adequate control and precautions when providing a counterparty with money or other assets are thus required to ensure that the assets are not used for bribes. Furthermore, taking this into account, a franchise agreement should provide for adequate control mechanisms.

Money laundering

Under the Swedish anti-money laundering legislation,²⁷ persons can be convicted of money laundering if they have committed an act with the intention to conceal the derivation of money or other assets obtained through criminal activity, or if supporting the possibility of someone benefiting from such assets. Moreover, a person can be sentenced for money laundering if assisting someone in concealing the derivation of criminal earnings, or if improperly favouring the possibility of someone utilising money or other assets obtained through criminal activity. Naturally, therefore, caution should always be exercised when managing transactions, and this may also be relevant in relation to franchise arrangements.

Fraud

Fraud and other fraudulent behaviour, including usury, dishonest conduct, breach of faith committed by an agent against its principal, embezzlement and dishonesty against creditors are criminalised under the Penal Code. Criminal liability for fraud requires an intention to commit an act for the purpose of gain that causes a corresponding loss to the victim. Within the contractual context, fraud and fraudulent behaviour generally constitute grounds for termination of a contract.²⁸

26 Further information can be found in the Swedish Supreme Court ruling, judgment NJA 2009 s. 672.

27 The Swedish Anti-Money Laundering Act (SFS 2014:307).

28 The Swedish Contracts Act (SFS 1915:218).

ix Dispute resolution

The most common dispute resolution mechanism in commercial relations in Sweden is arbitration. Usually, Swedish franchise agreements do not deviate from that practice. One of several reasons why the parties to a franchise agreement may prefer arbitration to litigation is that an arbitration procedure is confidential, which is of value particularly for the franchisor. In arbitration, the parties also have the opportunity to appoint one arbitrator each. The parties can therefore appoint an arbitrator with specific knowledge and relevant experience of franchising. In comparison to court proceedings, arbitration proceedings also tend to be quicker.

As a third alternative, or as a first step in resolving a dispute, the franchisor and the franchisee can agree on appointing an impartial mediator, with assistance, for example, from the Swedish Franchise Association or the Arbitration Institute of the Stockholm Chamber of Commerce (SCC). However, mediation is used less frequently compared with arbitration and litigation. Mediation, just like arbitration, is subject to an agreement between the parties.

The parties to a franchise agreement may decide that disputes arising out of the agreement shall be settled by arbitration in accordance with the Arbitration Rules of the Arbitration Institute of the SCC (the SCC Rules). The SCC is one of the world's leading forums for dispute settlement between commercial parties, and nearly 50 per cent of the cases filed with the SCC are international. The SCC Rules provide a flexible and efficient institutional framework for resolving commercial disputes. Pursuant to the SCC Rules, a final award shall be rendered no later than six months from the date upon which the case was referred to the arbitral tribunal. The Board of the SCC can extend the time limit upon a reasoned request from the arbitral tribunal, or if it is otherwise deemed necessary. However, this is rarely necessary since an arbitration award is usually rendered within the given time frame of six months.

The subject of a dispute between a franchisor and a franchisee may vary, but usually relates to the interpretation of the franchise agreement. For example, with respect to the licensing or transfer of rights, the question may arise as to whether rights are granted on an exclusive basis or on a non-exclusive basis, respectively. Pursuant to the Disclosure Act, as mentioned in Section IV.ii, a franchisor has an obligation to supply the franchisee with certain information before the agreement is concluded. The information listed in the Disclosure Act is rather detailed and in line with the types of matter that the parties should preferably set forth in detail in their contract. This statutory obligation to disclose relevant information is, of course, of significant relevance for a party that is contemplating initiating a dispute.

Pursuant to the Disclosure Act, a franchisee that does not, upon request, receive the information listed in the Act from the franchisor in writing, can apply to the Swedish Patent and Market Court and request that the Court order the franchisor to supply the franchisee with the relevant information. This injunction can be combined with a penalty, but the Disclosure Act does not provide for any other sanctions. If, on the other hand, a former franchisee continues to use the franchisor's trademark or other intellectual property rights belonging to the franchisor after the contractual term has ended, the franchisor can obtain a court injunction or even an interim injunction, combined with a penalty, which orders the franchisee to stop using the franchisor's intellectual property.

With regard to jurisdiction, the Brussels Convention and the Lugano Convention are both applicable in Sweden.²⁹ If neither of these regulations is applicable to an individual case, a Swedish court may determine the issue of jurisdiction based on the principles stated in Chapter 10 of the Swedish Code of Judicial Procedure.³⁰ With regard to the issue of applicable law, the Rome Convention is applicable to agreements entered into between 1 July 1998 and 17 December 2009. Agreements signed after the latter date are covered by the Rome I Regulation.³¹ As a final point, Sweden has also acceded to the Brussels I and Brussels II Regulations³² regarding jurisdiction and enforcement of foreign judgments.

The parties to a franchise agreement are at liberty to agree on the substantive law that should govern the agreement and thereby potential disputes arising out of the agreement. The parties may also agree as to the country in which potential disputes shall be adjudicated. In general, Swedish courts recognise and uphold choice of law and jurisdiction clauses in franchise agreements.

With respect to enforcement of arbitral awards, Sweden has acceded to the New York Convention.³³ Accordingly, and also according to the Swedish Arbitration Act,³⁴ foreign arbitral awards are enforceable in Sweden, irrespective of where they were rendered. However, Swedish courts may refuse recognition and enforcement on grounds such as public policy or because of violations of procedural due process.³⁵

There are no specific procedural laws on franchising in Sweden, except for the Disclosure Act mentioned above. Neither are there any specific rules for calculating damages arising from a breach of a franchise agreement or from misrepresentation. Hence, general principles of contract and tort law, as the case may be, are applicable, unless otherwise agreed by the parties. The general principle for calculating damages arising from a material breach of an agreement under Swedish law is that the injured party shall be placed in the position that it had been in if the other party had performed in accordance with the agreement.

With respect to legal costs for a litigation process or an arbitration procedure, the general rule in Sweden is that the unsuccessful party has to bear its own costs and reimburse the successful party for its legal costs. In arbitration, the unsuccessful party will also be liable for the costs of the arbitration. Nevertheless, a court or an arbitral tribunal may decide to allocate the costs between the parties in a way that the court or arbitral tribunal finds reasonable, taking into account relevant circumstances such as the outcome of the case and time spent on particular issues in dispute.

29 The 1968 Brussels Convention on jurisdiction and the enforcement of judgments in civil and commercial matters and the 2007 Lugano Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

30 The Swedish Code of Judicial Procedure (SFS 1942:740).

31 Regulation (EC) No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) and Regulation (EC) No. 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II).

32 Council Regulation (EC) No. 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels I) and Regulation (EU) No. 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (Brussels II).

33 The 1958 New York Convention on the recognition and enforcement of foreign arbitral awards.

34 The Swedish Arbitration Act (SFS 1999:116).

35 Kaj Hobér, *International Commercial Arbitration in Sweden* (2011), page 360.

VII CURRENT DEVELOPMENTS

There is no pending legislation or other upcoming events that can be expected to significantly impact the business operations of companies active within the franchising sector as such, but the sector appears to be thriving, especially taking into account the continued internationalisation of the retail sector, including, in particular, e-commerce.

As with all companies, franchising companies will need to observe the GDPR. Also other legislation requiring further compliance measures to be implemented will result in companies having to carefully consider and evaluate the implications of their practices and adjust routines accordingly. In relation to franchising, this sector is already very accustomed to implementing policies and procedures, which will be an advantage in this regard.

Finally, the results of the 2016 survey conducted by HUI Research on behalf of the SFF show that Swedish franchise companies have a very positive outlook with regard to future years, in terms of turnover and employment trends in particular. It will indeed be very exciting to follow the continuing development of these companies, as well as the challenges they may encounter moving forward.

TURKEY

*İlknur Pekşen*¹

I INTRODUCTION

Turkey became acquainted with franchising as a new business model in 1985 with the entry of McDonald's into the Turkish market, and franchising has grown since. In 1991, the National Franchise Association of Turkey (UFRAD) was established with a mission to support the growth of the franchising market in Turkey. UFRAD has also become a member of the World Franchise Council and the European Franchise Federation (EFF).

According to the most recent UFRAD and EFF statistics, there were 1,850 brand chains found in Turkey as of 2014 (the latest available information from UFRAD and EFF). Of these brands, 34 per cent were foreign and 64 per cent were national brands.² Franchising was used by 78 per cent of these brands. These numbers put Turkey, with 1,471 franchisor chains, ahead of France and Germany according to EFF reports. The total number of franchisors in Turkey has tripled over the past five years. The number of branches of franchisors has reached 47,000 countrywide. Preliminary forecasts show that the volume of Turkey's franchise market has exceeded US\$43 billion and was expected to reach US\$50 billion for 2015 (up-to-date data are not yet available). The sector distribution of the chains is 24 per cent in foods, 27 per cent in merchandise, 16 per cent in services and 33 per cent in the clothing sector.

These huge numbers keep growing and recent developments such as the rapid increase of the number of shopping malls all over Turkey are encouraging for the market. This has meant that both national and international chains are eager to realise Turkey's potential. At present, Turkey's foreign franchisors include global brands such as McDonald's, Domino's Pizza, Burger King, Subway and Caffè Nero. In addition to the foreign franchisors, local giants like Simit Sarayi (food), Koton (clothing) and Istikbal (furniture) are using franchising as their primary business model.

Despite the lack of any governmental reports on franchising, UFRAD and other related associations publish annual reports on the franchising market in Turkey.

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2 European Franchise Federation (EFF). Franchise Statistics Europe (2014). Retrieved from <http://www.eff-franchise.com/Data/FRANCHISE%20STATISTICS%20-%20EUROPE%20-%20source-EFF.pdf>.

II MARKET ENTRY

i Restrictions

Turkey's market is open to foreign franchisors. Pursuant to the Foreign Direct Investment Law No. 4875, foreign investors are free to make foreign direct investments in Turkey and are subject to the same treatment as domestic investors.

Despite the equal treatment of foreign and domestic investors, some bureaucratic formalities are required of foreign investors by the General Directorate of Incentives Implementation and Foreign Investment (the General Directorate). A foreign franchisor intending to enter the Turkish market has to establish an equity company or a branch office in Turkey. The two main vehicles, and those most used by foreign franchisors, are the limited liability company and the joint-stock company. Once they establish a presence in Turkey through one of these vehicles, foreign franchisors have to complete some bureaucratic formalities. The first of these is the submission of the Foreign Direct Investment Operations Data Form to the General Directorate, which then has to be resubmitted by the end of May on a yearly basis. The second form required by the General Directorate is Information on Foreign Direct Investment's Capital, which should be submitted within the first month of the date in which the payment is made to the company's capital account.

The foreign franchisor may authorise a local entity to grant a master franchise to other local entities. According to the EFF reports, as of 2012, master franchising was the most used method of entry for foreign franchisors as there are no restrictions or formalities for the foreign entity granting a master franchise.

There are no restrictions on foreign franchisors owning equity in a local business. However, the owning of real property by foreign franchisors is subject to certain conditions and restrictions in Turkey.

Foreign companies that are established according to the relevant laws of their country of origin can acquire property and limited rights *in rem* within the provisions of special laws. Despite the restrictions imposed on foreign-based companies, companies with foreign capital that are located in Turkey may acquire real estate under certain conditions. Companies with foreign capital may buy property in Turkey in accordance with Article 36 of Land Registry Law No. 2644 and the Decree on Acquisition of Property and Limited *in Rem* Rights by Companies and Corporations within the Context of Article 36 of Land Registry Law No. 2644, dated 16 August 2012:

- a* if the foreign investors hold, individually or collectively, 50 per cent or more shares of the company; or
- b* if the foreign investors do not hold any shares of the company, but have a right to assign or remove the managers of the company.

ii Foreign exchange and tax

Foreign investors can freely transfer abroad net profits, dividends, proceeds from the sale or liquidation of all or any part of an investment, compensation payments, amounts arising from licensing, management and similar agreements, reimbursements and interest payments arising from foreign loans through banks or special financial institutions. However, there is a reporting requirement for the banks pursuant to Decree No. 32 regarding the Protection of the Value of the Turkish Currency. Accordingly, banks are required to report outbound flow of Turkish lira and foreign currency exceeding certain amounts (for example, US\$50,000) to the Central Bank of Turkey.

If the foreign franchisor decides to enter the Turkish market through the establishment of a company, it will qualify as a Turkish resident and be subject to tax on its income derived both in Turkey and abroad. On the other hand, if the foreign franchisor opts for the master franchising model without establishing any presence in Turkey (legal and business centres should not be located in Turkey), it will qualify as a non-resident, subject to tax only on its income derived in Turkey.

III INTELLECTUAL PROPERTY

i Brand search

Formal registration is required for protection of intellectual property such as trademarks, patents and industrial design protection. A search can be effected through the official website of the Turkish Patent Institute (TPE).³ The website is also accessible in English and provides the necessary information and related links.

Copyright is granted automatically by the Turkish Code on Intellectual and Artistic Works and thus no registration is required for protection of such rights other than for cinematographic and musical works and video games. For purposes of personal data protection, the database listing registered copyrights maintained by the General Directorate of Copyright and Cinematography is not publicly accessible.

ii Brand protection

Brand protection is accomplished through filing with the TPE a trademark application, which is done electronically. The application can be made personally or through a trademark attorney. Non-residents of Turkey are, however, required to appoint a trademark attorney to act on their behalf to file such an application. Current application and registration fees as well as information on how to apply for protection are available on the TPE website.⁴ A trademark will be cancelled in the event it is not used without any justification for a period of five years starting from the registration date or the use thereof is suspended for five years.

As mentioned above, registration of a copyright is not mandatory, unless it is for cinematographic and musical works and video games, but it is recommended for convenience of proof. The registration application is made to the General Directorate of Copyright and Cinematography by submission of a letter of undertaking together with other application documents.

iii Enforcement

Pursuant to Industrial Property Law No. 6769, trademark-related intellectual property rights are enforceable and cannot be used by others without the consent of the owner of the right provided that the trademarks are registered with the TPE.

As to the enforcement of copyrights, the Law on Intellectual and Artistic Works provides for both the civil and criminal liability of infringers.

3 <http://www.turkpatent.gov.tr/TURKPATENT/?lang=en>.

4 <http://www.turkpatent.gov.tr/TURKPATENT/fees/informationDetail?id=110>.

iv Data protection, cybercrime, social media and e-commerce

Data protection, cybercrime, social media and e-commerce are regulated under various provisions.

Data protection

Turkey has recently enacted a framework law concerning the protection of personal data, which is inspired by the European Union Data Protection Directive 95/46/EC. This framework law on personal data protection entered fully into force in October 2016, and it requires processing of personal data to be legitimised on the grounds stipulated, including, in summary, the explicit consent of the data subject, performance of a contract, compliance with legal obligations, and legitimate interests of the data controller. Further, transfer of personal data from Turkey to abroad must be legitimised by either of the following means:

- a* by the explicit consent of the data subject, which by itself would suffice; or
- b* by one of the other grounds stipulated under the framework law without obtaining consent, in which case, the destination country must have an adequate level of protection; if there is no such protection, both sides of the transfer must commit, in writing, to provide adequate protection and the approval of the Data Protection Board must be obtained.

This area is also regulated by various applicable provisions under, for example, the Turkish Criminal Code, the Turkish Labour Code, the Turkish Code of Obligations, the Turkish Civil Code and the Electronic Commerce Law.

Cybercrime, social media and e-commerce

Franchisors and franchisees should be aware of the following rules regulated under the Turkish Electronic Commerce Law and its secondary legislation:

- a* commercial electronic messages (i.e., messages sent for purposes of introducing, marketing and increasing recognition of goods and services) require explicit prior consent by the recipients. Such marketing-related messages, however, can be sent to merchants without prior consent;
- b* easy and free tools shall be available providing access to the right to opt out without having to present any reason whatsoever; and
- c* service providers (i.e., franchisors or franchisees) shall take measures to protect information obtained through services provided by means of e-commerce.

IV FRANCHISE LAW

i Legislation

There is neither a specific law regulating franchise contracts nor a statutory or legal definition of franchise contracts under Turkish law. However, the Turkish Court of Appeal, in decision No. 819/4917, dated 25 June 2001, has defined franchising as a long-term and continuous contractual relationship between two independent parties where the party who holds the concession right of a product or service grants this right to the other party by providing information and support relating to the commercial business to be carried out, under certain conditions and limitations, for a definite period.

Since both agency and franchise agreements have similar characteristics, the agency provisions under the Turkish Commercial Code will by analogy be applied to franchise agreements to a large extent. As well as the general provisions of the Turkish Code of Obligations, the provisions scattered among various laws and regulations governing proxy and brokerage agreements will be applied to franchise agreements in respect of termination, notice periods, compensation and non-compete clauses.

ii Pre-contractual disclosure

Pursuant to the relevant provisions of Turkish civil law, agreements shall be concluded based on mutual declarations of intent by the parties, who shall agree on all essential terms that are not defined under the law and act in good faith in exercising their rights and in fulfilling their obligations. Although there is no specifically regulated *culpa in contrahendo* provision under Turkish law, precedents established by the Turkish courts provide that even where the distributorship relationship has not been set up by concluding an agreement, the distributor's reliance on the relationship arising from the contractual negotiations will be protected by law on the basis of principles of *culpa in contrahendo*.

Furthermore, pursuant to the Turkish Code of Obligations, in the event that a person enters into a contract as a result of deception by the other party, the contract will be invalid.

In light of the foregoing, the franchisor may be exposed to a damages claim over pre-contractual statements by the civil courts, if the franchisee proves that (1) even though the parties have not entered into a franchise agreement, there exists conduct by the parties on which they relied during their contractual negotiations, (2) there was misconduct by the franchisor during the pre-contractual period by means of misrepresentation or concealment, (3) the franchisee itself incurred loss because of the misconduct of the franchisor, and (4) there is a causal link between the franchisor's misconduct and the loss suffered by the franchisee.

The franchisee, for instance, may prove a pre-contractual relationship through royalty receipts (or any other document with conclusive force) issued by the franchisor.

iii Registration

In Turkey, every legal entity is required to be registered with the Trade Registry, the local chamber of commerce and the relevant tax office and social security institute. Although there is no requirement for franchisors or franchisees to register the agreement, trademarks must be registered with the TPE (see Section III.ii, regarding trademark registration).

iv Mandatory clauses

There are no mandatory clauses for franchise agreements. However, Turkish law recognises some general contractual rules that parties must abide by. Pursuant to the Turkish Code of Obligations, clauses contrary to the imperative provisions of the law, ethics, public order and personal rights shall be deemed null and void.

Also, trademark transactions are required to be in writing, otherwise the licensing agreement will be considered invalid.

v Guarantees and protection

In principle, guarantees provided by individuals are enforceable as long as the written consent of their spouse has been obtained.

The Turkish Code of Obligations, which was amended of necessity in March 2013, provides for an exemption to spousal consent for guarantees, namely that it will not be required provided that the guarantor is the shareholder or the manager of the company that will benefit from the guarantee, and that is registered with a trade registry. The relevant Article makes no distinction between local and foreign trade registries and it is not clear whether the exemption would also apply to companies registered with foreign trade registries. The prevailing view in this regard is that the Turkish Code of Obligations can only refer to the Turkish Trade Registry and therefore this exemption cannot apply to companies registered with foreign trade registries.

V TAX

i Franchisor tax liabilities

Turkish tax law does not impose specific tax liabilities for either franchise operations or for franchise agreements. However, any type of documents involving a sum of money, such as agreements, undertakings and deeds of assignment, that are signed in Turkey are subject to stamp duty of 0.948 per cent of the monetary value. If such a document is signed abroad, there will be no tax liability until the document is submitted to Turkish official authorities or until the terms of the document are performed within Turkey, or the terms of the same are benefited from within Turkey. Parties to a taxable document are jointly responsible for the stamp tax.

Non-resident franchisors

Pursuant to the Turkish Corporate Tax Law, if the franchisor is neither registered nor has any place of residence, registered office or place of business in Turkey, it will be taxed solely on its earnings sourced in Turkey. In the event of sale, transfer or assignment of copyright, privilege, invention, business, commercial name, brand and other incorporeal rights, then withholding tax will be withheld in respect of the fees paid by the franchisee.

As to value added tax (VAT), franchise services obtained from non-resident companies will be subject to VAT on the franchise fee. If the franchisor has no place of residence in Turkey through any means of establishment, the franchisees may be held liable for VAT by the Turkish Ministry of Finance as the parties to such a transaction can be held responsible if the principal taxpayer is non-resident.

These provisions will be applicable unless stipulated otherwise by double-taxation treaties.

Domestic franchisors

If the franchisor is registered in Turkey by means of either a resident company or a branch, it will be deemed as a domestic franchisor and therefore will be subject to corporate tax over the royalty determined under the franchise agreement.

Because franchising consists of a long-term agreement and requires a continuous relationship, the royalty paid by the franchisee to the franchisor will be subject to VAT.

ii Franchisee tax liabilities

Corporate tax will similarly be applied to franchisees on their earnings sourced both abroad and in Turkey. In the event that the franchisor is not registered in Turkey, franchisees may be held liable to pay VAT.

iii Tax-efficient structures

There are no specific tax-efficient structures for franchisors or franchisees. In Turkey, entities are generally established either as joint-stock companies or limited liability companies. In joint-stock companies, shareholders' liability is limited to their capital contribution while the limited liability companies' shareholders remain liable for public receivables such as taxes with all their assets. It would, therefore, be advisable for both franchisors and franchisees to perform their activities through joint-stock companies.

Minimising the royalty stipulated under the franchise agreement will also reduce the franchisors' exposure to excessive tax. Double taxation treaties should also be taken into account before determining tax efficient structures.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

Despite the lack of any duty of good faith specifically applicable to the franchise agreements, Article 2 of the Turkish Civil Code stipulates a general duty of good faith. Pursuant to the aforesaid article; 'Every person is bound to exercise her or his rights and fulfil her or his obligations according to the principles of good faith.' Because of the 'general' nature of the good faith duty, it is for the courts to determine what steps should be taken by the parties of a franchising agreement acting in good faith.

ii Agency distributor model

There is no legislation under Turkish law that specifically regulates franchising agreements or the relationship between the franchisor and the franchisee. In Turkey, franchisors or franchisees are not treated as agents or distributors. However, all the aforesaid business models have similarities and because of these similarities, the agency rules stipulated by the Turkish Code of Commerce might be applicable to both franchise and distribution relations.

iii Employment law

Despite the fact that a franchising agreement may encompass elements of different types of contracts, employment is not one of these. The relationship between the franchisor and the franchisee has not been treated as an employer–employee relation by the Turkish courts.

iv Consumer protection

Franchise agreements are concluded between two 'business persons' and therefore franchisees are not treated as consumers under existing laws nor by the courts in Turkey.

v Competition law

The Competition Law and the relevant secondary legislation are similar to the European Union competition legislation. According to Article 4 of the Competition Law, all agreements that have as their objective, effect or likely effect the prevention, distortion or restriction of competition directly or indirectly in a particular market for goods and services are illegal and prohibited. Despite this restriction, the Block Exemption Communiqué on Vertical Agreements (the Communiqué) regulates the relationship between a franchisor and a franchisee as franchising agreements are generally considered to be vertical agreements.

A franchising agreement that contains the restrictions listed below would be excluded from the exemption provided in the Communiqué:

- a* It is forbidden for the franchisor to set a fixed or minimum sale price for the franchisee. However, recommended or maximum sale prices are allowed to the extent that they do not amount to indirect means of achieving resale price maintenance.
- b* It is forbidden to restrict the territory into which, or the customers to whom, the buyer may sell. However, some exceptions are stipulated by the Communiqué; (1) restrictions on active sales by a buyer into an exclusive territory or to an exclusive consumer group reserved either to itself or to another buyer, (2) restrictions on active and passive sales to end users by a buyer at the wholesale level, (3) restrictions on sales to unauthorised distributors by the members of a selective distribution system, and (4) restrictions on active and passive sales of components for incorporation into another product to competitors of the supplier.
- c* It is forbidden to set restrictions on active and passive sales to end users by the members of a selective distribution system operating at the retail level, except for the right to impose restrictions on the operations of such a buyer in a territory where it is not authorised to operate.
- d* It is forbidden to set restrictions on cross-suppliers of a selective distribution system.
- e* Finally, it is also forbidden to set restrictions on sales of components by a supplier to customers or repairers that have not been authorised by the buyer to repair or service its goods.

Apart from these requirements, the franchisee is also under the obligation not to compete with the franchisor during the term of the agreement. This obligation is a result of the 'loyalty obligation' of the franchisee. In the event of such a violation, the franchisor will be entitled to claim damages arising from the same and, most importantly, will also be entitled to terminate the franchising agreement for just cause.

vi Restrictive covenants

In Turkey, non-compete, confidentiality and exclusivity are the most used restrictive covenants during the term of a franchising agreement. If the franchisor violates any of these restrictive covenants during the term of the agreement, the franchisor may terminate the agreement and will also be entitled to ask for damages arising from the franchisee's breach.

vii Termination

A franchising agreement made for a definite period expires automatically at the end of the term. There is no mandatory renewal right. However, the parties are free to determine a renewal clause. In such cases, if a party does not wish to renew the agreement on the expiry of the term, it should declare its intention to the other party.

After the franchise agreement expires, the franchisee is not, by law, under a non-compete obligation and the Turkish courts are reluctant to grant post-term non-compete injunctions. However, in practice the parties to the franchise agreement can explicitly agree to such a clause. In the event the franchise agreement includes a post-term non-compete obligation, it is only valid in certain conditions. Post-term non-compete obligations set forth in the franchise agreement should be limited in terms of time, place and subject. Further, under the Communiqué, a post-term non-compete obligation is only valid if all the following apply:

- a* it does not exceed a term of one year after the expiry of the agreement, with the condition that the prohibition relates to goods and services in competition with the goods or services that are the subject of the agreement;
- b* it is limited to the facility or land where the franchisee operates during the agreement; and
- c* it is required to protect the know-how transferred by the franchisor to the franchisee.

Besides, the courts are less reluctant to grant injunctions in the event that the franchisee continues to operate the business and use the assets and intellectual property rights transferred or made available for the sole purpose of running the franchised business. In such cases, the franchisee would be liable for 'unfair competition'.

viii Anti-corruption and anti-terrorism regulation

In Turkey, fraud, anti-corruption and money laundering are considered criminal offences and the Turkish Criminal Code No. 5237 prohibits such activities. As there are no provisions specifically applicable to franchising agreements, the general legislation would apply.

ix Dispute resolution

Parties to franchise deals tend to opt for litigation via the local courts. Since 2012, mediation has become a recognised form of alternative dispute resolution as the Law of Mediation for Civil Law Disputes No. 6325, entered into force on 22 June 2012. Local courts recognise and uphold foreign choice of law or jurisdiction clauses. Pursuant to Article 47 of the Code concerning Private International Law and Civil Procedure; parties are able to choose a different jurisdiction in the agreement, provided that there is a foreign element in the case and the court assigned by law is not exclusively competent.

There are no specific procedures nor industry practices for franchising disputes. Turkey's only franchise association, UFRAD, does not offer mediation or arbitration services.

It is accepted in Turkish doctrine that the franchisee should terminate the use of intellectual property rights after the term of the franchising agreement. If the franchisee continues to use these rights, it will have responsibility according to the *culpa post contrahendum* principle stipulated by the Turkish Code of Obligations; further this conduct will create unfair competition. In such cases, the franchisor can obtain an interim and permanent injunction to prevent the former franchisee from violating the franchisor's rights.

Damages for breach of contract are calculated after a report by experts. However, these expert reports are not binding, and the courts and the judges are the ultimate decision-makers.

The litigation costs in Turkey are not capped; after the court's final judgment, the losing party becomes responsible for all costs incurred.

Turkey is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). Furthermore, Turkey also has reciprocity agreements with non-New York Convention signatories. In such cases, Turkish courts readily recognise arbitral awards granted by these non-signatory countries.

Under Turkish law, enforcement of a foreign judgment is subject to the following conditions, which are set out in the Turkish International Private and Civil Procedure Code.

- a* there shall be reciprocity between the country wherein the judgment is obtained and Turkey;
- b* the judgment shall not be issued on a matter over which Turkish courts have exclusive jurisdiction;
- c* the judgment shall not be against the public order of Turkey;

- d* the defendants should be duly served with the points and claim, and requested (and thus granted the opportunity) to serve their defences; and
- e* the judgment shall be binding and finalised.

Despite the general acceptance of the conformity of post-term, non-compete clauses with the law in certain respects, the Eleventh Chamber of the Supreme Court has held that such clauses violate the principle of the freedom of work secured by the Turkish Constitution.

VII CURRENT DEVELOPMENTS

Because of the increase in public awareness regarding the benefits of franchising and the importance of brand loyalty, a recent trend has been for new entrepreneurs to enter into a franchise agreement with either a local or an international franchisor rather than establishing a market presence from the very beginning.

Further, although not specifically related to franchising, the Industrial Property Law entered into force on 10 January 2017. Previously, the protection of industrial rights (including trademarks, geographical indications, designs, patents, utility models and conventional product names) was mostly governed by separate decree laws. The Industrial Property Law harmonised all industrial rights under one uniform law, and its reforms relating to trademark law include the ability to register new kinds of marks, shorter registration periods, trademark co-existence, administrative invalidation, and the regulation of procedures relating to international applications in accordance with the Common Regulations under the Madrid Agreement Concerning the International Registration of Marks and the Protocol Relating to that Agreement 2004.

UKRAINE

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I INTRODUCTION

Franchising is still in the process of development in Ukraine. It remains a relatively new notion for the Ukrainian business community as it only appeared after the collapse of the Soviet Union in the early 1990s and had no legal framework for the following decade, until the Civil Code and the Commercial Code were adopted in 2003. Moreover, even though the Civil Code and the Commercial Code established a necessary platform, for another decade franchising regulation still lacked several important elements necessary for it to function properly. Ukrainian law still has a rather limited framework and the case law does not yet fully compensate for the missing components. Self-regulated non-governmental associations try to fill the void, particularly given that there has been no special governmental agency to regulate the offer and sale of franchises in Ukraine.

Despite the gaps and inconsistencies of the Ukrainian legal system, international and local franchise businesses have managed to find enforceable franchising structures or employed alternative arrangements to develop their business in Ukraine. For quite some time now, many international brands have successfully operated their franchise businesses, including, among others, McDonald's, Papa John's, KFC and InterContinental, along with a variety of local franchises in food, retail, services and other industries. The market continues to grow. The Ukrainian Franchise Association publicised information that more than 2,300 franchising companies are now members of the Association.

The recent necessary changes in applicable laws and the new Ukrainian government's general trend of reform towards a competitive and market-based economy give hope for further, even extensive, development of the franchising industry in Ukraine.

II MARKET ENTRY

i Forms of business entities

A foreign business would usually incorporate in Ukraine to operate a substantial business in the country. A foreign franchisor, however, may choose not to do so if it only licenses its franchise to franchisees in Ukraine.

The typical franchisor would incorporate as a limited liability company (LLC), like most businesses in Ukraine. There are other forms of business entity available, such as

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a private enterprise or a joint-stock company. However, those other corporate forms are either under-regulated or over-regulated, while the LLC strikes a proper balance. A single-person franchisor may also register as an individual entrepreneur.

ii Requirements

The Civil Code, the Commercial Code, the Law on Companies, the Law on Joint-Stock Companies and the Law on State Registration of Legal Entities and Individual Entrepreneurs govern the formation of business entities. Between them, these laws set a number of requirements for forming and maintaining a business entity.

The first step in establishing a legally formed entity in Ukraine is to file a registration form (which includes a statement of beneficial ownership), founding resolution and statutory documents, and to apply for registration of the company with a local state registrar. Currently, state registration of legal entities is free of charge.

Ukrainian law envisages some capital formation and maintenance rules for companies. In particular, a joint-stock company must have a minimum capital of not less than 4 million hryvnas² at its formation. There are also restrictive rules regarding consideration paid for the issue of shares of joint-stock companies. There is no minimum capital requirement for registration of an LLC and capital formation rules are generally less restrictive for LLCs.

A company must have a distinctive name that also contains an indication of its corporate form. Each business entity must have an office located in Ukraine. A company must have at least one responsible director, who must be a natural person.

Business entities must all be registered with tax and statistic authorities, and with the Pension Fund of Ukraine. They are required to keep accounting records and file returns on a monthly, quarterly and annual basis.

iii Restrictions

Foreign business and foreign investment are generally subject to the national regime in Ukraine, which basically implies the same rights and possibilities as apply to local residents. Moreover, foreign investors have certain statutory guarantees under Ukrainian law and bilateral or multilateral treaties that protect their investment, such as a guarantee of profit repatriation and compensation of losses, a guarantee against nationalisation and a guarantee against changes in the law. However, because of strict currency control regulations and continuing economic crisis, some severe restrictions and prohibitions currently exist with regard to the repatriation of investment and profits. In addition, Ukrainian law sets mandatory terms for the settlement of payments under cross-border (including franchise) contracts.

