

Legal 500

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United States

Franchise & Licensing

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This country-specific Q&A provides an overview of franchise & licensing laws and regulations applicable in United States.

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United States: Franchise & Licensing

1. Is there a legal definition of a franchise and, if so, what is it?

Franchising in the United States is regulated at both the federal and state level.

On the federal level, the Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule") defines a "franchise" as a continuing commercial relationship created by any arrangement where:

- (i) the franchisee obtains a license to operate a business identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services or commodities that are identified or associated with the franchisor's trademark or that must meet the franchisor's quality standards;
- (ii) the franchisor exercises, or has the right to exercise, significant control over, or gives the franchisee significant assistance in, the franchisee's method of operation; and,
- (iii) the franchisee, as a condition of obtaining or commencing the franchise operation, is required to make payments to the franchisor or an affiliate aggregating \$615 or more at any time prior to or within six months after commencing operation of the franchisee's business.

On the state level, there is no single uniform definition of a "franchise". Most state definitions include elements similar to the first and third prongs under the FTC Franchise Rule – the "grant of a trademark license" and "payment of a fee" – however, they replace the middle definitional element of "substantial assistance or control" with either a "marketing plan prescribed in substantial part by the franchisor" or, in a minority of states, "a community of interest between the parties."

Importantly, New York's definition is distinct. Under New York's franchise registration and disclosure law, a "franchise" will exist if there is: (i) the payment of a fee, and either (ii) the grant of a trademark license or the existence of a marketing plan/system prescribed in substantial part by the franchisor. Based on New York's two-prong approach, in the absence of an applicable exemption, a trademark license agreement may be subject to the application of New York's franchise registration and disclosure law.

2. Are there any requirements that must be met prior to the offer and/or sale of a franchise? If so, please describe and include any potential consequences for failing to comply.

The Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule"), which regulates franchising at the federal level, requires franchisors to furnish a franchise disclosure document ("FDD") to prospective franchisees no less than 14 days before any contract is signed or any monetary consideration is exchanged. The FDD must take the particular format specified by the FTC and must contain various disclosures concerning the franchisor, the franchisee's investment and the material terms governing the contractual arrangement between franchisor and franchisee. The FTC Rule's pre-sale disclosure obligation applies to the offer and sale of franchise opportunities in each of the 50 states, Washington D.C., and all U.S. territories.

Notwithstanding the 14 day pre-sale waiting period prescribed by the FTC Rule, certain state laws require that the FDD be furnished to prospective franchisees earlier in the sales process. By way of example, (i) New York requires prospective franchisees to be disclosed at the **earlier** of the first personal meeting or 10 business days before the execution of the franchise or other agreement or the payment of any consideration and (ii) Michigan requires prospective franchisees to be disclosed at least 10 business days before the execution of any binding franchise or other agreement or the payment of any consideration, whichever occurs first.

In addition to the pre-sale disclosure obligation under the FTC Rule, the following 14 states have their own franchise registration and disclosure laws that impose additional requirements on franchisors: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. In order to offer and/or sell franchises in these states, a franchisor must first file for registration (or an exemption therefrom) and secure state approval.

Further, 26 states (Alabama, Alaska, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia and Washington) have enacted "business

opportunity" laws that regulate the sale of opportunities to engage in new business ventures (which, by definition in many cases, includes franchises). Most of these business opportunity laws require that the seller gives potential purchasers a pre-sale disclosure document that has first been filed with a designated state agency. The disclosures required by state business opportunity laws differ from and are usually less onerous than those required by the FTC Rule and state franchise laws. Unlike the franchise registration and disclosure laws, however, some business opportunity laws impose security bonding requirements on the offeror to cover certain investor losses. In many states, franchise offerings are explicitly excluded from business opportunity law coverage if the franchisor complies with applicable federal and state franchise sales laws. In other states, however, even if the franchisor complies with applicable franchise laws, the offering will nevertheless be regulated by business opportunity laws. Further, in some states (e.g., in Connecticut, Georgia, Louisiana, Maine, North Carolina and South Carolina), franchise offerings fall outside the definitional scope of business opportunity laws where the franchisor is licensing a federally registered or state-registered trademark.

Consequences for Failure to Comply

Failure to comply with the FTC Rule's pre-sale disclosure obligation constitutes an unfair or deceptive trade practice under §5 of the Federal Trade Commission Act of 1914, as amended (the "FTC Act") and potentially subjects a franchisor to investigations, enforcement actions and fines of up to \$40,000 per violation. While there is no private right of action under the FTC Rule, a franchisee who was not properly disclosed or who purchased a franchise relying upon misleading or incomplete information may be able to bring claims against its franchisor under applicable state franchise laws (assuming the particular state at issue has a registration and disclosure law and statutorily prohibits misleading and/or fraudulent disclosures).

In addition, many states (including states with no franchise laws or regulations of their own) have enacted statutes, colloquially referred to as "Little FTC Acts," which render illegal any conduct that would be violative of the FTC Act and the regulations promulgated thereunder (including the FTC Rule). Unlike the FTC Act and the FTC Rule, however, these Little FTC Acts often confer private rights of action upon aggrieved franchisees (either expressly by statute or by virtue of case law that has conferred standing under such statutes) instead of reserving those rights to governmental authorities alone. Thus, if a franchisor violates the FTC Rule, the aggrieved franchisee may turn to a Little FTC Act, if available, to sue

for damages, rescission (i.e., essentially nullifying the franchise agreement and restoring the franchisee to the same position it would be in had it never acquired the franchise) and legal fees and expenses.

3. Are there any registration requirements for franchisors and/or franchisees? If so, please describe them and include any potential consequences for failing to comply. Is there an obligation to update existing registrations? If so, please describe.

Franchisees are not subject to any federal or state filing or registration requirement.

Franchisors are not subject to any federal filing or registration requirement. However, in 14 states (California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin) franchisors are required to submit filings / registration applications to the state prior to any offer or sale. In 10 of these states, a franchise law administrator will conduct an in-depth review of a franchisor's Franchise Disclosure Document (the "FDD"), financial statements and other related information and materials submitted prior to approving the franchisor's registration (as opposed to Indiana, Michigan, South Dakota and Wisconsin, where only a notice filing is required to be submitted and the FDD is not subject to an in-depth review). In connection with this in-depth review process, the franchise law administrators sometimes issue "comment letters", requiring the franchisor to make changes to its FDD or related offering documents and/or imposing other conditions to registration, such as the imposition of a fee deferral. In addition, these state franchise administrators are also empowered to deny, suspend or revoke a franchisor's right to offer and sell franchises in their respective states if the franchisor's FDD does not comply with the standards prescribed by law; the financial condition of the franchisor makes it uncertain that the franchisor will be able to fulfil its duties to prospective franchisees; or, any of the franchisor's employees, managers, owners, or others individuals involved in the operation or sale of franchises has a criminal or other record of misconduct that is believed to pose an unacceptable risk.

Potential Consequences for Failing to Register

In states with franchise registration and disclosure laws, it is unlawful to offer or sell a franchise prior to registration of the franchise offer with the state, unless an exemption is available (and properly perfected). These

state laws grant franchise administrators broad enforcement powers. In the event an administrator learns that a franchisor has illegally sold one or more franchises without properly securing state registration (or an exemption therefrom), the administrator may: (i) refuse to register the franchisor in that state in the future; (ii) issue a stop order to prevent the franchisor from conducting any further illegal offers or sales in the state; (iii) levy fines and bring civil actions (which can include injunctions to stop further violations); (iii) seek restitution and damages on behalf of injured franchisees; and/or, (iv) impose criminal penalties such as fines and/or jail time (however, it would likely take a truly extreme and unique situation for a criminal action to be pursued). In addition, certain registration states provide aggrieved franchisees with private civil rights of action against their franchisors (and in some states, also against the franchisors' officers, directors and other employees). In such cases, aggrieved franchisees may assert claims for actual damages, rescission (i.e., essentially nullifying the franchise agreement and restoring the franchisee to the same position it would be in had it never acquired the franchise), and in some cases, punitive damages.

Obligation to Update Registration

Once a franchisor has prepared its initial FDD pursuant to the Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule") and secured registration of such FDD under applicable state franchise law, in order to continue offering and selling franchises, the franchisor must revise and update the FDD at least annually.

In addition, both the FTC Rule and state franchise laws require franchisors to amend their FDDs upon the occurrence of any material change (the required time for making such amendment ranges from promptly after the material change to quarterly, depending upon the materiality of the change) and no less than annually (between 90-120 days after a franchisor's fiscal year end, depending on the state). A material change includes any fact, circumstance or set of conditions that has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a franchise business or which has any potential significant financial impact on a reasonable franchisee or reasonable prospective franchisee. Examples of material changes that would require an FDD amendment include: (i) closing or failing to renew a substantial portion of the franchisor's franchises; (ii) a significant change in the franchisor's corporate structure or management; (iii) a material adverse change in the franchisor's financial condition; (iv) a material change in the terms of the offering itself; (v) the commencement of litigation or

arbitration alleging certain types of claims against the franchisor or its principals; or, (vi) a change of the franchisor's address.