Furthermore, certain limitations and restrictions do naturally apply to foreign businesses and foreign investment and these are mostly related to national security and strategic interests in certain important industries (e.g., financial services, railway, mining, agriculture, publishing and media). Since franchising is usually not related to the above-mentioned strategic industries, it typically does not raise any purely foreign investment restriction issues. It should also be borne in mind that the Ukrainian government currently pursues a sanctions

2 As of 1 January 2017. The amount is equal to 1,250 minimum statutory wages and therefore increases with the adjustment of that figure (as a rule, three times a year).

policy in relation to Russia because of the backing of the insurgency in eastern Ukraine and the annexation of Crimea. Accordingly, a number of Russian companies and individuals are under sanctions, which would render their franchising activities in Ukraine impossible.

iv Real estate

The Ukrainian real estate market is rather structured and developed. Commercial real estate is rapidly expanding, and this is especially true for metropolitan areas. However, the development level still remains much lower than the usual level or trading area per capita found in Europe or the United States.

Real estate is normally leased or, less often, bought for franchising purposes. From a procedural point of view, real property sale and purchase transactions must be certified by a notary and rights to real estate registered with the relevant state register. Long-term lease agreements of three years and longer are also subject to notarisation, and lease rights thereunder must be registered. This implies additional costs, but it also provides for better certainty and protection. To avoid notarisation costs, the lease agreements are often concluded for two years and 11 months with a pre-emptive right to renew the lease.

Lease agreements must contain certain mandatory provisions (e.g., lease object description, its value with indexation, rent with indexation, lease term and renovations), but, in general, the parties are largely free to determine specific terms and conditions.

III INTELLECTUAL PROPERTY

i Trademark protection

Ukraine has a number of laws that regulate protection of intellectual property. In addition, the state is a member of international organisations and international agreements (e.g., World Intellectual Property Organization, the Berne Convention and the Paris Convention).

As for trademarks, they are subject to the territorial principle of protection and must be registered to enjoy protection. To safeguard a trademark in Ukraine, the foreign franchisor should either register the trademark in Ukraine directly with the Ukrainian patent office or apply for international registration to the WIPO through the Madrid System. The trademark registration is normally valid for 10 years and may then be extended further.

Some trademarks may qualify as well-known brands, which implies a stronger protection for the trademark holder. For this, a trademark must meet certain stringent criteria of identity and public awareness. To formalise such protection, the trademark holder must file an application with the State Intellectual Property Service of Ukraine, supporting it with substantive evidence, or obtain a court judgment in respect of a trademark dispute.

ii Know-how protection

Know-how is a novel and rather problematic notion for the Ukrainian legal system. Ukrainian law defines know-how as information obtained through experience and tests and that is:

- a* not public or easily accessible;
- b* substantive (i.e., important and useful for producing goods and rendering services); and
- c* defined (i.e., it is properly described in writing in sufficient detail such that it is possible to verify that it meets the criteria of being non-public and substantive).

In court practice, know-how is further defined as technical knowledge, experience, production secrets and information necessary for solving tasks of a technical or other nature. Know-how

is understood to be the result of technical creation, technical or other information, necessary for the production of certain products, or a technical decision, performed as an invention, which is not duly patented. Know-how is often associated to commercial and trade secrets, and is therefore similarly protected. There are no formal filings required to receive legal protection. However, some franchisors also employ patent filings to protect some aspects of their franchise other than trademarks.

iii Data protection

Ukraine has rules governing the collection, use, processing and transfer of personal data. Pursuant to the changes in the personal data protection laws of Ukraine, there is no longer a requirement to register personal databases. According to the new rules effective as of the beginning of 2014, the processor of personal data is obliged to notify the Ukrainian Parliament Commissioner for Human Rights only if the processing refers to information related to a particular area of risk (e.g., data on race, political views, health status, sex life, biometric data or movement tracking). In any case, the data controller must ensure an adequate level of protection of personal data it uses and processes.

A company is normally required to obtain consent from an individual to collect and process his or her personal data, with some statutory exemptions. In particular, a company is not required to obtain a consent when it collects and uses basic personal information necessary for a transaction with a consumer or when the law specifically requires the company to collect and retain some personal information (e.g., for the purpose of employment).

When individual consent is required, it must be obtained in either written or electronic form that shows it has been explicitly granted. The company must then retain this confirmation document (information) during the whole time of processing.

IV FRANCHISE LAW

i Legislation

The Civil and Commercial Codes of Ukraine provide specific regulation of the ongoing relationship between franchisor and franchisee. In particular, these laws set forth some default ongoing franchisor obligations, which may be varied in the franchise contract. Namely, the franchisor is obliged to control the quality of goods produced by the franchisee and to regularly provide technical and consultancy support and training for the franchisee's personnel.

Competition law has to be taken into consideration and may substantially affect the franchise relationship. Specifically, Ukrainian competition law prohibits concerted actions that impose prices or other hardcore restrictions such as limitation of production or technical development, territorial markets and supplier allocation, and tying. The franchise agreement requires careful consideration in this regard, and further relations between the franchisor and franchisee must be constantly controlled for compliance.

When providing payments to a foreign franchisor in foreign currency, currency control laws must be under constant consideration.

ii Definition of a franchise

Ukrainian law does not use the term 'franchise'; instead it provides a definition for a 'commercial concession agreement', which is the equivalent of a franchise agreement in Ukraine. It may be logically inferred that a franchise is a legal relationship based on an agreement under which one party (title-holder) undertakes an obligation to grant for remuneration to the other party

(user) the right to use a set of rights of the title-holder with the purpose of production or sale of certain goods and services. Pursuant to further provisions of Ukrainian law, the franchise agreement implies the use of a title-holder's rights, business reputation and commercial experience in the agreed scope, with or without reference to the territory and to particular areas of commercial activities.

iii Pre-contractual disclosure

Ukrainian law does not require formal pre-contractual disclosure in a franchise transaction. The parties decide on the information to present to each other and are not obliged to follow any particular procedure.

A franchisor does have to provide a copy of the technical and commercial documentation and other information necessary for performance of the franchisee's rights under the commercial concession agreement. However, this obligation only arises after the contract has been concluded.

iv Registration

Registration of franchise agreements is no longer required under Ukrainian law. The statutory registration requirement was abolished as of 5 April 2015, in the wake of the business deregulation policy pursued by Ukrainian government.

Nevertheless, to ensure better legal protection, the franchisee may (but is not obliged to) apply for and procure registration of the assignment or transfer of the trademark rights assigned to the franchisee by the franchisor under a franchise or trademark licence agreement. Such an assignment of trademark rights is registered with the State Trademarks Register of Ukraine and the franchisee is issued a registration certificate.

v Mandatory clauses

In general, provisions in franchise contracts should not contradict the statutory provisions of Ukrainian civil and commercial law. Even though some deviation from statutory provisions is generally allowed according to the principle of freedom of contract, this should not be a substantial deviation. Otherwise, there is a risk that the court would render a deviating contractual clause unenforceable and choose to apply a statutory provision instead.

vi Termination of the franchise agreement

If a franchise contract is conducted for an indefinite period, both parties are entitled to its unilateral termination upon a six-month notice unless the contract envisages a longer notice period.

If a franchise contract is conducted for a defined period, termination is only possible upon mutual consent of the parties or on the basis of a court decision. Court ability to terminate the franchise relationship is limited to the general restrictions available in the laws on contract termination. In particular, the court may terminate the franchise contract if the franchisor proves a substantial breach on the part of the franchisee. In some limited circumstances, the franchisor may also claim a substantial change due to unforeseen and irremediable circumstances.

The franchise contract also terminates under operation of law in the following cases: when a franchisor loses its title to the trademark, without substitution; or in the case of the bankruptcy (insolvency) of the franchisor.

vii Guarantees and protection

Guarantees are often necessary to protect the foreign franchisor against the lack of adequate creditor protection rules in Ukraine. Foreign franchisors usually request a surety from beneficial owners or affiliated business entities or, less often, a bank guarantee to secure financial obligations. It should be taken into account, however, that Ukrainian currency regulations may have specific regulatory requirements for the outbound payment under the surety agreement by an individual resident or a Ukrainian legal entity (other than a bank) in foreign currency, which may turn out to be rather problematic.

V TAX

i Franchisor tax liabilities

A Ukrainian franchisor is subject to corporate profit tax. The general corporate profit rate is currently 18 per cent. There are some simple taxation systems available for small and medium-sized businesses that do not have a substantial turnover.

For tax purposes, franchise fees shall fall within the definition of royalties under Ukrainian tax law. As a general rule, Ukraine charges a 15 per cent withholding tax (WHT) on outbound royalty payments. WHT is usually withheld and then paid into the state budget by a local franchisee. Where there is a double-tax treaty between Ukraine and the country in which the franchisor is domiciled for tax purposes, the applicable WHT may be lower (e.g., 10 per cent, 5 per cent or even zero per cent). Such treaties have priority over Ukrainian domestic legislation. The franchisor must, however, provide certificated confirmation of its place of residence.

Generally, royalties are not subject to VAT. Normally, however, supply transactions of goods (including their import) and services are subject to VAT at the rate of 20 per cent in Ukraine.

Foreign franchisors must be careful not to create a permanent establishment on the territory of Ukraine, as a permanent establishment would be subject to general corporate taxes in Ukraine.

ii Franchisee tax liabilities

Ukraine tax law limits deductibility of royalty payments made by Ukraine-resident companies to non-residents to an amount not exceeding 4 per cent of income (revenues) received from the sale of products (goods, works and services) during the year that precedes the reporting year (see Section 140.5.5 of the Tax Code of Ukraine). Payment of royalties exceeding 4 per cent of the previous year's turnover would just add to the Ukrainian franchisee's tax burden, unless it can prove that the arm's-length principle applies to the royalties.

The Tax Code of Ukraine provides for further specific restrictions on the deductibility of royalty payments in addition to the above-mentioned turnover limitation. In particular, royalty payments made to non-residents will not be deductible at all where:

- a* a non-resident receiving such payments has offshore status;
- b* a non-resident receiving such payments is not a beneficiary of the royalty payments (except in cases where the beneficiary has granted the right to receive the payments to the said non-resident);

- c* royalties are paid in respect of intellectual property that initially belonged to a Ukrainian resident (i.e., if the rights to the intellectual property were first owned by a Ukrainian resident, then transferred to a non-resident and then licensed to a Ukrainian resident); or
- d* a non-resident receiving royalty payments is not subject to taxation in respect of the royalties in its country of residency.

If the franchisee is a company, it will pay corporate profit tax unless it opts in to the simplified taxation regime. In addition, VAT is likely to apply to supply transactions of goods and services (including the transfer or assignment of intellectual property rights to the franchisor under licence, franchise or other agreement) conducted by the franchisee as a franchise business is always presumed to involve a trading business. Alternatively, in certain cases for small and medium-sized businesses, the franchisee may choose to pay a 'unified' tax (if it opts in to the simplified taxation regime), which can substitute for corporate profit tax and VAT.

Transfer pricing may also be a factor if the following criteria are met simultaneously:

- a* the foreign franchisor and the Ukrainian franchisee are related persons;
- b* the rate of corporation tax in the franchisor's offshore home jurisdiction is more than 5 per cent lower than the Ukrainian rate;
- c* the franchisee's annual income in the relevant tax year, according to accounting standards, exceeds 50 million hryvnas; and
- d* the value of all transactions between the foreign franchisor and the Ukrainian franchisee in the relevant tax year exceeds 5 million hryvnas.

Ukrainian tax legislation undergoes frequent changes, even following its substantial revision and codification in 2011. Moreover, the new government intends further reform of the tax system to facilitate easy tax administration.

VI IMPACT OF GENERAL LAW

i Competition law

The franchisor should bear in mind aspects of competition law that prohibit the imposition of certain vertical restraints on the franchisee in the franchise agreement. In particular, the franchisor should be careful regarding restrictions imposed on the franchisee that may affect competition. In practice, competition is considered to be substantially restricted when the undertakings involved approach a dominant position, separately or collectively. The imposition of such restrictions on the franchisee may also fall under certain market-based exemptions and the block exemption for intellectual property rights transfer. If none of these exemptions applies, the provisions may still be cleared by an approval from the Anti-Monopoly Committee of Ukraine (AMC).

The Law on Protection Against Unfair Competition is also relevant to the typical franchisor. As mentioned above, a franchisor may be held accountable for any deceptive or misleading statements about its franchise to potential franchisees. Besides that, on the other hand, the law provides certain protection to the franchisor against dishonest franchisees or third-party competitors in relation to passing off, infringement of trademarks and other intellectual property, trade libel, unlawful collection, misappropriation and unauthorised disclosure of trade secrets.

To enforce the provisions of unfair competition laws, the franchisor may file a lawsuit directly with the court and argue under general competition principles on the basis of the

evidence it has collected. Alternatively, the franchisor may file a complaint with the AMC, or its local division, which would take up some of the burden of collecting evidence against a breaching party. As a result of its investigation, the AMC may order the cessation of any violation and impose a substantial fine. Moreover, once the violation is confirmed, the franchisor may then, on the basis of that established fact, apply to the court for damages. There are, however, drawbacks to the AMC investigation process for the franchisor. First, because of bureaucracy, it takes an overly long time for the AMC to conclude the process. Second, the franchisor has no access to the information collected by the AMC during its investigation proceedings and, therefore, the franchisor has little influence on the course of such an investigation.

ii Product liability

A franchisor bears subsidiary liability with franchisees for consumers' claims in relation to the quality of products manufactured by the franchisor and further resold by the franchisee (i.e., a consumer is entitled to bring a claim against the franchisor only after the franchisee has been found unable to satisfy the claim in full).

At the same time, if the franchisee manufactures the products under the technology and the standards granted under the franchise agreement, the franchisor and the franchisee shall be jointly liable. Please note, however, that currently there is no case law addressing the issue of product liability under the relevant provisions of Ukrainian law. Furthermore, in general, product liability cases are not often tried in Ukrainian courts.

Ukraine has recently updated its law on product liability. The new law defines that consumers are entitled to bring claims in respect of the following:

- a* against an actual producer and any person that is the brand holder of a product (i.e., this can actually be the franchisor or its related companies);
- b* against any importer of a product for sale, hire, leasing or any form of distribution as a producer (i.e., usually the franchisee or its related companies); and
- c* where a producer cannot be identified, each supplier (i.e., the franchisee or its related companies) shall be liable as a producer unless they inform an injured person of a producer or an importer within 30 days. Moreover, under the new law if several persons are liable for damages (e.g, a producer and an importer, in the case of imported products), an injured person is entitled to address its claims either to all liable persons jointly or to one of them separately.

At present, there is no comprehensive case law or official interpretation of the new product liability law. It is difficult to predict how most of its provisions will apply in practice. It is especially unclear how new rules will correlate with existing civil and consumer protection law.

Under Ukrainian conflict-of-laws rules, Ukrainian consumer protection laws apply mandatorily if the consumer claims derive from products sold in Ukraine. However, there is an exception if the goods are not produced in Ukraine (and merely available on its territory). In this case, a claimant has a right to choose the law of the country of manufacture to be applied as well.

iii Dispute resolution

Most disputes concerning franchising matters are heard by the courts of either civil or commercial jurisdiction (depending on the parties), including contractual and non-contractual matters. Whenever a public act or failure to act is challenged, the case is resolved by the courts

of administrative jurisdiction. The criminal proceedings in public prosecutions are overseen by the courts of criminal justice. As regards franchise matters, a criminal prosecution may be initiated for intellectual property infringement.

Besides the system of state courts, parties can choose to submit their dispute to an arbitration tribunal. Although binding on the parties, decisions of arbitration tribunals can be appealed to the courts.

Foreign courts may also be used as an alternative. To enforce the decision of a foreign court in Ukraine, however, the courts of both jurisdictions should have established mutual recognition of judgments. A significant disadvantage is the burdensome and time-consuming notification process under the Hague Service Convention.

Dispute resolution in international arbitration tribunals is allowed and enforceable in Ukraine. Ukraine is a party to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards and Ukrainian courts respect and frequently enforce arbitral awards. There is an established international tribunal at the Ukrainian Chamber of Commerce.

The major advantage of international tribunals is that the case is heard by either a sole professional international practitioner or a bench of such arbiters selected in the manner agreed by the parties. This provides greater certainty of a fair and just award being made in the case. The Ukrainian courts may, however, refuse to enforce an arbitration award on the grounds set forth by the New York Convention. The most common grounds for such a refusal is that of public policy. The other disadvantage is that injunctions in support of arbitration procedures are not currently practicable in the Ukrainian courts.

VII CURRENT DEVELOPMENTS

The major development, as mentioned above, is the abolition of the state registration requirement for franchise agreements, which had been one of the most controversial issues in franchise law in Ukraine. With the adoption of the Commercial and Civil Codes in 2003, Ukrainian private law introduced a registration requirement for franchise agreements; the problem was that Ukrainian public law did not envisage any procedure for registrars to perform such a registration. For this reason, the state registrars in Ukraine refused to perform registrations of franchise agreements altogether. This posed a serious risk to the enforceability of such agreements in the Ukrainian courts and there was no completely safe means by which to comply with the registration requirement under Ukrainian law.

Another essential step towards liberalising business and trade relations in Ukraine is the adoption of the new E-Commerce Act, which came into force on 30 September 2015. This Act will certainly influence the franchising sphere, since it provides for the execution of electronic transactions, including franchise agreements. Thus, the parties of a franchise agreement may choose to execute it in an electronic form. According to the Act, an electronic transaction shall have legal force and consequences equal to those of any other valid legal transaction, in particular, an agreement in written (paper) form. Importantly, this principle applies only to electronic transactions signed by the parties concerned in one of the following ways:

- a* by a certified digital signature;
- b* by a digital signature provided by the seller to the customer in the form of a one-time identifier (a combination of numbers and letters); or

- c* using an analogue of the handwritten signature, such as a facsimile, provided the parties agree to this in writing and the agreement shall contain samples of the parties' respective signature analogues.

Despite the progressive character of the Act, and given that even after one year there is a lack of comprehensive practice in this regard, it remains to be seen how it will be received by traditional business and how, in light of the conservative nature of administrative and court practice, it will actually be applied (in particular, to cross-border contracts, including franchise agreements). Certainly, practical issues will emerge, necessitating adjustments of the Act and concurrent legislation.

In November 2016, the Ukrainian parliament approved progressive legislative changes removing a number of formalities pertaining to cross-border contracts. In particular, the changes explicitly provide for the option to execute such contracts in an electronic form. As regards contracts for the export of services, an exchange of emails, issuance of an invoice, including an electronic one, and the acceptance of a public offer will be considered to be as valid and binding a contract as a standard paper-form agreement. These changes to the law should simplify cross-border business relations between franchisors and franchisees.

UNITED KINGDOM

*Graeme Payne*¹

I INTRODUCTION

The United Kingdom is one of the more 'mature' franchise markets of all the nations that have embraced franchising as a vehicle for business growth. At the time of writing, the latest published NatWest/British Franchise Association Franchise Survey (the Survey) was the 2015 Survey. The 2015 Survey reported a total of 901 franchise systems in the United Kingdom. The Survey also reported that the overall contribution of franchising to the UK economy was about £15.1 billion, an increase of 46 per cent over the past 10 years and up 10 per cent since the previous survey in 2013.

The Survey goes on to report that between them, the franchise systems in the United Kingdom operate an estimated total of 44,200 franchised units, representing a 14 per cent growth in two years. On average, these businesses are becoming larger as the sector matures, with more than half those surveyed claiming a turnover in excess of £250,000. In addition, employment per unit continues to increase, with one-third now employing 10 or more staff; this is partly due to the rise in franchised units within the hotel and catering sector, which generally have higher numbers of staff.

The majority (80 per cent) of franchise systems in the United Kingdom are UK-owned, which is a huge contrast to 25 years ago, when the majority of systems were imported from the United States. About one in four systems have operations outside the United Kingdom and for those franchisors that do not currently operate internationally, one in nine (11 per cent) would consider doing so in the future. The number of franchisees has fallen by 15 per cent but franchisees are now operating more units. Currently 30 per cent of franchisees operate multiple units and this is expected to continue, with 20 per cent of franchisees anticipating increasing their operation in the next 12 months.

Sectorally, the Survey concludes that health and fitness franchises are increasing, as well-being awareness grows and established brands from overseas enter the UK market. A less positive outlook was revealed in the transport and vehicle services sector and the business and commercial services sector, both of which saw little growth in the past decade. They made up just over 17 per cent of all units in the survey, compared with a quarter in 2005. However, a record 97 per cent of franchisee-owned units reported profitability and commercial failure rates were correspondingly low (4.6 per cent) when compared with failure rates for small and medium-sized enterprises generally.

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The United Kingdom's national franchise association is the British Franchise Association (BFA), which was formed in 1977. The BFA is a voluntary self-regulating body whose stated aim is 'to promote ethical franchising practice in the United Kingdom and help the industry develop credibility, influence and favourable circumstances for growth'.

II MARKET ENTRY

i Restrictions

Typically, there are no restrictions faced by foreign franchisors in terms of the granting of master franchises or development rights to a local entity in the United Kingdom. The United Kingdom is generally considered to be a relatively easy and regulation light place in which to do business. Foreign ownership and investment in the United Kingdom – in terms of foreign franchisors owning equity in a local business or owning commercial or residential property (or other assets) – is subject to very few regulations. With relatively benign immigration laws and no mandatory approval conditions, there is little by way of legal barriers to, or restrictions on, foreign franchisors entering the UK market.

ii Foreign exchange and tax

There are no foreign exchange controls or restrictions on foreign currency payments that are applicable to cross-border franchising in the United Kingdom. It is, however, important that the franchise agreement expressly details the choice of payment currency, together with the rate and time of the conversion for payments where applicable.

An overseas or foreign franchisor will be exempt from UK tax unless:

- a it carries on a trade or business through a permanent establishment in the United Kingdom; or
- b it receives certain UK-sourced income that is subject to UK withholding taxes (for example, certain royalty or interest payments; see also Section V).

III INTELLECTUAL PROPERTY

i Brand search

The key intellectual property rights that will form part of a franchise business concept are trademarks; domain names; copyright – particularly in respect of materials such as the operations manuals, website and social media text and advertising, marketing and promotional literature – and database rights. To a lesser extent patents, design rights and image rights may play a role in the franchise business concept.

As copyright is a non-registrable right the key registered (or registrable) right is the trademark, or the franchisor's brand rights as they are commonly referred to. For the franchisor looking to register its trademarks, the recommended searches from a UK perspective are, with respect to registered trademarks, the centralised systems offered on the trademarks section of the UK Intellectual Property website and the trademarks section of the European Union Intellectual Property Office (EUIPO) website (for European Union trademarks, or EUTMs).

Searches should be carried out for both identical and similar marks and consideration given as to whether the trademarks are being used against identical or similar goods and services to those of the franchisor.

It is also recommended that general internet searches be carried out to check what trademarks are being used in the public domain, particularly those that are not registered and thus not identifiable on the trademark registers but that could still pose a threat to the franchisor's trademarks because of their use in the public domain.

If the franchisor's trademark is not registered and there are no registered trademarks identified through the searches that are identical or similar to that of the franchisor's trademark, an application for registration should be made as quickly as possible. If, however, searches identify that there are already registered trademarks identical or similar to that of the franchisor, the franchisor could be at risk of having infringement proceedings brought against it for the use of its trademark and should therefore stop all use of its trademark and consider what changes could be made to its trademark so that the mark cannot be deemed identical or similar to any others currently registered. The new trademark should then be registered to ensure it is protected going forwards.

In addition to carrying out regular trademark searches, it is advisable – particularly so that expensive opposition, invalidity or infringement proceedings can be avoided – that a trademark-watching service be set up to ensure that the franchisor or franchisee is continually notified of any potentially conflicting trademarks that other parties are applying to have registered with one of the trademark registries. The costs of such a service varies depending on the search criteria, in particular the number of trademarks required to be watched and what trademark classes need to be covered.

With regards to domain name searches, there is no centralised system as there is for trademarks. It is, however, possible to check whether a domain name has been registered using a WHOIS service.

ii Brand protection

To protect the franchisor's brand it is important that the franchisor's trademarks and domain names are correctly registered.

For UK trademarks, applications are made to the UK Intellectual Property Office (UKIPO). For franchisors looking at additional expansion in Europe it is advisable to obtain (depending on the precise European markets that a franchisor is looking to promote and provide its goods and services in an EUTM, which provides trademark protection in each Member State of the EU. An EUTM application is made to the EUIPO in Alicante, Spain. Alternatively, an international registration can be applied for (specifying the individual countries in which it is desired to protect the trademarks) through the World Intellectual Property Organisation (WIPO) under the Madrid Protocol.

The franchisor will need to determine which of its goods and services should be subject to registered trademark rights for the purposes of the franchise business and provide a description of each. It is often advisable to seek the advice of a specialist trademark solicitor when preparing the trademark application, in particular which goods and services should be included in the trademark specification. For UK and EU trademarks registered with the UKIPO and the EUIPO respectively, the classification system is divided into different classes, with goods in classes 1 to 34 and services in classes 35 to 45.

It is important to ensure that the franchisor's registered trademark specifications are sufficiently broad to cover all the goods and services currently offered by the franchise business to ensure that no other entity can use identical or similar trademarks in relation to identical or similar goods and services, thus causing the consumers of the franchise business

to be confused as to the origin of the goods and services being offered to them. The trademark specification should also cover goods and services that the franchise business might be looking to expand into in the future and thus not limit the direction of the franchise business.

In relation to domain names, as with the searches, there is no centralised system for domain name registration, therefore registration of a domain name is carried out through a registrar. There are a large number of registrars and the choice of registrar will be determined by price, reputation for reliability and other services offered such as website hosting, and domain name portfolio management. A domain name is registered for a set period (for example, two years) and will have to be renewed once that period is up.

iii Enforcement

There is an array of potential protection techniques enforcing intellectual property rights (IPRs), as well as protection in the event that a franchisor's franchisee (or master or developer) infringes the franchisor's IPRs. A number of IPR enforcement strategies are, however, equally applicable to the scenario in which an independent third party infringes the franchisor's IPRs.

Part of an effective strategy is to ensure that the franchisor's IPRs are correctly protected in the first place.

Contractual provisions

In addition to formal or registered protection for IPRs such as trademarks, domain names, patents and designs (as discussed above) a well-drafted franchise agreement should provide the franchisor (at least in terms of its franchise network) with contractual protection against infringement of its IPRs by franchisees.

As a minimum, the franchise agreement should include:

- a* an appropriately worded grant of rights clause defining the extent and limits of the franchisee's right to use the franchisor's IPRs;
- b* confidentiality provisions obliging the franchisee to only use and disseminate the franchisor's IPRs, know-how and confidential information to the extent necessary for the operation of the business;
- c* IPRs clauses regarding the franchisee's permitted uses of the franchisor's IPRs, together with express provisions regarding non-infringing use of the IPRs and how infringement actions are to be dealt with; and
- d* provisions regarding the collection, use and sharing of data and related database rights.

In addition to the above in-term provisions regarding the appropriate use of IPRs and materials featuring IPRs, it is important that the franchise agreement expressly details appropriate post-termination or expiration provisions regarding a terminated or expired franchisee's non-use of the franchisor's IPRs, including debranding obligations and time lines for so doing.

Operational and organisational methods

Closely tied in with and backed up by contractual provisions should be certain operational and organisational measures, including:

- a* initial and ongoing training emphasising key messages regarding the use of IPRs, know-how and confidential information;

- b* appropriate confidentiality, copyright and no copying notices on key operational documentation, including the manual – as well as technical and IT safeguards for such operational information as the franchisor makes available online;
- c* template stationery and promotional materials provided by the franchisor to ensure that the franchisor's IPRs are used in the correct manner; and
- d* appropriate policies and training regarding the franchisee's use of branded email accounts and branded social media.

Legal enforcement

With regard to enforcement for registered trademarks, if 'cease-and-desist'-style letters fail to resolve the issue, then a franchisor can seek injunctive relief to stop the infringing use by the franchisee (or third party) together with a claim for damages or an account of profits unlawfully made by the franchisee. In determining whether injunctive relief should be granted the court will have regard to the balance of convenience between the parties' interests and the prospect of unquantifiable or irreversible harm (or both).

With unregistered trademarks, a claim can be brought under the common law for the tort of 'passing off'. The franchisor will be required to establish that:

- a* it has goodwill in its unregistered marks;
- b* that the franchisee has made misrepresentations to customers or prospective customers that amount to a false imitation of the franchisor's branded goods or services; and
- c* that as a consequence of the franchisee's actions, the franchisor has suffered loss (i.e., loss or diversion of business).

As passing-off actions tend to be more complex and costly as compared with relatively simple trademark infringement actions, well-advised franchisors tend to invest in a brand protection (including searches) and registration programme at the outset.

In respect of domain name actions, proceedings can be initiated against cybersquatters and others infringing trademarks through use of a domain name. The relevant rules and procedure differ depending on the type of domain name. For example, disputes over .com, .net and .org domain names are governed by the ICANN Uniform Domain Name Dispute Resolution Policy (UDRP)² and .co.uk by the Nominet Dispute Resolution Service policy.³ Disputes under the UDRP are heard by a number of tribunals, for example, WIPO.⁴

Disputes in relation to UK domain names are heard by the Nominet Dispute Resolution Service. Domain name dispute resolution proceedings are generally simple and low cost. Proceedings are conducted on paper and hearings are extremely rare.

With regard to the protection of IPRs such as copyright and items such as know-how and confidential information, much like with trademarks, the franchisor's enforcement options will initially start with correspondence between the franchisor's and franchisee's legal advisers, which, if unsuccessful, may result in an application for an injunction by the franchisor and depending on the nature of the franchisee's conduct, a subsequent court-based trial to determine the franchisor's possible remedies.

2 www.icann.org/en/help/dndr/udrp.

3 www.nominet.org.uk/disputes/when-use-drs/policy-and-procedure/drs-policy.

4 www.wipo.int/amc/en/domains/.

iv Data protection, cybercrime, social media and e-commerce

After a period of incremental development of the laws that regulate data protection and security, Europe is in the process of undergoing considerable change in these areas of regulation.

For over 15 years, the key pieces of data protection legislation in the European Union have been the Data Protection Directive 95/46/EC and the Privacy and Electronic Communications Directive 2002/58 EC (as amended). The former regulates all personal data processing, the latter electronic and telephone marketing, the use of online tracking technologies such as cookies and a number of other communications issues.

In the United Kingdom, these Directives have been implemented as the Data Protection Act 1998 (DPA) and the Privacy and Electronic Communications (EC Directive) Regulations 2003 (as amended). In May 2018, the Data Protection Directive will be superseded by the General Data Protection Regulation (GDPR), which will have direct effect and therefore will not need to be implemented by domestic legislation in Member States. In the context of the United Kingdom's exit from the European Union following the June 2016 Brexit referendum, the GDPR will be adopted into law before any Brexit takes effect. A replacement for the Privacy and Electronic Communications Directive is also expected to be announced in early 2017. Even if the United Kingdom were to legislate away or ignore the GDPR and any replacement to the Privacy and Electronic Communications Directive, any UK-based franchisor or franchisee whose business targeted European Union customers or staff would be regulated by this legislation, and would therefore need to comply with the relevant provisions.

Given that many franchisors will want to retain rights of access to and use of data obtained via its franchisees, contractual arrangements made between franchisors and franchisees will need to be updated to account for the implications of the new data protection laws that Europe will shortly introduce, not least because the fines for non-compliance will increase dramatically under the GDPR (see below).

An introduction to current obligations under the DPA

At present, the DPA is likely to impose obligations on franchisors and franchisees with respect to any customer, staff or supplier personal data that they process, as in most situations both are likely to be considered data controllers.

If franchisors and franchisees are data controllers, they will need to notify the UK Information Commissioner's Office of their data processing activities and pay an annual registration fee.

Other obligations under the DPA include the need to abide by the data protection principles outlined in Chapter 7. In practice, this will mean ensuring that notice is given to relevant individuals (by either the franchisor or the franchisee) about what data are collected, with whom they are shared and how they are used, as well as ensuring that there is a legitimate basis for processing the data, such as consent. Consent may also be required for direct marketing, with opt-in consent required for marketing conducted by email, SMS or fax. The data should not then be used in any other way that is incompatible with the specified purposes, and appropriate steps should be taken to ensure data are secure, accurate, kept only as long as necessary and not excessive. The use of customer data in accordance with these principles is particularly important to enable a franchisor to contact customers obtained by franchisees or to provide a new franchisee with access to a former franchisee's customer database.

The final data protection principle in the DPA relates to international transfers of data. If data are being made available from the United Kingdom to a franchisor outside the EEA,

then the UK organisation (i.e., most typically a UK master franchisee or developer) will need to consider the data transfer restrictions, which only allow transfers to take place where data will be 'adequately protected'. Similar data transfer restrictions exist under the GDPR.

An introduction to future obligations under the GDPR

From 25 May 2018, the GDPR will introduce significant new personal data processing obligations and significantly higher fines than are currently imposed in the European Union for non-compliance – the maximum fine that can be imposed under the GDPR will be a figure equivalent to the greater of 4 per cent of worldwide turnover or €20 million.

The GDPR will also introduce a requirement for data breaches to be proactively notified to regulators and to individuals affected by the breach.