The occurrence of an event requiring an FDD amendment (whether resulting from a material change or an annual update) requires the franchisor to immediately cease offering and selling franchises until the amended FDD is prepared and re-registered (where necessary).

4. Are there any disclosure requirements (franchise specific or in general)? If so, please describe them (i.e. when and how must disclosure be made, is there a prescribed format, must it be in the local language, do they apply to sales to sub-franchisees) and include any potential consequences for failing to comply. Is there an obligation to update and/or repeat disclosure (for example in the event that the parties enter into an amendment to the franchise agreement or on renewal)?

Pre-Sale Disclosure Requirements

The Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule") requires franchisors to furnish a franchise disclosure document ("FDD") to prospective franchisees no less than 14 days before any contract is signed or any monetary consideration is exchanged. Notwithstanding the 14 day pre-sale waiting period prescribed by the FTC Rule, certain state laws require that the FDD be furnished to prospective franchisees earlier in the sales process. By way of example, (i) New York requires prospective franchisees to be disclosed at the earlier of the first personal meeting or 10 business days before the execution of the franchise or other agreement or the payment of any consideration and (ii) Michigan requires prospective franchisees to be disclosed at least 10 business days before the execution of any binding franchise or other agreement or the payment of any consideration, whichever occurs first.

The Franchise Disclosure Document

The FTC Rule specifies information that must be disclosed to prospective franchisees in the FDD, the style of writing that such disclosures must take, as well as the particular format with which the FDD must comply. The FDD is designed to provide a prospective franchisee with sufficient information to determine whether it wishes to acquire the franchise.

The FDD consists of required federal and state cover

pages and 23 substantive "Items," each of which seeks to elicit information pertaining to a particular subject or a related group of subjects.

The first page of the FDD must be the FTC Rule Cover Page, which sets forth the franchisor's name, type of business organization, principal business address, telephone number, email address, primary homepage address and a sample of the primary business trademark or service mark that franchisees will use in their businesses. A brief description of the franchised business follows, along with a recitation of certain federally prescribed language. FTC Rule Cover Page also must include the FDD's Issuance Date (i.e., the date on which the FDD was finalized).

Following the FTC Rule Cover Page is the State Cover Page, which is mandated by NASAA's (the North American Securities Administrators Association) Franchise Guidelines and is required by all franchise registration and disclosure states. This State Cover Page advises prospective franchisees that registration of a franchise does not infer government recommendation of the franchise or verification of the information contained in the subject FDD and includes certain standard franchise warnings and standard and individualized "risk factors." Finally, the franchisor must include the Issuance Date at the bottom of the State Cover Page.

The FDD then presents the substantive disclosures required by the FTC Rule and non-preempted state franchise registration and disclosure laws in a series of 23 "Items." Generally, these Items describe: (i) the franchisor and its management, its and their background and experience (including any litigation or bankruptcy history), the franchise system and the franchise offering at hand (Items 1-4); (ii) the fees which the franchisee will have to pay to the franchisor and its affiliates in connection with acquiring and operating the franchise, the initial costs the franchisee will incur in connection with establishing and operating its franchise and the financial arrangements between the parties, including restrictions as to sources of products and services (Items 5-10); (iii) the obligations, prohibitions and provisions of the franchise arrangement (i.e., territorial grants/prohibitions, the franchisor's pre-opening and ongoing obligations, restrictions on uses of the franchisor's proprietary marks and confidential information, restrictions on products or services that may be sold, etc.) (Items 11-18); (iv) the historic and/or projected financial performance of the system, the size of the franchise system (including company-owned and franchised units) and the franchisor's financial statements (Items 19-21); (v) the material contracts that the franchisee will have to sign to acquire the franchise

(Item 22); and, (vi) a form evidencing the franchisee's receipt of the FDD (Item 23).

If the franchisor is registering in multiple states, it must include the "State Effective Date Page" which contains effective dates of the franchisor's registrations in all franchise registration states where the franchisor is registered.

The FDD must be written in "plain English," defined as a manner easily understandable by a person unfamiliar with the franchise business, incorporating short sentences; definite, concrete, everyday language; active voice; and, tabular presentation of information, where possible. It avoids legal jargon, highly technical business terms, and multiple negatives.

Although a franchisor is permitted to offer unit franchises, area development franchises and multi-unit franchises in one single FDD, it is not permitted to offer subfranchise rights or area representation rights in that same FDD.

Requirement to Repeat Disclosure

If a franchisor makes any unilateral material changes to the form of its agreements disclosed in its FDD, the changed agreement must be furnished to the prospect for review no less than 7 calendar days prior to execution. It is helpful to note that changes to the agreements that are made at a prospective franchisee's request, based on negotiations initiated by the franchisee, and/or that are necessary in order to merely "fill in the blanks" of an agreement (i.e., name, entity type, address, etc.) do not trigger the 7-day rule. However, if a franchisor is relying on the former, it would be wise to include a specific representation to that effect in the amended documents.

Potential Consequences for Failing to Comply

The failure to comply with the federal and/or state pre-sale disclosure obligations can subject a franchisor to investigations, enforcement actions and fines of up to \$40,000 per violation, as well as (depending on the particular state at issue) damages, rescission and legal fees and expenses.

5. If the franchisee intends to use a special purpose vehicle (SPV) to operate each franchised outlet, is it sufficient to make disclosure to the SPVs' parent company or must disclosure be made to each individual SPV franchisee?

A franchisor is required to disclose all "prospective franchisees" with its franchise disclosure document

("FDD"). The term "prospective franchisee" is defined as "any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship." Because the Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule") permits representatives of a prospective franchisee to accept delivery of the FDD on the prospective franchisee's behalf, a franchisor may properly effect delivery of its FDD to a SPV's parent company as its representative. In addition, in situations where a franchisee forms separate SPVs to operate multiple outlets, prior disclosure to the actual owner of that SPV (whether an individual or entity) would be sufficient to satisfy the franchisor's disclosure obligation.

6. What actions can a franchisee take in the event of mis-selling by the franchisor? Would these still be available if there was a disclaimer in the franchise agreement, disclosure document or sales material?

Franchisee Actions in Event of Mis-Selling

The options available to a franchisee who was mis-sold a franchise, vary depending on the particular state at issue. While there is no private right of action under the the Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule"), a franchisee who was not properly disclosed or who purchased a franchise relying upon misleading or incomplete information may be able to bring claims against the franchisor under certain state franchise laws that require pre-sale disclosure and that prohibit misleading or fraudulent disclosures). In particular, the laws of California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin each afford franchisees a statutory private right of action to sue for damages or rescission (i.e., essentially nullifying the franchise agreement and restoring the franchisee to the same position it would be in had it never acquired the franchise).

In addition, many states (including states with no franchise laws or regulations of their own) have enacted statutes, colloquially referred to as "Little FTC Acts," which render illegal any conduct that would be violative of the Federal Trade Commission Act (the "FTC Act") and the regulations promulgated thereunder (including the FTC Rule). Unlike the FTC Act and the FTC Rule, however, these Little FTC Acts often confer private rights of action upon aggrieved franchisees (either expressly by statute or by virtue of case law that has conferred standing under

such statutes) instead of reserving those rights to governmental authorities alone. Thus, if a franchisor violates the FTC Rule by failing to timely furnish a franchisee with a compliant disclosure document (or otherwise), the franchisee may attempt to hold the franchisor liable under such state Little FTC Acts. Notably, Little FTC Acts typically permit the franchisee to sue for damages, rescission and legal fees and expenses.

Effect of Disclaimers

Disclaimers baked into franchise agreements, documents and related sales materials may help in a franchisor's defense; however, they are not dispositive and may actually be illegal under certain state franchise laws.

The the FTC Rule does not prohibit the use of integration clauses or contractual waivers but it does prohibit franchisors from disclaiming, or requiring a prospective franchisee to waive reliance on, representations made in the FDD. Because of this, franchisors commonly include in their franchise agreements affirmative representations that the franchisee was properly disclosed with the FDD and affirmative disclaimers of any responsibility for unauthorized financial performance representations made during the sales process. Importantly, a franchisor may not disclaim an actual authorized representation made by its salespeople or included in its FDD, nor may it require or permit the franchisee to waive its right to receive timely disclosure of an FDD (any such waiver would be deemed invalid and unenforceable).

In addition, most state franchise laws specifically prohibit franchisors from committing any "fraudulent" and/or "unlawful" practices in connection with the offer and/or sale of franchises. Examples of such "fraudulent" and/or "unlawful" practices include the intentional making of an untrue statement of a material fact; the intentional omission of a material fact the absence of which renders another statement misleading; a scheme or artifice to defraud; an act or practice which would or does operate as a fraud or deceit; a violation of any franchise registration or disclosure law or any rules or regulations promulgated thereunder; and, an attempt to compel franchisee to waive the statutory rights afforded to it under state franchise registration and disclosure laws.

Further, pursuant to a Statement of Policy effective January 1, 2023, the Franchise and Business Opportunities Project Group of the North American Securities Administrators Association, Inc. provided guidance that the use of acknowledgements violate anti-waiver provisions when they are used as contractual disclaimers that release or waive a franchisee's rights under a state franchise law. Many states have adopted

this guidance, and now prohibit franchisors from including such contractual waivers in its franchise agreements.