Under the GDPR, new accountability or data governance measures will also need to be implemented, which include running data protection impact assessments, audits, policy reviews, activity records and (potentially) appointing a data protection officer.

In most situations, franchisors and franchisees will continue to be considered data controllers, and therefore they will be required to adhere to the processing principles outlined in Article 5 of the GDPR. These principles cover the lawfulness, fairness and transparency of data processing, limitations on the purposes of data processing, data minimisation, data accuracy, limitations on the storage of data, and the integrity and confidentiality of data processing. The GDPR requires that there is a 'lawful' basis for processing and gives a range of examples that are very similar to those under the DPA, including consent.

The requirements for consent have, however, become stricter when compared with the DPA, and franchisors and franchisees alike should be aware that there is an effective prohibition on 'bundled' consents and the offering of services that are contingent upon consent for processing. Consent must also be separable from other written agreements, clearly presented and as easily revoked as given. As under the DPA, the use of customer data in light of the requirements set out by the GDPR will be crucial for ensuring that franchisors are able to lawfully contact customers obtained by franchisees, provide a new franchisee with access to a former franchisee's customer database, and to guarantee that franchisors and franchisees are able to lawfully carry out direct marketing.

Individuals, including a franchisor's customers and staff will obtain significant new rights under the GDPR, including the right to demand, in certain circumstances, that their personal data are transferred to a replacement service provider (the 'right to data portability'), and the right to demand the erasure of inaccurate information (the 'right to be forgotten'.)

If a UK franchisee is importing data from a franchisor based outside the EEA, it will need to consider whether there are any relevant data transfer rules in that particular country with which it needs to comply.

Taking all the above points together, franchisors and franchisee would be well advised to review their contractual and operational procedures to ensure that they are prepared for the changes that Europe's new data protection laws will bring.

Cybercrime

On 19 July 2016, the European Parliament published its directive on network and information security across the EU (the Cybersecurity Directive). The Cybersecurity Directive is the first comprehensive piece of EU legislation addressing the area of cybersecurity risk. Its objective is to seek to achieve a high level of commonality of approach in the way that Member States address the urgent need to improve security in networks and information systems. Following

the publication of the Cybersecurity Directive, Member States have until 9 May 2018 to implement the Directive in national law, and a further six months thereafter to declare for their jurisdiction the identities of ‘operators of essential services’.

As the brunt of the compliance obligations that will come into place in the United Kingdom’s enactment of the Directive fall upon the operators of essential services, it is important for the purposes of businesses to form a view on who is likely to be identified as such an operator.

In the Directive, the sectors in which operators of essential services are likely to be identified are energy, transport, banking, financial market infrastructures, health, drinking water supply and distribution, and digital infrastructure where the relevant entity provides a service that is essential for the maintenance of critical societal or economic activities; the provision of the service is dependent on network and information systems; and an incident affecting the network and information systems of that service would have significant disruptive effects on its provision.

Focusing a little closer on operators in the identified sectors, it seems the following can expect to be identified as operators of essential services:

- a* energy sector: electricity and gas suppliers, distribution system operators, transmission system operators, storage system operators, LNG operators, and operators of oil and natural gas production, refining and treatment facilities;
- b* transport sector: air and maritime carriers, traffic management control operators, airports, railways, road traffic management control and intelligent transport system operators;
- c* banking: credit institutions in accordance with the Capital Requirements Regulation (575/2013);
- d* financial market infrastructure: stock exchanges and central counterparties;
- e* health: healthcare providers (including hospitals and private clinics);
- f* drinking water: entities in the drinking water supply and distribution sector; and
- g* digital infrastructure: internet exchange points, top-level domain name registries, and domain name system service providers.

The requirements of the legislation for operators of essential services will include the need to take appropriate and proportionate technical and organisational risk management measures, including measures to prevent and minimise the impact of incidents that affect security of the networks and information systems used with a view to ensuring continuity of those services. They will also be required to comply with a reporting scheme to notify without undue delay to the competent authority or computer security incident response team ‘incidents having a significant impact on the continuity of the essential services they provide’.

While the anticipated legislation focuses on operators of essential services, it is inevitable that suppliers to those operators will be contractually drawn into compliance as the operators of essential services pass down their own compliance obligations to their supply chains.

Whether franchisors will be affected or not by the advent of national cybersecurity legislation, what should franchisors be doing now?

Key concepts:

- a* accept that a cybersecurity incident is a matter of ‘when’, not ‘if’;
- b* stop regarding cybersecurity as solely an IT issue;
- c* balance your approach between prevention and preparation for when an incident occurs;

- d* adopt a multidisciplinary approach, including: IT and IT forensics, legal and compliance, and PR; and
- e* do not seek to address cybersecurity resilience without simultaneously looking at compliance with the anticipated requirements of the GDPR, and vice versa.

Action points:

- a* establish your cybersecurity team – with senior board engagement;
- b* review your current cybersecurity technology and, if necessary, implement data monitoring and behaviourally based detection systems;
- c* prepare a cyber-response strategy – cyber-response plan, cyber-response teams and reporting mechanisms;
- d* train and test; and
- e* review cybersecurity-related insurances.

Social media

When the franchisor or franchisee posts personal data on a social networking site, message board or blog, they will need to ensure that they have complied with the DPA. The same applies if they download personal data from a social networking site and use it for their business purposes. Anyone running an online forum should take steps to ensure that there are (1) clear acceptable use policies; (2) easy-to-find procedures for individuals to dispute the accuracy of posts and ask for them to be removed; (3) mechanisms to add a note to a post indicating that the individual disputes its factual accuracy or to remove or suspend access. The organisations should also ensure that they respond to disputes about accuracy quickly and have procedures to remove or suspend access to content at least until any disputes have been settled.

The franchisor should also consider whether they want to manage the social media platforms on behalf of their franchisees or place restrictions on the franchisee's use of social media (such as requiring preapproval of the platforms, profiles and any trademarks or brand logos being used, ensuring compliance with all laws and relevant codes of practice, including the DPA, relevant laws and codes on advertising such as the CAP code, mechanisms to take down content at franchisor's request or following a third-party complaint and obligations to comply with the franchisor's social media policy). Depending on the level of control a franchisor wishes to exert – which to a large extent will depend on the franchisor's level of resources – will thereby determine the level of brand consistency for the franchise business across the internet, including social media.

IV FRANCHISE LAW

i Legislation

There are no specific franchise laws in the United Kingdom. The franchisor–franchisee relationship is governed by contract law with a number of statutes, voluntary codes and case law affecting both the franchisor–franchisee relationship and the franchise agreement itself. Franchisors who are members of the BFA are obliged to comply and ensure that their franchise agreements conform with the BFA Code of Ethics (the BFA Code) (see below).

ii Pre-contractual disclosure

As a starting point there is no mandatory pre-contractual disclosure requirement in the United Kingdom. This statement, however, is not particularly helpful for ethical franchisors or franchisors wishing to adopt best practice. The BFA Code to some extent enshrines best and recommended practice in relation to pre-contractual disclosure requirements. Members of the BFA are required to disclose certain information in writing to prospective franchisees within a reasonable (not defined) period prior to signature of the franchise agreement. This information includes:

- a* the business and financial position of the franchisor;
- b* the main officers of the franchisor;
- c* details of the franchise business;
- d* details regarding the franchise network and franchisees;
- e* any financial projections or historical financial performance data; and
- f* key terms of the franchise agreement.

With the exception of the BFA requirements there is no statutory or other pre-contractual obligation on franchisors to disclose relevant facts. Generally the principle of *caveat emptor* or ‘buyer beware’ applies to the pre-contractual phase of the franchisor–franchisee relationship. The laws of misrepresentation, however, apply to the pre-contractual phase of the franchisor–franchisee relationship. The concept of misrepresentation is enshrined both in the Misrepresentation Act 1967 and common law.

There are two main types of misrepresentation claims relevant to pre-contractual disclosure, which vary according to the level of belief held by the franchisor in the truth of the statement. If the franchisor makes a false statement knowingly, or without belief in its truth, or recklessly as to its truth, then they may be liable for fraudulent misrepresentation. If, however, the franchisor only made the statement carelessly, or without objectively reasonable belief in its truth, then the franchisor may be liable for negligent misrepresentation.

If a franchisee can demonstrate that the franchisor’s misrepresentations were statements of fact that induced the franchisee to enter the franchise agreement, as a result of which the franchisee suffered loss, the franchisee will be entitled to seek compensation for the loss. The franchisee may also be entitled to rescind the franchise agreement. Recent case law has shown that the courts are increasingly willing to award substantial damages for misrepresentation by franchisors.

In *Peart Stevenson Associates Ltd v. Holland*,⁵ the franchisor was awarded £20,000 for a breach of contract by the franchisee in relation to overdue payments and post-termination restrictions. The franchisee counterclaimed, however, stating that a number of representations, including those relating to projected turnover and profit, had induced it to enter the agreement and it transpired that the statements had been misleading. The court agreed with the franchisee and awarded £170,000 in damages, vastly offsetting the sum awarded to the franchisor.

Many franchisors use a ‘non-reliance’ clause in their franchise agreements, which involves either a warranty, undertaking or contractual obligation by the franchisee that no statement has been relied upon other than those contained in the written agreement. Such a clause is stronger if the franchisee is allowed an express opportunity to attach any

5 [2008] EWHC 1868.

relied-upon pre-contractual statements to the franchise agreement. It is important to note that non-reliance clauses cannot protect a franchisor against fraudulent misrepresentation, only negligent misrepresentation. Any clause that attempts to exclude liability for fraudulent misrepresentation will be unenforceable under common law as a matter of public policy. In principle, non-reliance clauses in business-to-business dealings are legitimate, but any clause that attempts to limit or exclude liability for misrepresentation or excludes any remedy for misrepresentation is enforceable only to the extent that it satisfies the test of reasonableness under the Unfair Contract Terms Act 1977 (UCTA) (by virtue of Section 3 of the Misrepresentation Act 1967). Whether a particular clause is, in fact, enforceable will be subject to the facts of each case. This is highlighted in the cases of *Henry Boot v. Foodco*⁶ and *Papa Johns (GB) Limited v. Elsada Doyley*.⁷

The court in *Papa Johns v. Doyley* (a case involving the provision of financial information and financial performance projections by the franchisor to the franchisee during the recruitment process) examined a number of relatively typical and common boiler-plate provisions in the franchise agreement that are normally designed to protect the franchisor against misrepresentation claims.

Despite case law having largely upheld such clauses in commercial contracts, the court in *Papa Johns* held the entire agreement and non-reliance clauses to be unenforceable as they failed to satisfy the reasonableness tests under the Misrepresentation Act 1967 and UCTA. The court's findings were largely based on:

- a* the inequality of bargaining power between the parties;
- b* Papa Johns' insistence that the agreement was non-negotiable; and
- c* the standard boiler plate clauses in the franchise agreement had not been brought to Ms Doyley's attention.

In contrast, in the case of *Henry Boot v. Foodco* (a case that involved performance projections provided by a landlord to franchisee tenants regarding motorway service stations) the bargaining power between the parties was more equal than in comparison with *Papa Johns*. The court held that the non-reliance clause was enforceable. In this specific dispute the court held that there was 'no doubt' that the clause was reasonable after considering the following factors under UCTA:

- a* certainty is desirable;
- b* there was no substantial imbalance of bargaining power between the parties;
- c* each of the tenants were advised by solicitors;
- d* the non-reliance provision was open to negotiation; and
- e* the clause permitted reliance by the tenants upon any replies given to them by Henry Boot's solicitors.

In *Lloyd v. Browning*,⁸ the Court of Appeal endorsed the *Henry Boot* reasoning under UCTA and stated that the general purpose of a non-reliance clause is to achieve certainty and forestall disputes, and that *Henry Boot* 'set out the features which are relevant to the assessment of reasonableness' and the approach of the courts in *Henry Boot* was to be 'endorsed'.

6 [2010] EWHC 358 (High Court).

7 [2011] EWHC 2621 (QB).

8 November 2013.

Despite the contrast in outcomes between *Henry Boot* and *Papa John's* it is advisable for international franchisors looking to enter the United Kingdom to ensure that any financial projections regarding the franchisee's business provided in the pre-contractual recruitment phase are not only capable of objective substantiation but are provided in writing with appropriate background information and health warnings. Express non-reliance clauses are important for franchisors' risk management but franchisors must be aware that their enforceability is not always guaranteed, especially in circumstances where the franchisee is an individual or small business inexperienced in commercial matters.

iii Registration

There are no registration requirements in the United Kingdom that impact on the franchisor–franchisee relationship or with regards to the franchise agreement itself. There is no requirement to register either the franchise agreement or the trademark licensing provisions as a registered trademark licence agreement.

iv Mandatory clauses

There are no mandatory clauses prescribed by statute or case law. Franchisors who are BFA members will need to ensure that their contracts comply with the BFA Code as well as the BFA's Extension and Interpretation of the Code. While the BFA Code does not specify mandatory clauses it does contain a list of terms to be contained in the franchise agreement.

It is therefore important that a UK franchisor or an international business franchising in the United Kingdom who wishes its master or developer to become a member of the BFA has its franchise documentation drafted by advisers familiar with the BFA Code.

v Guarantees and protection

In the event that a franchisor contracts with a sole trader then the sole trader franchisee will be personally liable for its performance and payment obligations and therefore a guarantee would not be required. In the event, however, that a franchisor contracts with a partnership or limited liability company franchisee, it is certainly advisable that a franchisor obtains a contractual guarantee from either the primary director or shareholder or partner as the case may be – or more than one key individual if commercially appropriate.

Where the franchise business involves an element of product supply by the franchisor to the franchisee it may also be prudent for the franchisor to request that the franchisee provides a letter of credit from a bank acceptable to the franchisor to cover payment defaults by the franchisee.

Provided that the contractual guarantee agreement is not unreasonable to the extent that it is legally unenforceable, then guarantees from individuals and companies to the franchisor are enforceable.

V TAX

i Franchisor tax liabilities

For UK tax-resident companies (which will generally include UK-incorporated companies unless 'treaty non-resident') or companies carrying on the franchising trade in the United

Kingdom through a permanent establishment, there will be UK corporation tax on the profits. For corporation tax purposes the main acts are Corporation Tax Act 2009, Corporation Tax Act 2010 and Taxation (International and Other Provisions) Act 2010.

Shareholders receiving dividends will – if UK tax resident, generally be subject to tax on the dividends received (although there may be exceptions). UK-resident corporate shareholders will be taxed under corporation tax principles – so under the above acts. UK individual shareholders will be taxed under the relevant income tax act. The charging provisions are set out in Part 4 of the Income Tax (Trading and Other Income) Act 2005.

If the supply of IPRs by the franchisor is segregated and a royalty is made to a non-UK resident company that is not trading in the United Kingdom, then there could be withholding tax on the royalty payment subject to relevant treaty (or other) relief; however, if the other provisions of the franchising agreement are supplied by the same company as the IP, then it is possible that the company may itself be trading in the United Kingdom as a result of the franchising arrangement.

The franchisor may need to register for and account for VAT on supplies to the franchisee. If the franchisor is not based in the United Kingdom, it is likely that the VAT on such supplies would be accounted for by the franchisee under the ‘reverse charge’.

ii Franchisee tax liabilities

If the franchisee is a UK-incorporated company, then pursuant to the main tax liabilities for franchisors discussed above, corporation tax will be applicable to the franchisee company’s profits. If the franchisee is a partnership or sole trader then the individuals’ income will be taxed under income tax rules and corporate partners will be taxed under corporation tax rules as per the above. Individual sole traders (and partners) will also be subject to National Insurance contributions – albeit at fairly low rates.

Withholding tax may also be payable – as also specified above. If there is a gross-up provision in the franchise agreement or IP licence then the liability for this could fall on the franchisee.

Subject to the nature of the goods and services sold or provided by the franchisee and supplied by the franchisor, the supply may be subject to VAT, which is governed by the Value Added Tax Act 1994. If the franchisee carries out an exempt (or partially exempt) business, then it may not be able to recover VAT (in full or in part) on the supplies made to it, including those of the franchisor.

iii Tax-efficient structures

If both franchisor and franchisee are UK entities then VAT registration for both parties is recommended.

For both tax reasons and contractual ring-fencing, franchisors may wish to consider which of their group companies should be the contracting entity and which supply (i.e., IP, products, services to the franchisees, etc.).

It may be better to ensure that the IP is supplied from a different entity to the company providing other franchisor ‘services’ to ensure that the withholding tax and trading position is clean.

Franchisors may wish to hold valuable functions (e.g., IP) in a tax-friendly offshore jurisdiction to accrue income and potentially realise gains at lower tax rates. However, this will potentially require a presence in that jurisdiction and may also require transferring

valuable rights to that jurisdiction, which may trigger exit taxes. Where the company holding the IP is a subsidiary, the ‘controlled foreign company’ or other anti-avoidance rules for the parent company may need to be considered.

For overseas-based franchisors receiving royalties from UK franchisees, the royalties may be subject to withholding tax and may be mitigated by treaty relief. Such treaty relief typically reduces the rate of royalty withholding taxes to a lower (or zero) rate but may require clearance from the relevant tax authority before payments can be made at the lower rate.

The structure of the fee arrangements (and therefore careful drafting in the franchise agreement will be required) may have a positive or negative effect on the tax treatment of both franchisor and franchisee. A franchisee will wish to maximise its tax deductions and the franchisor will wish to minimise its taxable income.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The traditional and long-standing position under English law was that a ‘good faith’ clause was not ordinarily binding, or capable of being enforced. Franchise purists historically have claimed that there is no overarching duty of good faith that can be implied into a franchisor–franchisee relationship under English law.

The idea, however, that good faith is not part of English law business-to-business contracting is now outdated. It remains broadly correct in relation to the pre-contract phase, but it is now clear that an implied concept of good faith is steadily gaining recognition as a legally binding concept during the performance phase of contracts particularly long-term ‘relational agreements’ such as franchise agreements.

Prior to the recent, and some would say ground-breaking ‘good faith’ case of *Yam Seng Limited v. International Trade Corporation Limited*,⁹ two franchise cases provided examples of where the English courts inferred a position equivalent to good faith into a franchise agreement. In *MGB Printing v. KallKwik*,¹⁰ the court implied an obligation on the franchisor to ensure that it provided services to the franchisee using reasonable skill and care on the basis of ‘business efficacy’. In *Stream Healthcare v. Pitman*,¹¹ the court ruled that services should be provided to the franchisee by the franchisor where reasonably required or requested.

In the *Yam Seng* case, Leggatt J analysed whether English law should impose an obligation of good faith in a distribution agreement. Leggatt J’s judgment drew together the pre-existing, disparate strands of English case law on the issue of good faith in commercial contracts and explained the importance of implied good faith in what he called ‘relational’ agreements, which are long-term agreements requiring extensive cooperation, a high degree of communication, mutual trust and confidence and expectations of loyalty. The judgment referred expressly to franchise agreements, long-term distribution agreements and joint venture agreements as examples of these relational agreements.

While arguably Leggatt J’s conclusion in the *Yam Seng* case that an implied duty of good faith did exist was potentially based on the facts of the particular case, including the fact

9 [2013] EWHC 111.

10 *MGB Printing and Design Limited v. Kall Kwik UK Limited*, High Court of Justice Queen’s Bench Division [2010] EWHC 624 (QB).

11 *Stream Healthcare (London) Ltd v. Pitman Education & Training Ltd*, High Court of Justice Chancery Division [2010] EWHC 216 (Ch).

that there was clear evidence of bad faith on the distributor's behalf, his judgment does clearly imply an objective duty of good faith between parties in long-term 'relational' contracts. The fact that franchising was specifically referenced as one of these forms of 'relational' agreements highlights its relevance to the performance phase of a franchisor–franchisee relationship.

In the July 2014 decision of *Bristol Groundschool v. IDC*,¹² the High Court ruled that a duty of good faith should be implied into a 'relational contract' for the production and distribution of training materials for pilots. The judge said that it is clear from the *Yam Seng* decision that 'good faith extends beyond, but at the very least includes, the requirement of honesty' and '[t]he relevant test is that of conduct which would be regarded as "commercially unacceptable" by reasonable and honest people in the particular context involved'.

However, these cases can be contrasted with the July 2014 High Court decision in *Carewatch Services Ltd v. Focus Caring Services Ltd & Others*¹³ in which the defendant franchisee tried unsuccessfully to argue that (among other alleged implied terms) the franchise agreement contained an implied term that the parties would conduct themselves in 'good faith and/or deal with each other fairly and in particular not in a manner that would damage each other's business interests'. The judge in *Carewatch* agreed with the reasoning of the judge in the case of *Hamsard v. Boots*¹⁴ (which concerned the termination of a supply agreement between the parties for the supply of children's clothes to Boots stores), who said that he did not regard the *Yam Seng* case as authority for the proposition that there is a general obligation of good faith implied into all commercial agreements or that there is some sort of positive obligation implied that a party to a contract should subordinate its own commercial interests (in this judgment, the franchisor's) to those of the other contracting party.

More recently, in the 2016 case of *Apollo Window Blinds Ltd v. Mr McNeil & Mr Taylor*, the franchisees argued that there was an implied obligation of good faith that obliged the franchisor to remind the franchisees of an obligation in the franchise agreement to give the franchisor notice that they wished to renew between six and nine months prior to the expiry date. While the judge did not discount the possibility that there may be an implied obligation of good faith in relation to some parts of the agreement, the judge said that he could not see a court implying a term that imposes a duty on one party to tell the other of its contractual rights. As the giving of notice was a requirement of a right to renew, the judge took the view that the franchisees had no automatic right of renewal, as they had failed to give the requisite notice.

For BFA-registered franchisors, a failure to act in good faith may constitute a breach of the BFA Code and therefore such challenges from unhappy franchisees may well increase. A standard of good faith is taking shape under English commercial contract law as seen in the *Yam Seng* and *Bristol Groundschool* decisions. By contrast, the *Carewatch* and *Apollo Window Blinds* decisions illustrate that the concept of good faith has its limitations and courts will not allow franchisees who are treated roughly, but commercially fairly, to use the concept to benefit from rights and protections that the written agreement did not give them.

12 *Bristol Groundschool Ltd v. Intelligent Data Capture Ltd* [2014] EWHC 2145 (Ch).

13 [2014] EWHC 2313 (Ch), 2014 WL 3002765.

14 [2013] EWHC 3251 (Pat), *Hamsard 3147 Limited Trading as 'Mini Mode Childrenswear', JS Childrenswear Limited (in liquidation) v. Boots UK Ltd* 2013 WL 5826153.

ii Agency distributor model

In the United Kingdom, a genuine franchisor–franchisee relationship will not be treated as one of principal and agent or manufacturer and distributor. It is, nevertheless, advisable to have an express provision in the franchise agreement confirming that the franchise relationship will not be construed as one of employer and employee (see below), or principal and agent or manufacturer and distributor.

iii Employment law

In a genuine franchisor–franchisee relationship, franchisees are not and cannot be treated by the courts as employees.

iv Consumer protection

Franchisees are not generally treated as consumers under English law and therefore are not afforded consumer protection rights.

Notwithstanding this, it is important for franchisors to be fully aware of consumer-facing laws as these will nevertheless have an impact on the franchisor, whether dealing with consumers directly or through its franchisees. A franchisor will need to ensure there are suitable provisions in the franchise agreement requiring its franchisees to comply with all consumer protection legislation.

The Consumer Contracts (Information, Cancellation and Additional Charges) Regulations 2013 (the Consumer Contracts Regulations) contain provisions that will be relevant to all franchisors and franchisees who deal with consumers (referred to in the legislation as ‘traders’), but will have a particular effect on the protections available to consumers when they purchase goods or services using a means of distance communication such as the internet. The Consumer Contracts Regulations require all traders to provide consumers with certain specific pre-contractual information prior to entering into any contract (e.g., on the total costs of the relevant products or services, and the arrangements for payment and delivery). Where orders are placed using the internet or other electronic means, the trader must clearly label the order button to indicate that placing the order entails an obligation to pay (e.g., by using words such as ‘order with obligation to pay’). For distance contracts, traders must also offer consumers a period of 14 calendar days in which they can cancel the contract. The Consumer Contract Regulations also contain specific provisions governing refunds, returning goods, delivery and risk, inertia selling and help-line charges, and introduced specific new rules regarding the supply of digital content.

A large proportion of consumer law has also recently been codified under the Consumer Rights Act 2015 (CRA). The CRA prohibits certain types of unfair terms in consumer contracts (e.g., in respect of excluding liability) and provides that certain terms must be implied in any agreement with a consumer (including the pre-contractual information required by the Consumer Contract Regulations, alongside other requirements such as that goods be of satisfactory quality, be fit for a particular specified purpose and match their description). It sets out a series of tiered statutory remedies for the consumer in the event their statutory rights are breached. These include: (1) a short-term right to reject the goods, lasting 30 days; (2) a right for the consumer to require the trader to repair or replace the goods at the trader’s cost; and (3) if the repair or replacement does not remedy the problem, a right to an appropriate price reduction or a final right to reject the goods. The CRA contains further

protections around digital content, including variations on the tiered remedies described above and an additional compensation mechanism where digital content causes damage to a device or other digital content owned by a consumer (e.g., by introducing a virus).

Other important consumer laws include the Consumer Protection from Unfair Trading Regulations 2008, which prohibit various unfair commercial practices by traders, such as providing misleading information or omitting material information, and include a 'blacklist' of commercial practices that are automatically prohibited (e.g., 'bait advertising'), and the E-Commerce Regulations 2002, which require website operators to provide additional specific information about themselves and their services.

v Competition law

The BFA Code does not provide a minimum term for a UK franchise agreement. Instead, it states that, as a minimum, the agreement should be long enough for the franchisee to amortise its initial investment. Franchise agreements in the United Kingdom are typically granted for an initial term of five years. This is often supplemented in the agreement by providing for two further five-year periods subject to the franchisor's approval and certain renewal criteria being met at the end of each period.

The five-year term approach in the United Kingdom is mainly a response to European competition law (as further discussed below), and in particular Article 101 of the Treaty for the Functioning of the European Union (Article 101). If an agreement is found to be contrary to Article 101, then either the prohibited provision – or in some circumstances the entire agreement – will be declared void and the relevant parties may be liable to fines. Chapter 1 of the UK Competition Act 1998 (the 1998 Act) largely replicates the key provisions of Article 101.

In-term non-compete provisions, including product ties or an obligation on the franchisee not to be involved in a similar business, are common in franchise agreements, which means that franchise agreements are typically regarded as having the potential to affect competition – contrary to the principles of Article 101 and the 1998 Act. In-term non-compete provisions are those that provide that, for the duration of the franchise agreement, the franchisee must not sell products or services that are in competition with those of the franchisor. Product ties are those provisions that restrict the franchisee to buying specified products, including those that the franchisee will sell on to customers, from the franchisor or its nominated supplier only.

As franchise agreements are classified as 'vertical agreements' (in that the franchisor and franchisee operate at different levels in the production or supply chain), subject to meeting certain conditions regarding market shares, they receive the benefit of an exemption found in the Vertical Block Exemption (VBE)¹⁵ and the European Commission's accompanying guidelines (the Guidelines). The VBE guarantees that the whole agreement does not infringe competition law provided it does not contain certain prohibited restrictions (called 'hardcore' restrictions).

A number of other provisions are 'excluded' under the VBE. Although these excluded restrictions cannot receive the benefit of the VBE themselves, and must therefore be assessed separately to understand if they infringe competition law, the remainder of the agreement

15 Commission Regulation (EU) No. 330/2010.

will continue to benefit from the VBE. One such excluded restriction is a non-compete obligation that lasts indefinitely or for longer than five years. As mentioned previously, most franchise agreements in the United Kingdom therefore adopt a five-year term.

Nonetheless, there is an exception to the five-year duration rule under the Guidelines,¹⁶ which is applicable to franchises. This states that a non-compete obligation on the products or services purchased by the franchisee may not be contrary to Article 101 if it is necessary to maintain the common identity and reputation of the franchised network. If this exception applies, the duration of the non-compete obligation is immaterial, and can be indefinite, provided that the obligation does not survive beyond the duration of the agreement itself. A very limited (no more than one year) post-term non-compete may be lawful if it is necessary to protect know-how and relates to the same premises that the franchisee used during the lifetime of the franchise agreement.

Price-fixing or resale price maintenance is classified as a hardcore restriction. Franchisors are permitted to set a maximum price or recommend a pricing structure for their franchisees but cannot take steps (contractual or otherwise) to enforce those recommended resale prices.

One of the more contentious areas has been websites and e-commerce, and at the time of publication the European Commission is undertaking a specific review of competition law in that area. Internet or web-based sales are generally classified as 'passive' sales by the European Commission and cannot be prohibited by the franchisor. Passive sales are typically reactive sales by a franchisee (i.e., where the customer seeks out the franchisee rather than the other way round). Franchisors can, however, prohibit a franchisee from making active sales (whether internet-based or otherwise) into any territory exclusively reserved for the franchisor or another of its franchisees.

Franchisors cannot, however, prevent franchisees from operating their own websites, although franchisors can impose quality standards, particularly in relation to representations of the brand and the general look, feel and content of the website. Similar rules appear to apply to restrictions on franchisees selling via internet platforms or price comparison websites. Franchisors cannot, however, prevent the franchisee setting up a website in a language other than that (or those) of the territories it is allocated; the Commission considers that to be passive selling.

vi Restrictive covenants

Non-compete and other restrictive covenants will typically be caught by competition or antitrust law principles (see Competition Law).

In terms of enforcement, if a franchisee is in breach of in term non-compete or restrictive covenants, the franchisor's initial course of action may be to terminate the franchise agreement. Following termination, the franchisor will either bring a claim against the franchisee for breach of contract or, depending on the nature of the franchisee's breach, apply for an injunction to compel the franchisee to either cease their infringing conduct or to comply with their obligations, if appropriate. The criteria for the grant of an injunction by the court are discussed elsewhere in this chapter. If the franchisor is successful in a contractual claim, the likely remedies include damages to compensate the franchisor for any losses it has suffered and potentially an account of profits that the franchisee has made from the competing business.

¹⁶ Paragraph 190(b).

vii Termination

Termination of a franchise agreement is dealt with under common law principles. It is therefore crucial that the termination provisions in the franchise agreement be not only clear but also significantly flexible so as not to limit or restrict the franchisor's ability to terminate.

Best practice dictates that the grounds for termination are clearly stated in the franchise agreement with a clear distinction between conduct that will result in immediate termination and conduct that is potentially remediable and therefore not damaging to the long-term or overall relationship.

The BFA Code dictates that franchisees must be notified of any breaches the franchisor claims have been committed and be given a reasonable time period to remedy the breach.

Under competition law principles, post-termination non-compete provisions are prohibited unless the franchisor's know-how is dependent on the provisions. In accordance with the VBE, as discussed above, such know-how is required to be 'secret', which is difficult for most franchisors to prove. If the know-how is deemed secret then the VBE recognises the right for franchisors to impose 12-month non-compete restrictions from the premises at which the franchisee operated its business.

Fortunately, case law has taken a more sensible approach than that set out in the VBE, recognising that a wider post-termination geographical restriction may be permitted provided the aim of the provision is to prevent the franchisor's know-how being used by competitors.

Enforcement of post-termination restrictive covenants will typically involve the franchisor applying to the court for an order injunctioning the former franchisee (i.e., preventing it from trading or otherwise acting in breach of its covenants).

Post-termination restrictive covenants will only be upheld if the court considers them reasonable. Typically, the court will look at the geographical width of the restriction and the duration. A 12-month restriction not to operate a competing business in the franchisee's former territory is likely to be enforceable, whereas a 24-month restriction for the whole of the United Kingdom is likely to constitute an unlawful restraint of the former franchisee's right to trade. Each case will, however, be examined on its own facts.

In the case of *Carewatch Care Services Limited v. Focus Caring Services Limited and others*, the High Court held and reaffirmed the position that restrictive covenants may be enforceable if it can be proven that they were designed to protect the company's legitimate business interests and went no further than necessary to achieve that purpose.

In the case of *Apollo Window Blinds* referred to above, the franchisees, who had 45 years of experience in the window blinds business, successfully defended the franchisor's application for an injunction against them on the basis that the restrictive covenants were not justified as the franchisees received no training and no goodwill; the franchisor was purely used by them as a source of good quality products.

viii Anti-corruption and anti-terrorism regulation

Within a contractual context, a franchisor's liability for fraud will largely be related to fraudulent misrepresentation as detailed above. In the event that the franchisee or principal shareholder or director commits an act or omits to act in circumstances that amount to fraud, it will often constitute an express ground for termination of the franchise agreement by the franchisor.

The UK Bribery Act 2010 (the 2010 Act) sets out a range of offences relating to bribery that may apply to the franchise relationship. The 2010 Act targets the payment or receipt of a bribe (which is not restricted to providing someone with a financial advantage) to a person

when the bribe is made with the intention of persuading that person to perform a function or activity improperly. The 2010 Act covers bribes paid and received by UK citizens, and also extends to bribes paid by UK citizens to foreign public officials.

The Money Laundering Regulations 2007 (the Regulations) aims to prevent money or assets that were obtained by criminal means, including money raised for the purposes of terrorism, being exchanged for money or assets that were legitimately obtained. Franchisors should ensure compliance with the Regulations by putting in place strict controls to verify the identity of their business partners and the sources of their wealth, along with having a clear reporting procedure for any suspicious activity.