7. Would it be legal to issue a franchise agreement on a non-negotiable, "take it or leave it" basis?

It is common for franchisors, particularly large, mature franchisors, to provide prospective franchisees with the franchise agreement on a "take it or leave it" basis. While certain state laws contain nuanced provisions technically limiting a franchisor from doing so, these technicalities are rarely relied upon. For example, under Virginia's franchise law, although a franchisor is under no obligation to actually agree to a franchisee's proposed negotiation points, a franchisee may technically void its franchise within 30 days after the sale if it was not afforded the opportunity to negotiate

8. How are trademarks, know-how, trade secrets and copyright protected in your country?

In the United States, trademarks, know-how, trade secrets and copyrights are protected by federal and state statute, as well as by common law.

Trademarks

A trademark is created by virtue of its owner's use of the mark in connection with a certain set of goods or services, thereby resulting in "common law" rights in the mark. Neither federal nor state registration is required in order to create a trademark. However, trademarks are at the core of a franchise system's brand value; therefore, early trademark registration is imperative. Registration puts the general public on notice that the franchisor claims ownership of the mark and also provides the franchisor with presumptive rights to the mark in the event of trademark infringement.

Trademark protection in the United States is afforded on both a federal and state level. On the federal level, the Lanham Act (also known as the Trademark Act of 1946) gives the registrant, except for prior uses in any given market, protective rights throughout the entire United States of America (and requires that the mark in question be used with goods or services in interstate commerce (i.e., across state lines)). On the state level, trademark registration only protects a subject trademark in the particular state within which registration was accomplished (and within which the mark is used with goods or services).

While a trademark that is federally registered in the United States only provides protection therein, the Paris Convention sometimes allows for an early priority date in other countries in which registration is sought. Further, under the **Madrid Protocol (to which the United States of America is a party)**, trademark holders can ensure protection for their marks in multiple countries through the filing of one application with a single office, in one language, with one set of fees, in one currency. While each country retains the right to grant or deny protection of a mark, once the trademark office in a designated country grants protection, the mark is granted the same protection as if such application was filed directly with the United States Patent and Trademark Office (the "USPTO").

It is important to note that trademark owners can unintentionally lose rights to their marks. In order to maintain trademark registration in the United States, an owner must be able to prove continued use of the mark in the identical and consistent form originally filed with the USPTO. If it cannot, the USPTO may refuse to renew the owner's registration and/or the owner may lose its presumptive rights to the mark. So, for example, if a trademark owner engages in "naked" or uncontrolled licensing (i.e., it fails to exercise control over third parties using its marks and/or fails to require third parties to enter into written trademark license agreements delineating clear quality control provisions), it may put its ownership rights at risk. As well, a trademark owner must actively monitor the use and enforce restrictions on the use of its trademarks in order to maintain ownership. By way of example, if a trademark owner fails to take action (like sending a cease and desist letter or commencing legal action) upon learning of a third-party infringing use, its presumptive ownership could be lost.

As such, while not technically required for the offer and/or sale of franchises, it is important that a franchisor register its trademarks; specify the terms of use and quality control standards for such use in its franchise agreements; actively monitor and police such use; and, take appropriate action upon learning of an unapproved use.

Know-how and Trade Secrets

While a franchisor's trademark may be the face of its franchise system, its trade secrets and know-how are the soul. These trade secrets and know-how can include any confidential information that is used in the franchisor's business and gives the brand an opportunity to obtain an economic advantage over competitors who do not know such information. It may include a formula, pattern, compilation, program, device, method, technique or

process.

The United States enacted the Defend Trade Secrets Act in 2016, which created a federal private right of action for trade secret misappropriation and access to federal courts to resolve disputes. While the Defend Trade Secrets Act does not pre-empt applicable state law regulating trade secret protection, and plaintiffs can (if they so desire) still choose to litigate in state court and under state law, the Defend Trade Secrets Act served to strengthen trade secret protection in the United States. Importantly, a plaintiff seeking protection under the Defend Trade Secrets Act must demonstrate that it has taken reasonable measures to keep such information secret; the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information; and, the trade secret is used in, or intended to be used in, interstate or foreign commerce.

In addition, trade secrets may be protected by court order. A court can order an injunction to cease misappropriation; order a misappropriating party to take overt steps to maintain secrecy; order the payment of a royalty to the owner; and/or, award damages, court costs, and reasonable attorneys' fees. If a trade secret owner fails to maintain the secrecy of its supposed trade secrets, if the supposed misappropriator independently discovers the information, or if the information becomes generally known to the public, the owner will lose all rights to such trade secrets.

Copyrights

Copyrights are protected in the United States on the federal level under The Copyright Act of 1976 (the "Copyright Act"), which prevents the unauthorized copying of a work of authorship. The Copyright Act provides that a copyright is established when the author "fixed the copy for the first time," so long as the work is original to the copyright owner. Importantly, this Copyright Act is limited to copying the actual work itself; it does not protect the ideas that underlie the work. Similar to trademark registration, copyrights are not required to be registered in the Copyright Office in the Library of Congress. However, registration is a pre-requisite for instituting a lawsuit to protect against copyright infringement, and may lay the grounds for an award for statutory damages and attorneys' fees. In addition, registration serves to provide notice to the general public of the fact of such ownership. The United States has copyright relations with most countries throughout the world and, as a result of these

agreements, generally honours such other citizen's copyrights.

Although it is less common for franchisors to register their copyrights, franchisors should claim copyright protection, and explicitly recite same, in their manuals and other written materials.

9. Are there any franchise specific laws governing the ongoing relationship between franchisor and franchisee? If so, please describe them, including any terms that are required to be included within the franchise agreement.

23 U.S. jurisdictions (Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, the District of Columbia, the U.S. Virgin Islands and Puerto Rico) have enacted "franchise relationship" statutes to regulate ongoing franchisor conduct in relationships with franchisees.

These franchise relationship laws vary from state to state; there are no uniform standards. The general thrust of these laws, however, is to prohibit certain practices that are considered to be "unfair" or "unjust". Thus, most of these laws limit a franchisor's right to do one or more of the following: (i) terminate or fail to renew a franchise without good cause; (ii) interfere with the right of free association among franchise owners; (iii) disapprove the transfer of a franchise without good cause; (iv) discriminate among similarly situated franchisees regarding charges, royalties and other fees; and, (v) place new facilities too close to existing franchises.

Franchise registration states that also features relationship laws will typically require that certain provisions be included and/or others excluded from a franchisor's franchise agreement. These provisions are often effected through a series of state-specific addenda that are applicable to residents of and/or franchised businesses to be located in such states. By way of example, many state registration laws prohibit franchisors from requiring franchisees to consent to litigation venues outside of such state. By way of further example, Minnesota requires a state addendum expressly providing that "Minn. Stat. §80C.21 and Minn. Rule 2860.4400J prohibit Franchisor from requiring litigation to be conducted outside Minnesota. In addition, nothing in the disclosure document or agreement can abrogate or reduce any of Franchisee's rights as provided for in Minnesota Statutes, Chapter 80C, or Franchisee's rights

to any procedure, forum or remedies provided for by the laws of the jurisdiction."

10. Are there any aspects of competition law that apply to the franchise transaction (i.e. is it permissible to prohibit online sales, insist on exclusive supply or fix retail prices)? If applicable, provide an overview of the relevant competition laws.

Franchisors are generally free, so long as the franchise agreement grants them the contractual right, to regulate sources and methods for distributing products and services (i.e., by requiring participation in systemwide supply contracts and/or by prohibiting online sales). However, before a franchisor regulates its franchisees' resale prices, it must conduct a 3-fold analysis. First, is the regulation of resale pricing permissible under federal law? Second, is the regulation of resale pricing permissible under the particular states in which such pricing regime is applicable? And third, does the franchise agreement grant the franchisor the contractual right to regulate such pricing and, critically, was such right properly disclosed in the franchisor's disclosure document?

Federal Law

On the federal level, for nearly a century resale price maintenance ("RPM"), otherwise known as "price fixing", was deemed a per se violation of Section 1 of the Sherman Act (the United States principal antitrust law). However, this precedent changed through two key court cases. In *State Oil Co. v. Kahn*, 522 U.S. 3, 100 (1997), the U.S. Supreme Court eliminated the per se rule against maximum RPM programs, instead subjecting such programs to a liberal "rule of reason" analysis (i.e., determining whether there is a reasonable justification for same). And in 2007, the U.S. Supreme Court, in *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877 (2007), eliminated the per se rule against minimum RPM programs, holding that such programs must similarly be analysed under the liberal "rule of reason" standard. Noting the possible anticompetitive dangers of its decision, the Supreme Court in *Leegin* stated that an analysis of price maintenance conduct under the rule of reason should consider: (i) the number of competing manufacturers using the practice in a product category; (ii) the source of the restraint (manufacturer vs. retailer); and, (iii) the manufacturer's market power. Thus, federal antitrust law now permits franchisors to influence, or even prescribe, their franchisees' retail prices so long as they can cite one or more economic justifications for

doing so (i.e., meeting competition, preventing consumer confusion and customer anger resulting from advertised prices not being available consistently throughout the franchise network, etc.).