Along with ensuring their own internal compliance, franchisors should have clear anti-bribery, anti-corruption and money-laundering policies in place for their franchisees. These policies should form part of the operating manual, as well as being part of the initial and ongoing training provided by the franchisor. The policies themselves, and any guidance given on them, should include key messages for the franchisees and practical considerations that flow from them. This should then be backed up by express contractual provisions in the franchise agreement so that a breach of any of the policies triggers a breach of the franchise agreement.

ix Dispute resolution

In domestic franchise disputes depending on the nature of the franchisee's conduct or breach a franchisor may seek an injunction to either stop or compel certain conduct by the franchisee. For most breach of contract claims litigation as opposed to arbitration is the typical form of dispute resolution in the United Kingdom. While mediation is a recognised form of alternative dispute resolution and actively encouraged by the Civil Procedures Rules, it is not mandatory. However, the parties can incorporate a mandatory mediation process in the dispute resolution clause in the franchise agreement, which is likely to be upheld by the courts in the United Kingdom.

For international franchisors, the English courts will recognise and uphold foreign choice of law and jurisdiction clauses. It is, however, advisable to ensure that a franchise agreement is reviewed by an English law expert in franchising to ensure that there are no clauses that would be unenforceable or contrary to public policy.

There is no specific procedure for franchise disputes in the United Kingdom – most are settled before reaching formal alternative dispute resolution methods or court-based litigation. The BFA offers both a mediation and arbitration scheme although the latter has not experienced a significant take-up rate. Certainly, for international franchisors and more sophisticated disputes, it is probably advisable to use one of the more experienced international arbitral bodies such as the London Court of International Arbitration.

Where a franchisor seeks an injunction against a franchisee, the reasons for which may include, for example, a former franchisee continuing to trade in breach of a non-compete provision or using the franchisor's trademarks or other IPRs, once the application is issued it may be heard on a without notice preliminary basis within one to three days or on notice with three clear days' notice to the opposing party. The courts will normally only grant an interim injunction on a without notice basis if there is a real risk that the franchisor will suffer severe harm if the franchisee is given notice of the application or it is extremely urgent. It is more common for an application to be made on notice in order that the franchisee has time to prepare for and be represented at the hearing.

The court's decision to award an injunction will be based on a consideration of the balance of harm to the franchisor caused by allowing the franchisee to continue to trade or use the IPRs against the harm caused to the franchisee by requiring the cessation of the conduct. If monetary compensation is deemed to be an adequate remedy for the franchisor, the court will not grant an injunction.

An interim injunction will be granted until trial or the end of the contractual period of restrictions, whichever is sooner.

It may take between 12 and 18 months before a dispute reaches full trial. By this point the restrictive covenants (and the injunction) will most likely have expired and the dispute will primarily focus on the level of harm suffered by the franchisor and the level of damages to which the franchisor (if successful) is entitled.

If a franchisor is successful in a breach of contract claim against a franchisee, it will be entitled to damages to put it in the position it would have been in had the contract been performed correctly by the franchisee. There are two limbs to the damages that can be claimed: those that flow directly and naturally from the breach and those that are indirect but that were in the reasonable contemplation of the parties at the time that the agreement was entered into. The types of losses that may be recoverable could include the franchisor's profit on the royalty fees for the remaining term of the agreement or until the franchisor could reasonably be expected to appoint a new franchisee; the costs of appointing a new franchisee; loss of profit on product sales that the franchisee would have bought; damage to the franchisor's goodwill or reputation (although this can be very hard to quantify); the costs of taking over and running the franchisee's territory until it can be refranchised.

If a franchisee is successful in a claim for negligent or fraudulent misrepresentation, it could be entitled to rescind the agreement (i.e., treat it as set aside) and damages to put it in the position that it would have been in had the agreement not been entered into. This could entitle the franchisee to claim a refund of the initial and all other franchise fees paid; refund of all set up and running costs (minus any profits made); a refund of the costs of any bank lending; and compensation for lost opportunity based on what the franchisee would or could have done had it not entered into the franchise agreement. The damages can therefore be substantial.

As a general rule, the successful party to litigation will be entitled to an order that the losing party pays its legal costs; however, the costs are always at the discretion of the court and unreasonable conduct by the successful party, such as issuing a claim without going through the appropriate pre-action protocols, refusing to enter into ADR or informal negotiations, or refusing to accept a without prejudice offer that it then failed to beat at the final hearing could result in it only recovering a proportion of its costs or even being ordered to pay the other side's costs. Costs are also subject to assessment by the court to ensure they are reasonable and proportionate and, as a general rule of thumb, a party can expect to receive around 70 per cent of its costs under assessment.

For claims over £25,000, the costs will not be capped (although they are subject to assessment, as explained above). For claims between £10,000 and £25,000 the costs will be capped and for claims below £10,000 (which are called 'small claims') the successful party will not be able to claim any costs from the losing party other than court fees.

In terms of enforcement, it is important for international franchisors to note that the United Kingdom is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitration Awards (the New York Convention) and the English Courts will readily recognise and enforce foreign arbitral awards from other Convention

countries. As an EU Member State, the UK courts will also recognise and enforce court judgments from other EU Member States by virtue of the Brussels Regulation and Lugano Convention.

VII CURRENT DEVELOPMENTS

In terms of specific legislation and case law that deals directly with franchising, 2016 has produced little that impacts significantly on either domestic franchise arrangements or relationships between an international franchisor and a UK developer, master or unit franchisee. There have, however, been other notable legal developments that will impact on the franchisor–franchisee legal arrangements and on both the franchisor’s and franchisee’s relationship with the ultimate consumer.

With the impending new European GDPR data protection legislation scheduled for 2018, most franchisors should now be checking not only the data protection provisions in their franchise agreements, but more importantly the policies, processes and data handling training that these organisations provide to both their franchisees and employees.

The ruling in *TRW Lucas Verity v. Globe Motors*¹⁷ represents a further weakening of ‘no variation except in writing’ provisions and should be taken into account by those involved in franchising. The Court of Appeal concluded, albeit in *obiter*, that it is possible to enter into a legally binding oral variation, despite the existence of a no-variations clause. The judges detailed that freedom of contract would prevail and that it was open to parties to waive compliance with particular provisions, although actual performance was the crucial factor in determining an oral variation. To protect against this potential risk, parties should ensure any variation is either expressly rejected in writing or fully agreed and documented in a side letter before goods or services are provided. However, no-variation provisions remain of some value because they raise the level of evidence required to show intention and authority.

In the wider commercial context UK franchisors continue to make considerable investments in technology, not only as a means for improving business efficiency but also to enable their franchisees to offer a uniform digital marketing platform and integrated e-commerce channel. The twin issues of investment in technology and the evolving landscape around handling, storing and processing data are likely to continue as trends and developments in 2017.

Obviously the seismic political decision of the United Kingdom to leave the European Union has both wide-reaching legal and commercial implications for franchisors, master franchisees, developers and franchisees. While at the time of writing the full extent of Brexit is not yet known, franchisors should be reviewing their brand protection strategies, and their franchisees’ employment policies and the constitution of their employee workforce, as these are areas that will need to be addressed whatever the outcome of the discussions between the UK government and the EU. In addition to free movement of labour issues, key considerations for international franchisors looking at entering the United Kingdom will focus on currency and import versus export prices.

17 [2016] EWCA 396 (Court of Appeal).

UNITED STATES

Richard L Rosen, Leonard Salis, John Karol, Michelle Murray-Bertrand and Avi Strauss¹

I INTRODUCTION

Franchising in the United States during 2017 experienced somewhat ‘mixed’ results, and while continued growth can be reasonably anticipated for 2018, some concerns still remain. While US gross domestic product (GDP) increased by approximately 3.2 per cent during 2017, increased GDP in the US franchising field during that period was almost 2 per cent higher. Fast food (as usual) and personal services were at the top of the franchising heap in 2017 (especially in the more temperate climate areas), but the potential for government restrictions on immigration may prove to be problematic as restaurateurs search for other sources to fill staff needs.

Savvy real estate developers anticipate a downturn in the domestic retail market as a result of the emergence of internet sales as the prime competitive factor for that portion of consumer spending that had previously found its way into the cash registers of franchised retail outlets. Some reports have predicted that as many as 20 per cent to 25 per cent of shopping centres in the United States, about 275 in total, will close within the next five years. If this prediction proves to be accurate, US franchising is certain to be negatively impacted.

Despite these hurdles, the United States franchise industry remains, and is likely to continue to remain, the most vibrant in the world and is the favoured destination for entrepreneurs, worldwide. The US franchise market is complex and challenging, but for both domestic and international companies that hope to achieve brand recognition and to maximise growth and expansion, it is the one market that cannot be ignored and must be explored.

II MARKET ENTRY

i Restrictions and factors applicable to market entry

Many international franchisors salivate at the opportunity to enter the US franchise market, because it has the largest consumer market in the world. However, foreign franchisors considering entering the US market would be well served to approach this decision carefully and strategically, because entering the US franchise market is a costly and extremely complex process. Non-US franchisors must navigate an intricate framework of federal and state franchise disclosure and registration laws, accounting standards that require strict transparency, the requirements for state registrations, regulations covering advertising,

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trademark protection and common law torts, as well as employment law and tax law issues. International franchisors must also take into consideration the multicultural differences between the country from which the franchisor originates and US culture; barriers between the language of the franchisor's native country and the US English language; the fierce competition that the franchisor may face in the US franchise market; and the difficulty in developing brand awareness in such a large territory.

While foreign franchisors do not generally face governmental restrictions when entering the US franchise market, there are certain industries or businesses that, because of the nature of their business, are statutorily required to make certain disclosures or that are subject to foreign investment limits, particularly businesses that have a potential impact on national security (e.g., technology, weapons manufacture, maritime industries, aircraft, banking, energy resources, etc.) Since franchise opportunities rarely involve industries that could impact national security, such restrictions are not usually applicable to foreign franchisors seeking to operate in the United States. With respect to real estate, there are no restrictions in the United States on foreign owners, including franchisors, owning real property in the United States. Under federal law, foreign owners of US real estate that is 'effectively connected' to a US trade or business are subject to the same tax restrictions and obligations as domestic owners.

When a foreign franchisor elects to enter the US market, the franchisor should amass a team of advisers, including accountants and attorneys (as well as knowledgeable US franchise counsel) to put together a comprehensive franchise programme that will establish, among other things: (1) the proper corporate structure for the franchisor and its affiliates; (2) the method by which the franchisor will market its franchises (e.g., whether through direct franchising, area development arrangements or master franchise opportunities, or a combination of the three approaches, to investors or franchisees); and (3) the form of franchise documents that prospective franchisees will be required to sign upon purchasing a franchise or multi-unit development rights.

ii Foreign exchange and tax

An important factor that franchisors looking to enter the US market must consider is the tax implications on cross-border franchising from both the franchisor's native country and the United States. Because of the complexity of the US tax code, it is strongly advised that a foreign franchisor entering into the US market consult with accountants and other financial advisers who specialise in US tax law, to clearly understand the impact that the US tax laws will have on its franchise business. Any tax implications that a franchisor may face will strictly depend upon the structure of the franchise that it elects to utilise to establish its brand in the United States. Non-US franchisors looking to enter the US market will have to decide which corporate structure best addresses its needs. Most foreign franchisors will either grant master franchise rights for the entire US territory or establish and operate a US-based wholly owned subsidiary that will offer and sell single unit franchises or multi-unit development rights to designated geographical areas within the United States. However, they may choose to enter into a joint venture with a business partner or engage in direct cross-border franchising. Regardless of the franchise structure that a foreign franchisor uses, it is imperative that the franchisor understand and abide by the applicable US tax laws. The failure to abide by the applicable tax laws or treaties that accompany each structure can result in substantial fines or even, in unusual cases, imprisonment (see Section V).

Other than the requirements of the Office of Foreign Asset Control (OFAC) (which may limit or prohibit payments to certain restricted persons or jurisdictions subject to economic or trade sanctions), US law does not generally impose any exchange control restrictions on the transfer of money by a US-based franchisee to a foreign franchisor, so long as the overseas franchisor and the franchisor's country of residence are not subject to any US economic sanctions. However, under the Bank Secrecy Act, a US financial institution that wires payment in excess of US\$10,000 must comply with certain reporting requirements.

III INTELLECTUAL PROPERTY

i Brand search

While the franchisor having a proven business model with clearly defined procedures and operating guidelines is an important factor in purchasing a franchise, part of the 'franchise allure' is the strength of the franchisor's brand. Intellectual property is the cornerstone of a franchise system and, although intellectual property is an intangible asset, its value has a real impact on the franchisor's likelihood of success. A franchisor's intellectual property, including its trademarks, patents, trade dress (colour schemes and the 'look' of a brand), etc. are critical to how a customer perceives, identifies and chooses the franchisor's goods or services over those of another brand. Therefore, brand identification is one of the most critical aspects of building a successful franchise.

A trademark is a word, phrase, symbol, tagline, design, drawings, the shape and packaging of goods, sound or scent (or a combination of the foregoing) that identifies and distinguishes the source of the goods of one party from those of others. A service mark identifies and distinguishes the source of a service rather than goods (the term 'trademark' is often used to refer to both trademarks and service marks).

Trademarks are registered at both the federal and state levels. The United States Patent and Trademark Office (USPTO) is the US federal agency responsible for granting US patents and registering trademarks. Individual states also have their own trademark registration offices. In addition, most states have registration requirements for business entities, and each entity must register its name (and often also any associated trade names, or 'doing business as' names) as part of the entity registration process necessary to conduct business within the state.

Unlike many other jurisdictions, in the United States, a party can also establish and acquire 'common law' rights to a trademark simply through usage of the mark in commerce. Common law rights to a mark, especially if it is in use prior to another party's registration of that mark, can be superior to registration (provided that the registration is challenged properly). To secure common law rights to a mark, the mark is required to be used not only 'first in time', but also consistently in commerce, and not just on a casual or sporadic basis. While trademarks do not have to be registered, federal registration with the USPTO acts as 'notice to the public' of the franchisor's claim on the mark, which creates a legal presumption of ownership nationwide, and the exclusive right to use the mark on or in connection with the goods or services detailed in the registration. Inherent in the owner's exclusive right to use the mark, is the right to license the mark to third parties in exchange for payment. This exclusive right is generally granted for an initial 10-year period, but is perpetually renewable.

Once a franchisor has identified what it would like its trademarks to be (the 'look' and 'feel' of their branding), it must engage in a sophisticated and careful search (a 'trademark clearance' search), including an analysis of the internet, federal, state and local databases, etc.,

to ensure that its trademarks are indeed unique; that no one else has registered them; or that no one is otherwise using them (or whether any use is within the same industry or geographic area). In the case of trademarks, the USPTO has a searchable online database of registered trademarks (the Trademark Electronic Search System), a review of which should be the first step in searching for trademarks. This should allow the reviewer to ascertain if a desired mark is available for federal registration, or if some other party is already using the mark (or a similar mark). However, because local registration is also possible, each state, especially states in which a franchisor is planning to engage in business, should also be searched. Finally, because of the potential existence of common law trademark rights, internet searches and other methods of searching for competing usage of a mark should be performed, even if no 'registered' mark has been found. Most law firms that provide trademark registration services (as well as private search companies) can be hired to perform these types of trademark clearance searches. If a trademark clearance search reveals that there may be competing persons or entities with the same or a similar mark, a franchisor should carefully consider whether or not to try to register a mark. Under such circumstances, it may be more prudent to utilise a different, more distinctive and unique mark. In searching trademarks, it is important to remember the USPTO's standard in electing to register a trademark. There cannot be a 'likelihood of confusion' between the franchisor's proposed mark and those marks currently registered with the USPTO. If the marks are confusingly similar, then the franchisor should avoid using the proposed mark since the USPTO will more than likely conclude that the franchisor's proposed mark is infringing upon another company's trademark.

While trademark conflicts do arise, registration, especially with the USPTO, can significantly minimise risk. Since common law usage grants a trademark holder common law rights, the first person in time to utilise a mark generally has superior rights to all others. However, such rights are limited, including being limited by geographic area and by the industry in which the mark is utilised. Also taken into account is the fact that the possible difficulties of establishing such usage stand in contrast with the 'bright-line' registration offered by the USPTO. Once established, federally registered trademarks provide for national usage and clear protection for the marks 'as registered'. Federal law grants enhanced legal remedies for federally registered marks. Further, once registered, the federal mark holder has a presumptive argument that it was first in time as of the date of its registration, and, if the mark has been granted, it is very difficult for a common law mark holder to overcome the federal registration.

An important factor to consider in selecting a trademark (besides its marketability) is how distinctive the mark is (referred to as the 'strength' of the mark), including how similar it may be to other marks, especially in the industry in which the services or goods are being offered. A 'weak' mark may (1) not be distinctive; (2) look confusingly similar to other marks; (3) contain generic terms; and (4) be merely descriptive of the goods or services. It is easier to obtain trademark protection for a strong mark, and a strong mark may be granted broader protection than will be provided for a weak one. Strong trademarks are inherently distinctive. Marks that include 'made up' or arbitrary words and phrases are more distinctive than marks that contain generic or descriptive words and phrases.

While trademarks are typically the most prominent type of intellectual property found in a franchise, a franchisor may have other intellectual property it seeks to protect, such as a unique process or invention it may wish to patent. Patents are registered on the federal level, again through the USPTO. A patent is a 'limited duration property right relating to an invention', granted by the USPTO. The USPTO has several searchable databases (such as

PatFT, the Patent Full-Text and Image database). These databases can be searched to ascertain if any similar or identical patents have been filed. Patent law is a specialised legal practice in the United States, and franchisors should consult with attorneys who have passed the Patent Bar Exam if they need representation before the US Patent Office. However, if a franchisor is contemplating seeking patent protection, it ought to search generally, and on the USPTO's websites (and early in the process), to see if a similar patent has already been granted (or rejected), as the case may be.

Trade secrets are a type of intellectual property that consist of a formula, practice, process, design, device, mechanism, instrument, pattern, technique, pattern, commercial method, compilation of information, sales or distribution methods, consumer profiles, advertising strategies, lists of suppliers and clients not generally known or reasonably ascertainable by others and that give a business an economic advantage over its competitors or customers. Trade secrets can include the ingredients to a restaurant's 'secret sauce' or a computer program's source code, to name just a few typical categories. Trade secrets are an invisible asset with great value to company owners, and therefore company owners will go to great lengths to protect their trade secrets and maintain their confidentiality. If you look at the term 'trade secret', the word 'secret' underscores the importance of the confidentiality of this kind of information. This is problematic in franchising, since the foundation of franchising is based upon giving franchisees access to this secret information to replicate the service or product being sold to customers. Therefore, the protection of this information will primarily lie in the terms and conditions of the franchise agreement, particularly the confidentiality restrictions imposed upon franchisees.

Trade dress is one of the least discussed intangible assets that many franchisors own. Trade dress refers to the packaging of a product and its overall appearance (including features such as size, shape, colours and colour schemes, and graphics) with respect to a certain product, restaurant or store atmosphere. Trade dress can be registered both federally and on the state level. Examples of trade dress include, the blue packaging used by Tiffany & Co, the 7-Eleven and Dunkin' Donuts store concepts and the McDonald's Happy Meal packaging. The probability of a franchisor registering its trade dress will increase if the franchisor can establish that the overall appearance of the product or service is distinctive. A search for trade dress can be conducted on the USPTO's Trademark Electronic Search System or a franchisor can hire a law firm or IP search company to perform the search.

ii Brand protection

Once a franchisor has decided upon a trademark that it wishes to register, it must then decide where it intends to conduct business and seek to register its trademark in those jurisdictions. The United States is a party to international treaties that govern international trademarks, including the Paris Convention and Madrid Protocol, which allow a trademark to be registered internationally with member nations through a uniform process (an international application, which is managed by the World Intellectual Property Organization (WIPO)). If a franchisor is contemplating selling franchises in several different countries, the Madrid Protocol is an efficient means of seeking trademark protection across international borders.

By using the Madrid Protocol, a trademark can first be registered in any member nation (such as the United States). If it is approved by the member nation, it can then be submitted to the WIPO for international approval and registration. Once approved internationally by the WIPO, the trademark can then be submitted to any other member nation where the franchisor wants to obtain trademark protection. Then that particular nation will review the

mark and decide whether or not to grant approval for trademark protection. The Madrid Protocol provides a uniform and efficient method for streamlining multiple trademark registrations in multiple countries.

In the United States, the USPTO is the federal agency responsible for registering trademarks. Franchisors can file online with the USPTO for trademark registration. The USPTO's online system should be regularly monitored throughout the registration process, and registrants should promptly respond to enquiries and issues as they arise. The USPTO will first review the application to ensure it has met the USPTO's filing requirements. If so, then the application will be assigned to an 'examining attorney' to review the application, and the USPTO will search for conflicting marks or other problems in the application. If a problem arises, the USPTO will issue a letter that explains the reason for refusing the registration, or explaining the deficiency, thereby commencing what is known as an Office Action, whereby a registrant may take steps to address the USPTO's concerns. A registrant must respond within six months, or the mark will be 'abandoned'. If the mark is approved, or overcomes the Office Action, the USPTO will then 'publish' the mark. After the mark is published, any third party may issue a challenge or objection within 30 days. (Notably, it is good practice to ensure that all parties that may hold potentially conflicting marks, such as those that might be discovered in a trademark clearance search (discussed above) should be identified, and given notice of the objection process, so as to avoid potential challenges to the process at a later date.) If no objection is successful, the USPTO's process then proceeds to the formal registration stage, which generally takes several more months. Importantly, after a federal trademark has been obtained, a franchisor must take steps to maintain its registrations, including renewal of the mark (approximately every 10 years), and the filing of a 'declaration of use', between five and six years after registration, failing which the mark may be cancelled.

Many of the individual states also have their own trademark registration offices (with their own registration process). However, while individual state registration is better than not registering at all or relying upon common law trademark rights, franchisors should seek federal registration of their trademarks to obtain the benefits of federal registration.

If a franchisor wishes to protect an invention or unique process it has developed, it may apply for a patent with the USPTO. However, patents are difficult to obtain, and the categories of inventions or processes that rise to the level of patent protection are limited. An applicant may consider utilising the 'provisional' patent application process with the USPTO, which can, for a limited period, give an applicant a lower-cost 'first patent filing in the United States' to obtain first-in-time status, or if exigency is required. The patent process is outlined by the USPTO on its website, www.uspto.gov, and specialised counsel who have passed the special Patent Bar Exam should be consulted if a franchisor wishes to file for a patent.

Franchisors should also take steps to protect their other intellectual property, such as operations or procedural manuals, proprietary systems and software, and customer lists, as proprietary and confidential. They should also require all recipients (including franchisees) to treat such items as confidential, including through specific provisions in franchise agreements and separate confidentiality and non-disclosure agreements, as applicable. Much of a franchisor's confidential intellectual property, even if it is not protectable as a trademark or patented invention, will still be protectable as a trade secret, or at common law, as long as the proper steps are taken. New or prospective franchisors should be wary before they start sharing their ideas or intellectual property with others in their process of formation or the implementation of their franchised business (including with potential investors or

business partners). Non-disclosure and confidentiality agreements are generally enforceable, and should be entered into prior to having significant conversations with third parties. Such agreements should always be considered, especially where the prospective franchisor has a trade secret or idea that is unique and worth protecting. Publications by the franchisor, including operations manuals and policy and procedure manuals, as well as proprietary computer programs, may also be protected by federal copyright law.

iii Enforcement

In the United States, while enforcement powers are granted to federal and state agencies, and an aggrieved party can certainly report theft and misappropriation to the appropriate law enforcement agency, generally, as a practical matter, the owner of any intellectual property that is being infringed upon must bring a private action to effectively protect its rights.

Since the most important intellectual property a franchisor owns is likely to be its trademark, franchisors must be vigilant in protecting their trademark rights. A trademark holder in the United States is generally required to 'police' its mark by actively monitoring the market to discover infringement, and then to take action against infringers to protect its mark. A franchisor who fails to take timely action against infringers may lose its right to obtain any relief (because of, *inter alia*, affirmative defences of laches, acquiescence or waiver). Therefore, it is important for a franchisor to diligently search and discover if someone is improperly using its marks, and demand that any improper usage cease immediately (cease and desist). Should a party fail to cease utilising an infringing mark, a trademark infringement action may be brought in federal or state court. A franchisor may employ the Lanham Act (15 USC Section 1051 et seq.), which provides remedies for trademark violation in this regard. State statutes and common law may apply as well. Notably, former franchisees who are still utilising a mark after termination of their right to do so (which may occur when a franchise has expired or been terminated) are violating that trademark, and a prudent franchisor should diligently and promptly seek to force a former franchisee to stop infringing that mark, or risk being barred by waiver, estoppel or acquiesce for failure to promptly police its mark.

If a franchisor discovers that a third-party website domain name is improperly utilising the franchisor's mark (or a confusingly similar permutation thereof), it may initiate a proceeding under the Uniform Domain-Name Dispute-Resolution Policy in one of several arbitration forums, seeking to 'shut down' or even 'seize' the offending domain name. The process differs between arbitration forums, but it is usually a streamlined proceeding, and may be conducted entirely by paper submission. Such a process may be preferable to attempting to obtain the same relief in court if the only offending infringement is usage of a domain name, or where the loss of the domain name will result in the elimination of the infringing activity.

The United States Uniform Trade Secrets Act (UTSA), which was drafted by the National Conference of Commissioners on Uniform State Laws in 1970 and amended in 1985, provides the basic principles of common law trade secret protection, and it has been adopted by virtually every state, with the exception of New York, Massachusetts and North Carolina. The UTSA was written in an effort to harmonise the laws of the states. Under the UTSA, companies whose trade secrets have been misappropriated are entitled to injunctive relief in addition to damages, the amount of which is limited to the actual wilful losses suffered by the franchisor as a result of the misappropriation. If the misappropriation is deemed to be wilful and malicious, then the franchisor would be entitled to attorney's fees. On 11 May 2016, federal protection was afforded to trade secrets through the enactment of the Defend Trade Secrets Act of 2016 (See 18 USC Section 1831 et seq.) (DTSA).

The DTSA is a new federal statute that provides uniform federal protection to trade secrets and, perhaps most importantly, creates a private civil right of action (which may be brought in federal court) for theft or misappropriation of trade secrets. A party can seek damages, and if a violation is wilful and malicious, double damages and attorney's fees. A party can also use a specialised form of *ex parte* injunctive relief, allowing a federal court to issue an order for expedited seizure of the trade secret under certain circumstances (see 18 USC Section 1836). The DTSA also can apply to violators outside the United States (see 18 USC Section 1837). Notably, each state's common law trade secret protection also still applies (and there can be significant variation between states). One guiding principle is that the party seeking protection of a trade secret must make a showing that it sought to maintain the secrecy of that information. As discussed above, it is very important that franchisors implement confidentiality policies and procedures designed to prevent the disclosure of confidential information, including franchisee non-disclosure agreements (which also apply to employees and agents) and by including confidentiality provisions in their franchise agreements.

iv Data protection, cybercrime, social media and e-commerce

The advent and proliferation of the internet and e-commerce have altered traditional franchising, necessitating an increased level of awareness by franchisors regarding the myriad laws governing data protection and privacy for customers, new methods of advertising, supplying goods and services, and maintaining the protected areas of its franchisees. E-commerce has increased both the benefits and risks of conducting business, both in franchising and in business, generally.

A franchisor must take care to ensure that its franchise agreement does not permit a franchisee to engage in e-commerce to the detriment of either the franchisor or other franchisees. Because the internet enables a business to reach geographically wider audiences, a franchisor may wish to place geographic limitations on a franchisee's ability to advertise, solicit, sell or distribute goods on the internet. In failing to do so, a franchisor may become vulnerable to lawsuits from franchisees whose protected areas are being infringed upon.

Another potential source of liability for franchisors in the current age of e-commerce is the protection and security of customer information exchanged during online transactions. Franchisors engaging in e-commerce must take special care to develop policies and procedures for their franchisees to adequately secure all customer information, and to protect against hackers and viruses. Failure to do so may leave a franchisor and its franchisees vulnerable to lawsuits from customers whose private information has been hacked or stolen.

Brand protection has also become more unwieldy in the context of e-commerce. To protect the franchisor's brand, the franchise agreement should explicitly reserve the franchisor's right to review all online content on social media sites, blogs, in electronic communications and on other online sites where its trademarks are used. To that end, the franchisor may require that various types of marketing or advertising utilise a specific format and that franchisees obtain the franchisor's prior consent before filing for registration of any proposed trademarks to be used in electronic commerce, including any internet or website address domain names. A franchisor should require that upon the expiration or termination of the franchise agreement, any internet or web addresses and domain names should be transferred to the franchisor or to an affiliate, sometimes by the franchisor having the right to execute the applicable documents as agent or attorney in fact for the franchisee.

As the United States does not, on the federal level, have any single unified comprehensive legislation protecting data, the privacy and protection of customer's information is ensured

through various laws. The United States does not have a cohesive federal law governing data protection and privacy. As a result, businesses must address a collection of federal and state laws, rules and requirements. Therefore, a franchisor must be aware of the complex variety of federal and state laws that may affect its collection, access, use and disclosure of personal information, since it may be held liable for its failure to properly secure and protect the personal information of its customers and franchisees. Many of these issues are regulated by separate laws specific to certain industries, several of which may come under the franchise umbrella. Some examples of these laws include the Telephone Consumer Protection Act of 1991 (TCPA), the Children's Online Privacy Protection Act (COPPA) and the Fair Credit Reporting Act (FCRA). The TCPA, among other things, regulates telemarketing and robocalls to wireless and residential phone numbers. The FCRA regulates the compilation and use of consumer reports and credit reports, requiring companies that use credit reports to notify consumers when their credit report is used, for example, to deny an application for credit. COPPA regulates the collection, dissemination or usage of data concerning minors under 13 over the internet without parental permission. A seemingly innocuous educational or social media app, when appropriate safeguards are not implemented, can create COPPA liability risks. While the Federal Trade Commission Act (the FTC Act) prohibits unfair or deceptive practices, the FTC has applied this Act against companies that fail to comply with their posted privacy policies and that permit the unauthorised disclosure of customers' personal data. Although there is no comprehensive single compliance source, the FTC's Franchise Rule Compliance Guide provides information regarding the risks and obligations with regard to e-commerce. This area of the law is rapidly developing, and franchisees and franchisors should keep abreast of industry-specific data and privacy regulations that may apply to their franchise systems, at both federal and state levels.

IV FRANCHISE LAW

i Legislation

Franchising is a heavily regulated industry in the United States and for many foreign franchisors understanding the complexity of the framework of federal and state franchise laws is critical to successful entry into the US market. Many foreign franchisors are surprised to find that there is no single body of laws that regulate franchising in the United States but that they must educate themselves on upwards of 40 different federal and state franchise laws, rules and regulations that were enacted to prevent franchisors from engaging in unfair or deceptive practices (such as making false statements, willfully omitting pertinent information and employing schemes to defraud) in the offer and sale of franchises. At the federal level, the US FTC is charged with overseeing and governing the franchising industry. Under the auspices of this authority, the FTC enacted the FTC Franchise Rule (16 CFR Part 436) on 21 October 1979, and amended it in 2007. Through the FTC Franchise Rule, the FTC regulates the offer and sale of franchises in all 50 states in the United States, as well as Washington, DC and all US territories. The FTC Franchise Rule imposes mandatory disclosure obligations on franchisors in connection with the sale of any franchise, to ensure that franchisors provide prospective franchisees with the information necessary to permit them to make an informed decision about the franchise opportunity being offered.

Under federal law, there are three elements to a franchise: (1) the franchisee is granted the right to sell goods or services under the franchisor's trademark, service mark, trade name, logo or other commercial symbol; (2) the franchisor has significant control over the

franchisee's method of operation; and (3) the franchisee is required to pay to the franchisor (with certain exceptions) a franchise fee of at least US\$500. Sometimes business arrangements or relationships that are intended to be 'licences' or 'dealerships' may fall within the definition of 'franchise'. Therefore, it is imperative that businesses seeking to expand into the US market determine whether or not their business model constitutes a franchise. The FTC Franchise Rule (see below) as well as any applicable state laws should be reviewed in this regard.

Under the FTC Franchise Rule, franchisors must provide prospective franchisees, area developers and master franchisees with detailed disclosures (including 23 mandatory disclosure items that relate to a wide range of information) at least 14 days prior to either the execution of a contract regarding the offer or the payment of money relating to the franchise relationship. These disclosures are memorialised in a voluminous document (sometimes comprising upwards of 200 pages) called a franchise disclosure document (FDD), which includes a variety of information, including: (1) information about the franchisor, its parent, affiliates and key officers, along with any past or pending litigation and bankruptcies; (2) the fees and costs associated with developing and operating a franchised business (including the franchise fee and the estimated initial investment in the business); (3) the territory in which the prospective franchisee will operate, along with any rights retained by the franchisor to operate or permit a third party to operate within that territory; (4) the franchisor's pre-opening and post-opening obligations; (5) registered and pending trademarks and patents that will be used in connection with the operation of the franchised business; (6) restrictions on the sources of products and services used in connection with the business, and on the products and services the prospective franchisee would be permitted to sell; (7) the franchisor's and prospective franchisee's rights and obligations in the event that the other party defaults in their obligations under the franchise or multi-unit development agreement; (8) exit strategies available to both the prospective franchisee and the franchisor; (9) the manner in which disputes will be resolved; (10) representations with respect to the franchisor's financial performance; and (11) the franchisor's audited financial statements, etc. The Franchise Rule is designed to enable potential franchisees to inform and protect themselves before investing, by providing them with information that is essential to: an assessment of the potential risks and benefits; meaningful comparisons with other investments; and further investigation of the franchise opportunity. The FDD must be updated annually or more frequently if there are any 'material' or significant changes.

Many franchisors utilise a multi-state FDD, which they provide to prospective franchisees regardless of which state the franchisee resides in. However, franchisors typically supplement their FDD with state-specific addenda to comply with state laws that require additional state-specific disclosures. The FDD may be delivered to the prospective franchisee in either hard copy format or electronically (for example, by email, website download or CD-ROM), as long as the FTC Franchise Rule's procedural requirements are met. Also, there are limited exemptions to the FTC Franchise Rule's disclosure requirements. For example, where a franchisee is an officer, director, general partner or manager of the franchisor an exemption may apply. A franchisor that qualifies for an exemption under the FTC Franchise Rule should also confirm that it is exempt under any applicable state law.

In addition to the disclosure requirements under the FTC Franchise Rule, foreign franchisors (like US franchisors) must comply with the franchise laws of the states in which they choose to conduct business. State and federal laws are not coextensive, and 15 states have registration franchise laws that require franchisors to register their franchise opportunities before they are permitted to 'offer' or 'sell' franchises either from that state or to its residents.

Under these state franchise registration laws, franchisors are also required to renew their franchise registration annually and to file amendments to their FDDs in the event that a material change occurs (i.e., where a franchisee would reasonably want to have this additional information when considering whether or not to purchase or renew the franchise). As with the FTC Franchise Rule, many state franchise registration or disclosure laws also prohibit franchisors from engaging in fraudulent or deceptive conduct in connection with the offer or sale of franchises. Another 26 states in the United States have business opportunity laws that require pre-sale disclosures similar to the disclosures set forth in the FDD. Approximately 20 of these business-opportunity states require the franchisor either to register or notify the state before being permitted to advertise or sell franchises in those states. Approximately one half of the states, as well as Washington, DC and the US territories of Puerto Rico and the US Virgin Islands, have enacted relationship laws that govern the franchisor–franchisee relationship, and in particular: (1) the termination, renewal and transfer of franchise rights; (2) a franchisee’s right to form a franchisee association; and (3) a franchisor’s obligation to repurchase a franchisee’s inventory in the event of termination. In addition to state franchise relationship laws, more than half of the states have promulgated Little FTC Acts that give aggrieved ‘consumers’ (including franchisees) a private right of action for a franchisor’s violation of the FTC Franchise Rule. Basically, under the Little FTC Acts, a franchisor’s violation of the FTC Franchise Rule will be deemed to be *per se* a violation of that state’s Little FTC Act or evidence of a violation. While the FTC oversees franchising on the federal level by imposing a comprehensive pre-sale disclosure requirement, it is relatively rare for the federal government to step in to ensure the compliance with or enforcement of the FTC Franchise Rule. Thus, the regulation of franchise activities and overseeing the enforcement of laws affecting the franchisor–franchisee relationship is largely left up to the states.

ii Pre-contractual disclosure

The FTC Franchise Rule and states with disclosure or registration laws impose a pre-contractual disclosure requirement upon franchisors. This requirement mandates that franchisors provide prospective franchisees with specific material information (including, but not limited to, background information on the franchisor, the costs associated with acquiring and operating a franchise and the legal obligations of the franchisor and franchisee) prior to the offer of a franchise opportunity or the consummation of the sale of a franchise. In addition to imposing a pre-contractual disclosure requirement, state disclosure or registration laws also typically prohibit franchisors from engaging in ‘fraudulent and unlawful practices’, such as making false statements of material facts (or wilfully omitting any such material fact) in connection with the registration or disclosure process; employing any scheme to defraud franchisees; or engaging in any act or practice that would operate as a fraud or deceit upon a prospective franchisee.

Violations of disclosure or registration laws can carry serious consequences, both criminal and civil, for franchisors. Under the FTC Franchise Rule, a violation of the disclosure requirement constitutes a violation of the US Federal Trade Commission Act, and gives the FTC the right to sue franchisors in federal court and seek any or all the following remedies: (1) civil penalties of up to US\$11,000 per violation; (2) injunctive relief with respect to violations of the FTC Franchise Rule, including barring franchise sales in the United States; and (3) restitution, rescission, or damages on behalf of the affected franchisees. While the FTC Franchise Rule gives the FTC a right to bring an action against franchisors

who violate the Rule, it does not give aggrieved franchisees a right of private action. Only the FTC can commence an enforcement action against a franchisor that has violated the FTC Franchise Rule.

State disclosure or registration laws that impose pre-contractual disclosure obligations incorporate an enforcement structure, which gives that state's state administrator or attorney general the right to investigate and prosecute violations by franchisors. If a state administrator or attorney general suspects that a franchisor has violated that state's franchise laws, then the state administrator or attorney general may bring an enforcement action against the franchisor seeking: (1) to deny or revoke the franchisor's registration in that state (which would preclude the franchisor from offering or selling franchises in that particular state); (2) to impose fines and civil penalties; (3) rescission of the franchise agreement; (4) actual damages and, at times, consequential damages; and (4) to enjoin the franchisor from continuing to engage in franchise activities. Under certain circumstances, the state administrator or attorney general may seek criminal penalties against the franchisor and, in some cases, against the officers, directors or senior management of the franchisor, if those persons engaged in the proscribed conduct. Unlike the FTC Franchise Rule, state disclosure or registration laws also give aggrieved franchisees the right to assert a private right of action against the franchisor for rescission of the franchise agreement or actual damage suffered by the franchisee.

Some states have franchise disclosure or registration statutes or franchise investment or relationship laws that allow aggrieved franchisees to assert statutory fraud claims for material misrepresentations or omissions of fact in an FDD. Under such claims, aggrieved franchisees must plead with particularity and prove with clear and convincing evidence: (1) a material misrepresentation of a presently existing or past fact; (2) knowledge or belief by the other person of its falsity; (3) an intention that the other person rely on it; (4) reasonable reliance thereon by the other person; and (5) resulting damage. Some state franchise laws require aggrieved franchisees to prove that the franchisor intended to commit the violation, but some states will hold franchisors strictly liable for merely making an untrue statement of a material fact.

Aggrieved franchisees that are not protected by a state disclosure or registration statute may find protection under that state's unfair or deceptive trade practices statutes (Little FTC Acts). State Little FTC Acts provide that any violation of the federal FTC Act or related regulations, including the FTC Franchise Rule, is *per se* a violation of that state's Little FTC Act. Such violations give aggrieved franchisees a private right of action against franchisors who have engaged in unfair trade practices. However, not all state Little FTC Acts are created equal. Little FTC Acts protect consumers against unfair and deceptive trade practices, but some states do not deem franchisees to be 'consumers' because of the purported level of sophistication necessary for the purchase of a franchise. Therefore, aggrieved franchisees in those statutes will be precluded from asserting an action under that state's Little FTC Act. Franchisees that can bring claims under state Little FTC Acts may be able to recover damages (including, treble damages and reasonable attorneys' fees).

The enforcement provisions incorporated in federal and state franchise laws should make it clear to franchisors that the FDD is not merely a disclosure document but a liability document that can give rise to causes of actions for: (1) the franchisor's failure to comply with federal and state disclosure laws (and registration requirements, as applicable); and (2) the franchisor's misrepresentations or omissions (albeit negligent). Such violations can be used against the franchisor to award damages, rescission and injunctive relief (to name a few remedies) to aggrieved franchisees. On the other hand, proper disclosure by the franchisor

may act as a shield against lawsuits or arbitration proceedings brought by aggrieved franchisees who find themselves unable to overcome the franchisor's defence that the franchisee was given the subject information in the FDD.

The FDD contains 23 specific disclosure items that each provides prospective franchisees with pertinent information about the franchisor and the franchise system. That said, particular attention should be paid to the disclosures made in Item 7 – Estimated Initial Investment, and Item 19 – Financial Performance Representations. Both governmental and aggrieved franchisees have, more often than not, used the information disclosed (or not disclosed) in these items as the basis for lawsuits against the franchisor. Under Item 7, franchisors must set forth an estimate of the franchisee's initial investment necessary for the franchisee to commence operations (which should be based upon the franchisor's experience). Item 19 provides franchisors with the opportunity, if they so elect, to make financial performance representations (earnings claims) about the actual or projected financial performance of their franchised or company-owned outlets, provided that there is a reasonable basis for making the representation and the franchisor can substantiate the basis in writing. Misrepresentations and omissions under Item 7 or improper earnings claims under Item 19 may give rise to a governmental action under federal or state law and can also form the basis for private causes of action (lawsuits or arbitration proceedings depending on the terms of the franchise agreement). Statements that indicate that a franchisee can expect to make a specific profit or generate a certain sales volume of goods or services are typical of the types of representation that can give rise to such causes of action, if the franchisor has not disclosed (in the FDD) the basis for the representations. However, mere puffery does not fall under the FTC Franchise Rule's definition of financial representation. Exaggerations or statements that no reasonable person would take literally, like 'this franchise opportunity is a gold mine', or 'this franchise is an opportunity of a lifetime' are not actionable under Item 19.

After disclosures have been made to a prospective franchisee and the requisite disclosure period has elapsed (10 business days in New York), the franchisee may sign the franchise or multi-unit development agreement or pay the initial franchise fee to the franchisor. However, prior to consummating the franchise purchase, prospective franchisees (through franchisee counsel) will seek to negotiate certain terms and conditions contained in the franchise agreement. Some franchisors may elect to negotiate certain terms and conditions, while others will contend that it is their 'policy' not to negotiate any changes to their form of franchise agreement.

iii Registration

While the FTC Franchise Rule mandates franchisors to provide certain pre-sale disclosures prior to that franchisor having the right to engage in franchise activities in that state, 15 states in the United States (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington and Wisconsin) have franchise filing or registration laws that require a franchisor to either: (1) register its FDD; or (2) file a notice of intent to engage with the appropriate regulatory authority prior to any offer or sale of a franchise opportunity within the state. The state registration and disclosure statutes strictly regulate how, when and under what circumstances franchises can be offered and sold in that state. In 'registration states' the franchisor and the disclosure document must be registered and approved by the appropriate state agency before the franchisor can commence any franchise sales activity. Further, under these state registration laws, franchisors are required to renew their franchise registrations

annually and to file amendments to the FDDs in the event that a material change occurs (i.e., where a franchisee would reasonably want to have this additional information when considering whether or not to purchase or renew the franchise). In some instances, state disclosure and registration laws require franchisors to register any franchise brokers or sellers that will be offering and selling franchise opportunities on that franchisor's behalf. Other than the registration requirements imposed by the registration states identified above, franchisors are not subject to any franchise registration requirements.

However, there are general business requirements that a franchisor must comply with to conduct business in any state. One of the definitional elements of a franchise is the requirement that franchisees offer and sell goods and services associated with a federally registered trademark. Therefore, franchisors will need to register their trademarks prior to commencing the offer or sale of franchises. As a general business matter, franchisors (who commonly operate their business through an operating entity) will need to register any assumed business names with the appropriate state regulatory agency to protect their right to use that name within that particular state.

iv Mandatory clauses

The franchise agreement is the legal contract that governs the franchisor–franchisee relationship. While there is no ‘form’ of uniform franchise agreement, there are several key provisions or sections that can typically be found in most franchise agreements. An explanation of these clauses is given below.

Protected (or exclusive) territory clause

The protected territory clause demarcates the franchisee's customer source by setting forth the territory in which the franchisee may offer and sell goods and services. Protected or exclusive territories may be defined by radius (in miles), postal zip codes, municipalities, cities, population size or just the address of the franchised location. This clause also sets out whether the territory is exclusive. It is important to note that not all franchise agreements designate a protected territory. If the franchise agreement grants a protected territory, the protected territory clause will provide that the franchisor will not operate or permit another franchisee to operate a franchised business within that territory, except under certain circumstances. Although a franchise agreement may provide that a franchisee's designated territory is exclusive, the exclusivity of the territory is usually not absolute. Typically, the exclusivity of a protected territory is contingent upon the franchisee being in full compliance with the terms and conditions of the franchise agreement. Even if the franchisee is in full compliance with the franchise agreement, the exclusivity of the franchisee's territory will be subject to certain rights that the franchisor may reserve for itself. Some rights that a franchisor will reserve for itself include the right to: (1) sell the franchised goods and services in alternate channels of distribution, such as the internet, mail-order catalogues, grocery stores, etc.; (2) sell the franchised goods and services in certain ‘non-traditional’ locations, such as airports, sports stadiums, colleges, hospitals, etc.; and (3) to acquire or merge with competing franchises or chains and operate them under the same or a different trademark, etc. The protected territory is sometimes negotiated between the franchisor and franchisee. Protected territories are sometimes modified or adjusted upon renewal.

Royalties and other fees

One of the most important factors for entrepreneurs looking to own a franchise is the start up and ongoing costs for owning and operating a franchise. Typically, the franchise agreement will set out the various fees that the franchisee is required to pay to the franchisor. These fees usually include: (1) an initial franchise fee; (2) an ongoing royalty fee; and (3) advertising fund contributions. Typically, the initial fee is paid up front simultaneously upon the execution of the franchise agreement. Many people view the initial franchise fee as the price of admission as a member in the franchise system, and the royalties as the ongoing membership fees. Franchisees pay royalty fees, typically on a monthly basis, for their ongoing use of the franchisor's trademarks and for the services that the franchisor provides. The typical range for royalties may be from 4 per cent to 8 per cent of the franchisee's gross revenues, although sometimes flat-rate fees are charged. As many franchisors in the United States create a national advertising fund (or sometimes a regional advertising fund), franchisees are often required to make regular contributions to the fund. The typical range of these fees is from 1 per cent to 3 per cent of the franchisee's gross revenues, with 2 per cent being fairly common.

Use of marks, etc.

The franchise agreement grants franchisees a non-exclusive licence to use the franchisor's trademarks, service marks or trade names in strict compliance with the terms and conditions contained in the agreement. The franchise agreement will usually spell out the manner in which the franchisee is authorised to use the franchisor's marks. Any unauthorised use by the franchisee of the franchisor's marks is typically grounds for the franchisor to immediately terminate the franchise agreement, among other forms of legal recourse that the franchisor may have (including the obligation for the franchisee to indemnify and defend the franchisor against any third-party claims involving unauthorised use of the marks).

Products and services

Franchise agreements usually provide what products and services must be purchased from the franchisor (or its affiliates) or from an approved supplier. The agreement also typically sets forth the limitations on the franchisee's use, sale or distribution of products or services in connection with the franchised business.

Renewal

Usually franchise agreements will grant franchisees the right to renew the franchise term for a designated number of successive terms (however, some franchisors grant perpetual renewal terms), provided that the franchisee satisfies certain conditions. This right to renew is usually conditional. Some of these conditions include, without limitation: (1) the franchise providing timely written notice to the franchisor of its intent to renew; (2) the franchisee being in full or substantial compliance with the terms and conditions of the franchise agreement; (3) the franchisee paying a renewal fee; and (4) the franchisee's execution of a release and franchisor's then current form of franchise agreement, which may materially differ from the terms and conditions of the franchisee's current franchise agreement. Protected territories are sometimes modified or adjusted upon renewal.

Transfer and assignment

The franchise agreement will typically prohibit a franchisee from selling its franchised business or transferring or assigning its rights under the franchise agreement, without the franchisor's prior written consent. In this section, the franchise agreement will detail: (1) what constitutes an assignment; (2) the circumstances in which the franchisee can assign its rights and obligations under the franchise agreement; and (3) any fees associated with such an assignment. If a franchisee wishes to sell its franchised business and transfer its rights under the franchise agreement, the franchisor will normally have a right of first refusal. Pursuant to this right of first refusal, the franchisee is obligated to inform the franchisor of its desire to sell its franchised business and transfer its rights under the franchise agreement. Once the franchisee has identified a potential buyer and terms upon which it will sell its franchised business, the franchisor will have the right to purchase the franchised business upon the same terms. Rights of first refusal tend to create an unreasonable 'cooling effect' on a franchisee's ability to market and sell its franchise. For example, it is not practical to think that a businessman will invest the time, effort and attorneys' fees, do the evaluations, consult with family members and partners, deal with accountants, bankers, etc., only to find that he may not end up being the purchaser after all, but that the franchisor is going to take the deal instead. A viable alternative to a right of first refusal is a right of first purchase. In the event that a franchisee desires to transfer, sell or assign its franchised business or a controlling interest therein, other than to: (1) any partner, co-shareholder, or member of the franchisee; or (2) any member of the immediate family thereof or trusts for the benefit of any such family member, then the franchisee will have to first notify the franchisor. In its notification, the franchisee must set forth the price and terms upon which it is willing to sell, transfer or assign its franchised business or its interests in the franchised business (the Offer). The franchisor will have a period from the date it receives the franchisee's Offer to decide whether it wishes to purchase the franchisee's business or interests therein. If the franchisor elects not to purchase, then the franchisee would have the freedom to solicit *bona fide* third-party purchasers. However, the franchisee must sell its business or interests, at the same (or higher) price and upon the same (or less favourable) terms as that set forth in the franchisee's Offer to the franchisor. If the franchisee cannot get a purchaser to agree upon the price and terms in the Offer, but is able to secure a buyer that will purchase the franchisee's business or interests therein at a lower price or on more favourable terms, then the franchisee must re-offer the 'deal' to the franchisor. If no transaction occurs within a set time frame, such as a year, the process starts over again.

Confidentiality

Franchisors will entrust certain proprietary information to its franchisees to be used in connection with the operation of its franchisees' franchised businesses. To protect themselves from unfair competition, franchisors will require franchisees to maintain the confidentiality of that information during and after the term of the franchise agreement. Typically, franchisors will require that the franchisee (and any other personnel that will have access to the franchisor's proprietary information) execute a confidentiality agreement that will obligate the franchisee (and its representative) to maintain the confidentiality of the information contained within these manuals during the franchise term and thereafter. A violation of this clause may result in the franchisee being enjoined from violating or continuing to violate the confidentiality clause, or even require the franchisee to pay liquidated damages to the franchisor. These remedies are in addition to any other remedies that the franchisor may have under the law.

Non-competition

Most franchise agreements contain non-competition clauses (sometimes referred to as restrictive covenants) that prohibit the franchisee (including, its owners, operating owners, officers, directors, personal guarantor, the spouse, family member, business associate of an owner or an affiliate partnership or corporation) from owning or being involved with a 'competitive business' during the franchise term and for a period (usually two years) following the expiration or termination of the franchise term, so long as the competitive business is located within a designated radius of the franchisee's location and, frequently, any other franchised location. A competitive business is usually a business that offers goods or services that are either identical (or confusingly similar) to or competitive with the goods or services offered under the franchise system. Some franchisors also require their franchisees to have the franchisee's key employees enter into similar non-competition agreements. (See also Section VI.vi, on restrictive covenants.)

Default or termination of franchise

Generally, the franchise agreement will detail: (1) what actions or inactions constitute a default under the franchise agreement, and (2) the period within which the franchisor or franchisee has to cure such a default (provided that the franchise agreement provides that the default is curable). If the franchisee fails to comply with the terms of the franchise agreement and is deemed to be in default, the failure to cure any curable default will normally give rise to the franchisor's right to terminate the franchise agreement upon written notice. However, some defaults are not curable by their nature (i.e., making an unauthorised use of the franchisor's trademarks) and, subject to applicable state law, the franchisor may immediately terminate the agreement following the occurrence of a designated 'non-curable' default under the agreement (without providing the franchisee with notice or an opportunity to cure). After the agreement is terminated or expires, the franchisee is required to comply with certain enumerated post-term obligations, including having to 'de-identify' its business to prevent it from being associated with the franchisor's brand in all respects. Some franchise agreements contain a liquidated damages provision that seeks to compensate the franchisor, usually pursuant to a specific formula or calculation, for its lost future royalty stream in the event that the agreement is terminated.

Post-termination obligations

Upon the expiration or termination of the franchise agreement, the franchisee is obligated to, among other things: (1) de-identify the franchised business; (2) cease its use of the franchisor's trademarks; and (3) comply with the restrictive covenants set forth in the franchise agreement (including the covenant not to compete and to maintain the confidentiality of the franchisor's proprietary information).

Liquidated damages

In the event that a franchisee breaches its in-term or post-term restrictive covenant or a franchisor terminates the franchise agreement for 'cause' (such as: (1) the franchisee's unauthorised use of the franchisor's marks or proprietary information; (2) the franchisee filing for bankruptcy, being deemed to be insolvent or making a general assignment for the benefit of creditors; or (3) the principals of the franchisee being convicted of or pleading no contest to a felony or other crime or offence that would be likely to adversely affect

the reputation of the franchisee, the franchisor or the franchised business), the franchise agreement may provide that the franchisor will be entitled to liquidated damages. While the formulae for determining liquidated damages will vary, the calculation used to determine the liquidated damages owed to the franchisor will typically utilise some multiple of the average monthly royalty fees that the franchisee paid (or should have paid) during the 24 months of operation prior to the termination. By including a liquidated damages provision in a franchise agreement, the franchisor is trying to ensure that it will be adequately compensated in the event that a franchisee breaches the franchise agreement. Liquidated damages provisions also allow franchisors to avert having to engage in prolonged and expensive litigation.

Choice of law and venue

The franchise agreement will almost always include a choice of law and venue provision that sets out which laws will govern the agreement and any disputes that arise in connection with the agreement, as well as the jurisdiction in which disputes will be heard. Usually the franchisor will select: (1) the state in which it is located as the state whose laws will govern the franchise agreement and any disputes that derive therefrom; and (2) the state and county in which the franchisor is located as the venue where any and all related disputes are heard. It is, therefore, crucial that the franchisor understand the franchising laws of the state that governs the franchise agreement, as well as the laws of the state in which the franchisee resides or in which the franchised business is located.

Dispute resolution

In the event that a dispute arises between the franchisor and franchisee, the dispute resolution clause will set forth the manner in which the disputes will be resolved. Many franchise agreements require the parties to arbitrate their disputes, because most franchisors view arbitration as a cost-efficient manner for resolving disputes. Arbitration awards are binding upon the parties, and effectively preclude the unsuccessful party from appealing the arbitrator's decision. A three-step method for resolving disputes, which begins with good-faith negotiation between the parties, followed by mediation and then by arbitration or litigation (if mediation is unsuccessful), is typically found to be more beneficial.

The negotiations can be conducted in person or via teleconference. Mediation will usually be held in the city in which the franchisor is located, but some franchisors will agree to hold it in the county of the franchisee's principal place of business to help defray the franchisee's costs associated with such mediation. The costs of the mediation are often equally divided between the franchisor and franchisee. Arbitration is generally held in the county in which the franchisor has its principal office, and the associated fees are frequently shifted to the non-prevailing party.

Class actions

The franchise agreement will usually require that the franchisee waive its right to initiate or participate in a class action or arbitration in any forum. Under this provision the franchisee is typically relegated to bringing any actions arising out of or related to the franchise agreement or the transactions contemplated thereunder on an individual and not a class-wide basis. This clause also typically precludes any proceedings in which the franchisor and franchisee are parties from being consolidated with any other proceedings between the franchisor and any other third party.

Typical franchise documents

Under the FTC Franchise Rule, franchisors are required to include copies of 'all agreements proposed for use or in use regarding the offering of a franchise'. This includes copies of the franchise agreement and multi-unit development agreement, and all other agreements prepared in connection with the franchise offering and that prospective franchisees may be required to execute. In Item 22 of the FDD, Franchisors are required to list the agreements that a prospective franchisee or multi-unit developer will have to execute to consummate the franchise purchase. Some franchise documents or agreements that are typically attached to the FDD include, but are not limited to, the: (1) franchise agreement; (2) multi-unit development agreement; (3) personal guaranty and assumption of obligations; (4) confidentiality and non-competition agreement; (5) operations manual table of contents; (6) general release; (7) lease rider; (8) collateral assignment of lease; (9) multi-state addenda; and (10) electronic funds transfer authorisation agreement; as well as other agreements, where appropriate.

The franchise agreement is the cornerstone of the franchisor–franchisee relationship, because it governs and defines the franchise relationship. Within the franchise agreement, the franchisor legally grants the franchisee the right to develop and operate a franchised business under the franchisor's name and trademark, provided that the franchisee operates that business in strict compliance with the standards and specifications and pays an ongoing royalty to the franchisor. The agreement explains in great detail the franchisor's and franchisee's respective rights, duties and obligations arising out of their relationship. Since the terms and provisions of a franchise agreement are likely to vary depending on the type of franchise opportunity being offered and the franchisor's industry, there is no standard form of franchise agreement. However, there are several key provisions that US franchisors commonly include in their franchise agreements. These provisions address: (1) the franchisee's territorial rights and restrictions; (2) the duration of the franchise term; (3) royalties and other fees; (4) contributing to an advertising fund; (5) franchisor's training of and ongoing support to franchisees; (6) franchisee's renewal rights; (7) restrictive covenants; (8) assignment; (9) defaults and termination rights; (10) post-termination obligations; and (11) dispute resolution. In addition to these common provisions, franchise agreements will typically be accompanied by various ancillary agreements, which may include: (1) personal guaranty; (2) confidentiality and non-competition agreement; (3) lease rider; (4) electronic transfer of funds agreement; and (5) collateral assignment of lease (see Section IV.iv). For franchisors operating in the United States, the franchise agreement dictates, to a certain extent, the manner in which franchisees are to operate their franchised business – in accordance with the franchisor's system and standards. However, when drafting the franchise agreement (and other related agreements) it is imperative that the franchisor does not appear to exert too much control over the franchisee's day-to-day operations, because, as recent US court decisions have indicated, it can potentially expose the franchisor to liabilities, including being considered a 'joint employer' along with the franchisee.

For franchisors looking to enter the US market, multi-unit development may be an attractive option because it assists the franchisor in developing designated markets within the United States. The multi-unit development agreement will typically grant the developer the right to open a certain number of units by a specified date within a given, exclusive development area. The relationship between the franchisor and multi-unit developer will be governed by a multi-unit development agreement that will contain most of the same key provisions found in (and ancillary agreements that accompany) franchise agreements. In addition to these provisions and ancillary agreement, the multi-unit development agreement will also

include a development schedule pursuant to which the multi-unit developer is obligated to open a certain number of units within a designated time frame. Four of the most heavily negotiated issues in a multi-unit development deal concern: (1) the development schedule; (2) what happens to the territory when a multi-unit developer defaults in its development obligations; (3) what happens to the territory when the multi-unit development agreement expires or is terminated; and (4) the inclusion of cross-default provisions, particularly the impact that the default in one franchised unit will have with respect to the other units.

v Guarantees and protections

Often franchisees and multi-unit developers are newly formed entities with little or no financial history or significant assets. Consequently, most franchisors require the principals of the franchisee entity to execute a personal guaranty, guaranteeing all the franchisee's contractual commitments (including, any financial obligations and restrictive covenants) because the guaranty provides franchisors with additional security in the form of the guarantor's personal assets. Without the guaranty, might have to chase after franchisee entities that may have little to no assets. Typically, franchisors will use the guarantee to, among other things: (1) recover monies the franchisee owes to the franchisor; (2) protect the franchisor's trademarks and proprietary information; and (3) enforce the restrictive covenants. Generally, courts will uphold the enforceability of a personal guarantee.

V TAX

i Franchisor tax liabilities

Generally, a foreign franchisor, like any foreign corporation, must pay US federal taxes at the graduated corporate tax rate if it is 'engaged in trade or business' within the United States during the tax year and generates business income that is 'effectively connected with a US trade or business'.² The tax implications for a foreign franchisor entering into the US market will depend on the ownership structure that the franchisor elects to utilise. If the foreign franchisor elects to directly enter into franchise, multi-unit development or master agreements with a US business or citizen, then it is more than likely that the franchisor will be taxed as an entity that is deemed to be engaged in US trade or business. This means that under 26 US Code Section 882, the franchisor will have to pay taxes on all income that is 'effectively connected with the conduct of a trade or business within the United States'. The foreign franchisor will be deemed to engage in trade or business within the United States if it is actively involved in 'considerable, continuous and regular' business activities on US soil.³ Thus, all franchise fees and other fees (including, the costs for products or services that franchisees are required to acquire from the franchisor) would be considered taxable income. In addition to taxing the foreign franchisor's US-based income, 26 US Code Section 884(a) imposes a second tax at the rate of 30 per cent for all income that is transferred from the United States to the franchisor's office in its native country. A foreign franchisor may be able to alleviate this tax liability, if the franchisor's native country has a tax treaty with the United States. If there is a tax treaty between the franchisor's home country and the United States,

2 See 26 USC Section 882(a)(1). See also 26 USC Section 864 (definitions).

3 Will K Woods, 'Tax Considerations Related to Cross-Border Franchise Transactions' in *Fundamentals of International Franchising*, ch. 3 (2nd edn, 2013).

then the franchisor's liability will depend on whether the franchisor is considered to have a permanent establishment in the United States. The definition of 'permanent establishment' will vary from treaty to treaty. If the franchisor's country has a permanent-establishment provision in its treaty, then the franchisor will be required to file taxes and pay the applicable tax rate on the income attributable to the permanent establishment. So it is imperative for the franchisor to ascertain competent tax counsel and accountants that can advise with respect to this issue. A third tax that may be imposed on the income generated by a foreign franchisor would be income that the United States considers to be fixed or determinable annual or periodic income (the FDAP Income) rather than income that is effectively connected to the business the franchisor is conducting in the United States. In this case, such FDAP Income would be subject to a 30 per cent US withholding tax. This tax would normally apply to royalty payments, requiring the US franchisee to withhold 30 per cent of its royalty payments to the foreign franchisor. Again, if there is a tax treaty in place, this withholding tax can be reduced to as little as 10 per cent.

If the foreign franchisor elects to operate its business through a wholly owned US-based subsidiary, then the subsidiary's profits would be liable to a tax of up to 35 per cent. In addition to paying taxes on the profits generated, any dividend distributions that the subsidiary pays to the foreign franchisor would be subject to a 30 per cent withholding tax. However, any tax treaty that is in place between the franchisor's country of origin and the United States may reduce the percentage of tax required to be withheld.

The application of US federal tax laws to an overseas franchisor selling franchises in the United States is impacted by the terms of any income tax treaty or convention between the United States and the franchisor's country of residence that may be in effect. As long as the treaty-country franchisor does not maintain a 'permanent establishment' in the United States, the applicable treaty will reduce or eliminate altogether the franchisor's obligation to pay income tax on certain income earned in the United States.⁴ Where the franchisor maintains a permanent establishment in the United States, or where there is no applicable treaty, taxes must be paid as required by US law.⁵

A foreign franchisor may, of course, take advantage of any legal means at its disposal to minimise its US tax obligations. However, a franchisor may not manipulate the pricing or allocation of funds in self-dealings with its affiliates as a means of minimising taxes for the entities as a whole. To prevent tax evasion and to clearly reflect the income of each entity, the Internal Revenue Service (IRS) is authorised to 'distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [. . .] organizations, trades, or businesses [that are owned or controlled directly or indirectly by the same interests] if [. . .] necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses'.⁶

At the state level, franchisors are also responsible for paying state income taxes to the extent that they conduct business in a US state that imposes such a tax. The analysis for determining whether a franchise is 'doing business' within a particular state varies by state.

4 See IRS Publication 901 ('US Tax Treaties'), available at www.irs.gov/uac/about-publication-901.

5 See generally George J Eydtt et al., 'Bringing a Foreign Franchise System to the United States 7-11' (ABA 32nd Annual Forum on Franchising, 14 October 2009).

6 26 USC Section 482.

An increasingly important and fluid issue in recent years is the extent to which some states assert claims for income taxes due where the franchisor's only operations in a particular state are through its franchisees.

The Internal Revenue Code Section 1253 (Transfers of Franchises, Trademarks, and Trade Names) addresses specific tax issues governing the sale of a franchise and the related fees paid by the franchisee to the franchisor. Upfront franchise fees and royalty payments received by a franchisor are generally taxed as income at the time they are received. Advertising fees, in contrast, are usually business expenses and are not generally subject to income tax if expended for legitimate advertising or marketing purposes.

A franchisor can usually treat the transfer of rights to a franchisee as a sale or exchange of a capital asset (and the payments as capital gains) if the franchisor does not maintain a 'significant power, right, or continuing interest' in the franchise or trademark. This is also the case when a franchisee transfers its interest in a franchise to another franchisee. Pursuant to Section 1253 of the Code, a significant power, right, or continuing interest includes, but is not limited to: (1) a right to disapprove any assignment of such an interest, or any part thereof; (2) a right to terminate at will; (3) a right to prescribe the standards of quality of products used or sold, or of services furnished and of the equipment and facilities used to promote such products or services; (4) a right to require that the transferee sell or advertise only products or services of the transferor; (5) a right to require that the transferee purchase substantially all the transferor's supplies and equipment from the transferor; and (6) a right to payments contingent on the productivity, use or disposition of the subject matter of the interest transferred, if such payments constitute a substantial element under the transfer agreement.