State Law

Notwithstanding the federal rules described above, certain states have their own antitrust laws that continue to prohibit RPM programs (maximum, minimum or both) as per se unlawful. As such, there is currently a disparity between federal and state laws governing RPM.

Many state antitrust statutes contain a "harmonization" provision, providing that the state law should be construed in harmony with judicial interpretations of the federal Sherman Antitrust Act. Even in the absence of a harmonization statute, some courts have ruled that state antitrust statutes should be construed in harmony with judicial interpretations of the federal Sherman Antitrust Act. However, a number of the larger states, such as California and New York, have taken a more independent approach. It is much more difficult to predict the outcome of an enforcement proceeding or civil action challenging the legality and/or enforceability of an RPM program in such jurisdictions.

Notwithstanding the foregoing, maximum resale price maintenance is generally not regarded as inflicting the same sort of consumer harm as minimum resale price maintenance. Therefore, it would likely take the truly exceptional case to trigger an antitrust challenge to a maximum resale price regime.

Contract Rights

The question of whether a franchisor may establish a maximum RPM program has been addressed in a series of divergent cases involving Burger King and Steak 'N Shake.

The Eleventh Circuit and the U.S. District Court for the Southern District of Florida ruled on three separate occasions that Burger King Corporation ("BKC") has the right to impose maximum prices on franchisees for its "Value Menu" items by virtue of a franchise agreement provision stating that the franchisor could make changes and additions to its operating system "...which BKC in the good faith exercise of its judgment believes to be desirable and reasonably necessary...". See *Burger King v. E-Z Eating 41 Corp.*, 572 F.3d 1306 (11th Cir. 2009) ("BKC has the right, under the parties' franchise agreements, to require compliance with the Value Menu. The franchise agreements specifically require Defendants to adhere to BKC's comprehensive restaurant format and operating

system."); National Franchisee Association v. Burger King Corporation, 715 F.Supp. 2d 1232 (S.D.Fla. May 20, 2010), ("...(plaintiff's) claim that (the Burger King franchise agreement) does not grant BKC the authority to impose maximum prices...fails as a matter of law."); and, National Franchisee Association v. Burger King Corporation, Slip Copy, 2010 WL 4811912 (S.D. Fla, November 19, 2010) ("there is nothing inherently suspect about such a pricing strategy for a firm selling multiple products. There are a variety of legitimate reasons where a firm selling multiple products may choose to set the price of a single product below cost. Among other things, such strategy might help build goodwill and customer loyalty, hold or shift customer traffic away from competitors, or serve as "loss leaders" to generate increased sales on other higher margin products.").

Taking a contrary approach, in *Stuller, Inc. v. Steak N Shake Enterprises, Inc. et al.*, 877 F. Supp. 2d 674 (C.D. Ill. 2012), the Court held that the general "system modification" language in the franchise agreement was insufficient to entitle Steak N Shake to require its franchisees to adhere to prices established by the franchisor. Observing that "[t]he agreements do not specifically address whether [Steak N Shake] can modify operational standards to require uniform pricing and promotions...[T]his Court finds that the undisputed extrinsic evidence demonstrates, as a matter of law, that the parties did not intend for the System to include pricing and promotion...The undisputed extrinsic evidence demonstrates that price and promotions were not part of the System. As such, [Steak N Shake] could not modify the System to require Plaintiff to following [Steak N Shake] pricing and promotions." Accordingly, the Court granted plaintiff-franchisee's motion for summary judgment, and enjoined Steak N Shake from implementing its pricing policy.

Notably, neither the Burger King decisions nor the Steak N Shake decision addressed the antitrust aspect of a franchisor compelling (or attempting to compel) its franchisees to observe fixed retail prices, whether under federal or state antitrust laws. Instead, these decisions were limited to a contractual analysis alone.

11. Are in-term and post-term non-compete and non-solicitation clauses enforceable and are there any limitations on the franchisor's ability to impose and enforce them?

Non-Competition

Franchisors necessarily provide franchisees with invaluable confidential business information, intellectual

property, and trade secrets and it is therefore typical for franchisors to include non-competition covenants in their franchise agreements. These non-competition covenants are meant to ensure that the franchisee devotes the necessary time and attention to the franchised business and to protect the franchisor's legitimate business interests, such as (i) ensuring that the franchisor's confidential information is not disclosed to a competitor (thereby damaging the value of, and the franchisor's and other franchisees' investment in, the brand) and (ii) ensuring that the franchisee does not terminate its agreement to simply continue operating a similar business under a different trademark, thereby obviating its requirement to pay the franchisor duly owed royalties.

Courts have generally recognised the legitimacy of non-competition covenants and upheld the enforceability of same so long as they are: (i) reasonable in terms of type of restricted activity, geography and time and (ii) no more restrictive than reasonably necessary to protect the franchisor's legitimate business interests. This generalization is not true in California, however, under which law non-competition covenants are typically found unenforceable, except under certain very limited circumstances. Franchisors are often successful in enforcing covenants not to compete where they are limited to: (i) the term of the agreement and (ii) the two year period (1½ in the State of Washington¹) following the expiration or sooner termination of the agreement and limited to a 10 mile geographic radius surrounding the formerly franchised outlet as well as all other branded outlets in the franchise system.

Not all covenants not to compete are made equal. Whether a court will deem a particular covenant reasonable may depend on the subject facts, such the particular franchise offering, the particular industry in which the franchised business will operate, the franchisee's prior and other skills, and the state implicated. Depending on the particular facts, franchisors have been successful in securing much longer restrictive periods and much wider geographic restrictions.

Upon finding a covenant unreasonable and unenforceable, certain courts may "blue-pencil" the provision, essentially rewriting it as the court deems necessary in order to make the purportedly unreasonable restriction, reasonable. Other courts will strike an unreasonable covenant not to compete altogether, so that the franchisor is left with no protection whatsoever. Therefore, franchisors should be mindful of the repercussions of drafting an unreasonable or unenforceable restrictive covenant.

Non-Solicitation

Until relatively recently, franchisors in the United States almost universally included employee non-solicitation provisions (a.k.a. no-poaching provisions) in their franchise agreements. These provisions essentially prohibit a franchisee from hiring away the employees of the franchisor and/or other franchisees in the system. Franchisors have numerous legitimate grounds for including no-poach provisions in their franchise agreements, including to protect the hiring party's investment in employee training.

Notwithstanding the foregoing, the use of no poach provisions has become the subject of intense regulatory scrutiny in recent years. The Federal Trade Commission (the "FTC") and the United States Department of Justice (the "DOJ") have targeted "naked" no-poach agreements (i.e., agreements between competitors to refrain from recruiting, soliciting or hiring each other's employees), contending that – because they purportedly inhibit employees from benefiting from a competitive employment market and restrict employees who never agreed to such restrictions – they are per se violations of Section 1 of the Sherman Act. Attorneys general in at numerous states, most notably, Attorney General Bob Ferguson in the State of Washington, investigated the use of no-poach agreements in restaurant chain franchise agreements, resulting Washington signing the Non-Compete Act into law, essentially banning the use of no-poach provisions in franchise agreements, and the vast majority of franchisors removing these provisions from their franchise agreements altogether

12. Is there an obligation (express or implied) to deal in good faith in franchise relationships?

Most courts recognise the common law covenant of good faith and fair dealing, requiring parties to act honestly and observe commercial standards of fair dealing, in all commercial contracts. This common law covenant does not generally create obligations and restrictions where none exist. Instead, it requires the parties to perform their express contract duties in good faith.

Claims that a franchisor has breached the implied covenant are typically asserted where the franchisee believes that the franchisor engaged in some act or practice that allegedly denied the franchisee the benefits of its franchise agreement or that the franchisor failed to exercise its contractual discretion in a reasonable fashion. Most savvy franchisors include the following types of language in their franchise agreements to protect against such claims: (i) clearly stating that certain actions or omissions are required and/or prohibited (as mentioned above, the implied covenant is meant to

address contractual ambiguities, rather than contravene express provisions); (ii) expressly stating that the franchisor has exclusive and sole right to exercise its discretion (i.e., so the franchisee is on notice that the franchisor need not exercise its discretion reasonably); and (iii) replacing the concept of "discretion" with the concept of the franchisor's "business judgment" (i.e., in an attempt to provide franchisors with as much leeway as corporate executives have under the corporate law concept of the "business judgment rule").

Representing an unexpected turn of events, in a 2017 case out of California, *Bryman v. El Pollo Loco*, 2017 WL 9772377, Sup. Ct. (2017), the court completely uprooted this practice and declared that franchisor El Pollo Loco violated the implied covenant of good faith and fair dealing by placing a company-owned restaurant in close proximity to a franchised restaurant **even though the parties' franchise agreement explicitly permitted El Pollo Loco to do so**. The court held that the subject franchise agreement's grant of permission to El Pollo Loco to place company-owned restaurants anywhere, even proximate to franchisee Bryman's restaurant, was "substantively unconscionable" and so one sided as to "shock the conscience." El Pollo Loco appealed this decision and the parties ultimately reached a settlement that included a stipulation to reverse the judgment; however, it would be wise for franchisors to take caution when exercising even their express contractual rights and to weigh the likelihood of an implied covenant claim.