Congress is currently in the process of revising the current tax laws, and the proposed changes, if passed, will likely have an impact on some, and possibly many, of the tax liabilities and the level of taxes described in this Section.

ii Franchisee tax liabilities

While a franchisee is granted a business opportunity by a franchisor, the franchised business is like any other typical small business that has to pay taxes on its profits. Franchised businesses must abide by the same federal, state and local tax laws as all other small businesses. While franchisees must pay taxes on the profits it generates, franchise royalties are generally deductible by franchisees in the year that they are paid or accrued. However, upfront franchise fees are not fully deductible by franchisees at the time of payment. Rather, franchise fees are typically amortised in equal annual deductions over a 15-year period irrespective of the term of the franchise agreement.

Royalty payments are considered US sourced 'fixed or determinable annual or periodic' income (FDAP income), which is taxed at the 30 per cent tax rate. Accordingly, franchisees are required to withhold tax at a 30 per cent rate on royalty payments made to the foreign franchisor. Payments to a foreign franchisor in exchange for the right to use its intellectual property (e.g., trademarks, copyrights) and technology, as well as fees for management services, qualify as 'royalty' payments for tax purposes and are subject to the 30 per cent withholding tax rate. If the United States has an income tax treaty with the franchisor's country of residence, however, the foreign franchisor will benefit from either a reduced withholding tax rate or a full exemption. If the foreign franchisor has set up a US franchising entity, or if payments are made to a master franchisee, the withholding tax would not apply.

iii Tax-efficient structures

Most franchisors and franchisees will utilise a corporation, limited liability company (LLC) or limited liability partnership to operate their business. The franchisor and franchisee's respective decisions as to the entity structure under which they operate their respective businesses will solely depend upon the level of personal liability the principals of the business will face in the event they are sued, as well as the amount of taxes they will be required to pay.

For franchisors and franchisees who elect to use a corporation as its operating entity, the corporation will be recognised as a legal entity separate and distinct from its owners (shareholders). A corporation has its own legal rights, independent of its shareholders. This separation of identity relieves the corporation's shareholders from personal liability, with certain exceptions. Generally, the owners' liability for the payment of the corporation's debts, obligations and from liabilities is limited. The personal assets of shareholders of corporations are typically protected and their liability is limited to the amount the shareholder invested in the corporation. With corporations, not only are the personal assets of the shareholders protected but that protection extends to the assets of the corporation's directors, officers, shareholders and employees. This liability protection precludes creditors from pursuing the personal assets of a shareholder (or the corporation's directors, officers, shareholders and employees), such as personal bank accounts or real estate, to pay business debts. In exchange for this shield of protection, shareholders entrust the management of the corporation's business affairs to its board of directors.

Generally, the profits of C corporations (which are typically used by publicly traded companies), as opposed to 'S corporations', are subject to double taxation. This means that the corporation is taxed on its income and the corporation's shareholders are separately taxed on the profit distributions they individually receive as 'dividends'. The double-taxation aspect of C corporations is what makes this entity structure unappealing to many franchisees and franchisors. To avoid double taxation many franchises elect to become S corporations. Under 26 US Code Section 1366 of the Internal Revenue Code, S corporations are treated as pass-through entities. Instead of corporations being taxed on their business income, any business income or loss is 'passed through' to shareholders who report it on their personal income tax returns, which is an extremely appealing aspect of S corporations. With this pass-through tax treatment, business losses can offset other income on the shareholder's tax returns. However, not all corporations can elect to be an S corporation. To qualify as an S corporation, the corporation must be a domestic corporation that only offers one class of stock with no more than 100 shareholders, none of whom can be non-resident aliens; this last qualification presents a problem for many foreign franchisors. Thus foreign franchisors wishing to utilise a corporation will probably have to form a C corporation and be subject to double taxation. Franchisors using corporations must strictly adhere to the various corporate governance requirements imposed by state law, which may include but are not limited to: (1) adopting by-laws; (2) holding shareholders' and board of directors' meetings; and (3) maintaining corporate minute books. Failure to observe these requirements may result in 'piercing the corporate veil' and can expose shareholders to personal liability for the obligations of the corporation.

A foreign franchisor looking for a more flexible type of business entity may prefer to utilise an LLC as its franchising entity. LLCs are a great option for franchisors who want operational flexibility. The members of an LLC generally have control over the business, whereas a board of directors elected by the shareholders makes the major decisions on the corporation's behalf. Similar to a corporation, an LLC is a legal entity separate from its owners

(members). Usually the amount of a member's investment constitutes the limit of the liability for which the member is responsible. For taxation purposes, LLCs are treated as pass-through entities, unless they elect to be taxed as a C corporation. Therefore, all the profits and losses of the LLC pass through the business to the LLC members. The members report these profits and losses on their personal tax returns; thus, the LLC does not pay federal income taxes; however, some states do charge the LLC itself a tax. Therefore, double taxation is avoided. Unlike corporations, LLCs: (1) can have an unlimited number of domestic or foreign members with different classes of ownership and who can (if they so elect) manage the LLC's business affairs; and (2) are not subject to strict corporate governance requirements, such as scheduling regular owners' meetings and maintaining corporate minute books. Although, the laxity in LLC corporate governance requirements may be appealing, it can, as with corporations, be a double-edged sword in that it may be used to pierce the corporate veil. Recently, aggrieved franchisees have used this approach and have persuaded courts to peel away the protections afforded by LLCs. Thus, it is advisable that franchisors implement a strict corporate governance practice. A drawback of an LLC is that the managing members' share of the LLC's profits is considered earned income, and therefore subject to self-employment tax.

In determining the appropriate corporate structure, some franchisors may elect to use a two-tiered or multi-tiered corporate structure to protect the assets of the business. This type of structure will typically comprise a holding company and several wholly owned subsidiary operating entities. The holding company will serve as the parent, and separate operating entities can be formed to, among other things: (1) serve as the franchisor; (2) own the intellectual property associated with the franchise system; (3) offer services to franchisees; (4) manage company-owned units; (5) own and lease real estate; and (6) purchase, sell or lease equipment, etc. Many franchisors (and even franchisees, particularly, those who own multiple franchises) will find the use of a multi-tiered structure to be extremely beneficial to the business, particularly as it relates to liabilities and creditor claims. In general, with a tiered corporate structure, the liabilities and any creditor claims stay with that subsidiary and cannot be passed on to the parent company because the two entities are considered to be separate legal entities. Therefore, the liabilities of the franchisor operating entity will not be passed to the holding company entity, so the assets of the holding company cannot be reached. An important factor in establishing a tiered corporate entity is understanding the manner in which entities can own each other. For example, an LLC may own another LLC or a C corporation, but it cannot be an S corporation shareholder. A C corporation and an S corporation can both own an LLC, but there is little reason for an LLC to own an S corporation since both are pass-through entities.

VI IMPACT OF GENERAL LAW

i Good faith and guarantees

The common law of many states automatically incorporates an implied covenant of good faith and fair dealing (GF&FD) into every contract, including franchise agreements. There is some variation among jurisdictions, but GF&FD generally requires that where one party has discretion to act in a certain way it should not unfairly enrich itself, or act in an overly arbitrary or capricious manner so as to eliminate the other party's benefit of the contact. By imposing the implied covenant of good faith and fair dealing, the states are looking to ensure that the contracting parties are getting the benefit of their bargain.

There are limits on GF&FD. The requirement that parties (particularly, the franchisor, in this case) act in good faith and deal fairly is not a requirement that the franchisor act against its own economic self-interest in favour of the franchisee. Parties are free to enter into such contractual provisions as they may choose, especially where both parties are sophisticated and represented by counsel. A franchisee may knowingly enter into a bad economic arrangement, and if the contract is clear, the implied covenant of good faith and fair dealing will not be permitted to contradict the express terms of the agreement. Consequently, a detailed and properly drafted franchise agreement will eliminate most circumstances where GF&FD might otherwise arise, as there will be an express contractual term addressing the particular issue. However, as parties may not anticipate every potential issue, and since the application of GF&FD is a fact-driven analysis, the ‘implied covenant’ is a meaningful litigation tool.

There are also state franchise statutes that require good faith on the part of a franchisor. A franchisor’s conduct, if it is sufficiently unfair, may also become ‘unfair and deceptive’ under other statutes (such as under the FTC Act, provided the circumstances warrant it).

Regardless of whether a good-faith obligation is legally required in a particular instance, a franchisor that takes unfair advantage of its franchisees may find itself unable to sell new units if the system’s franchisees are unsuccessful or unhappy and they convey these feelings to prospective franchisees who enquire. Negative reviews or, worse, litigation by disgruntled franchisees against a franchisor (which generally must be disclosed in an FDD) can have a real impact upon franchisors. Therefore, even though there may not be a legal requirement to act fairly and reasonably in every instance, prudent franchisors should consider accommodating a struggling franchisee in the interest of the long-term health of the system.

ii Agency distributor model

Each state has its own body of common law regarding agency, and an agency relationship may be implied, or imposed by law, even if not directly created by contract. Since franchisees sell services or products under the franchisor’s name subject to the terms and conditions set by the franchisor, there is a risk that an agency relationship (whether actual or apparent) will be found to exist between a franchisor and a franchisee. If a court determines that there is an agency relationship between a franchisor and its franchisees, a franchisor may become vicariously liable for harm directly caused by a franchisee to a third party.

In determining if actual agency or general agency exists, courts will examine whether an actual principal–agent relationship exists, and may also find general agency will attach, if factors exist that are relevant to the degree of control exerted by the franchisor over the franchisee’s general day-to-day operations. General agency, however, is not likely to be an issue if a franchisor has an appropriate franchise agreement in place that specifically references the fact that a franchisee is an independent contractor, and the franchisor does not exert so much control over the operations of the franchisee, generally, that it can be considered its agent for all intents and purposes.

Apparent agency may be found by a court if a plaintiff seeking to hold a party liable on the basis of an agency theory reasonably believed the franchisee to be an agent of the franchisor; and reasonably relied upon that belief to its detriment. The risks of liability due to apparent agency can be minimised by distancing the franchisor and franchisee in the eyes of the consumer. For example, requiring that franchisees utilise visible and conspicuous signage in a franchisee’s location stating that each franchise is independently owned and operated, and requiring similar disclaimers in advertisements, may undermine an apparent authority argument.

A franchisor may also be found to be vicariously liable for the acts or omissions of its franchisees (or its franchisees' employees). However, vicarious liability, as a general rule (again, there is variation depending upon the jurisdiction) will only attach where a franchisor exerts sufficient 'control' over the franchisee's performance of the specific process or activity that is being complained of such that the franchisor will be deemed to be jointly responsible. There may be specific situations or statutes, particularly in the employment context (discussed below) where vicarious or joint liability can attach in a particular context. However, in general, courts have become increasingly adverse to over-application of vicarious liability in the specialised context of franchises, and are less likely to find vicarious liability based upon practices that are typical of the franchisor–franchisee relationship. Practically every common law jurisdiction has found that general operation or procedure manuals, or compliance with a franchisor's general franchise system, will not, in and of itself, result in vicarious liability. Nonetheless, when a franchisor has required a franchisee to comply with a specific practice or policy that is directly responsible for the harm, there is a significant risk that vicarious liability will attach.

Therefore, franchisors should balance the need to provide a cohesive and comprehensive franchise system to their franchisees (including the utilisation of operation and procedure manuals) against exerting too much control over the day-to-day operations of franchisees, which can result in a risk of vicarious liability. Whenever a detailed instruction or requirement is not truly necessary to maintain quality control, such micromanaging should be avoided. To further minimise potential exposure, franchisors are well advised to: (1) incorporate an indemnification clause in their franchise agreement that would protect them against losses to which they may be exposed that may arise out of the operation of the franchisee's business; (2) require that franchisees maintain adequate insurance coverage (which names the franchisor and its principals and affiliates as additional insured parties), especially where necessary to protect against particular liability concerns that could result in vicarious liability; (3) include a provision in the franchise agreement that clearly states that the franchisee is an independent contractor and not an agent of the franchisor; and (4) require franchisees to conspicuously post notices in its establishment and advertisements that notify the public that the franchisee is an independent contractor and not an agent of the franchisor.

iii Employment law

The franchise community in the United States has become increasingly concerned with the issue of joint employer liability – the potential for franchisors to be held jointly liable (along with their franchisees) for employment claims brought by a franchisees' employees. It should be noted, however, that the joint employer doctrine only applies in connection with violations of employment law (for example, violations of the Fair Labor Standards Act, 29 USC 201 et seq., or National Labor Relations Act, 29 USC Section 151 et seq.). The joint employer doctrine is an exception to the general rule that a franchisor and a franchisee are independent contractors and the actions of the franchisee do not expose the franchisor to liability. This doctrine, in the franchise context, essentially finds that franchisors who exert too much control over the 'terms and conditions of employment' that their franchisees impose upon their employees (e.g., by setting 'standard' work hours, wage and salary levels, employment practices and policies, and resisting unionisation of employees) run the risk of being held jointly liable with their franchisees for employment claims.

While the joint employer doctrine has been utilised in the employment context for decades, recently regulators, including notably the National Labor Relations Board (NLRB)

and the US Department of Labor (DOL) Wage and Hour Division, have aggressively utilised it to reach franchisors, even for a franchisor's 'indirect' control over the terms and conditions of employment of franchisees' employees. This presents a conflict, as the franchisor–franchisee relationship, by its very nature, requires a franchisee to adhere to the franchisor's system or business model and to follow certain procedures. As a result, the unwary franchisor, by over-regulating what the franchisee's employees do, may find itself to be liable for employment law violations as a joint employer. This is a rapidly developing area of law and conflicting decisions from different regulatory agencies and courts have made the landscape confusing at best. The bottom line is that prudent franchisors, wherever possible, should avoid exerting excessive control over the terms and conditions of employment of their franchisees' employees, balancing levels of control against maintaining system standards.

Another issue regarding employment law and franchising occasionally arises in the context of 'misclassification' under labour law, where a franchisee (typically a single-person franchise) will be found by a court or regulator to be an employee of the franchisor, and not an independent contractor or franchisee. There are requirements under US federal law (e.g., the Fair Labor Standards Act) and state common law (e.g., state wage and hour statutes) that generally use a multi-factored test to determine whether, even if the parties may call a relationship a franchisor–franchisee relationship, it is in fact, *de facto* employment. Franchisors should be clear, especially when working with single-person franchisees, to maintain an independent contractor relationship (typically problematic areas are single-person franchisee 'black car' drivers or franchisees of delivery distribution routes). Franchisors should avoid excessive control over a franchisee to the point where a court might decide that what was intended to be a franchise relationship is in actuality one of employment directly with the franchisor.

iv Consumer protection

In general (there is significant variation between common law jurisdictions, and exceptions), franchisees are not considered to be 'consumers' in the sense that they will not normally fall under common law or state statutory consumer protection statutes, especially in jurisdictions where there is an existing law specifically regulating franchises. As noted above, the FTC Act does regulate the offer and sale of franchises (see Section IV.i–iii), and many states also regulate the offer and sale of franchises, as well as the franchise relationship (*id.*), and may additionally provide for private rights of action (which the FTC Act does not). Nonetheless, in some jurisdictions, a franchisee may be able to utilise the FTC Act in conjunction with state common law and state statutes to qualify as a consumer deserving of protection in the franchise context. The FTC Act contains a broad prohibition against 'unfair and deceptive acts or practices'; for example, see Section 15 USC 45 ('Unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful.') Since many states also have enacted similar statutory regulations prohibiting unfair or deceptive trade practices, there may be circumstances in certain jurisdictions where an offer or sale of a franchise, or other act that would be considered an unfair or deceptive act or practice under an analogous state law (Little FTC Acts) can give rise to a private right of action.

v Competition law

In the United States, competition law is generally known as antitrust law and it prohibits agreements that unreasonably restrain trade. The federal antitrust statutes that are most likely

to apply in a franchise context are the Sherman Act. (15 USC Section 1 et seq.) (prohibiting 'anticompetitive or monopolistic conduct'), and the Clayton Antitrust Act (15 USC Section 12 et seq.) (prohibiting, *inter alia*, anticompetitive 'price discrimination', 'exclusive dealing', and 'tying'). In addition to the federal antitrust statutes, almost every state in the United States has enacted its own antitrust laws, which are often modelled after the federal antitrust statutes. Since, however, there may be significant differences among the state statutes, the law of each state (where a franchise will be conducting business) should be analysed along with applicable federal laws. The ultimate purpose of federal and state antitrust laws is to preserve and promote competition in relevant markets.

Antitrust was once a major area of litigation and concern for both franchisors and franchisees, particularly with respect to the issues of: (1) price-fixing (e.g., franchisors setting maximum or minimum prices); (2) exclusive dealing requirements (e.g., requiring franchisees to deal only with particular designated suppliers); and (3) tying (e.g., requiring that franchisees purchase products or services not directly related to the trademarked franchised product or service). However, in the past few decades, courts have significantly reduced the applicability of antitrust laws in the franchise context by narrowly interpreting the definition of the applicable 'market' for antitrust claims so as to exclude franchises. In short, many courts have found that the market for antitrust analysis purposes should be limited to the sale of the franchise itself, and as long as a franchisee was properly advised of the restrictions applicable to its trade (e.g., disclosed in an FDD) before it became a franchisee, it could not seek antitrust protection after agreeing to the terms of the franchise agreement. Further, courts are increasingly using the more permissive 'rule of reason' test in analysing the permissible conduct of a franchisor in areas that had been considered *per se* antitrust violations. Therefore, a franchisor's ability to point to a reasonable economic justification for the complained of conduct will usually be sufficient to defeat an antitrust claim.

Consequently, as the law now stands in most jurisdictions, including in most federal courts, a well-drafted franchise agreement, and FDD, which contain sufficient disclosure of any contractual requirements to purchase certain goods or services, restraints on a franchisee's ability to freely conduct business, or requirements that franchisees deal with specific vendors, will defeat most antitrust claims.

vi Restrictive covenants

It is typical for a franchisor to impose a non-competition restriction upon the franchisee during the franchise term and after the expiration or termination of the franchise term, as well. In these non-competition clauses, franchisors will require franchisees to refrain from directly or indirectly owning, engaging in or associating with any business that directly competes with the franchisor's system. Non-competition clauses will also preclude franchisees from hiring current or former employees of the franchisor, the franchisee or the franchisor's other franchisees or soliciting business from the franchisor or other franchisees. To be enforceable, it is important that the non-competition clause is reasonable in duration and geographical scope. Non-competition clauses that impose a restriction during the term of the franchise agreement and one to three years after the expiration or termination of the franchise agreement, with a geographical scope encompassing a radius of 10 to 20 miles surrounding the franchisee's 'unit' and, perhaps, other existing units within the geographic area in which the franchised unit was located are not uncommon. If a franchisee violates the non-competition clause, the franchise agreement will usually provide that the franchisee consents to the franchisor having

the right to obtain an injunction against the franchisee without the need for the franchisor to prove the merits of its case. Violation of the non-competition clause may result in the franchisee having to pay liquidated damages to the franchisor (see Section VI.vii).

vii Termination

Franchise agreements typically contain provisions whereby a franchisor, under certain circumstances, may terminate a franchise. Usually, the franchise agreement will require that the franchisor or franchisee have 'cause' to terminate the franchise agreement, but this is not always the case. Generally, the franchise agreement will detail: (1) what actions or inactions constitute a default under the franchise agreement (an event of default), and (2) the period within which the franchisor or franchisee has to cure such a default (provided the franchisor deems the default to be curable). If an event of default has occurred, the franchisor will provide the franchisee with either: (1) written notice of the default and provide the franchisee with an opportunity to cure the default within the requisite cure period; or (2) written notice of termination if the default is incurable, such as in the case where a franchisee uses the franchisor's trademarks in an unauthorised manner or discloses the franchisor's confidential or proprietary information without the franchisor's prior written consent.

While no federal law regulates the relationships between franchisors and franchisees, approximately half of the states in the United States (as well as US territories Puerto Rico and the US Virgin Islands) have relationship laws, which vary from state to state. While they usually relate to several aspects of the franchise relationship, the most significant is the franchisor's ability to terminate or fail to renew a franchisee's franchise agreement. Many relationship laws require franchisors to have good cause before they are permitted to terminate, or fail to renew, a franchise. While there is no standard definition of 'good cause', typically, good cause will exist if the franchisee has breached a material obligation of the franchise agreement. Relationship laws generally require the franchisor to provide the franchisee with written notice that it seeks to terminate (or will not renew) the franchise agreement. Franchisees typically have between 30 and 90 days to cure the alleged default and avoid termination. However, where the default is based upon events that should not require an extended period to cure (e.g., health violations in a food-related franchise or the franchisee's failure to pay royalties or other sums owed to the franchisor), the franchisor is often permitted to provide the franchisee with a much shorter period to cure the defaults and avoid termination. Where certain defaults are alleged that are perceived to be egregious (e.g., unauthorised use of the franchisor's trademarks, or otherwise seriously impairing the franchisor's brand and reputation), or where certain exigent circumstances exist (e.g., franchisee's loss of its right to occupy its premise), some relationship laws permit the franchisor to terminate the franchise immediately and without providing the franchisee with any opportunity to cure the alleged default.

Often, franchises make large investments of both time and money in connection with their franchises, and relationship laws were passed to provide franchisees with some protection against the loss of their franchise investment through no fault of their own. Of the states that have relationship laws, some incorporate relationship law provisions into a broad franchise disclosure or registration statute; some have a relationship law that is separate from the state's disclosure or registration law; and others have relationship laws but have no franchise disclosure or registration statute. Any inconsistent or contrary provision that is contained in a franchise agreement will be set aside and superseded by an applicable relationship law.

Thus, if the franchisor is operating in a relationship state, it will likely have to establish good cause for termination, even if the franchise agreement allows the franchisor to terminate the franchise agreement with or without cause.

In the event that the franchise agreement expires or terminates, the franchise agreement will set forth the franchisor and franchisee's rights and obligations thereafter, including: (1) the franchisee's obligation to de-identify its business and cease using the franchisor's trademarks; (2) the franchisor's right to purchase the franchisee's franchised business; and (3) the franchisor's right to replace the franchisee as lessee under any lease.

Almost all franchise agreements contain post-term restrictive covenants that seek to prevent the franchisee from operating, owning or being involved in a business that competes with the franchisor. Franchisors typically seek to impose such restrictions because they assert they are necessary to protect their 'legitimate business interests', which, for example, would include the protection of confidential or proprietary information or the goodwill that has been developed by the franchisor over time. While such restrictions were disfavoured in the early years of modern franchising (i.e., the 1980s and 1990s), the more current trend has seen courts broaden their view of franchisors' legitimate interests and to expand the enforceability of such restrictive covenants within 'reasonable' limits. Generally, the 'reasonableness' standard will focus on three major aspects of the provision: (1) what kinds of businesses are said to be 'competitive' and therefore prohibited; (2) the geographic area covered by the restriction; and (3) the duration of the restriction. Currently, most states in the United States, with the major exception of California, will enforce such reasonable post-term restrictive covenants. This issue is almost always determined as a matter of state common law, although some states have passed legislation that addresses this issue. (These restrictions almost never run afoul of federal antitrust laws because they rarely, if ever, affect competition in a relevant market.) Many states permit their courts to utilise some form of blue-pencilling to either strike out certain portions of a restrictive covenant that the court may deem to be 'overreaching' or to otherwise modify and more narrowly tailor such a restriction that has been deemed by the court to be overly broad. Other states will simply strike down as unenforceable a restrictive covenant provision that is deemed to violate that state's statutory or common law.

Many franchise agreements contain provisions by which the franchisor reserves the right to take over the operation and management of a franchisee's business under certain circumstances, such as where a principal owner and manager of the franchise passes away and no 'certified' manager is available to properly manage the business. Sometimes this is referred to as a 'step-in right'. Other circumstances where franchisors may try to assert a step-in right include where the franchisee has failed financially and has closed the franchised location, where the franchisee has committed an incurable default such as engaging in the unauthorised use of the franchisor's trademarks or the unauthorised disclosure of the franchisor's proprietary information, or where the franchisee has under-reported royalties that are owed to the franchisor. Where franchise agreements provide that the franchisor has the right to effectuate an assignment of the franchisee's lease upon the termination or expiration of the franchise agreement and the landlord has agreed to this provision in a lease rider, then the franchisor may be able to take over the franchised location. While most franchise agreements provide for payment by the franchisor to the franchisee for the franchisee's assets, the pricing formulae utilised vary from, among many, the fair market value of the business as a going concern to the depreciated cost of the 'hard assets'. Where the franchise agreement does not contain such a right, or where the landlord has not agreed to such a right, then the franchisee or the landlord may object to the franchisor's attempts to step in and take over the location. In such

a situation, the franchisor may not be permitted under state law to use 'self-help' to take over the location and it is likely that the franchisor would be forced to seek relief in the courts before it takes such action.

Where a franchisor seeks to assert step-in rights to take over the franchisee's location, a franchisee may pre-emptively file for bankruptcy protection under the US Federal Bankruptcy Code. Under bankruptcy law, generally, the filing of a bankruptcy petition results in what is called an 'automatic stay', which protects the debtor (in this case the debtor or franchisee) from acts or actions by creditors seeking to enforce claims against the debtor. Under such circumstances the franchisor would have to petition the bankruptcy court for relief, a process (which may not move very quickly) with no certainty of success.

While many franchise agreements provide that the franchisor may terminate the franchise agreement if the franchisee becomes insolvent or if it files for bankruptcy, provisions permitting the franchisor to terminate the franchise agreement where the franchisee files for bankruptcy protection may not be enforceable under the US Bankruptcy Code (see 11 USC Section 365(e)(1)(A)). In the event that a franchisee files for bankruptcy protection before its franchise agreement has been properly and effectively terminated by the franchisor (or prior to the franchisee's lease having been properly terminated by the landlord), then the franchise agreement or lease becomes part of the debtor or franchisee's 'bankruptcy estate'. Where a debtor or franchisee seeks to 'reject' the franchise agreement or lease in its bankruptcy petition, the franchisor may be able to obtain quick relief from the bankruptcy court permitting it to take over the franchised business or location. However, where the debtor or franchisee wishes to continue operating its business and to 'assume' the obligations under the franchise agreement or its lease, it may not be easy for a franchisor to quickly take over the business or location where the debtor or franchisee was not otherwise in default of the franchise agreement or its lease (other than for the filing for bankruptcy) and where the bankruptcy court deems the assumption of the franchise agreement or lease to be in the best interests of the estate and its creditors. It will be more difficult for the debtor or franchisee to persuade the bankruptcy court to permit the debtor or franchisee to assume the franchise agreement or lease if the debtor or franchisee was also in material default of the terms and conditions of the franchise agreement or lease at the time the bankruptcy petition was filed.

viii Anti-corruption and anti-terrorism regulation

Franchisors that globalise their business operations must familiarise themselves with US federal anti-corruption and anti-terrorism laws and implement system-wide safeguards to ensure that they do not enter into franchise agreements with, or support franchisees who; (1) bribe foreign officials; (2) launder money; or (3) conduct business that supports terrorists. A franchisor that fails to do its due diligence and properly monitor its system risks being held civilly and criminally liable for its franchisees' illegal conduct, at a potentially devastating cost to the franchise system.

Pursuant to the Foreign Corrupt Practices Act of 1977 (FCPA),⁷ companies and individuals are prohibited from bribing foreign government officials (i.e., providing money or anything else of value to a foreign public official in exchange for any assistance in obtaining or

7 15 USC Section 78dd-1 et seq.

retaining business). A company can be liable for an FCPA anti-bribery violation committed by one of its employees or by a third-party individual acting as an agent of the company if the company knew or should have known about the violation.

The Department of Justice (DOJ) and the Securities and Exchange Commission have been particularly aggressive in enforcing the FCPA's anti-bribery provisions and have been successful in extracting millions upon millions of dollars in penalties and settlements.⁸ DOJ officials were reported as saying in 2009 that 'enforcement of the FCPA is second only to fighting terrorism in terms of priority'. Accordingly, franchisors are well advised to adopt anti-corruption compliance measures or conduct due diligence on their foreign franchisees to protect against any FCPA violations and to shield themselves from any exposure.

Franchisors should carefully monitor their business dealings and comply with US anti-money laundering and anti-terrorism laws, which are strictly enforced as well. The Bank Secrecy Act (BSA),⁹ as amended over the years and as augmented in the regulations issued by the US Department of Treasury,¹⁰ requires that US financial institutions; (1) maintain appropriate records of their customers' currency transactions and banking activity; and (2) file reports, including the currency transaction report for transactions over US\$10,000 and the suspicious activity report for transactions suspected of being in violation of federal criminal law, with the Department of Treasury's Federal Crimes Enforcement Network. Also known as the 'anti-money laundering (AML) law', the BSA was initially designed as a tool to combat tax evasion and money laundering. In recent years, the reports generated by banks to meet their BSA reporting requirements have been increasingly used by law enforcement officials to detect and prevent drug trafficking and terrorist financing activity.¹¹

In October 2001, Congress responded to the 9/11 attacks by passing an amendment to the BSA, known as the USA PATRIOT Act, which strengthened the BSA's AML and anti-terrorism financing provisions. The USA PATRIOT Act requires, *inter alia*, that financial institutions establish their own AML programmes to detect money laundering schemes; and create customer identification programmes to verify customer identities.

*The Office of Foreign Assets Control (OFAC) of the US Department of the Treasury administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States.*¹²

Franchisors operating abroad must keep current with OFAC's published list of sanctioned individuals (Specially Designated Nationals) and targeted countries (e.g., North Korea and Sudan) and avoid conducting business with any listed countries and individuals, and their entities.

8 See, e.g., *NY Times*, at B1 (18 November 2016), available at www.nytimes.com/2016/11/18/business/dealbook/jpmorgan-chase-to-pay-264-million-to-settle-foreign-bribery-charges.html?_r=0 (reporting on the settlement agreement between JPMorgan Chase and the DOJ for US\$264 million relating to an alleged bribery scheme involving the bank's practice of hiring Chinese officials' children).

9 31 USC Section 5311 et seq.

10 See 31 CFR Part 103.

11 See FDIC Risk Management Manual of Examination Policies, Section 8.1-1, available at www.fdic.gov/regulations/safety/manual/section8-1.pdf.

12 www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx.

To ensure compliance with the anti-corruption and anti-terrorism laws, franchisors should incorporate anti-corruption and anti-terrorism provisions within their franchise agreements. These provisions should: (1) obligate the franchisee to comply and assist the franchisor in complying with all applicable anti-corruption and anti-terrorism regulations and executive orders; (2) restrict franchisees from entering into prohibited transactions; (3) require franchisees to comply with all applicable currency reporting laws; and (4) require franchisees to guarantee to the franchisor that no owners or key personnel have been designated as (or associated or affiliated with) a terrorist or suspected terrorist.

ix Dispute resolution

The US judicial system generally follows a common law adversarial model, where each party must argue its position before a neutral judge or arbitrator, who will then decide the issue on the basis of the arguments and evidence presented. While juries may also determine factual issues in the US court system, most franchise agreements provide that the franchisee waive the right to a jury trial. In general, each party must bear its own legal costs and expenses, including attorneys' fees, and disputes can be costly, even if a party prevails. Therefore, both franchisors and franchisees are well advised to take steps, such as hiring competent franchise counsel to review agreements and key legal documents, and complying with all applicable rules and regulations, to minimise the likelihood of having disputes. Further, when disputes do arise, parties are similarly advised to attempt to try to resolve them amicably, as the cost of litigating over an issue will often be significant.

There is not a uniform forum in the United States where all franchise disputes are litigated. Which court has jurisdiction (e.g., federal or state court) can be a complex question depending on a variety of factors, including the types of claim brought, the amount in controversy, who the parties are, where they are located and whether they have agreed to a specific forum for resolving their claims. Choice of law provisions, and forum selection provisions, including those that require international forums and choice of law, are generally upheld, but can be challenged in court, normally in the context of a motion to compel arbitration, or to stay arbitration (often under the Federal Arbitration Act (FAA), 9 USC Section 1 et seq.). The United States is a signatory to the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards, and courts will normally recognise foreign arbitral awards from other Convention Member States.

Private parties can also mutually agree to resolve their disputes outside court, and often do so. This is generically referred to as alternate dispute resolution (ADR). Common forms of ADR are arbitration and mediation (discussed further below). Usually the specific form of ADR (if any), along with applicable procedures and rules, are detailed in the franchise agreement (generally called dispute resolution provisions). Parties can agree to waive certain types of damages (e.g., waive punitive and consequential damages), limit the amounts that can be recovered under certain circumstances (e.g., liquidated damages provisions) or agree that attorneys' fees, or arbitrators' fees, and other costs shall be paid by the losing party (fee-shifting), agree to litigate or arbitrate a dispute at a specific location (a forum-selection clause), agree to a choice of law (e.g., only New York State law will apply), limit or reduce the period in which to file a lawsuit (a shortened statute of limitations), agree to waive their rights to bring any collective or class actions (a class action waiver) and to engage in ADR (e.g., agree to arbitrate or mediate a dispute). There are limits to what a party can contract to.