In addition, a number of states have gone a step further and enacted legislation specifically aimed at regulating the contractual relationship between franchisors and franchisees (via so called, relationship laws). These relationship laws mandate that certain minimal franchisee rights and franchisor obligations be imposed, regardless of whether such rights and obligations are expressly stated in the parties' franchise agreement (and, in fact, often times contrary to what is stated in the parties' franchise agreement). By way of example, the relationship laws of a number of states require that the franchisor have "good cause" to terminate a franchisee, specify the types of defaults that constitute "good cause", and require the franchisor to grant a right of renewal unless the franchisor has good cause to terminate.

13. Are there any employment or labour law considerations that are relevant to the franchise relationship? Is there a risk that the staff of the franchisee could be deemed to be the employees of the franchisor? What steps can be taken to

mitigate this risk?

Franchisor as Joint Employers of their Franchisees' Employees

The answer to whether a franchisor can be held the joint employer of its franchisees' employees is one that continues to change and for which there is little certainty.

In 1984, The National Labor Relations Board ("NLRB") promulgated its standard for who could be characterized as "joint employers" – that is, two or more distinct entities nevertheless legally charged as co-employers of the same employee. Under that 1984 standard, if an entity exercised actual control over another entity's employees (as opposed to merely possessing a reserved but unexercised right to exert control), then that entity could be deemed those employees' "joint employer" (sometimes referred to as a "co-employer") and, as a result, accrue legal responsibility for employee compensation, taxes, labour law violations and the other legal mandates and restrictions imposed on employers. The franchise industry generally considered this 1984 standard sufficiently manageable and joint employer liability was of little concern.

However, this began to change under President Obama's administration, when franchisors faced a concerted effort by the U.S. Department of Labor ("DOL"), the NLRB and certain state attorneys general to thrust direct joint employer liability upon. By way of example, in 2014, the NLRB's General Counsel issued complaints against McDonald's Corporation ("McDonald's") and certain McDonald's franchisees alleging that those franchisees violated the rights of their employees and that, as a "joint employer," McDonald's was equally liable for any violations of the National Labor Relations Act ("NLRA") that may have transpired. Then, in the 2015 case of *Browning-Ferris Industries* (362 NLRB 186 (2015)), the NLRB announced a new "joint employer" standard under the NLRA, holding that a franchisor need only exert indirect control or even just reserve the right to control the terms and conditions of employment in order to qualify as a joint employer—even if the control was never actually exercised. The *Browning-Ferris* decision completely overturned years of precedent and sent shock waves through the franchise industry.

It appeared as though the franchise industry may get a reprieve in 2020, when the NLRB restored the joint-employer standard applied for decades prior to the *Browning-Ferris* decision. This 2020 standard held that "an employer may be found to be a joint employer of another employer's employees **only if it possesses and exercises substantial, direct and immediate control** over

the essential terms and conditions of employment and has done so in a manner that is not limited and routine.

Indirect influence and contractual reservations of authority would no longer be sufficient to establish a joint employer relationship." Following in the NLRB's footsteps, the DOL adopted a new rule in 2020 to determine whether a business (such as a franchisor) should be considered the joint employer of another business (such as a franchisee). Under that 2020 DOL rule, a business should be considered an employee's putative employer if it: (1) hires or fires the employee; (2) supervises and controls the employee's work schedule or conditions of employment to a substantial degree; (3) determines the employee's rate and method of payment; and, (4) maintains the employee's employment records. Of note, the 2020 DOL rule specifically stated that the franchise business model did not, in it and of itself, implicate joint-employer liability.

Although the 2020 changes were largely championed by the franchise industry, providing much needed certainty over the question of joint employer liability, this victory was short lived. Soon after the 2020 DOL rule took effect, a federal district court in New York struck it down, finding the change to the previously existing standards "arbitrary and capricious". At the same time, the change in presidential leadership brought a change to the DOL leadership. In 2021, the 2020 DOL rule was rescinded and in September of 2022, the NLRB moved to revive the Obama-era standard, making it easier for workers and unions to hold franchisor's liable for labour law violations by their franchisees.

Given the ongoing evolution and never-ending uncertainty surrounding this issue, franchisors and their counsel should remain abreast of all legal developments in this area.

Steps that Can be Taken to Mitigate the Joint Employer Risk

As described above, the standard for determining joint employer liability continues to be moving target, and as of the date of this writing, there is no definite test upon which franchisors may take significant comfort relying. However, it is recommended that franchisors endeavour to limit day-to-day operational control over their franchisees to the greatest extent possible, instead focusing on the standards necessary to protect their brand name and goodwill associated therewith. Set forth immediately below are 5 tips to avoid joint employer liability:

1. A franchisor should prohibit its franchisees from including the brand name in their

business entity (corporation, LLC or other) names.

2. A franchisor should require its franchisees to place a conspicuous notice of independent ownership on the premises of their franchised businesses, as well as on all of the following: employment applications, employee manuals, employment contracts, checks, etc. (which documents should specifically identify the franchisees' business entity name, rather than the franchisor's name or the brand name).
3. A franchisor should distance itself from the hiring, firing, payment, scheduling and other involvement in its franchisees' employment activities.
4. A franchisor should distance itself from the training of its franchisees' employees as much as possible, implementing (by way of example) train-the-trainer programs and/or management training programs (as opposed to direct employee training programs).
5. If a franchisor is mandating particular point of sale or other software programs that include scheduling and/or other applications to manage labour force activities, such applications should be disabled so that the franchisor has no visibility or involvement in such programs.

Franchisor as the Employer of its Franchisees

In January of 2020, 'California Assembly Bill 5' or 'AB-5' took effect, codifying the so-called ABC test for determining what relationships are properly classified as an independent contractor relationship versus an employee-employer relationship.

Under the ABC test, a worker is properly considered an independent contractor to whom a wage order (or other labour laws) does not apply only if the hiring entity establishes: (A) that the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact; (B) **that the worker performs work that is outside the usual course of the hiring entity's business**; and, (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

The distinction between an 'employee' versus an 'independent contractor' is an essential distinction in the franchise model. Virtually every franchisee is contractually deemed, and operates as, an independent contractor of its franchisor. Notwithstanding the

importance of this distinction, since the vast majority of franchisors own and operate businesses identical to those of their franchisees, it is likely that most will fail part 'B' of the ABC test (i.e., **that the worker performs work that is outside the usual course of the hiring entity's business**). Indeed, it is almost always the case that a franchisee does not perform work that is outside the usual course of its franchisor's business.

If, pursuant to AB-5, a franchisee is now deemed to be an employee of its franchisor, the franchisor will not only become responsible for employment liabilities (i.e., franchisee wages; FICA contributions; unemployment insurance premiums; workers' compensation premiums; Affordable Care Act mandates; wage-and-hour compliance; and, all of the other duties, requirements and prohibitions imposed by federal and state law upon employers), but also for all acts, errors and omissions of its franchisees under the doctrine of respondeat superior.

While AB-5 was not intended to target the franchise industry specifically, its language is broad and it has the power to dramatically shift the liability exposure for franchised businesses located in California and/or for franchisors whose franchise agreements are governed by California law. Numerous organizations have challenged the constitutionality of AB-5, but so far, the Supreme Court has refused hear such cases.

Importantly, however, California is not alone in its efforts. Massachusetts and New Jersey have passed similar versions of AB-5 and the U.S. House of Representatives has passed the PRO Act (short for "Protecting the Right to Organize Act of 2021") to federalised the ABC test (though the PRO Act has not yet passed the Senate or been signed into law).

It is imperative that franchisors and their counsel closely follow these developments to determine whether and how resulting shifts to the franchise business model may be necessary.

14. Is there a risk that a franchisee could be deemed to be the commercial agent of the franchisor? What steps can be taken to mitigate this risk?

As a practical reality, franchisors frequently find themselves the subject of "vicarious liability" claims arising from harm sustained by third parties at franchised locations. This risk is inherent in having the franchisor's brand name on the front door. Often the injured third party is unaware that the franchised location is an independently owned and operated business and/or does

not understand the legal and business distinction between a franchisor and franchisee. Other times, a franchisor is targeted by the injured third-party merely because it is more likely to have deeper pockets than the independent franchisee.

From a legal perspective, a principal may be held vicariously liable for the acts, errors and/or omissions of its agent if the agent is acting under the control of the principal. Most courts use the "instrumentality" test when analysing vicarious liability issues in the franchising context. Recognising that general "control" is inherent in the franchise relationship, courts utilizing the "instrumentality" test typically hold that a franchisor may only be held vicariously liable where it actually controlled, or had a right to control, the daily operation of the specific aspect, or "instrumentality," of the franchisee's business alleged to have caused the harm. While this is the current trend in case law, the law varies state-by-state, and it some courts apply different tests. As such, franchisors must be careful to manage this dynamic, always aiming to balance (a) its oversight and control over a franchisee's operation to ensure uniformity of customer experience with (b) the risk of being held vicariously liable based on its exercise of so much control that it is deemed the franchisee's principal.

While not always dispositive, a carefully drafted franchise agreement can go a long way in mitigating this risk. It is recommended that franchisees be required to place a conspicuous notice of independent ownership in the window of its franchised outlet, advising the public that the outlet is not owned and operated by the franchisor. A similar notice should be required on any other facilities of the franchisee's business, as well as on all printed materials, business cards, stationery, marketing and advertising materials, signs and other written or electronic modes. In addition, franchise agreements should expressly require franchisees to indemnify and hold the franchisor harmless from any claims arising from the franchisee's operation of its franchised business or the franchised outlet. This indemnification should further require the franchisee to reimburse the franchisor for any costs and fees (including attorneys' fees) incurred in connection with a third-party action by virtue of statutory, "vicarious," "principal/agent" or other liabilities asserted against or imposed on the franchisor. Finally, in order to bolster the indemnification and reimbursement provisions, a franchisee should always be required to obtain and maintain insurance coverage of such types, nature and scope sufficient to satisfy its indemnification obligations, and the franchisor should be named as an additional insured thereunder.

15. Are there any laws and regulations that affect the nature and payment of royalties to a foreign franchisor and/or how much interest can be charged? Are there any requirements for payments in connection with the franchise agreement to be made in the local currency?

A franchisor is free to determine the royalties and other fees that it will charge its franchisees, so long as those fees are properly disclosed in the franchise disclosure document.

Many states have enacted usury laws which limit the amount of interest that may be charged on overdue payments. These state-mandated maximum interest rates vary depending on the circumstances surrounding the imposition of such interest (whether there was a written contract in place) and on the state at issue. Therefore, any interest fee included in a franchise agreement will remain subject to applicable state law.

16. Is it possible to impose contractual penalties on franchisees for breaches of restrictive covenants etc.? If so, what requirements must be met in order for such penalties to be enforceable?

Under the law of most U.S. states, contractual penalties are unenforceable as against public policy. However, in situations where it will be difficult to calculate the amount of damages resulting from a particular breach, parties may pre-emptively agree that in the event of such breach, the non-breaching party will be entitled to recover a specified amount of liquidated damages. As long as the court determines that the imposition and amount of such liquidated damages constitute a good faith estimate of actual damages and not, alternatively, a penalty, the provision will generally be enforced.

17. What tax considerations are relevant to franchisors and franchisees? Are franchise royalties subject to withholding tax?

Federal Tax Considerations for Franchisors

Generally, any person or entity that is engaged in trade or business in the United States, and earns income from such business, must pay taxes on that income. In particular, where a foreign franchisor enters into a franchise agreement with a U.S. franchisee who pays royalties and/or other fees based on or earned in connection with the franchise grant, the foreign franchisor has engaged in trade or business in the United

States and therefore must pay taxes on its U.S. income, as well as whatever taxes may be imposed in its home country.

Notwithstanding the foregoing, the United States has entered into tax treaties with over 60 countries which, depending on where a franchisor is "permanently established," may significantly reduce or eliminate withholding taxes altogether. While the particular tax benefits of such treaties vary significantly, a favourable treaty may result in a franchisor's income being entirely exempt from paying withholding taxes (rather than the standard United States 30% withholding tax).

In general, foreign franchisors should carefully consider the following factors with their tax and accounting advisors:

- Is there an international tax treaty between the franchisor's home country and the United States?
- Are there withholding issues on payments both inbound and outbound from the franchisor's home country?
- Who is the party responsible for paying the withholding tax, the United States franchisee or the foreign franchisor?
- Should a blocker corporation be created or just a pass through entity?
- How should the international tax structure be set up?
- Where must tax returns be filed? Do the foreign franchisor's tax returns need to be filed in the United States or should the United States tax returns be filed in the foreign franchisor's home country?
- Will the franchisor operate "remotely" (solely from its home country) or have an actual presence in the United States?
- What effect will the local performance of franchisee services have on tax issues relating to the franchisor?
- Are there foreign tax credits available for taxes paid abroad?

State Tax Considerations for Franchisors

It should also be kept in mind that franchisors are responsible for paying taxes to particular states within which they conduct business. The tax laws of each state vary significantly; while some states impose taxes on the franchisee, others impose the tax directly on the franchisor.

In addition, franchisors doing business in California (as

well as certain other states like New Jersey and Massachusetts which recently followed suit) should pay close attention to how the promulgation of 'Assembly Bill 5' and similar legislation will affect their tax burden. Notably, this recent legislation imposes a new test for determining whether a relationship is properly classified as an independent contractor versus employee-employer. Under this new test, a franchisee and the employees of a franchisee may be deemed the employee of the franchisor. As an employer, a franchisor may thereby become responsible for payroll taxes, Federal Insurance Contributions Act contributions, and a host of other employment liabilities.

State Tax Considerations for Franchisees

Franchisees are subject to the same obligation to pay taxes on their income as other types of business owners. While initial franchise fees paid in connection with a franchisee's acquisition of a franchise are generally not fully tax deductible, continuing royalties are deductible in the year incurred.

18. How is e-commerce regulated and does this have any specific implications on the relationship between franchisor and franchisee? For example, can franchisees be prohibited or restricted in any way from using e-commerce in their franchise businesses?

There is no single comprehensive authority that regulates e-commerce in the United States. Instead, there is a patch-work of applicable federal, state and local regulations as well as standard industry guidance on relevant topics such as data privacy, accessibility for the disabled, payment security and online marketing and advertising.

These regulations have no specific implications on the relationship between franchisors and franchisees. Depending on the particular industry at hand, franchisors often exclusively reserve the right to engage in e-commerce activities, including within their franchisees' protected territories. Where a franchisee is granted the right to engage in e-commerce activities, that franchisee will typically be solely liable for ensuring compliance with applicable regulations and will be required to indemnify the franchisor from any and all associated liabilities.

What are the applicable data protection laws and do they have any specific implications for the franchisor/franchisee relationship? There is no single comprehensive authority that regulates data protection in

the United States. Instead, data protection issues are addressed by a patch-work of applicable federal, state and local regulations – all of which continue to rapidly evolve.

California passed the first comprehensive privacy legislation in 2018 with the California Consumer Privacy Act ("CCPA"), which was further supplemented by the California Privacy Rights Act of 2020 ("CPRA") which took effect in 2023. Certain key components of California's data protection laws include the following: (a) companies may only retain personal data in an identifiable form for as long as necessary to fulfill the purposes for which it was collected and about which individuals were properly informed using a privacy notice; (b) individuals have a number of rights regard to their personal data (i.e., the right to know, access, delete, correct, non-discrimination, opt-out of the sale and sharing, etc.); (c) companies are required to post comprehensive privacy notices on their websites (describing what data is collected, how the data is collected, why the data is collected, how the data is used and shared, whether the data is sold, how long the data is retained and what rights the individual has with respect to the data, etc.); (d) where a company shares an individual's personal data with a third party, the company must enter into a contract with that third party addressing specific requirements; and, (e) companies must apply reasonable security measures to protect personal data collected.

Virginia became the second state to implement a comprehensive data privacy law this year. Four additional states – Colorado, Connecticut, Utah, and Iowa – have each recently passed similar legislation that will soon become effective (see, e.g., the Colorado Privacy Act, the Connecticut Data Privacy Act, the Utah Consumer Privacy Act, and the Iowa Act Relating to Consumer Data Protection).

Although these laws are still developing, they will likely raise a number of questions for franchise companies, such as which party is responsible for compliance when the franchisor claims ownership over its franchisee's data and how compliance is to be achieved when data is transmitted from the franchisee's computer system to the franchisor's computer system.

19. What are the applicable data protection laws and do they have any specific implications for the franchisor/franchisee relationship? Does this have any specific implications in the franchising context? Is the franchisor permitted to restrict

the transfer of (a) the franchisee's rights and obligations under the franchise agreement or (b) the ownership interests in the franchisee?

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20. Does a franchisee have a right to request a renewal on expiration of the initial term? In what circumstances can a franchisor refuse to renew a franchise agreement? If the franchise agreement is not renewed or it if it terminates or expires, is

the franchisee entitled to compensation? If so, under what circumstances and how is the compensation payment calculated?

Except for those United States jurisdictions that have enacted laws regulating a franchisee's right to renew and limitations and conditions imposed on a franchisor's decision not to renew, renewal is a matter of contract law, determined by the express terms of the parties' franchise agreement. Thus, if a franchise agreement provides the franchisee with a fixed term during which it may operate, the franchisee cannot later legitimately claim that it is entitled to more. Alternatively, if the franchise agreement provides a franchisee with a right to renew upon the satisfaction of certain enumerated conditions, and the franchisee so complies, the franchisor will be prohibited from denying the franchisee the right to renew.

As mentioned above, however, certain states have enacted relationship laws that regulate a wide range of item, including limitations on a franchisor's right to not renew; the process by which a franchisor must comply in order to not renew; and, concessions that the franchisor must make if it elects not to renew. Where applicable, these statutory regulations may supersede the express terms of a franchise agreement.