There are some public policy exceptions, a waiver must be knowing and voluntary, and some rights cannot be waived or altered (for example, many state franchise statutes do not allow parties to waive their rights under those statutes).

Arbitration is a form of ADR that is binding. The parties agree, by contract or consent, to submit their dispute to a neutral arbitrator (or panel of arbitrators), who is empowered to make a determination. The Federal Arbitration Act, 9 USC Section 1 et seq. is a statute that governs arbitration and provides that arbitration is generally favoured and that arbitration clauses, and arbitrators' rulings, will usually be enforced (with some rare exceptions). After the arbitrators make a ruling, the prevailing party may turn that ruling into a court judgment by having it confirmed by a court and the non-prevailing party can seek to have the award vacated. However, the ability for an unsuccessful party to overturn, or vacate, an arbitration award is limited and extremely difficult to achieve. Arbitration is a 'creature of contract', meaning that the parties can determine by agreement what the rules are and how the arbitration will be conducted. Typically, however, parties will agree to conduct their arbitration through a nationally recognised arbitration service, which will have well-established rules and procedures for conducting the arbitration (such as the American Arbitration Association or the International Institute for Conflict Prevention and Resolution). It is imperative that the arbitrator have experience in franchise law, and having been a practitioner in the field is certainly a plus. Arbitration is generally held in the county in which the franchisor has its principal office, and the associated fees are often shifted to the non-prevailing party.

There is no 'correct' answer as to which forum is 'better' for franchise disputes, and there are positive and negative aspects to each method of dispute resolution. In general, arbitration is less formal than litigation, involves less discovery and motion practice, and does not necessarily follow formal rules of procedure or evidence. Therefore, arbitration can be less expensive and time-consuming than litigating before a court. Arbitration proceedings are also usually private and confidential. In contrast, court proceedings are generally open to the public. Therefore, arbitration is a very popular forum (especially for franchisors), and many franchise agreements contain dispute resolution provisions requiring arbitration. However, in recent years, arbitration costs have increased, and arbitration has increasingly incorporated more discovery, rules and motion practice (thereby becoming more like court litigation). Arbitrators are also not necessarily bound to strictly follow the law, so long as they do not make a decision in 'manifest disregard' of the law. Litigation may be preferable where a party can quickly resolve a dispute (that has little or no legal basis) through motion practice (e.g., through a motion to dismiss), which can eliminate baseless claims quickly and efficiently.

Mediation is a form of ADR that is non-binding, and typically involves the parties agreeing to submit their dispute to a neutral person, who in turn will attempt to help the parties reach a settlement. While many ADR forums provide mediation services, the parties may also select their own private mediator. The mediator is not empowered to decide the dispute, but rather seeks to facilitate the parties' efforts in reaching a settlement. Therefore, unless the parties settle, the dispute is not resolved, and the parties will return to litigating or arbitrating the dispute. Nonetheless, mediation is an excellent means of trying to resolve disputes without incurring the cost of litigation, and a sophisticated, experienced and knowledgeable neutral mediator can be invaluable in resolving disputes by providing an unbiased view of each party's position. Many franchise agreements require mediation, then arbitration or litigation if mediation is unsuccessful. Mediation can take place at any time during a legal proceeding, not only prior to its commencement. Mediation will usually be held in the city in which the franchisor is located, but some franchisors will agree to hold

it in the county of the franchisee's principal place of business to help defray the franchisee's costs associated with such mediation. The National Franchise Mediation Program (NFMP), in which many of the larger US franchisors participate, encourages this approach. The costs of the mediation are often equally divided between the franchisor and franchisee.

Notably, regulatory actions (those where a governmental entity is bringing an action) are not private lawsuits (and do not typically allow parties to engage in arbitration), and may require a party to appear in a specialised forum or proceeding before that regulatory body. Examples are the FTC, which regulates franchises, or the NLRB; these have their own regulatory forums and proceedings, and may also bring certain actions in federal court.

Actions for temporary restraining orders, preliminary injunctions and permanent injunctions (commonly called injunctive relief) can be brought in federal or state courts (depending on the circumstances) to obtain emergency relief. Injunction actions will usually only be granted if, without an injunction, a party will suffer 'irreparable harm'. Common examples in the franchise context include protection of intellectual property (such as protection of a franchisor's trademark or confidential operations manual being used without permission), instances where irreparable damage, not compensable by monetary damages alone, will result in the complete loss of a business (e.g., a franchisee who is being improperly terminated, or not being 'renewed', and as a result their entire business will be destroyed) or cases where a party seeks by injunction to stay a litigation (put it 'on hold') and 'compel' a party to arbitrate, where arbitration is required by the FAA.

Where a former franchisee continues to improperly utilise the franchisor's registered trademark, a franchisor can initiate an injunction action, alleging violations of the federal Lanham Act by the former franchisee, and apply for immediate relief, asking a court to issue a preliminary order enjoining or preventing the former franchisee from utilising the mark, and forcing it to de-identify (without having to go through the formal and more lengthy process of litigating or arbitrating the entire dispute). The newly enacted Defend Trade Secrets Act (DTSA) also provides for injunctive relief and expedited *ex parte* relief (including orders for seizure of trade secret materials), and has extra-territorial (international) application. Therefore, while the DTSA is a relatively new statute without many decisions interpreting it, it has significant potential for use in the franchise context, especially in the circumstance where a terminated franchisee continues to improperly utilise a franchisor's trade secrets.

Many franchise agreements with dispute resolution provisions requiring arbitration contain 'carveouts' – specific clauses allowing injunction actions to be brought in court even though the balance of the dispute must be arbitrated. Recently, a number of arbitration forums have built into their standard rules an injunction procedure, allowing for expedited or interim relief akin to an injunction action. However, the enforceability, speed and effectiveness of these new provisions has yet to be vetted, particularly since, to enforce an arbitrator's decision, a prevailing party must generally first confirm an arbitration award.

x Real estate matters

Whether offering single-unit franchise opportunities, area development rights, master franchise opportunities or area representative arrangements, a factor crucial to the successful expansion of a franchise system is the location of its units. Most franchise systems will require its franchisees to operate from a commercial property. If the franchisee does not own a commercial property (which typically they do not), then the franchisee will need to lease a commercial space to operate the franchised business. The franchise agreement will

often require the franchisee to obtain first the franchisor's approval of the location before the franchisee can commence lease negotiations. Once the franchisee has notified the franchisor of its proposed location, the franchisor, or its representative, would be likely to visit the location to assess whether it satisfies the franchisor's location criteria. Once the franchisor has approved a location, the next step is to negotiate the lease.

Negotiating a lease where the commercial tenant is also a franchisee can be challenging since the lease must protect not only the landlord's and tenant's interest, but also that of the franchisor. While the franchisor, franchisee and landlord share the common goal of negotiating a successful lease arrangement, each party has distinct, conflicting issues that they must reconcile to protect their respective interests. Some of these conflicting issues include: (1) the permissible uses of the commercial premises; (2) franchisee default notification and the franchisor's right to cure any such default; (3) assignment clauses and the ability to assign to the franchisor (or its affiliates) or another franchisee, whether on sale or upon a default under the franchise agreement; (4) restrictions on the landlord leasing to the franchisor's competitors; and (5) franchisee's signage, decor and future remodelling obligations.

To protect its brand, the franchisor will frequently utilise a lease rider that will require the landlord to inform the franchisor of the franchisee's failure to meet its lease obligations and will give the franchisor the right to cure the defaults, if it elects to do so. The lease rider may also include language granting the franchisor the right to either: (1) step into the franchisee's position under the lease; or (2) substitute another franchisee to operate the store without the landlord's consent. Some landlords will simply consent to such a provision in a three-party rider or addendum to the lease, which is signed by the franchisor, franchisee or tenant and the landlord. While other landlords may require franchisors to cure any defaults (including outstanding rent or additional rent) before the franchisor or another franchisee can take over the lease. Whether the franchisor will enter into the lease directly and sublet to the franchisee or have the franchisee enter into its own lease is a business decision franchisors must address, as is the issue of whether or not a franchisor will provide a lease guaranty (not often the case). The franchisor's ability to take over the franchisee's location upon the expiration or termination of the franchise agreement is also an issue about which franchisors and franchisees are likely to have differing views.

xi Franchisee associations

In recent years, franchisees have increasingly sought to form associations that allow them to interact with the franchisor as a group rather than on a one-to-one basis. True franchisee associations are independent and are formed and financed by the franchisees themselves as opposed to franchise advisory councils or other franchisor-designated groups or committees.

Since the relationship between a franchisor and its franchisees is generally not between financial equals, and since the parties' franchise agreement typically favours franchisors and seeks to protect the franchisors' rights and interests, having an active and effective independent franchisee association can help franchisees to level the playing field to some extent when interacting with the franchisor.

When a franchise system has an independent franchisee association, it often results in meaningful benefits to the system as a whole. For example, a well-organised franchisee association will enable a system's franchisees to report issues and concerns that they have to the franchisor relatively quickly after they arise. Where both sides discuss these issues openly (at scheduled meetings, for example), and where good-faith efforts are undertaken to find acceptable resolutions, potential conflicts between the franchisor and its franchisees can be

addressed and averted. Where franchisees are provided with an opportunity to communicate with each other and to exchange ideas with the franchisor on a collaborative basis, it can be beneficial to the system and the franchisor's brand. Prospective franchisees who are considering entering the franchise system may perceive the existence of an independent franchisee association to be a positive factor. If a given franchise system has a franchisee association, it is recommended that prospective franchisees contact the franchisee association's leaders (as well as a number of franchise owners and even former franchise owners) when doing their due diligence (prior to making the franchise investment) to gain insights and information about the pros and cons of how the franchisor operates its system and to get a sense of the satisfaction (or dissatisfaction) levels that many of the franchisees have.

Several states have enacted franchise relationship laws that prohibit franchisors from interfering with or restricting their franchisees from forming independent franchisee associations. The trend in the law and in the US franchising industry generally is that the continued recognition and increasing acceptance of such independent franchisee associations will have an overall positive impact on franchise systems.

xii Private equity deals

Once upon a time, private equity funds held little interest in investing in the franchise industry, but times have changed. The predictable cash flow, favourable investment returns and growth opportunities in franchising have made the industry an attractive investment option for private equity funds. Private equity funds are looking to invest not only in franchisors, but also in franchisees. Recently, Sun Capital Partners Inc purchased CCW LLC, a HuHot Mongolian Grill franchisee with just 21 total locations. This added to its investment portfolio, which includes Boston Market, Captain D's Seafood Kitchen and Fazoli's Restaurants. Investors are attracted to large, well-known brands that are sure to be profitable, and both franchisors and franchisees are attracted to the reliable, large amounts of capital that private equity firms can provide. Both franchisors and franchisees often use this interest by private equity firms to their advantage, because private equity groups can: (1) provide skilled expertise; (2) expose the franchise system to new business contacts; and (3) implement efficiency enhancing protocols, which may increase the overall value of the franchise system by making it more competitive and more profitable. The large amount of reliable capital allows them to acquire more units and ultimately provides more leverage in the franchise relationship and more leverage with suppliers. This option is particularly attractive to area developers and multi-unit operators, who need more capital to operate numerous locations within their area.

When private equity investors enter into an agreement with a franchisee (usually a multi-unit developer), the franchisor's concerns must be addressed. This is usually done when the franchisee and franchisor initially enter into their contract. An operating agreement may allow a franchisee the option to enter into deals with investors, but the franchisor will usually require the franchisee to maintain full managerial and operating control over the company and, frequently, a controlling interest in the company. However, franchisors are often open to private equity relationships between the franchisee and the investor because the private equity investment makes it more likely that the franchisor will continue to receive its royalties and fees on time and in accordance with the agreement between franchisor and franchisee, and that the area developer will have the ability to open more units.

Franchisors and franchisees can face complications in soliciting investors, and the process can be time-consuming. When entering into an agreement with investors, the franchisor or

franchisee must prepare a deal prospectus and a private placement offering memorandum that outlines (for potential investors) the terms of the investment and will include a copy of the operating document between the franchisor and franchisee. Taking on investors can also present a change of pace for the entrepreneurial franchisor or franchisee (who is often accustomed to working independently) since the investment may require the franchisor or franchisee to be at least partially beholden to the investors providing loans or capital (or both) for the business. Careful planning and the delineation of parameters of control, responsibility and financial matters at the outset will govern the private equity relationship, and are crucial to ensuring a profitable and healthy relationship between all parties going forward.

Private equity deals can provide exit strategies for foreign-based investors and can, if necessary, save a franchisor facing financial uncertainty. Mergers can also provide similar relief and benefits for franchisors looking to increase in size or obtain financial strength or a greater market presence.

VII CURRENT DEVELOPMENTS

i Joint employer liability

The application of joint employer liability has been a hot-button issue in the franchise industry ever since the National Labor Relations Board (NLRB) issued its 27 August 2015 decision in *Browning-Ferris Indus of California, Inc.* In that decision the NLRB announced a new standard for determining whether two separate employers constitute a joint employer under the National Labor Relations Act. Prior to this announcement, the NLRB had held that joint employer liability existed if ‘one employer, while contracting in good faith with an otherwise independent company, has retained for itself sufficient control of the terms and conditions of employment of the employees who are employed by the other employer’. In applying this standard, the NLRB and the courts primarily focused on whether a putative joint employer’s control over another company’s employment matters is ‘direct and immediate’. In 2015, that long-standing analysis was reversed and a new standard instituted. This new standard no longer required a putative employer to have direct and immediate control of the terms and conditions of employment of another employer’s employees. Instead, indirect control was now sufficient to establish a joint employer relationship, thereby potentially ensnaring franchisors in the joint employer liability net. To date, no courts have followed the NLRB’s decision, and it looks as if the NLRB’s expansion of joint employer liability is going to be scaled back under the Trump administration. On 7 June 2017, the US Secretary of Labor announced the DOL’s withdrawal of guidance on independent contractors and joint employer liability issued in 2015 and 2016 by the DOL under the Obama administration, which indicates that the Trump administration will likely take a more pro-employer stance on the joint employer issue. This was a minor victory for businesses (particularly, franchisors), because the DOL’s announcement did not rescind the NLRB’s interpretation of joint employer liability. Thus, the NLRB could (as of the date of that announcement) still apply its interpretation of joint employer liability against companies despite the Board’s withdrawal of its guidance on joint employer liability. However, as of the finalisation of this chapter, that minor victory turned into a major victory for businesses. On 14 December 2017, in a three-two decision, the NLRB reversed the Board’s 2015 decision in *Browning-Ferris Indus of California, Inc.* In its decision, the Board held that ‘in all future and pending cases, two or more entities will be deemed joint employers under the National Labor Relations Act (NLRA) if there is proof that one entity has exercised control over essential employment terms of another entity’s employees

(rather than merely having reserved the right to exercise control) and has done so directly and immediately (rather than indirectly) in a manner that is not limited and routine'. Thus, 'proof of indirect control, contractually reserved control that has never been exercised, or control that is limited and routine will not be sufficient to establish a joint-employer relationship'. US franchisors will now emit a long sigh of relief, and franchise pundits who have been writing about this for two years may actually have to find another topic to write about.

ii Financial representations made under Item 19

One of the essential factors that prospective franchisees and multi-unit developers take into consideration in evaluating whether a franchise opportunity is the right one for them is disclosed in Item 19, which addresses the question (albeit indirectly) 'How much money can I expect to make?' Under Item 19, franchisors may (but are not obligated to) provide prospective franchisees with financial performance information (such as past or projected revenues or sales, gross income, net income or profits) concerning existing franchised and company-owned units, provided that there is a reasonable basis for the information, and that information can (and has, in many instances) give rise to a governmental or private cause of action under federal, state or common law. As a general rule, franchisors are precluded from providing prospective franchisees and developers with any financial representations that are not disclosed in the franchisor's FDD, with the exception that: (1) franchisors can provide the actual operating results of a specific unit that the franchisor is offering for sale, provided that the information is given only to potential purchasers of that unit; and (2) if a franchisor has furnished an Item 19 disclosure, it may furnish a prospective franchisee with a supplemental financial performance representation pertaining to a particular location. Until recently, there was little guidance concerning the manner in which franchisors made financial performance representations. However, on 8 May 2017, the North American Securities Administrators Association (NASAA) adopted guidelines regarding how franchisors are to make and substantiate any financial performance representation they disclose under Item 19. The guidelines, among other things: (1) restrict the information that a franchisor can use as the basis for its projection or forecast; (2) require franchisors disclosing the average of gross sales or a median between gross sale levels to also include the highest and lowest number in the range; and (3) require that franchisors also disclose its worst performers, if it elects to disclose its best performing outlets. The guidelines become effective 180 days after the date NASAA adopted them, or 120 days after a franchisor's next fiscal year end, if the franchisor has an effective FDD as of the date of adoption of the guidelines by NASAA. This means that franchisors renewing their FDDs for 2018 must make sure that they comply with NASAA's guidelines. Therefore, it is even more imperative for franchisors to retain knowledgeable franchise counsel who are familiar with and understand the new NASAA guidelines.

iii The impact of the internet on franchising, shopping-centre development and real estate

The rise of e-commerce has changed the face of the retail industry. With more consumers opting to purchase goods and services online in lieu of waiting in line to purchase items at a brick-and-mortar store, there has been an influx of brick-and-mortar store closures, which has already impacted and, inevitably, will continue to impact a variety of factors relating to franchised retail locations). A report issued by Credit Suisse on 31 May 2017 predicts that between 20 per cent and 25 per cent of shopping malls in the United States, some 275 shopping centres, will close within the next five years. This staggering (potential) occurrence

could have a cataclysmic effect on franchising at the retail level. While this is not the death of franchising, it may call for some modification of the typical franchise model. Most franchise agreements have a carveout that gives the franchisor the right to sell its goods (or services, where applicable) at certain types of venues within the franchisee's territory. Internet sales are universally included in this carveout. As internet sales of goods typically sold at retail by franchisors rise, the viability of retail franchised locations will be placed in jeopardy. Franchisors may be forced to consider giving franchisees a relatively small percentage of the gross online sales revenues generated within the franchisee's territory, to keep the franchise system alive. This profit-sharing formula would take into account the profit that the franchisee would have generated in its retail store from the 'lost sale', as well as the fact that the franchisee would incur virtually no overhead expenses with respect to the income received.

iv Franchising and crowdfunding offerings

Franchisors and franchisees are both always looking for ways to inject capital into their businesses. The Jumpstart Our Business Startups Act (the JOBS Act), enacted on 5 April 2012, established a regulatory structure for startups and small businesses to raise capital through securities offerings using the internet through crowdfunding. The crowdfunding provisions of the JOBS Act were intended to help provide start-ups and small businesses with capital by 'making relatively low dollar offerings of securities featuring relatively low dollar investments by the "crowd" less costly. Not only franchisors, but also multi-unit developers, franchisees and small franchise systems may find this to be an attractive alternative to conventional methods of raising capital, but they must be mindful that they will have to comply with certain statutory disclosure and regulatory requirements. In particular, issuers must file a Form C with the Securities and Exchange Commission (SEC), wherein the issuer must provide information about its: (1) principal owners (i.e., beneficial owners of at least 20 per cent of outstanding voting ownership interest) and directors; (2) a business plan; (3) the intended use of the funds being raised through the offering; and (4) audited financial statements. This same information must be provided to all prospective investors. For franchisors, meeting this criteria will be fairly simple since virtually all this information is contained in the franchisor's FDD. However, franchisees and multi-unit developers looking to use crowdfunding will first have to obtain the franchisor's consent and, if granted, retain knowledgeable counsel to prepare the necessary disclosures and ensure compliance with the SEC's regulations. Moreover, crowdfunding does not permit issuers to raise unlimited capital. Issuers of this type of offering are limited to raising a maximum of US\$1million during any 12-month period. While crowdfunding lessens the restrictions on securities offerings, it has its limits and will require franchisors, franchisees and their counsel to be familiar with and to fully understand the pros and cons of raising capital through this method.

v Elder-care franchises and elder abuse

The US population continues to age and a large segment of the population now needs 'elder care', 'home health care', or other services targeted towards assisting the elderly. Franchised businesses targeting this segment of the population present attractive opportunities for prospective franchisees. However, these opportunities offer the potential to be exploited by those seeking to prey on the elderly community. Recently, President Trump signed the Elder Abuse Prevention and Prosecution Act of 2017, which is aimed at combating elder abuse. The legislation, among other things: (1) designates at least one US attorney in every federal district to prosecute elder abuse cases; (2) imposes stiffer criminal penalties for

email and telemarketing fraud against seniors; and (3) provides comprehensive training for those conducting elder-care abuse investigations. It is, therefore, important that franchisors carefully vet their prospective franchisees and advise them to carefully vet their employees to guard against those who may target elder-care businesses as a means to take advantage of this vulnerable community.

DISPUTE RESOLUTION APPENDIX

GENERAL TERMS AND CONDITIONS IN A FRANCHISE CONTRACT: AN EXAMPLE IN SPANISH CASE LAW

*Beatriz Díaz de Escauriaza*¹

If an oversight in a contract is potentially damaging, this can prove even worse in a franchise situation. Because the same template is generally used for the entire network of franchisees, the oversight might potentially be reproduced a number of times equivalent to the number of franchisees – and it is perfectly plausible for a franchisor to have more than 500 franchisees spread across the relevant territory.

The fact that the same template is generally used for the entire network of franchises is sometimes used as an argument to obtain the annulment of a clause that has turned out to be contrary to the interests of the franchisee. However, the Spanish courts have established that this cannot be invoked as a reason *per se* to render an agreement a nullity, and does not release the adherent party (the franchisee) from duly complying with its onus of the proof when a conflict arises and the corresponding action is filed before the courts. The judgment of 20 March 2015 issued by the Commercial Court of Castellón is a good example of this. This judgment referred to the dispute between Servicio de Restauración de Costa, SL and McDonald's Sistemas de España Inc, Sucursal en España.

The aforementioned Servicio de Restauración de Costa, SL signed three franchise agreements with McDonald's, which were not later renewed. Servicio de Restauración de Costa, SL filed a claim before the Commercial Court in Castellón asking for the declaration of the nullity of certain clauses in the corresponding agreements on the basis of those clauses being mere general terms and conditions that had been unilaterally established by the franchisor and were contrary to the unfair competition regulations. The plaintiff also asked the Court to declare its right to renew the franchise agreements or, on a subsidiary basis, to be indemnified for the damage suffered because of the lack of renewal of those agreements. The plaintiff also asked the Court to declare its right to establish new franchised business within the territory. One of the arguments used to ask for the renewal of the franchise agreements was that the pre-contractual documentation that was handed to the franchisee before entering into the three franchise agreements included a 'White Book', in which the options to establish new franchised business and to agree a new term to the agreements were foreseen.

When addressing the alleged nullity of the clauses mentioned by the plaintiff, the Court established that their general character and their lack of individual negotiation was not a reason to declare their nullity *per se*. In this regard, the Court referred to the case law of the Spanish Supreme Court and, in particular, to its judgment of 9 May 2013, wherein it was said that such 'mass agreements' represent a common tool in the current legal situation, with this type of agreement justified by the need to speed up negotiations and provide legal certainty to the parties during their transactional agreements.

¹ Beatriz Díaz de Escauriaza is a senior associate at Bird & Bird (International) LLP.

Notwithstanding that, the Court mentioned the need to establish certain controls that every general condition needs to pass to be considered valid. These are the 'transparency control' (which would include a control on the 'incorporation and transparency' of every single clause in the agreement, and the 'real comprehensibility' of the clauses in the agreement when entered into with a consumer) and the 'content control' (which would affect those clauses that are null and void according to the applicable regulations, and those others that are abusive when the adherent party is a consumer).

In the case submitted to the Commercial Court in Castellón, the adherent party was not a consumer. As a result, only the incorporation and transparency control and the content control could be applied when assessing the nullity of the clauses invoked by the plaintiff. The plaintiff, however, relying only on the *iura novit curia* principle, failed to comply with his onus of the proof and did not devote any effort to explaining why the alleged clauses were contrary to the unfair competition regulations. Only the clause in the contract determining the court's jurisdiction was found to be null since it contravened an imperative principle (the courts mentioned in the agreements were not the courts of the franchisee's domicile).

With regard to the requested declaration of the franchisee's right to renew the franchise agreements, the Court indicated that the provisions in the White Book could not be interpreted as being part of the franchise agreements. The White Book reflected only the protocol with which the franchised business had to comply, and was a document that had been unilaterally drafted by McDonald's. Moreover, the White Book expressly established that its content was simply a complement to the franchise policies and had an informative purpose only. Nothing in the White Book could be understood to modify any of the clauses agreed upon by the parties in the corresponding franchise agreements.

It turned out that the franchise agreements established no right of renewal. On the contrary, the agreements included a clause stating that the franchisor made no promises regarding possible renewals. The reference to the new term was only mentioned in the White Book. Moreover, the intention of the franchisor not to renew the franchise agreements had been clear well before termination. As a result of that and despite the assertions made by the plaintiff, the Court rejected the plaintiff's claim and found that the inclusion of the clause regarding possible renewals was not abusive at all. Bearing in mind the *intuit personae* character of franchise agreements, the franchisor could quite legitimately establish such a general clause in the agreements.

The Court applied the same reasoning when deciding about the right to establish additional franchised business: this possibility was not foreseen in the agreements. On the contrary, the franchise agreements mentioned the possibility of other parties settling franchised business in the territory. In this regard, the Court said that, even if exclusivity was common when entering into a franchise agreement, it was not a requirement of these types of agreement. As a result, the plaintiff was not entitled to claim any damages.

As can be seen, therefore, the validity of general terms and conditions in a franchise agreement need to be assessed from the outset. Their general nature is no reason to invoke the agreement's nullity and does not release the franchisee from the burden of proof in the event that a conflict arises.

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Jones & Co

Paul Jones's practice is broadly focused on the national and international distribution of goods and services. Paul helps clients develop franchise systems and licensing and distribution programmes, including preparation of disclosure documents and agreements, and he negotiates

disputes. He assists many foreign businesses expanding into Canada and internationally. He regularly advises on national and multi-jurisdictional trademark applications and disputes, including counterfeiting matters, and on copyright protection issues. Paul has developed significant expertise in marketing and pricing practices and advises clients on the interaction between intellectual property and competition law.

Paul is familiar with both common law and civil law systems. In addition to his Canadian law expertise, Paul is internationally known for his expertise in Chinese franchising, intellectual property and competition law.

FARID KANI

Atieh Associates Law Firm

Farid Kani is a senior associate at Atieh Associates Law firm. He is a licensed attorney admitted to the Iranian Central Bar Association. Farid has an LLB from Allameh Tabataba'i University and has an LLM in international commercial law from both Shahid Beheshti University and Queen Mary University of London. He also holds an LLM in public international law from the University of Tehran. His main areas of practice include corporate transactions, the automotive sector, logistics, transportation, labour, pharmaceuticals and franchising. Farid has also been recognised as a leading lawyer by international publications such as *IFLR1000*, and he is fluent in Farsi and English.

JOHN KAROL

The Richard L Rosen Law Firm PLLC

John A Karol joined the Richard L Rosen Law Firm PLLC in 2010, and has been a partner since 2014. Mr Karol practises litigation, arbitration, franchise law, intellectual property law and employment law. He has litigated and arbitrated a wide variety of franchise-related disputes, for both franchisees and franchisors. John has also worked with Mr Rosen on a wide variety of franchise-related, commercial, trademark and intellectual property advisory matters. Mr Karol has several significant reported decisions on his résumé, including decisions concerning the NY Franchise Sales Act and the spoliation of evidence (ESI).

Mr Karol graduated from Fordham University School of Law in 2002. He is admitted to practise in New York, New Jersey and the United States District Courts for the SDNY, EDNY, DNJ, DMI and associated bankruptcy courts, and is a member of the NYSBA (Business Law Section's Franchise Committee), and the NYC Bar Association.

KENNETH T KIM

Yoon & Yang LLC

Kenneth T Kim is a senior foreign attorney and partner at Yoon & Yang LLC. His practice mainly focuses on antitrust and fair trade laws, telecommunication, media and technology and corporate matters. He has handled many complex high-profile cases for leading multinational corporations concerning franchise and investment-related matters, abuse of dominance, unfair trade practices, mergers, subcontracting, cartels and related litigations. Before joining Yoon & Yang, he served as a litigation associate at Taylor Miller LLC in 2007 and as a staff attorney in the First District Appellate Court from 2004 to 2006. He is admitted to the bar of Illinois.

EDUARDO KLEINBERG

Basham, Ringe y Correa, SC

Eduardo Kleinberg has been a partner at Basham, Ringe y Correa, SC since 2003. His practice focuses on matters related to intellectual property and franchising. Eduardo has been practising law in the field of intellectual property since 1993 and he has been a managing partner at Basham, Ringe y Correa, SC since 2014. He is head of the firm's trademark and licensing practices and has extensive experience in domestic and international matters, including in advising clients in IP matters in general; negotiating and drafting licence, franchise, copyright and confidentiality contracts; filing and prosecuting trademarks and patents before the Mexican Institute of Industrial Property (IMPI); filing copyrights with the National Copyright Institute (INDAUTOR); due diligence in IP matters; classifying and registering product and service trademarks for Mexican and leading foreign companies; registering trademarks in South and Central America, Europe, Asia and the United States, working with local counsel in each of those regions; counselling Mexican and international clients in intellectual property-related e-commerce issues; and registering and cancellation of domain names.

Eduardo is president of the Intellectual Property Commission of the Confederation of Industrial Chambers of Mexico (CONCAMIN), and is designated by CONCAMIN as the representative of the Mexican private sector with respect to the intellectual property chapter of the Trans-Pacific Partnership Agreement (TPP). Among other positions he has held, he is a past president of the Mexican Association for the Protection of Intellectual Property (AMPPI); of the Mexican chapter of the International Association for the Protection of Intellectual Property (AIPPI); and of the Copyright Committee of the International Chamber of Commerce Mexico. He is a member of the Association of European Trade Mark Owners (MARQUES), the Mexican Franchise Association and the International Franchise Association (IFA).

Eduardo is ranked in the principal legal directories, including *The Legal 500*, *Chambers* and *Who's Who Legal*, and by the International Legal Alliance Summit. He is the contributor in charge of the Mexican chapter in *International Licensing* published for the Center for International Legal Studies in Salzburg, Austria by BNA International Inc.

Eduardo graduated from the Ibero-American University and has a master's degree from the University of Chicago. He speaks Spanish and English.

MARTINE DE KONING

Kennedy Van der Laan

Martine de Koning studied law at the University of Utrecht, graduating in 1995. She studied and lectured in the United States and Australia. In 1997, Martine joined Kennedy Van der Laan, where she started in information technology law and has in the past 15 years developed a practice in EU and Dutch competition law and international franchising, agency, distribution, sales, procurement, logistics and other commercial contracts and disputes. Martine has extensive experience with cross-border franchising in the EMEA region and competition law compliance issues in this context. In particular North American clients seek her out for her experience in working with Anglo-American partners. She works for multinationals, as well as strong national players with an international business or ambition. Martine handles the drafting and negotiating of contracts, as well as litigation and (international) arbitration in

national and international courts and arbitration institutes. Martine receives praise for her hands-on, pragmatic approach and sharp strategic vision. Martine regularly publishes articles and lectures on competition law, international franchising and related subjects.

MARKUS KÖRNER

Bird & Bird LLP

Markus Körner is a partner at Bird & Bird LLP (Munich office). His main focus is intellectual property, copyright and unfair competition law, in particular in contentious matters. He advises clients on IP and advertising strategies and coordinates international projects and proceedings. Markus Körner is admitted to the Bar in Germany.

BETTINA KÖVECSES

Knight Bird & Bird Iroda

Bettina Kövecses is an associate working in the IP and corporate teams in Bird & Bird's Budapest office. She has in-depth experience in intellectual property matters, including contentious and non-contentious trademark issues, commercial and transactional IP matters and customs measures. She regularly advises small fashion labels, as well as design and architectural companies, on copyright law, branding, licensing, know-how and trade secrets protection. She has advised leading stakeholders in the Hungarian film industry on intellectual property matters such as screenplay, production and performers' agreements. She also supports clients with general corporate issues, corporate housekeeping and division and merger agreements, with special emphasis on protection and transfer of IP rights in start-up funding. Dr Kövecses graduated from the Eötvös Loránd University faculty of law in Budapest in 2010. Before commencing university she studied English in Auckland, New Zealand for two years. In 2008/2009, she also participated in a scholarship programme at the Saarland University in Saarbrücken, Germany; at the Europa-Institut, the university's postgraduate and master's studies institution, she studied, among other topics, EU and German civil law. Currently, she is attending the academic industrial property course of the Hungarian Intellectual Property Office. A member of the Hungarian Trademark Association, the Hungarian Association for the Protection of Industrial Property and Copyright and the Budapest Bar, Dr Kövecses speaks Hungarian, English and German.