Notice

From a process standpoint, some states impose requirements concerning the minimum notice that must be furnished in connection with the franchisor's decision not to renew. The particular period of required advance notice varies from state to state, but ranges from 60 days prior to the expiration of the term to a full year prior to the expiration of the term. The intent behind these provisions is to afford the franchisee sufficient time to "wind down" its business operations.

Limitations on a Franchisor's Right Not to Renew

Certain state statutes also limit / condition a franchisor's right not to offer renewal to a franchisee. By way of example, the franchise laws of the following states require the franchisor to demonstrate "good cause" in order to refuse to renew the franchise relationship: Arkansas, California, Connecticut, Delaware, Hawaii, Indiana, Iowa, Minnesota, Nebraska, New Jersey, Puerto Rico, the Virgin Islands, and Wisconsin. Unfortunately for franchisors, there is no single prevailing definition as to what constitutes "good cause," and determining whether the franchisor has satisfied such prerequisite often requires the franchisor to make subjective analyses as to whether it had a legitimate business reason or whether the franchisee had failed to comply with material

provisions of the franchise agreement. However, typical "good cause" statutory triggers for non-renewal include the following: (i) if the franchisee abandoned its franchise; (ii) if the franchisee failed to pay amounts owed within certain time periods enumerated by the particular state; (iii) if a franchisee is convicted of a crime; (iv) if the franchisee files for bankruptcy, makes an assignment (or attempts to make an assignment) for the benefit of creditors, or is otherwise insolvent; (v) if the franchisee fails to substantially comply with the franchise agreement or fails to comply with an essential provision of the franchise agreement; (vi) if the franchisee commits an act that impairs the franchisor's trademark or brand name; (vii) if the franchisee's continued operation of the franchised business represents a danger to public health or safety; and/or, (viii) if the franchisor decides to withdraw from the franchisee's market (importantly, with no intent to capture the franchisee's business and goodwill itself). This list is not exhaustive. Whether any or all of these examples are sufficient to satisfy a particular state's definition of "good cause" requires an analysis of the laws of the particular state at issue.

Required Franchisor Concessions in the Event of Non-Renewal

Even in those instances where a franchisor is not statutorily restricted from failing to renew a franchisee, some states nevertheless require the franchisor to offer certain concessions to the franchisee in connection with same. By way of example, in Hawaii, Michigan and Washington, the franchisor must pay the franchisee fair market value, at the time of expiration, for the franchisee's inventory, supplies, equipment, fixtures, and furnishings if purchased from the franchisor or one of its designated suppliers. Certain states also require the franchisor to compensate the franchisee for the value of its business and/or business assets. In the state of Illinois, for example, if a franchise agreement imposes and the franchisor intends to enforce a non-competition covenant, the franchisor may not refuse to renew a franchise agreement without repurchasing the franchise. The laws of Hawaii and Washington, on the other hand, require the franchisor to pay the franchisee for the loss of goodwill associated with the franchised business if the franchisor is taking over such business upon expiration or did not provide the franchisee with sufficient prior written notice regarding its intent not to renew.

While, as stated above, franchisors are largely free to set the terms governing renewal in their franchise agreements, it is fairly settled case law that where a state statute governs renewal, such state statute will supersede the language of a franchise agreement. Of course, where a particular state has no such statute

governing renewal, it is equally settled law that the terms of the parties' franchise agreement will control.

21. Are there any mandatory termination rights which may override any contractual termination rights? Is there a minimum notice period that the parties must adhere to?

Almost all of the 23 U.S. jurisdictions which feature franchise "relationship" laws (i.e., Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, the District of Columbia, the U.S. Virgin Islands and Puerto Rico) regulate termination by the franchisor of the franchise relationship. These statutes vary from state to state, but most require the franchisor to have "good cause" in order to terminate and to provide notice and an opportunity to cure in advance of termination.

While the definitions of "good cause" vary, they generally include a failure to comply with the lawful and material provisions of the franchise agreement. Some states go further and outline specific situations constituting "good cause" for termination, such as (depending on the particular state) a franchisee's bankruptcy, abandonment of the franchised unit, failure to pay amounts due, material impairment of the goodwill of the franchise system or the franchise trademarks and/or repeated defaults of the franchise agreement.

In addition to requiring that the franchisor have good cause for termination, certain state statutes also specify mandatory minimum cure periods and prior notice periods with which a franchisor must comply. The particular requirements of each state statute vary, however, three general trends exist. First, a number of states do not require a cure period at all but do require notice of termination (also known as a "wind down" period), varying from 60-120 days. Second, some states mandate a "reasonable" cure period but do not specify the particular period of time that is deemed reasonable. Finally, some states require that franchisees be given a specific period of time to cure, ranging from 30 to 90 days, depending on the state and the type of default at issue. Importantly, a number of these statutes specifically exclude incurable defaults. By way of example, the State of Washington permits termination without notice or opportunity to cure where the franchisee: (i) is bankrupt or insolvent; (ii) assigns the assets of the franchised business to creditors; (iii) voluntarily abandons the franchised business; or, (iv) is convicted of violating any

law relating to the franchised business.

Given the particularities of each state's laws on termination, before issuing a default or termination notice, a franchisor should always consider whether any (and if so, which) state laws may be triggered (by analysing where the franchisor is headquartered, where the franchisee is domiciled, where the franchised business is operated, and where the offer and sale originated from/was directed to); review such law (if any); and, determine whether there are procedural or other requirements with which the franchisor first must comply in order to properly effectuate a default and/or termination notice. In those states where a franchisor's right to immediately terminate if a franchisee commits an incurable default is not expressly addressed by state statute, or a franchisor believes a particular situation is so time sensitive that it would be imprudent to comply with statutory notice and/or cure provisions, the franchisor must ultimately weigh their urgency against the risk of a franchisee claim for unlawful termination.

22. Are there any intangible assets in the franchisee's business which the franchisee can claim ownership of on expiry or termination, e.g. customer data, local goodwill, etc.

It is vital, and almost universal, for franchise agreements in the United States to specify that the franchisor (and not the franchisee) owns all intellectual property associated with, arising out of, or developed in connection with the franchised business (including all trademarks, trade names, service marks, logos, emblems, etc.); all systems and methods of operating the franchised business; all customer data derived from the operation of the franchised business; and, all goodwill associated therewith or engendered by any of the foregoing. This standard contractual language is well supported by federal law (specifically, by the Lanham Act), which provides that the use of a trademark inures to the benefit of the registered owner of the trademark.

Notwithstanding the foregoing, the laws of certain states require that in certain limited situations franchisors compensate their franchisees for the "local goodwill" developed by the franchised business upon expiration or termination. By way of example, in Washington, if a franchisor fails to provide sufficient advance notice of its intent not to renew the franchise agreement, it must compensate the franchisee for local goodwill engendered in connection with such franchisee's use of the trademark and system. This requirement also applies in Connecticut and Illinois, but only in situations in which

the franchisor also won't agree to waive its covenant not to compete against the franchisee (if applicable). In addition, Hawaii requires that a franchisor compensate the franchisee for such local goodwill where the franchisor refuses to renew the franchise agreement so that it can take over the franchisee's formerly franchised business. Similarly, the laws of Minnesota, Missouri, Mississippi, New Jersey and Virginia also require franchisors to compensate the franchisee for such goodwill, but in these states, this requirement is hinged upon the franchisor's unlawful termination of the franchise agreement.

23. Is there a national franchising association? Is membership required? If not, is membership commercially advisable? What are the additional obligations of the national franchising association?

There are various franchise associations in the United States but the most established and well known is the International Franchise Association (the "IFA"). Membership is not required but there are helpful benefits to membership. The IFA provides information on legal developments, networking opportunities, helps connect businesses with useful suppliers and access to new technologies and generally seeks to educate franchisors and franchisees on beneficial methods and business practices to improve franchising. There are no obligations related to participation in the IFA (other than yearly membership dues). The IFA has established a Code of Ethics with which it expects its members to comply; however, the Code is largely a self-regulation program with no real enforcement mechanism. It mainly attempts to resolve disputes better members as they arise. Importantly, the Code is not intended to establish, and does not have the effect of establishing, standards to be applied by third parties, such as the courts.

24. Are foreign franchisors treated differently to domestic franchisors? Does national law/regulation impose any debt/equity restrictions? Are there any restrictions on the capital structure of a company incorporated in your country with a foreign parent (thin capitalisation rules)?

United States franchise laws apply with equal force to foreign and domestic franchisors, however, certain requirements of United States franchise laws may represent hurdles for foreign franchisors.

By way of example, the FTC Franchise Rule requires that franchisors prepare and disclose in their franchise disclosure documents audited financial statements that have been prepared in accordance with United States Generally Accepted Accounting Procedures ("GAAP"). While this requirement is intended to ensure that franchisees and state franchise administrators (who, in certain states, analyse and must pre-approve the franchise disclosure document prior to its use) are able to understand and rely upon the veracity of such financial statements, and not to bias foreign franchisors, it may be difficult for a foreign franchisor to find in its own country an accountant who has knowledge of and the ability to prepare compliant audited financial statements in accordance with United States GAAP. Also, in the event that a foreign franchisor already has audited financial statements that have been prepared in accordance with generally accepted accounting procedures in its home country, it will nevertheless have to undergo the time and expense to have a another set of audited financials prepared just for purposes of United States franchise law compliance (for this reason, it is often recommended that a foreign franchisor form a new United States entity to serve as the franchisor, and audit that new franchisor entity, rather than the existing operational foreign franchisor entity).