LEE LIN LI

Tay & Partners

Lee Lin Li is a partner of the firm and the head of the intellectual property and technology department. She handles contentious matters involving patent, trademark, copyright and industrial design infringement, and passing off, including seizure and anti-counterfeiting actions, and notably provides strategic advice on settlement negotiations. She also advises on domain name registration issues and disputes. Ms Lee regularly advises clients on cross-border transactions involving licensing, technology transfer, assignment and franchising as a model for business expansion. She also advises on applications to register foreign and local franchises. A major part of her practice consists of advising and working closely with local and international clients on the management, protection and commercialisation of their IP

portfolio in various sectors. She regularly speaks at seminars and workshops on franchising and personal data protection. Ms Lee read law at the University of Leeds and was admitted as an advocate and solicitor of the High Court of Malaya in 2001.

KATYA LOGUNOV (STEPANISHCHEVA)

Jones & Co

Katya Logunov (Stepanishcheva) is an international business lawyer experienced in both civil law and common law systems. Katya's practice is focused on franchising law, intellectual property licensing and corporate commercial law. Katya holds a master's degree in international business law from Osgoode Hall Law School (Toronto, Canada) and a law degree from the Moscow State University (Russia). Prior to joining Jones & Co, Katya practised corporate law and mergers and acquisitions with Moscow offices of major international law firms.

SERGEY MEDVEDEV

Gorodissky & Partners

Sergey Medvedev, PhD, LLM is a senior lawyer working in the Moscow office of the law firm Gorodissky & Partners (Russia). He specialises in various legal issues related to legal protection, ownership, acquisition, exploitation, licensing, franchising, litigation and enforcement of IP and IT rights in Russia and CIS.

Sergey deals with various types of IP and IT matters, including copyrights and related rights, software and databases, patents and designs, trademarks, brands and domain names. He also deals with know-how and confidential information, as well as privacy and data protection.

Sergey provides legal support to clients in connection with various transactions related to disposal and conveyance of IP and IT assets. He is regularly in charge of developing, reviewing, negotiating and perfecting assignment deeds, licence agreements, franchise contracts, security agreements and other contractual arrangements. Sergey is also involved in heavyweight M&A, joint venture and investment projects, master development and franchise transactions, IP and IT legal due diligence and IP and IT transfer processes.

Sergey litigates IP and IT rights and combats unlawful or unauthorised use of IP and IT as well as illegal content on the internet, unfair competition and false advertising. He also tackles parallel imports and grey market goods, and fights against counterfeit goods and piracy. He represents the interests of clients in the courts and before law enforcement agencies on a variety of IP and IT infringement matters. Sergey participates in extra-judicial and judicial dispute resolution actions, civil and litigation procedures, and administrative and criminal proceedings.

Sergey frequently delivers speeches at national and international seminars and conferences. He is the author of a number of articles and works, including on franchising, published by the leading Russian and international publishing houses.

He is a registered member of the EuroFranchise Lawyers association (EFL), Licensing Executives Society International and is the official attendee of the International Franchise Association. Sergey is also a registered trademark, design and software attorney in Russia.

RAPHAËL MELLERIO

Aramis

Raphaël Mellerio is one of the founding partners of Aramis, which was established in 2006. He formerly worked for the firm Clifford Chance in London and Paris, where he spent 10 years and became counsel in 2003.

Mr Mellerio is the partner in charge of the corporate and mergers and acquisitions practice at Aramis. His main activities relate to mergers and acquisitions, restructurings and joint ventures. He also represents companies on a regular basis in the setting up of complex agreements in the field of franchising and industrial transactions. He also deals with certain issues of economic law and international commercial law.

In the field of franchising, Mr Mellerio regularly assists French and foreign franchisors in the areas of retail distribution, restaurants and services, and he is a regular contributor to various legal publications on the subject. He is also a member of the IBA International Franchising Committee.

JOSÉ MARIA MONTENEGRO

Morais Leitão, Galvão Teles, Soares da Silva & Associados

José Maria Montenegro joined the firm in 2005. He has been very active in a wide variety of tax matters, namely in tax litigation, and also in advising both national and multinational corporations, covering a wide range of subjects related to double-taxation treaties, VAT, corporate and personal income tax, and criminal tax law. He is also a member of the sports law team – an internal team that, on a daily basis, provides expert advice on sport matters.

Since 2010, José Maria has been an invited professor at the Polytechnic Institute of Porto, teaching the courses Tax Law I, Tax Law II and Legal Simulation. Before joining the firm, he worked with a multinational consultancy company and a national law firm in the tax field.

Between 2003 and 2004 José Maria Montenegro served as legal counsellor to the Minister of Justice in the XV Constitutional Government.

STEFAN MÜNCH

Bird & Bird LLP

Stefan Münch is a partner at Bird & Bird LLP (Munich office). His main focus is corporate and M&A law. He also advises clients on related commercial aspects, including distribution, franchise and agency agreements. Stefan Münch is admitted to the Bar in Germany.

MELISSA MURRAY

Bird & Bird (MEA) LLP

Melissa Murray holds the position of partner in Bird & Bird's Abu Dhabi and Dubai offices, having practised in the United Arab Emirates since 2006. She provides advice to international businesses on commercial and corporate matters relating to their operations in the UAE and the wider Middle East region. Her experience includes advising on franchising, hospitality, IT, IP, data protection, privacy, consumer protection, food, health care and regulatory matters.

Before moving to the UAE, she worked with an Australian national commercial firm in private practice and as an in-house lawyer with Australia's largest childcare company, providing a range of corporate and commercial advice.

Ms Murray has published articles on a variety of topics, including franchising, distribution and agency matters, in publications such as the International Bar Association (IBA) Newsletters, *Gulf News*, *Legal Week* and the *Dubai Chamber of Commerce Guide to Franchising*.

Ms Murray is admitted to the Supreme Court of Queensland (2003), and holds an LLB from the Queensland University of Technology and a graduate diploma of applied corporate governance (Australia). She is a member of the Australian division of the Institute of Chartered Secretaries and Administrators, the Middle East representative for the Franchising Section of the IBA and is a member of a number of UAE and Australian business associations.

MICHELLE MURRAY-BERTRAND

The Richard L Rosen Law Firm PLLC

Michelle Murray-Bertrand is a corporate associate with the Richard L Rosen Law Firm PLLC. She practises corporate law (with a focus on franchise law and asset purchases), intellectual property law, commercial real estate, corporate structures, and trusts and estates. Prior to joining the Richard L Rosen Law Firm PLLC, Mrs Bertrand was a corporate associate at Proskauer Rose LLP and the principal of her own firm, where she represented foreign and domestic companies in an array of transactional matters, including mergers and acquisitions, capital markets, private equity, corporate finance, regulatory compliance and corporate governance.

Mrs Bertrand earned her JD in 2006, *magna cum laude*, from New York Law School, and in 1996 her Bachelor of Science in computer engineering from Syracuse University. Mrs Bertrand is admitted to the New York State Bar.

SHELLEY NADLER

Bird & Bird LLP

Shelley Nadler is a member of Bird & Bird's franchising, licensing and multichannel strategies team based in London.

She is a specialist franchise lawyer with over 20 years' experience in advising on all aspects of franchising.

Shelley is retained as counsel for a number of household names in the retail and food and beverage sectors.

She also advises a wide variety of businesses in the leisure and services sectors including start-ups and established brands looking at multicountry expansion strategies. Shelley's particular expertise is in the structuring and development of franchise networks in the United Kingdom and new markets including India, the Middle East, the Far East, South East Asia, Russia and South America.

In addition, Shelley advises on multichannel expansion strategies, intellectual property ownership, protection and exploitation structures and general commercial contracts including agency, distribution, wholesale, supply, confidentiality and know-how agreements, together with domestic and international terms and conditions of sale.

The author of many articles for the franchise trade press, Shelley also writes a monthly 'ask the experts' column in *Making Money* magazine. She has spoken at a number of national

and international franchise and licensing seminars and British Franchise Association conferences and workshops. Recently Shelley spoke on franchising in the United Kingdom for a webinar for the Franchise Association of India. Shelley is recognised as an expert in franchising in the *Legal Business Guide to Legal Experts*.

Shelley co-wrote the UK section of the *The International Encyclopaedia of Franchising* published by Kluwer.

DZHAMIL ODA

Morais Leitão, Galvão Teles, Soares da Silva & Associados

Dzhamil Oda joined Morais Leitão, Galvão Teles, Soares da Silva & Associados (MLGTS) in February 2011. He is a member of the European law and competition team. He is also a member of the 'Team Genesis', sports law and life sciences teams.

Previously, Dzhamil worked with the litigation and arbitration team and also with the corporate and commercial and capital markets teams.

In the context of the European law and competition practice, among other matters, Dzhamil works in merger control, antitrust compliance and state aid (including in matters related to the European structural and investment funds and major projects), as well as in competition-related litigation. Dzhamil also provides, on a daily basis, legal advice in the energy sector (on regulatory matters, compliance and litigation).

In the MLGTS sports law practice, Dzhamil provides legal advice in relation to football players' transfers, UEFA Financial Fair Play and football intermediation matters, and he is also active in litigation before international sports organisations (in particular, FIFA and the AFC) and before the Court of Arbitration for Sports, Lausanne, Switzerland. Dzhamil is also member of the Justice Council of the Portuguese Bridge Federation.

Within Team Genesis – created by MLGTS to instruct start-ups and SMEs and advise business angels, venture capital and private equity – Dzhamil is responsible for non-dilutive fundings (both national and European Union).

CHINWEIZU OGBAN

Jackson, Etti & Edu

Chinweizu is a senior associate in the firm's IP department. She advises various blue-chip companies on a number of IP issues, particularly in relation to commercial IP transactions, ranging from preliminary advice on the registrability of a trademark, to franchising, licensing and assignment-related issues.

MATHEW OLIVER

Bird & Bird LLP

Mathew Oliver is a solicitor and a member of the Chartered Institute of Taxation. He is a tax partner in the London office of Bird & Bird LLP and specialises in corporate and business taxation, both domestic and international. He has acted for a wide variety of clients across a broad spectrum of business sectors. Mr Oliver joined Bird & Bird in November 2005 from another large London law firm and prior to that worked in a large accountancy firm.

GUSTAVO PAPESCHI

Beccar Varela

Gustavo Papeschi has been a senior lawyer with Beccar Varela since 2014. He started his career there in 2007. His practice areas include general corporate advice, banks and financial institutions, class actions, distribution law and private international law. He received his law degree from the University of Belgrano (graduated as an attorney with first-in-class Academic Merit Recognition in 2006), and obtained his LLM in international and comparative law from SMU Dedman School of Law at Southern Methodist University (Dallas, Texas, United States, 2013). He worked as a foreign associate at Haynes and Boone, LLP (Dallas, Texas, 2013) and Holland and Knight, LLP (Miami, Florida, 2014). He is a member of the Buenos Aires Bar Association and the New York State Bar Association (2017), where he is admitted to practise. Gustavo has authored several articles and lectured on distribution and franchising law, as well as on the Civil and Commercial Code (which entered into force in 2015).

GRAEME PAYNE

Bird & Bird LLP

Graeme Payne is a partner in Bird & Bird's global franchising, licensing and multichannel strategies team. He works closely with businesses to determine and develop the most commercially appropriate expansion models and routes to market.

Mr Payne's practice focuses on the retail, leisure, food and beverage, services and healthcare sectors. He is retained as counsel by a number of leading and up-and-coming brands in these sectors. He has particular expertise in advising businesses on the use of franchising as a tool for strategic growth and expansion.

In addition to advising on appropriate multichannel expansion strategies, he advises on intellectual property ownership, protection and exploitation structures, technology transfer licensing and general commercial contracts including agency, distribution, wholesale, supply, confidentiality and know-how agreements together with domestic and international terms and conditions of sale.

Mr Payne's clients range from individual entrepreneurs, early-stage ventures and SMEs to multinationals. He has particular experience in assisting businesses expand into new markets including India, the Middle East, the Far East, South East Asia, Russia and South America.

He has written numerous articles for *Franchise World*, and has spoken at a number of national and international franchise and retail seminars, and British Franchise Association conferences and workshops.

Mr Payne has contributed to a number of publications including 'Alternative Corporate Re-engineering: Building Businesses through Third-Party Relationships and Expansion into New Markets' (*European Lawyer*, 2011) and *International Business Transactions: Standard Forms and Documents (Franchising)* (Wolters Kluwer).

İLKNUR PEKŞEN

ErsoyBilgehan Lawyers and Consultants

İlknur Pekşen was a trainee at Aybay & Aybay between 1995 and 1997; in 1997 she was admitted to the Istanbul Bar Association. She was an attorney at Ersoy & Atamer & Karaman from 1997 to 1999 and has been at ErsoyBilgehan since then. She has more than 15 years'

experience and specialises in negotiation and enforcement of public contracts, restructuring of public and private loans, and administrative and civil litigation. She also has particular expertise in advising on administrative aspects of real estate projects, including satisfaction of various licensing and authorisation requirements and environmental clearances. On the shipping side, she has extensive experience in both 'wet' and 'dry' shipping matters. She is regularly called upon by foreign investors for assistance in the establishment and structuring of their Turkish ventures and affiliates.

DIOGO PINTO

Morais Leitão, Galvão Teles, Soares da Silva & Associados

Diogo Pinto joined the firm in September 2016. He is currently a member of the litigation and arbitration team, working mainly in civil and commercial litigation and arbitration. Previously, Diogo worked with the tax team.

CRISTÓBAL PORZIO

Porzio, Rios, Garcia

Cristóbal Porzio joined Porzio, Rios, Garcia in 1993 and has been a partner since 2002. He was admitted to practise in 1994 after gaining his JD at the Pontifical Catholic University of Chile in 1993. His practice areas include intellectual and industrial property, distribution law and franchising, and corporate law.

He advises local and foreign clients in matters related to patents, trademarks and technology transfer. Moreover, he participates in the boards of directors of companies and acts as local counsel for foreign companies in Chile.

He is a professor at the School of Law of the Pontifical Catholic University of Chile and he is the immediate past president of the Chilean Association of Intellectual Property (ACHIFI). He is the Chilean expert for the International Distribution Institute, a member of honour of the International Association of Young Lawyers (AIJA), and a member of the Chilean Bar Association, AIPPI, AIPLA and INTA. Cristóbal Porzio is also an accredited International Distribution Institute (IDI) arbitrator and an appointed member of the IDI IDArb list of arbitrators (providing dispute resolution in the field of international distribution).

ALLAN POULTER

Bird & Bird LLP

Allan Poulter is a partner based in Bird & Bird's London office.

He has particular expertise in all aspects of international brand management, protection and enforcement with a specific focus on portfolio management, legal clearance searches, contentious registry proceedings and advising on global branding strategies. He has represented the owners of many of the most recognised and valuable international brands.

Mr Poulter has experience as a barrister, trademark attorney and solicitor, and in-house, having spent three years as a director of the world's largest branding consultancy, Interbrand.

Mr Poulter is a member and former chair of the International Trademark Association's publications committee and has written and contributed to numerous leading publications on trademark law and branding issues. He is a regular speaker at international conferences.

JACOB ØRSKOV RASMUSSEN

Plesner Law Firm

Jacob Ørskov Rasmussen is head of Plesner's commercial contracts team and also of the franchise and automotive teams – and he has years of experience in advising Danish and international clients on contractual relationships, both nationally and internationally.

Jacob has acquired in-depth knowledge of and experience in a broad spectrum of commercial contract types, including sales and distribution agreements, agency agreements, franchise agreements, logistics and warehousing agreements, facility management agreements and supply agreements, as well as purchasing contracts.

Jacob has extensive experience in franchising, including comprehensive experience in the drafting and negotiation of franchise agreements, Danish and EU competition law related to franchising, and setting up franchise systems in Denmark. Jacob has, among others things, been involved in franchise matters concerning the following brands: Starbucks Coffee, Carl's Jr Restaurants, KellyDeli (Sushi Daily), Joe & The Juice and Gucci.

Jacob has been designated by the International Distribution Institute (idiproject.com) as country expert regarding franchising in Denmark. He is also an expert in relation to distribution and agency law and he has years of experience in advising national, international and multinational clients within this legal field.

Jacob furthermore provides legal advice on export control and trade sanctions, contract management, compliance and legal risk management.

The automotive industry is also one of Jacob's special areas of expertise and he has in-depth knowledge of this industry. Jacob's clients include car factories and factory-owned and private car importers, as well as banks and financing companies.

Jacob is listed by *The Legal 500 EMEA 2017* as a 'recommended lawyer' in the commercial, corporate and M&A practice area.

In addition Jacob is listed by *Who's Who Legal: Franchise 2017* as a 'leading franchise lawyer': 'Jacob Ørskov Rasmussen receives wide-ranging endorsements for his outstanding contractual practice and specialist experience in the retail sector.'

CLAUDIA RICCIARDI

Studio Legale Bird & Bird

Claudia Ricciardi joined Bird & Bird in April 2003; she primarily focuses on intellectual property and information technology, copyright, telecommunications and advertising law.

Before joining Bird & Bird, Ms Ricciardi worked for three years in the IP department of Andersen Legal and for some months at the Studio Legale Tributario associated with Ernst & Young.

Her experience includes: advising on issues relating to trademarks and patents, drafting deeds and opinion, and in particular, advising in judicial proceedings related to trademarks and patents; drafting and review of trademark licence and transfer agreements; patent licence agreements, know-how licence agreements, domain-name transfer agreements, franchising contracts, software development and licence agreements, distribution and supply agreements, advertising agency agreements, outsourcing contracts and internet-related contracts (general conditions for access and use of websites, and lease of advertising spaces); legal advice in the

course of the realisation of websites, with specific reference to the examination of the various issues connected to the supply of products and services through the web; and due diligence relating to immaterial goods (trademarks, patents, etc.).

Ms Ricciardi is a native Italian speaker and is fluent in English.

PÉTER RIPPEL-SZABÓ

Knight Bird & Bird Iroda

Péter Rippel-Szabó has more than seven years of experience working in an international environment and specialises in commercial and sports matters. He advises market-leading companies from, *inter alia*, the media, sports, IT and energy sectors on commercial agreements such as contracts for work and services, assignment, lease and build-to-suit lease, supply and various sports-related agreements; corporate housekeeping and M&A; and real estate transactions, as well as exploitation of sports rights, both in English and German. Further, Dr Rippel-Szabó has experience in complex international arbitration. Dr Rippel-Szabó graduated from the University of Pécs and also studied at the University of Trier in the Erasmus scholarship programme. In 2008/2009, he obtained a Master of Laws degree (LLM) at the University of Erlangen-Nuremberg, where, as a DAAD scholarship holder, he studied German law and sports law. He co-authored the textbook *Sports Law II* (Budapest, 2011) and his articles on sports law are regularly published in prestigious law journals and on prominent websites. Dr Rippel-Szabó is often invited to speak at national and international conferences and lectures on sports law, and he acted as the national correspondent for Hungary in the preparation of the EU studies on sports organisers' rights and betting-related match-fixing.

FLORENCIA ROSATI

Beccar Varela

Florencia Rosati has been a partner at Beccar Varela since 2015 and specialises in intellectual property, telecommunications, media and technology. She began her career at EBV in 1993, before graduating as lawyer. Her practice areas include litigation and advice to clients on trademarks, patents, copyright, entrepreneurship, entertainment, communications and new technologies, and she has extensive experience in data protection and privacy. She received her law degree and her post-graduate degree in telecommunications from the University of Buenos Aires, in 1997 and 2001 respectively, and her post-graduate degree in new technologies from the Pontifical Catholic University of Argentina (2009–2010). She is a registered patent and trademark agent. She is a member of the Buenos Aires Bar Association, the International Trademark Association (INTA) and the International Technology Law Association (ITechLaw). In 2011, She received the INTA Volunteer Service Award for Pro Bono Services by an individual. In 2016, Florencia was included in the *The Legal 500 TMT* ranking, and was recognised as a 'notable practitioner' in the IP ranking of *Chambers Latin America*, which stated that she 'is very experienced in trademark law. Sources highlight her as "an excellent, intelligent and credible lawyer who is committed to providing practical solutions for her client".'

RICHARD L ROSEN

The Richard L Rosen Law Firm PLLC

Richard L Rosen, the founding member of the Richard L Rosen Law Firm PLLC, has been actively engaged in the practice of franchise law in New York City for over 40 years, during which time he has represented countless franchisors and franchisees – both as counsel and as a business adviser. Mr Rosen has counselled and represented franchisors in the setting-up of franchising systems and programmes; formed franchising entities; drafted and negotiated franchise agreements, registration statements, disclosure and other ancillary franchise documents; represented franchisees and franchisee associations; litigated in both state and federal courts; and mediated, arbitrated and litigated matters on behalf of both franchisors and franchisees.

Mr Rosen is a founding member and immediate past chairman of the Franchise, Distribution and Licensing Law Section of the New York State Bar Association, a member of the Steering Committee of the National Franchise Mediation Program, the CPR Institute for Dispute Resolution, Distinguished Panel of Neutrals and a member of the Executive Committee of the Business Law Section of the New York State Bar Association. He is the chairman of the American Association of Franchisees and Dealers (AAFD) Fair Franchising Standards Committee and a member of the AAFD's board of directors. In 2008 he received the AAFD's Total Quality Franchising Lifetime Achievement Award for his contributions to the field of franchising. Richard Rosen and the firm have earned Martindale-Hubbell's highest rating for legal ability and integrity, and Richard is rated among Martindale Hubbell's list of Preeminent Lawyers. Mr Rosen's law firm is rated among the best franchise law firms in the United States by *US News and World Report* magazine. Mr Rosen is listed in *Who's Who in America*; *Who's Who in American Law*; *Who's Who in the World*; *Best Lawyers in America*; '101 best franchise lawyers in America' (*Franchise Times*); the *Franchise Times* 'Hall of Fame' of franchise attorneys (a charter member); *Best Lawyers in the US Franchise Attorney of the Year*, New York, 2015; *America's Super Lawyers*; *Best Attorneys in America*; *Who's Who Legal: Franchise* and *Who's Who Legal* (compendium edition); and he is a recipient of the Global Award for Franchise Law. Mr Rosen and his firm authored the US chapter in the third and fourth editions of *The Franchise Law Review* and the review of US franchise law in *The International Comparative Legal Guide to: Franchise 2017* and *2018*. Richard was named Franchise Attorney of the Year in the United States for 2016 and 2017 by *Lawyer Monthly*. He received the Global 100 award as Franchise Attorney of the Year in the United States in 2017 and was chosen as one of the 100 Best Attorneys in the World by *LegalComprehensive.com* for 2018.

KUBA RUIZ

Bird & Bird Szepietowski i wspólnicy sp.k.

Kuba Ruiz is head of the business transactions practice at Bird & Bird's Warsaw office. He has been advising clients since 2004 and has extensive experience in new technology and IT-related legal practices, transactional and commercial law, and dispute resolution, including litigation and court administrative disputes, arbitration and mediation.

He has advised on, drafted and negotiated all manner of contracts and commercial arrangements, including contracts for supply of goods or services, contracts relating to telecoms equipment, networks, agency, distribution, franchising, licensing, outsourcing, content, sponsorship, media and entertainment, IP and leasing and maintenance.

He studied law at the Faculty of Law and Administration of the Warsaw University. He also obtained a second Master of Laws degree from the Amsterdam Law School at the University of Amsterdam, (specialisation: International Trade Law and International Investment Arbitration).

LEONARD SALIS

The Richard L Rosen Law Firm PLLC

Leonard Salis is a Brooklyn Law School graduate with almost 20 years of legal experience. Working closely with Richard Rosen since August 2002, Leonard has acquired an expansive knowledge of franchise law and franchise-related matters. He became a partner at the firm in April of 2010. Since 2002, Leonard has also gained significant experience in the practice areas of corporate law, real estate, trusts and estates and commercial litigation.

Mr Salis is admitted to practise law before the courts of the State of New York, and the Southern and Eastern Federal Districts of New York, as well as the Second and Ninth Circuit Courts of Appeals. He is a member of the American Bar Association's Forum on Franchising, as well as the New York State Bar Association (Business Law Section's Franchise Committee), the Association of the Bar of the City of New York and the New York County Lawyers' Association.

DIVYA SHARMA

DBS Law, Corporate legal advisers

Ms Sharma is dual qualified to practise in England and India. After spending over six-and-a-half years at Bird & Bird in London, where she was part of the India group at Bird & Bird, Divya is now based in Mumbai and advises Indian and international clients on corporate, commercial, franchising, joint ventures, company law and related matters in India.

AVI STRAUSS

The Richard L Rosen Law Firm PLLC

Avi Strauss joined the Richard L Rosen Law Firm PLLC as an associate in April of 2016. He focuses his work on litigation and arbitration matters involving franchise and other business related disputes. Earlier in his career, Mr Strauss also developed an expertise in litigating landlord-tenant and real estate matters.

Mr Strauss received his JD in 2013 from Fordham University School of Law and is currently admitted to practise in New York, New Jersey and the United States District Court for the Southern and Eastern Districts of New York.

KENTARO TANAKA

TMI Associates

Kentaro Tanaka joined TMI Associates as an associate in the corporate finance group in 2010. His main practice area is franchising, mergers and acquisitions, alliances, assistance in establishing new businesses and IPO.

He is currently pursuing an LLM at the University of Michigan Law School.

LORRAINE ANNE TAY

Bird & Bird ATMD LLP

Lorraine is the joint managing partner and head of the intellectual property group at Bird & Bird in Singapore.

Lorraine focuses primarily on non-contentious intellectual property (IP) and general IP advisory work. She works closely with numerous clients across various industries to manage and protect their portfolio of intellectual property rights, which include trademarks, patents and designs, and covering multiple jurisdictions worldwide. She is also very experienced in handling complex cross-border IP issues, as well as disputes, including oppositions and negotiations.

She also manages commercial transactions involving IP issues (such as mergers and acquisitions, licensing, franchising and the sale and purchase of intellectual property rights), and has experience in managing global due diligence and clearance exercises, negotiations and the drafting and preparation of related documentation. Aside from these areas, Lorraine also regularly advises clients on regulatory and advertising-related issues.

Lorraine actively participates on various committees with the International Trademark Association (INTA) and is consistently recognised as a leading IP lawyer by clients and top legal directories, including *The Legal 500*, *Chambers Asia-Pacific*, *Managing Intellectual Property*, *World Trademark Review* and *Expert Guides*. She regularly presents on intellectual property issues at seminars and events. Lorraine is also a registered Singapore patent agent. She is also a member of the editorial board of the *International Journal of Franchising Law*.

ALFONS UMSCHADEN

Deschka Klein Daum Lawyers

Alfons Umschaden is a lawyer at Deschka Klein Daum Lawyers. He has a Master of Laws from the University of Graz, a Master of Business from the University of Salzburg and a Master of Business Administration. He joined the Austrian Bar Association in 2007.

Alfons Umschaden was previously an associate at Baker & McKenzie in Vienna, and at Raists Ebner Lawyers in Salzburg, and a counsellor at the Austria International Chamber of Commerce. He speaks English, German and Polish.

ELIZABETH UPTON

Bird & Bird LLP

Liz Upton is a senior associate in the commercial group based in London. She has been practising data protection law since joining Bird & Bird in 2000. Her areas of expertise include general compliance and GDPR strategies for organisations, as well as specific matters such as drafting policies and data processor agreements, direct marketing, individual rights and international data transfers.

Ms Upton's experience has been strengthened through recent data protection secondment roles at a large media company and at a large UK telecommunications company. She regularly gives external and internal seminars and training on data protection issues.

ELISABETH VESTIN

Hannes Snellman Advokatbyrå AB

Elisabeth Vestin is a partner and heads the intellectual property and technology, media and telecom (IP&TMT) practice at Hannes Snellman's Stockholm office. Her fields of expertise include IT, outsourcing, telecoms, data protection, IP, marketing, consumer law, e-commerce and distribution, sports, media, music and entertainment law, as well as general commercial law.

Her practice includes drafting, interpreting, negotiating and disputing commercial agreements. She also advises on M&A in the IP&TMT field.

In addition, Elisabeth has worked with corporate sustainability, bribery, anti-corruption and compliance matters for over a decade. She regularly conducts presentations and training in these areas.

Because of her vast experience of working with franchise chains and other chain companies, Elisabeth has become a board member of the Swedish Franchise Association.

JUST WANG

Bird & Bird ATMD LLP

Just Wang is an associate in the intellectual property group at Bird & Bird in Singapore.

Mr Wang has been involved in a variety of both contentious and non-contentious matters, including intellectual property litigation and enforcement work, review of intellectual property and technology contracts, and general intellectual property advisory work. In particular, he recently assisted in Singapore's first shape mark infringement trial and appeal.

Mr Wang graduated from the National University of Singapore with an LLB (Hons.) in 2013 and was admitted as an advocate and solicitor of the Supreme Court of Singapore in 2014, after completing his training contract with the firm.

WARREN WAYNE

Bird & Bird LLP

Warren Wayne is a partner in Bird & Bird's employment group in London and is recognised as a leading international employment lawyer. He also jointly leads the firm's International Trade Secrets Protection Group and is 'renowned for his handling of contentious confidentiality matters and restrictive covenants' (Chambers Global 2011).

Working across a variety of business sectors and recognised for his 'strong international practice' (Chambers UK 2010), Mr Wayne specialises in a range of issues, with particular experience in handling sensitive and high-value disputes, such as 'insider' confidential information and trade secret theft cases, discrimination disputes, and drafting and litigating restrictions on employee competition.

He also specialises in international restructures and acquisitions, executive severances, and data protection and privacy issues within the employment relationship. He has represented clients in leading cases in the Court of Appeal and Employment Appeal Tribunal, and has an excellent track record across all the commercial divisions of the High Court and employment tribunals. He is recognised by the legal directories for his commercial guidance and ability to absorb pressure while maintaining focus on the main objectives.

SVEN-MICHAEL WERNER

Bird & Bird

Sven-Michael has over 12 years of experience in practising Chinese law. His extensive experience includes M&A and foreign direct investment transactions, with a strong focus on advising European clients in relation to their inbound investment into China.

Dr Werner joined Bird & Bird in January 2014 as a partner in the international corporate group based in Shanghai.

He has been living and working in China since 1999 and based in Shanghai since 2003. During his career he has also been based in both London and Munich with a remit to develop inbound and outbound work for the Chinese market.

In addition to his extensive experience in M&A and foreign direct investment transactions, Dr Werner also regularly advises European and US clients in the automotive, technology, media, life sciences, consumer goods, high-end retail and services sectors in relation to commercial, compliance and anti-bribery matters.

Dr Werner was admitted to practise law in Germany in March 2004, and is fluent in German and English, and is proficient in Mandarin Chinese.

In October 2003 Dr Werner obtained a PhD degree (Dr. iur.) in Chinese and Hong Kong law. Prior to this, he studied law and business administration in Hamburg followed by a Master of Laws programme at the University of Hong Kong in the field of Chinese business law and international financial transactions.

ROBERT WILLIAMS

Bird & Bird LLP

Robert Williams is a partner and co-head of the UK intellectual property group of Bird & Bird.

He has significant experience in both contentious and non-contentious IP work, advising on the full range of issues relating to patents, copyright, trademarks, designs and trade secrets and confidential information.

Mr Williams has particular experience of complex IP disputes, advising clients from a range of IP-rich industries, including life sciences, energy and utilities, speciality chemicals, mechanical engineering and electronics on strategic IP issues, including life-cycle management.

He was a member of the teams acting for Pfizer in patent cases concerning Viagra and Lipitor, and acted for Synthron in its action against GSK concerning paroxetine mesylate, which resulted in one of the leading House of Lords judgments on the law of novelty in the United Kingdom.

RISTI WULANSARI

K&K Advocates

Risti Wulansari is a partner at K&K Advocates. Risti's main role in the firm is to oversee the non-contentious division and the commercial intellectual property (IP) division. Risti has extensive expertise in the field of IP and has been actively involved in providing assistance for both Indonesian and foreign clients in a variety of IP projects, including trademark, industrial design, copyright and patent matters, enforcement of IP rights and also IP

commercial works and projects, such as providing advisory services relating to franchising, licensing, distributorship, telecommunication and data protection and privacy issues. Risti has been practising law, and specialising in the IP practice area, for the best part of 17 years.

Risti is a member of INTA, APAA and the Indonesian Association of Intellectual Property Consultants (AKHKI).

Risti obtained his licence as an IP consultant in 2006, and is also a licensed advocate and a member of the Indonesian Advocates Association (Peradi).

VOLODYMYR YAKUBOVSKYY

Nobles

Volodymyr Yakubovskyy is a partner at Nobles. He has a trusted reputation for representing major international corporations and leading national market participants in various transactional, investment and commercial matters. He regularly advises companies on business projects with a particular focus on corporate, labour, distribution, franchising and intellectual property issues. Mr Yakubovskyy's areas of expertise include such industries as retail, e-commerce, agriculture, media, pharmaceuticals, regulated industries and financial institutions.

Mr Yakubovskyy has written a number of articles on franchising, e-commerce, and corporate and commercial matters. He is the member for Central and Eastern Europe of the editorial advisory board of the *International Journal of Franchising Law*.

Mr Yakubovskyy has an LLM in corporate and commercial law from the University of Cambridge (2010), an LLM in American and international business law from Boston University (2009) and degrees in law and international law from Lviv University (2005).

Mr Yakubovskyy speaks Ukrainian, Russian, English and German.

Appendix 2

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