Further, United States laws relating to money laundering and terrorism may impose certain additional hurdles to foreign franchisors. For example, if a franchisor or its owners are based in a country in which the United States has imposed sanctions or such entities or individuals are on the United States Department of Treasury's Office of Foreign Assets Control's Specially Designated Nationals and Blocked Persons List, expansion into the United States would be forbidden. Also, while not only implicating foreign transactions, foreign franchisors should note that, pursuant to the United States Bank Secrecy Act, cash transactions over \$10,000 USD and wire transactions over \$3,000 USD are subject to additional scrutiny, and banking institutions are also under a specific obligation to inform the Internal Revenue Service of any other suspicious activity. This sort of monitoring and reporting process is intended to deter and discover any individual trying to avoid paying tax, or any flows of money linked to illegal activity, such as crime, money laundering, or funding terrorism.

United States law imposes certain rules regarding a company's debt to equity threshold and capital structure. Generally, a 3 to 1 debt to equity ratio is considered reasonable; however, there is no set ceiling. A company can have higher ratio, depending on the relevant facts, such as the norms in the industry in which the company

operates. If a company intends to have an unusually high debt to equity ratio, it is recommended to first obtain a debt capacity analysis; however, that is not a requirement under law. With respect to capital structure, a debt agreement must be written, represent an arms-length transaction, and include terms such as the applicable interest rates and events of default. There are also limitations on company's ability to deduct interest payments, requirements with respect to withholding tax on interest payments (depending on the country to which payments will be made), compliance requirements, and requirements to report inter-company debt and interest payments on a company's tax returns.

25. Must the franchise agreement be governed by local law?

Virtually every franchise agreement contains a "governing law" provision that designates which state law that will govern disputes between the franchisor and franchisee. A franchisor may designate any state law it wants to govern the franchise agreement (most franchise agreements designate the state of the franchisor's principal place of business as governing; provided, however, that where the laws of a franchisor's home state are unfavorable, the franchisor can instead designate any other state law as governing (i.e. a California franchisor may designate New York law as controlling because it is more "business friendly").

However, a contract's "governing law" provision is not always dispositive as to the state law that will ultimately govern a dispute. Virtually every state franchise registration and disclosure law, as well as every state relationship law, contains an "anti-waiver" provision, prohibiting any attempt by a franchisor to compel its franchisee to waive the protections afforded by the statute (indeed, under most state franchise laws, seeking to compel such a franchisee waiver of the statute's protection is itself an express statutory violation). What this means is that a franchisee will almost always be able to invoke the franchise law of its home state (whether the state of the franchisee's residence or the state where the franchisee operates its franchised business) in any arbitration or litigation with the franchisor regardless of what the "governing law" provision of the subject franchise agreement says. For example, if the franchise agreement stipulates that California law will govern all disputes, a New York resident (whose franchise is situated in New York) will always have the right to invoke the New York Franchise Act's rights, remedies and damages. Indeed, some state franchise administrators will refuse to register a franchisor's disclosure document unless the franchisor first agrees to amend its franchise

agreement to expressly provide that, regardless of the contract's "governing law" provision, the franchisee can always invoke protection of the subject state franchise statute.

26. What dispute resolution procedures are available to franchisors and franchisees? Are there any advantages to out of court procedures such as arbitration, in particular if the franchise agreement is subject to a foreign governing law?

While litigation is the most traditional method to resolve contractual disputes, alternative dispute resolution mechanisms such as arbitration and mediation are becoming increasingly more common. Each mechanism has its own benefits and detriments, and there is no uniform procedure used.

Mediation of international franchise disputes may be a cost and time efficient resolution procedure, but it lacks the ability to provide immediate relief to an injured party. If a franchisor learns that a franchisee is misusing its trademarks or represents a risk to public health or safety, the mediator is unable to issue a temporary restraining order; the franchisor would have to seek this relief from a judge. In addition, where parties are unlikely to resolve a dispute through mediation, it winds up just delaying the inevitable and wasting resources. Lastly, mediation is not an adjudicative process; that is, it does not actually decide or resolve a dispute. Instead, regardless of whether a party's position has merit (and, in fact, even if it does not), the goal of mediation is for the parties to reach a settlement to avoid the time and cost of litigation. Accordingly, in the author's opinion, it would be in the franchisor's interest to either make mediation one sided – that is mandatory for the franchisee to commence mediation prior to instituting an action, but not for the franchisor – or, if mutual, including clear carve outs in the types of actions that are subject to mandatory mediation (such as misuse of the franchisor's marks and claims subject to injunctive relief).

Arbitration is an increasingly common dispute resolution mechanism around the world. While many believe that arbitration is a more informal and time and cost efficient mechanism than litigation, others believe that the risks (such as the arbitrary nature of the decision and lack of meaningful ability to appeal) outweigh the perceived benefits. Nevertheless, where an agreement is subject to arbitration, the following issues should be clearly addressed: the law that will govern the dispute; the parties' relationship and the agreement to arbitrate itself; the venue and choice as well as the body of rules

governing the arbitration; the number of arbitrators and the process for selecting such arbitrators; the language in which the proceeding will be conducted; and, a carve out for the types of actions that are not subject to arbitration (such as misuse of the franchisor's marks and claims subject to injunctive relief).

27. Must the franchise agreement and disclosure documents be in the local language?

The Federal Trade Commission (the "FTC") Franchise Rule (the "FTC Rule") requires that Franchise Disclosure Documents (each, an "FDD") (which FDD incorporates franchise and other ancillary agreements) be written in "plain English." Under the FTC Rule, plain English is defined as a manner easily understandable by a person unfamiliar with the franchise business, incorporating short sentences; definite, concrete, everyday language; active voice; and, tabular presentation of information, where possible. It avoids legal jargon, highly technical business terms, and multiple negatives. Regardless of a statutory mandate to draft the FDD and franchise agreement in English, the foreign franchisor should keep in mind that a number of states require the FDD to be filed with, and approved by, the state prior to use; and those states would, of course, refuse to accept an FDD written in a foreign language.

28. Is it possible to sign the franchise agreement using an electronic signature (rather than a wet ink signature)?

Yes, franchise agreements can be signed using electronic signature. In 2000, the Electronic Signatures in Global and National Commerce Act ("E-SIGN") was enacted to give electronic signatures, contracts and records the same legitimacy as handwritten and hard copy documents. E-SIGN generally provides that a signature, contract or other record "may not be denied legal effect, validity, or enforceability solely because it is in electronic form." E-SIGN defines an "electronic signature" as "an electronic sound, symbol or process attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." E-SIGN does not provide any additional, specific standards for electronic signatures and contains no provisions dealing with the attribution of electronic records or signatures to the signatory.

States have also adopted laws concerning the use of electronic documents in commerce. The vast majority of the states, the District of Columbia and the U.S. Virgin Islands have adopted the Uniform Electronic

Transactions Act ("UETA") with certain state/territory-specific variations. New York has not adopted the UETA, but has enacted the Electronic Signatures and Records Act ("ESRA"). Like E-SIGN and the UETA, the ESRA defines an "electronic signature" as "an electronic sound, symbol, or process attached to or logically associated with an electronic record and executed or adopted by a person with the intent to sign the electronic record." The ESRA provides that "unless specifically provided otherwise by law, an electronic signature may be used by a person in lieu of a signature affixed by hand. The use of an electronic signature shall have the same validity and effect as the use of a signature affixed by hand." The ESRA is very brief and does not provide any other authentication or attribution standards. Like E-SIGN, under the ESRA, there is no requirement to follow a particular authentication process other than receipt of an electronic sound, symbol or process that is logically associated with the contract and given with intent that a record be signed. Therefore, a code or password system intended to be a signature to a record would create a valid electronic signature.

Because federal and state laws leave open the exact procedures needed to authenticate an electronic signature, the following steps are some "best practices" which may help ensure the incontestability of an electronic signature:

1. Require the signer to show a clear intent to sign the document by typing their name or clicking an accept box.
2. Include an express contractual provision indicating that the parties mutually agree to effect the transaction via electronic signature.
3. Provide each party to the agreement with a fully signed copy of the document.

29. Do you foresee any significant commercial or legal developments that might impact on franchise relationships over the next year or so?

On March 10, 2023, the Federal Trade Commission (the "FTC") issued a request for information seeking public comment on franchise agreements and franchisor business practices, including how franchisors may exert control over franchisees and their workers. The FTC has stated it is interested in how franchisors disclose certain aspects and contractual terms of the franchise relationship, as well as the scope, application, and effect of those aspects and contractual terms. Comments were due by June 8, 2023, and the FTC reportedly received more than 5,500 comments from various franchise industry stakeholders. It is unclear what, if anything will

result from this investigation. Some believe that the FTC may enact new or updated regulations governing

franchising; however, even if new or updated regulations are proposed, it would likely be years before such regulation would take effect.

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